QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

Growth has tended to become widespread in the world economy as 2004 has unfolded. The momentum from the United States and other central and eastern Asian regions has gradually spread to most European countries and to Latin America. This has been despite the fact that geopolitical tensions, oil price rises and the imbalances weighing on certain economies are causing some uncertainty over the continuity and intensity of this process, at a time when the first symptoms of a turnaround in the stance of US monetary policy have come about.

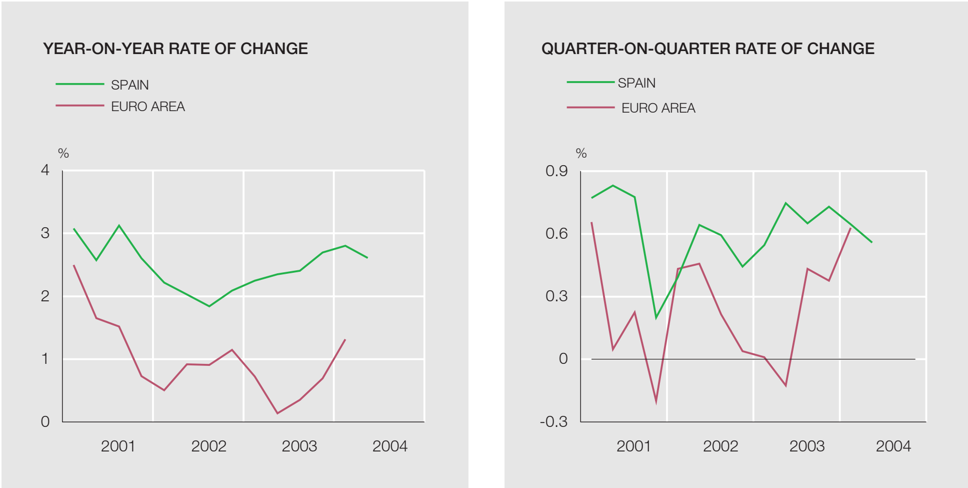
Against this background, the Spanish economy has maintained a growth rate that does not differ substantially from that released by INE for 2004 Q1. Specifically, the estimated quarter-on-quarter rate of increase of real GDP in 2004 Q2 was 0.6%, unchanged on Q1, while the year-on-year rate slowed modestly to 2.6%, 0.2 pp down on the previous quarter. Real net external demand exerted a moderating influence on the year-on-year growth of output, subtracting 1.4 pp from it, almost 0.5 pp more than in the first quarter of the year. Domestic demand, meantime, continues to show signs of notable stability. Indeed, if the change in stockbuilding is excluded, the growth rate of domestic demand in Q2 compared with the same period a year earlier might again be 3.5%, as three months earlier, and scarcely unchanged on the average for 2003 (3.3%). If stockbuilding is taken into account, the increase in domestic demand in 2004 Q2 would have steepened slightly. The most relevant development in this aggregate has been the change that is beginning to be discernible in its composition, with a greater robustness of investment in capital goods that is not detracting from the resilience of investment in construction and of consumption, this latter variable having slackened somewhat. Lacklustre merchandise exports have meant that the recovery in industrial activity has not been as intense as expected, while the rate of increase of employment may have eased by 0.1 or 0.2 pp, in line with the results of the EPA (Labour Force Survey), which have just been released. Finally, the increase in consumer prices stood at 3.5% in June, led by energy and processed food prices in the main. This figure, which should ease in the coming months, places the differential with the euro area at 1.1 pp.

The key development in the recent international picture, in addition to the above-mentioned extension of the expansionary climate, has been the increase in US interest rates in June. With the rise in the target for its federal funds rate to 1.25%, the Federal Reserve has brought to an end a long period of continuous cuts. Although neither the scale of the change (25 bp) nor the level of interest rates (real rates remain considerably negative) entail a substantial turnaround in US monetary conditions, the decision was received by the markets as a signal that, against a background of high growth and with deflationary risks forgotten, interest rates should progressively adapt to the economy's new circumstances. The rise in rates passed through to the longer-dated terms, more sharply so at first and somewhat less intensely subsequently, in response to certain less favourable data on the performance of the economy, in which, in fact, no substantial changes are apparent.

The data on employment, which is one of the most closely monitored variables, appear to be holding firm. Also, the increase in productivity continues to be high, which lessens the risk of inflationary pressures arising, despite the fact that the rate of increase of consumer prices has edged up to 3.3%, in response above all to the pressure of energy prices. This increase in inflation may have diminished somewhat the buoyancy of the consumption indicators. Finally, the exchange rate of the dollar has held stable, with slight fluctuations, although in recent weeks there has been a more marked depreciating movement.

GROSS DOMESTIC PRODUCT (a)

CHART 1



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

a. Seasonally adjusted series.

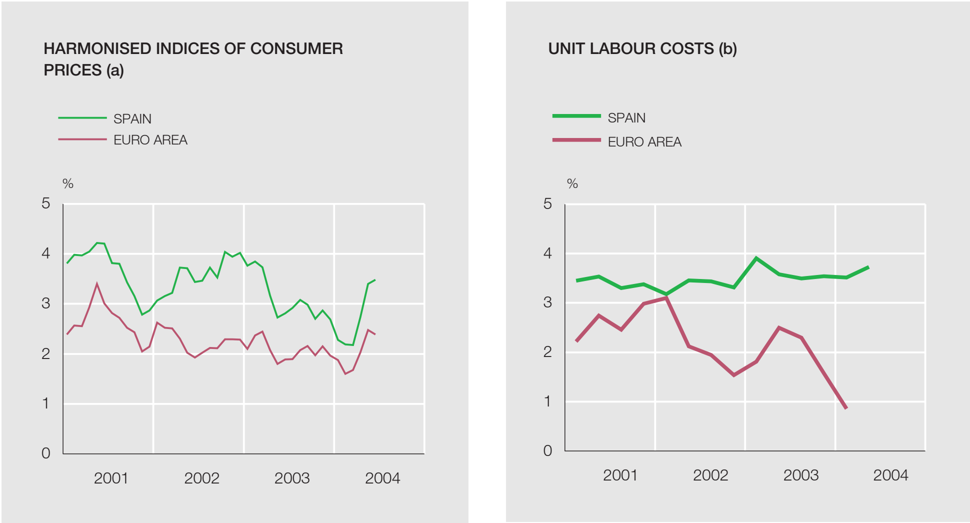
The central and eastern Asian region is one of the biggest centres of expansion in the current international setting, although its impact is distributed with differing degrees of intensity across markets. Japan is one of the economies that has most benefited, and its growth has been revised upwards, although its deflationary tendencies have not fully disappeared. The Chinese economy has slowed slightly, perhaps as a result of the policies adopted to tether what is an excessive growth rate that was unleashing numerous imbalances.

Most eastern European countries, including those that have recently joined the EU, are participating in this expansionary climate, as they are in some of the resulting inflationary imbalances. The same is happening in Latin America, where certain countries have benefited from the rises in commodity prices. These, however, have begun to recede, with the exception of oil products. The conditions of financial stability prevailing on international markets and the high growth rates posted in many Latin American economies have provided for a reversal of the notable rise in sovereign debt spreads at the beginning of the quarter, on the back of expectations about rises in US interest rates.

The recent data on developments in the euro area economies are optimistic, although they do not quite dispel the doubts about the firmness the current pick-up may attain. Following such favourable National Accounts results in Q1, the latest indicators offered mixed signals, although the growth rate in Q2 is expected to be around 0.5% in quarter-on-quarter terms. Despite the low level of interest rates, the sluggishness of employment, the relative slackness of the securities markets and the low level of consumer confidence are restricting any increase in consumption, especially in certain economies, such as Germany, whose incipient expansion continues to be based on the notable contribution of external demand. Other countries, however, have not managed to benefit from the recovery in trade flows, in view of the flatness still prevailing in intra-Community trade. The main doubts concern the behaviour of business investment. The figures for Q1 were influenced by the poor results in the construction industry and, for the moment, more accurate information is not available. In any event, it is significant that while financing received by households has been increasing at a relatively sustained rate, lending to non-financial corporations has not ceased to decelerate in recent months.

PRICES AND COSTS

CHART 2



SOURCES: Eurostat, ECB and Instituto Nacional de Estadística.

a. Year-on-year rate of change. To December 2001, the rates relate to those released as at that date.
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

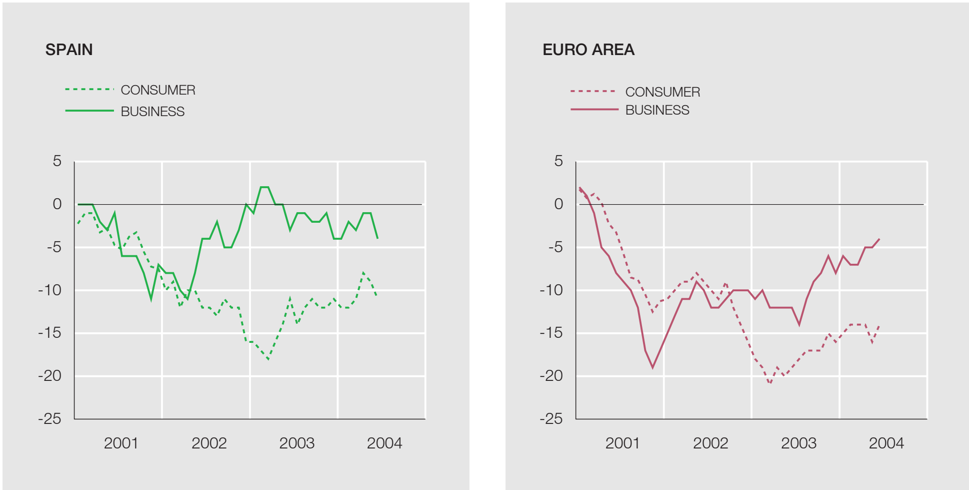
The inflation rate for the euro area as a whole stood at 2.4% in June. Its rate of change is expected to moderate in the coming months, once the intensity of the rises seen in energy-product prices begins to abate. In fact, the measures of inflation that strip out the most variable components – energy and unprocessed food, which have also increased significantly – have retained a more contained tone. Indeed, the CPI excluding unprocessed food and energy has held slightly above 2% since the start of the year. The slowdown in the rate of change of prices will be assisted, moreover, by the recent trend of unit labour costs, the rate of increase of which has slackened notably.

In this setting, the ECB monetary policy stance has remained stable given the lack of significant risks for price stability in the medium term. Nonetheless, the ECB should remain watchful in case there are changes in the trend of economic activity in the area or in the degree of wage moderation that may alter this assessment. In any event, the changes in interest rates expected by the markets in the coming months will be very modest. Turning to fiscal policy, the main development has been the ruling by the European Court of Justice on the action brought by the Commission to have the conclusions of the Ecofin Council of November 2003 on the application of the Excessive Deficit Procedure (EDP) to Germany and France overturned. This ruling, which supports the Commission's assertion as to the Council's lack of competence to suspend the EDP unilaterally and to adopt recommendations outside the proposals of the Commission, reinforces the validity of the euro area's current fiscal discipline mechanisms.

As 2004 unfolds, the Spanish economy is thus in a favourable international setting, the only adverse development being the rise in the prices of oil products. Further, it continues to benefit from easy monetary conditions which are boosting spending by private agents. Budget outturn data are confined to the State and to Social Security transactions, and interpreting them is a complex matter due to the changes in the calendar for certain taxes and to the movements in transfers between the different levels of government, on which virtually no budgetary information is available. Overall, the fiscal policy stance might prove to be moderately expansionary in 2004.

CONFIDENCE INDICATORS

CHART 3



SOURCE: European Commission.

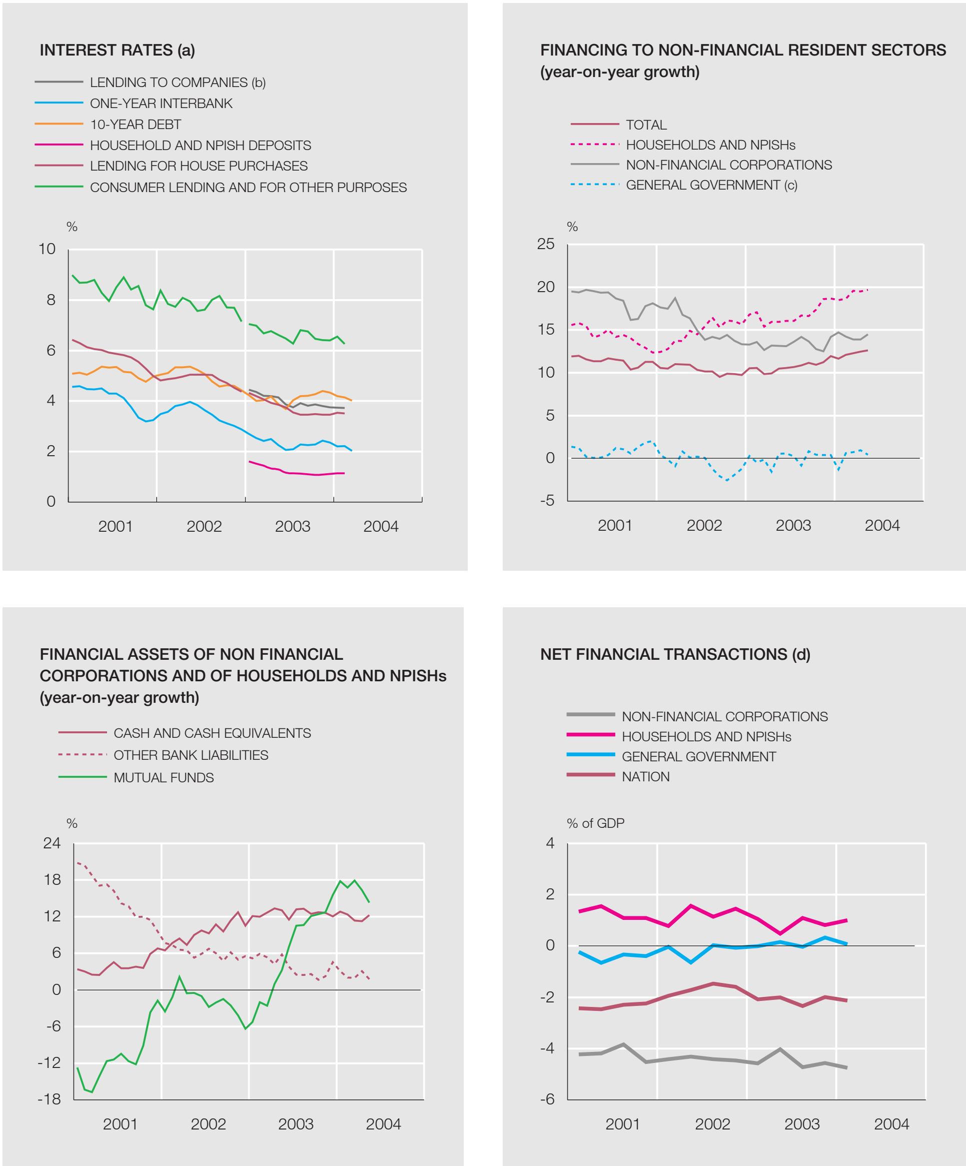
These circumstances, which scarcely differ from those initially perceptible at the beginning of the year, reveal no substantial changes in the patterns of the main macroeconomic variables, which are advancing in many cases with notable inertia. However, the first signs of certain changes appear to be discernible. And should such changes be confirmed, they would alter the composition of growth in the Spanish economy in the coming quarters as the monetary impulses tend to ease off, the expansion of construction slackens and the growth of investment firms.

Household expenditure on consumption and housing increased appreciably once again in 2004 Q2. Most of the indicators confirm this, although a tendency towards moderation is apparent in almost all of them. The financing received by households continues, however, to grow at a very high rate, especially credit for house purchases, which reached a high of 23% in May. Financing extended for other activities has, nevertheless, stabilised at a relatively high rate. The growth of household disposable income has, despite being substantial and although it may even exceed last year's figure, been curbed by the rise in consumer prices and, to a much lesser extent, by the slight slowdown in employment. The saving ratio is not expected to recover over the year as a whole, whereupon household lending capacity – given the vigour of investment in housing – may end the year at a very low level. Indeed, the level of debt has continued increasing, although the wealth position of households remains sound, partly as a consequence of the fact that the increase in non-financial wealth has offset the hesitant movements on stock markets.

In any event, the growth of debt and the high proportion of saving that has to be assigned to service debt might, in the medium term, have a bearing on the expansion of household consumption and investment, especially if there were significant increases in the cost of financing or substantial corrections in the value of household assets. In this respect, the recent data on house prices point to continuing high growth rates, although there has been a slight slowdown.

The most favourable figure in recent months has undoubtedly been the recovery in investment in capital goods. Its year-on-year rate of increase is expected to exceed 5% in Q2, and this strength should take root in the course of the year. The situation in the corporate sector, now that the restructuring undertaken by certain major companies appears to have concluded, and

FINANCIAL INDICATORS OF THE SPANISH ECONOMY CHART 4



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. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
c. Consolidated financing: net of securities and loans that are general government assets.
d. Cumulative four-quarter data.

the favourable earnings expectations are stimuli that should be conducive to recovery. The growth of financing extended to corporations has stabilised, and considerable differences across the various sectors are apparent: the construction and real estate industries show the most dynamism and the industrial sector the least. In any event, despite the increase in the latter sector's interest burden, this remains moderate.

The recent performance of exports of goods and services does not match the recovery in international markets. According to Customs figures, the real increase in goods exports in the first five months of the year was 3.8%, approximately half the expected increase for export markets over the year as a whole. Several factors influenced this result, such as the surprisingly high growth of the figures for the first half of last year and the scant buoyancy, to date, of the European market, the main destination for Spanish products. However, the presence of certain signs of losses in competitiveness should not be ruled out here. In the coming months, exports may nevertheless be expected to become stronger, which will provide a sustained boost to industrial activity and employment, which have yet fully to take off. The modest growth forecast for goods exports in Q2 has been further accentuated by the figures for tourism, which has undoubtedly been affected by the impact of the terrorist bombings on 11 March. The notable robustness of imports has been in response to the momentum and composition of demand, whereby the most burgeoning increases have been in purchases of consumer goods and of equipment.

The firmness in the growth rate of employment is one of the most notable characteristics marking recent developments in the Spanish economy. The indicators available for Q2 confirm that job creation remains buoyant, despite slackening slightly. The slowdown in the rate of change of numbers employed, according to the EPA, has spread to virtually all branches. In industry, although employment was created in Q2, this did not prevent the year-on-year change from still being considerably negative. It is essential that the increase in employment should continue so that household spending decisions and their capacity to cope with debt are underpinned by sound foundations and by favourable expectations about the future. For this to occur, among other factors, unit labour costs should resume the slowdown that appears to have been interrupted, and which has widened the differential with the euro area countries most significantly (see Chart 2). The results of collective bargaining are, generally, proving positive. But it is important, once again, that the temporary increases in the inflation rate should not feed through to wage increases and that these should be accommodative of productivity gains. In turn, such gains should be based on investment and on the efficient use of quality productive factors.

As regards the behaviour of prices, the CPI posted an increase of 3.5% in June compared with the same month a year earlier, the same rate as for the harmonised index (HICP). Energy and unprocessed food set the pattern for the behaviour of consumer prices during the year and, in step with this, for the differential with the euro area countries, which is hovering at around 1 pp. Forecasts point to a slowdown in the 12-month growth rate of the CPI in the coming months. But in order to curb the recent inflationary spurt, the slowdown needs to become embedded and be of sufficient intensity, despite the fact that import prices may not perform as favourably as in recent months (the exchange rate has contributed, in part, to easing the increases in imported oil prices) and that the repercussions of energy price rises may not have finished feeding through to other sectors of the economy.

In order to bring about a permanent correction of the Spanish economy's inflation differential with the euro area countries, unit labour costs must slow in such a way that, as commented, wage increases and productivity growth run in parallel. The necessary market reforms must also be undertaken in order to restrain the growth of services prices, the rate of increase of which has been stable for several years at a level in excess of 3.5%, which is incompatible with price stability. The reforms should, moreover, cover the markets for the distribution of food products, the prices of which have been growing at over 4% for four years.

2 The external environment of the euro area

The 25 bp rise in US official interest rates on 30 June was a turning point in this country's monetary policy stance, following a cycle of official rate cuts lasting more than three years. The decision had been widely discounted by the financial markets in the preceding months, which gave rise during the quarter to a significant and widespread increase (particularly marked in the United States) in long-term interest rates, albeit departing from very low levels. Subsequently, in the first half of July, there was a moderate decline in long-term rates in the industrialised countries and a slight fall in the main stock market indices. The adjustment of expectations led to a low level of debt issues and to a widening of sovereign spreads in the emerging economies, although most of the previous increases were reversed as from the second half of the quarter. On the foreign exchange markets, the dollar fluctuated at around $1.20 per euro during Q2. After depreciating significantly against the euro as from the first week of July, the dollar resumed a level of below $1.21 at the end of the month. In contrast to the drop in agricultural prices, oil prices held on a rising trend over the quarter and, after a slight decline in July, Brent oil exceeded $39 per barrel at the end of the month.

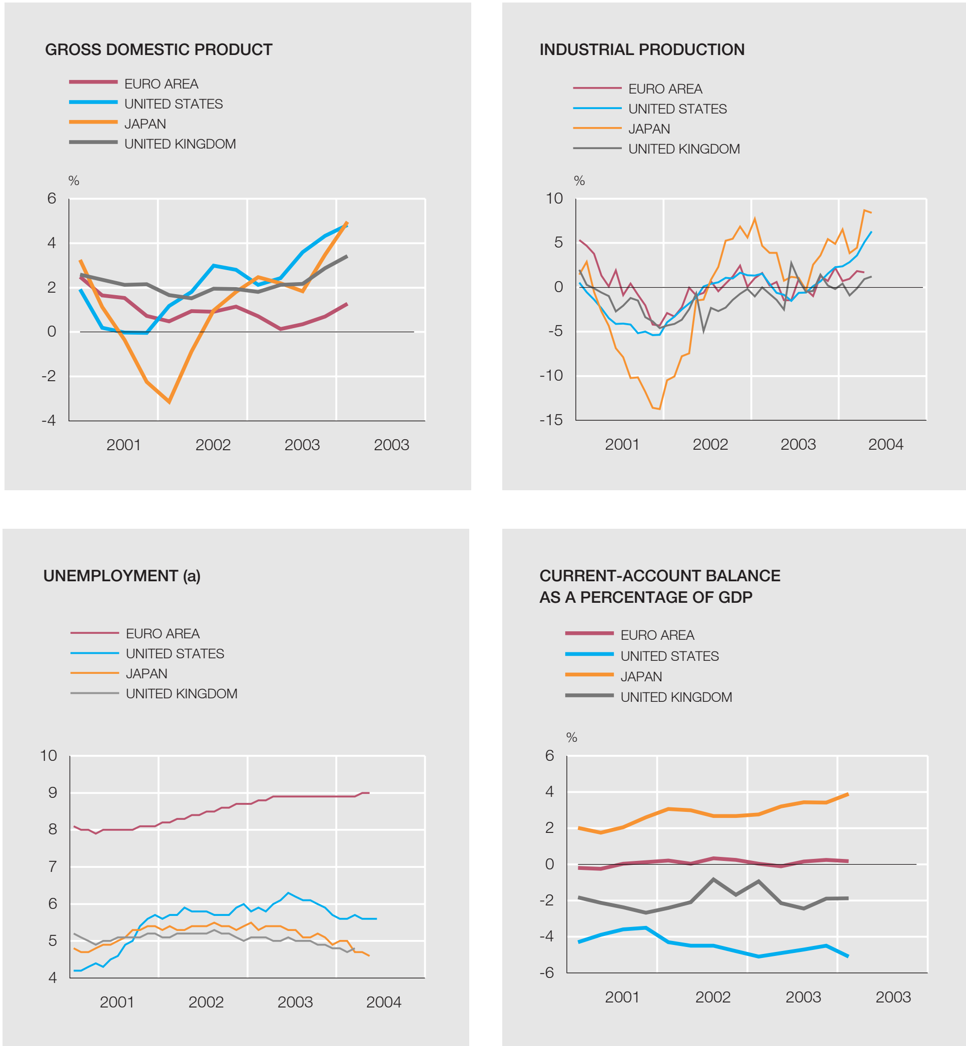
In the United States, following the downward revision of the quarter-on-quarter growth rate of GDP in Q1, from 4.4% to 3.9%, the pace of activity appeared to moderate somewhat towards end-Q2 in view of the employment, private consumption and industrial production indicators. In the labour market, net job creation was lower than expected in June, at 112,000 jobs. Nevertheless, the unemployment rate continued to stand at 5.6% in June, with a little over one million net jobs having been created since March. With regard to private consumption, retail sales fell heavily in June, by 1.1% month-on-month, although during Q2 as a whole they rose by 7.7% year-on-year. Consumer confidence, however, continued to grow. Private investment data for the last few months were also unfavourable, with two consecutive declines in durable goods orders in April and May, which the 0.7% increase in June failed to offset. On the supply side, industrial production fell by 0.3% month-on-month in June, after accelerating at the start of the quarter, although the Purchasing Managers' Surveys are still at high levels despite having fallen back in June. Turning to the external sector, the trade deficit narrowed slightly in May, after having reached a new high in April, with exports up 2.9% on the previous month (17.6% in year-on-year terms), outpacing the 0.4% month-on-month rise in imports (15.9% year-on-year). Prices quickened considerably in Q2, as the consumer price index grew at a 12-month rate of 3.3% in June, mainly owing to the increase in energy prices, while underlying inflation stood at 1.9%.

In Japan, the supply, demand and labour market indicators for Q2 tended to confirm the firming of the recovery following the increase in the GDP growth rate to 5.6% in Q1 compared with the same period in 2003. On the supply side, industrial production grew by 4.6% year-on-year in May. The growth of machinery orders and the recovery in business confidence were also notable. As regards demand-side indicators, personal income and household expenditure grew in May, in contrast to the decline in retail sales. The labour market created 320,000 net jobs between March and May, resulting in a fall in the unemployment rate to 4.6%. However, in spite of the economic buoyancy and the increase in energy prices – which led to a year-on-year rise in wholesale prices in June of 1.4% – the CPI again turned decisively negative over the quarter, with inflation at a 12-month rate of –0.5% in May and underlying inflation at –0.3%.

In the United Kingdom the economy continued to show signs of strength. The preliminary estimate for GDP in Q2, with year-on-year growth of 3.7%, showed that the rate of expansion

MAIN MACROECONOMIC INDICATORS
Annual rates of change

CHART 5



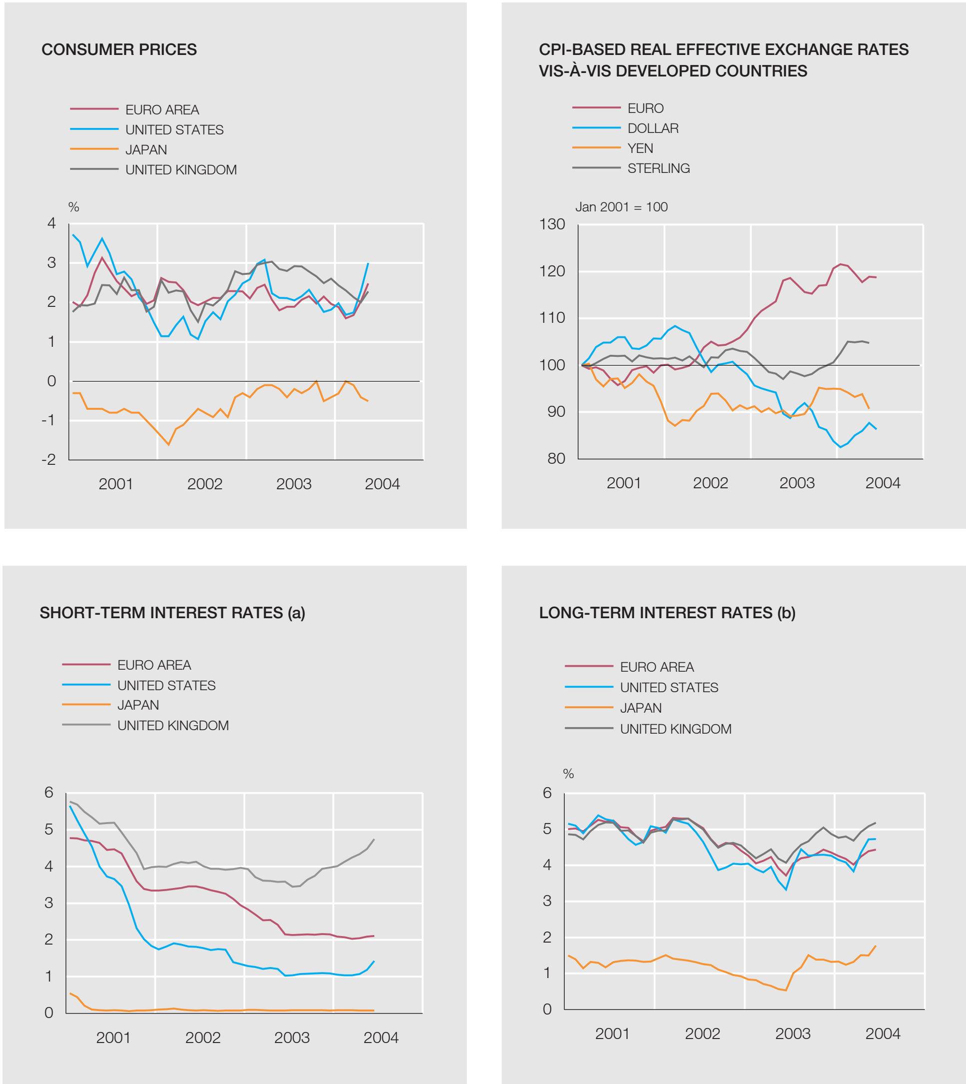
SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of the labour force.

was maintained following the 3.4% rise recorded in Q1. Retail sales grew by 7.2% year-on-year in June, while orders surveys continued to post increases. In the labour market, the unemployment rate remained at a historical low of 4.8% on average in the three months to May and wages continued to rise. On the supply side, industrial production increased by 0.5% month-on-month (1.2% year-on-year) for the second month running in May. The trade deficit widened in May as a result of the rise in imports (0.5% month-on-month) and the drop in exports (–0.7%). Turning to prices, the 12-month growth rate of the HICP increased over the quarter from 1.1% in March to 1.5% in June, although this is still below the 2% target. In July the Bank of England decided to maintain the official interest rate at 4.5%, the level prevailing since June, in line with market expectations.

Activity in the new EU Member States continued to accelerate in 2004 Q1, especially in the Baltic States and Poland, where year-on-year growth rates exceeded 6%. The indicators for Q2 continued to show strong increases in retail sales, industrial production and exports in the main countries in the region. There was a considerable rise in prices, partly as a result of the liberalisation of certain administered prices and the increase in indirect taxes following EU ac-

PRICES, REAL EXCHANGE RATE AND INTEREST RATES CHART 6



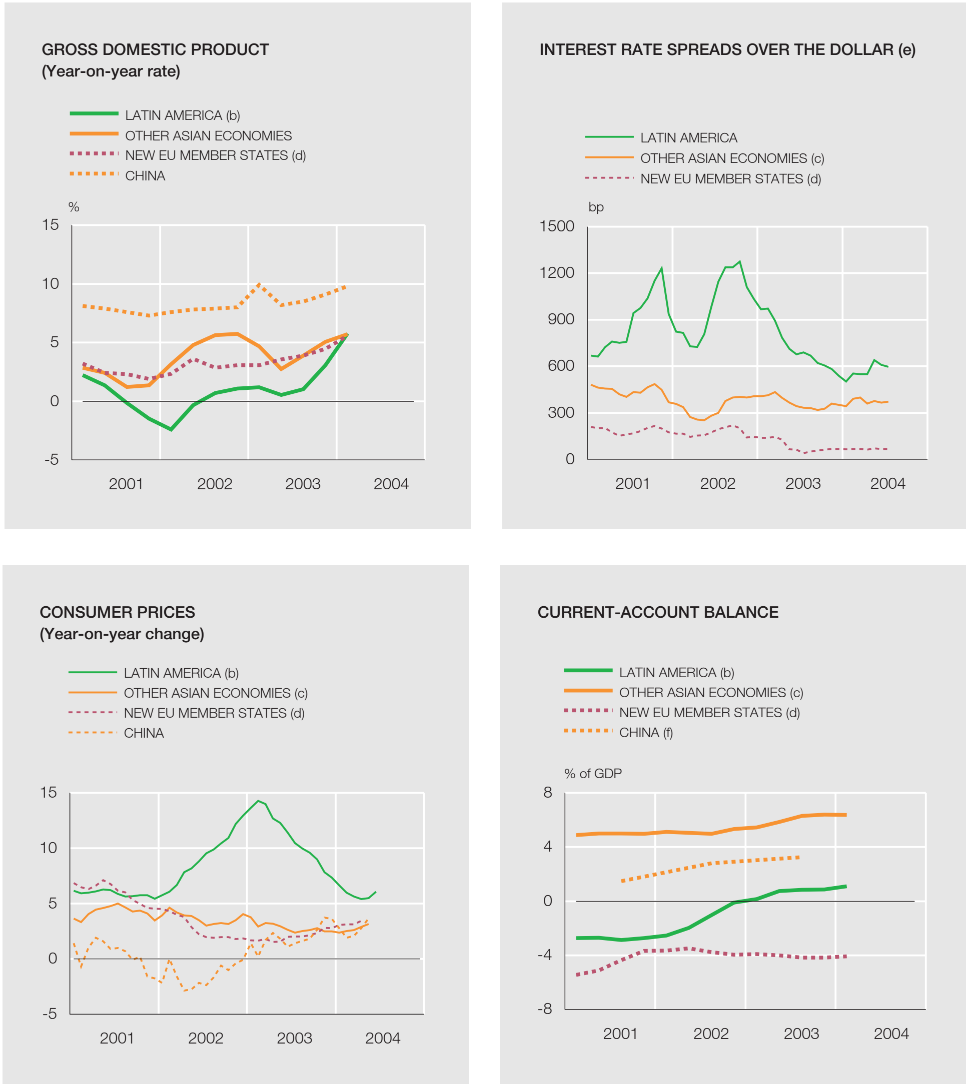
SOURCE: Banco de España.

a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

cession. Against this background, in Q2 there were increases in the official interest rates of Poland (from 5.25% to 5.75%) and the Czech Republic (from 2% to 2.25%), while in Slovakia they were cut from 5% to 4.5% in order to dampen the exchange rate appreciation. On 27 June, Slovenia, Estonia and Lithuania joined ERM II, with fluctuation bands of ±15%, although the latter two countries maintained their currency board arrangements against the euro on a unilateral basis. At the beginning of July the EU Council decided to initiate an excessive deficit procedure for six countries (the Czech Republic, Poland, Hungary, Slovakia, Malta and Cyprus).

In the main south-east Asian economies, the export and activity indicators available for May and June, after having increased at year-on-year rates of between 5% and 6% in Q1, showed that the region continues to be buoyant. At the same time, the indicators for retail sales improved in most countries (except in South Korea), pointing to a gradual recovery of private consumption. Year-on-year inflation rates rose gradually in May and June, driven mainly by energy prices. In China, real GDP grew by 9.6% year-on-year in Q2, only 0.2 pp down on Q1, but notably below the forecasts of over 10%, implying that the policies intended to reduce

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a) CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregate of the various areas has been calculated using the weight in the world economy of the countries included in said aggregate, drawing on IMF information.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. 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 data on the new EU Member States are for Hungary and Poland. The Asia aggregate does not include China.
f. Annual data.

investment, and thereby moderate economic growth, had begun to have an impact. However, the external sector remained considerably buoyant, since both exports and imports quickened in June, with year-on-year growth of over 45%. The 12-month inflation rate rose to 5% in June (4.4% in May), in spite of the aforementioned restrictive policies and a moderate slowdown in the money supply.

In Latin America, the indicators showed that the strong rate of expansion of activity in Q1 firmed in Q2. In particular, the recovery in domestic demand was confirmed by the acceleration in retail sales growth rates in many countries in the region. This greater buoyancy in activity was manifest in greater inflationary pressures, also arising from the higher commodity prices and the currency depreciations in the preceding months. The rise in inflation – which reached 6% year-on-year in the area as a whole – is making it harder to meet inflationary targets in many countries and has resulted in greater monetary policy caution. Initial volatility in Q2 subsided and financial markets in the region stabilised in June as a result of an easing off of prospects of interest rate hikes in the US and an improved outlook for activity in the area. This allowed international debt issuance, concentrated in Brazil, to resume during the last few weeks of the quarter, after little activity on this front in the region over the quarter as a whole. Lastly, there was headway in the various processes of economic and commercial integration in the area, including most notably the progress at the recent Mercosur summit, at which Mexico and Venezuela were admitted as associate members.

The information available on the economic performance of the euro area in Q2 confirms that the greater buoyancy in activity observed since the end of last year – thanks to the momentum of the world economy and, to a lesser extent, domestic demand – is continuing. However, the modest impetus of private consumption over this period has cast some doubt on how to sustain domestic demand growth. Furthermore, the heterogeneity of the composition of growth in the euro area countries prevents any identification of a generalised pattern of economic recovery. Turning to price developments, the HICP growth rate has picked up in recent months, mainly as a result of strong increases in energy prices. Nonetheless, the recovery in productivity against a background of wage moderation supports the expectations of a decline in the inflation rate in the second half of the year, providing oil prices do not begin to rise again.

Monetary and financial conditions remained generous throughout Q2 and did not therefore prove to be an obstacle to economic recovery. With regard to fiscal policy it seems evident, despite the improvement in activity, that the budgetary targets contained in most stability programmes will not be reached in 2004 and, according to the European Commission's spring forecasts, six countries will again exceed the 3% ceiling set in the Treaty on European Union. Given the difficulties of maintaining budgetary rigour in the euro area, the Commission, whose role in disciplinary proceedings has been strengthened thanks to a recent ruling by the European Court of Justice, is drawing up a list of proposals to enhance the application of the mechanisms in force.

3.1 Economic developments

According to the second euro area National Accounts estimate, GDP in the area in 2004 Q1 grew by 0.6% compared with the preceding quarter, 0.2 pp above the average quarter-on-quarter rate for the second half of 2003 (see Table 1). The greater robustness of output was down to the performance of the external sector, whose contribution to quarter-on-quarter growth was 0.3 pp, after standing at a negative rate of almost –0.5 pp the previous quarter. This change in the contribution of external demand to GDP growth was largely due to the notable improvement in exports, the result of the robustness of the external environment, despite the cumulative appreciation by the euro over the past three years (see Box 1). Domestic demand (excluding stockbuilding) contributed 0.4 pp to GDP growth, on a similar scale to the two preceding quarters. Significant under domestic demand is the acceleration in private consumption, in contrast to the notable deterioration in government consumption. Investment grew very moderately, compared with its buoyancy the previous quarter. This was due to the fall-off in investment in construction, influenced by presumably temporary factors, since investment in equipment increased by 0.6%. Finally, stockbuilding made a zero contribution to output growth (see Chart 8).

The breakdown of National Accounts across countries reveals a quickening in economic activity in most of them, albeit with relatively significant differences in intensity and composition. Among the biggest economies in the area, France and Spain – posting quarter-on-quarter rates of 0.8% and 0.6%, respectively – experienced more robust growth than Germany and Italy. Italian output expanded by 0.4% after having been flat the previous quarter. Regarding the composition of growth, the most notable discrepancies were between Germany and the other large countries. The contribution of domestic demand to German GDP was negative, since the chronic weakness of private consumption was compounded by the slide in government consumption and the contraction in investment, especially construction investment. Indeed, investment in the euro area, excluding construction in Germany, accelerated moder-

EURO AREA ECONOMIC INDICATORS TABLE 1

		2002	2003				2004		
		Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
GDP	Year-on-year growth	1.1	0.7	0.1	0.4	0.7	1.3		
	Quarter-on-quarter growth	0.0	0.0	-0.1	0.4	0.4	0.6		
	European Commission forecasts (c)							(0.3;0.7)	(0.3;0.7)
IPI (d)		1.1	1.0	-0.6	-0.2	1.4	1.2	2.7	
Economic sentiment		92.4	90.5	91.4	94.2	97.8	98.7	100.0	
Industrial confidence		-10.0	-11.0	-12.0	-11.4	-7.3	-6.7	-4.7	
Manufacturing PMI		49.0	49.3	47.1	49.1	52.0	52.8	54.4	
Services confidence		-4.3	-5.7	-2.0	5.3	10.3	10.7	11.4	
Services PMI		50.5	48.9	47.9	51.9	56.7	56.0	55.2	
Unemployment rate		8.6	8.8	8.9	8.9	8.9	8.9	9.0	
Consumer confidence		-14.0	-19.3	-19.3	-17.3	-16.0	-14.3	-14.7	
HICP (d) (e)		2.3	2.4	1.9	2.2	2.0	1.7	2.4	
PPI (d) (e)		1.3	2.3	1.3	0.9	0.9	0.4	2.4	
Oil price in USD (e)		28.2	30.3	27.6	27.1	29.9	33.8	35.3	37.4
Loans to the private sector (d) (e)		4.8	4.7	4.6	4.9	5.5	5.4	5.6	
Euro area ten-year bond yield		4.5	4.2	4.0	4.2	4.4	4.2	4.4	4.3
US-euro area ten-year bond spread		-0.51	-0.22	-0.32	0.09	-0.05	-0.11	0.28	0.22
Dollar/euro exchange rate (e)		1.049	1.090	1.143	1.165	1.263	1.222	1.216	1.239
Appreciation/depreciation of the euro (e)		19.0	3.9	9.0	11.1	20.4	-3.2	-3.8	-1.9
Dow Jones EURO STOXX Broad index (e)		-34.5	-12.9	2.9	4.1	18.1	1.9	3.7	0.1

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available up to 20 July 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.

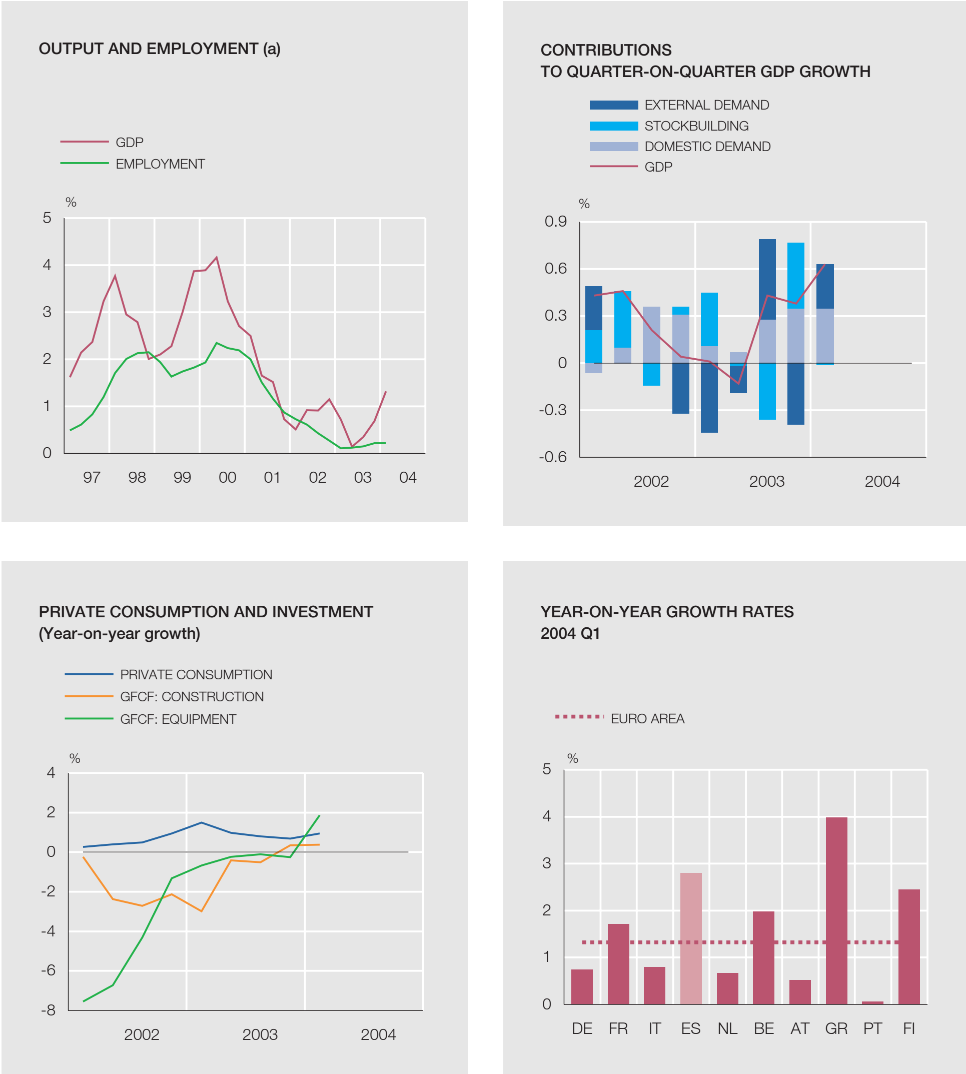
ately, rising to a rate of 0.5% in quarter-on-quarter terms. By contrast, the contribution of Germany's net external demand was very positive as a result of buoyant exports. Conversely, private consumption in France, Italy and Spain expanded vigorously, making for a very positive contribution of domestic demand to GDP, while the contribution of net external demand was slightly negative.

Across the production branches, the acceleration in value added in the euro area economy in Q1 was due, in line with the breakdown of output on the demand side, to a brisker pace of expansion in industry, the distributive trade and financial intermediation, while the rate of increase of construction and government-provided services slowed. In the labour market employment continued to increase slowly, which, against a background of quickening economic activity, saw productivity expand by 1% compared with the same period a year earlier. However, this result masks significant differences in the behaviour of the different sectors of the economy. Job destruction continued in industry and in construction, while job creation quickened mildly in the services sector. The unemployment rate held at 9% in May, 0.1 pp up on March.

Into 2004 Q2, the supply-side indicators available point to the maintenance of a vigorous rate of increase. On the demand side, however, the signs of improvement are less conclusive, especially regarding private consumption developments (see Chart 9). Generally, the industrial activity and construction indicators have emitted positive signals. In this respect, the industrial production index trended favourably in April and May. Similarly, the latest data (to June) for the European Commission's business confidence index offered an encouraging result, character-

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

a. Year-on-year rates of change.

ised by improvements in all its components. In quarterly average terms, this entailed headway in relation to Q1. The Purchasing Managers' Survey for manufacturing industry also signals a clear increase in activity in the sector in average quarterly terms. Finally, the confidence indicator in the construction industry increased in Q2 in relation to Q1, and the services sector confidence indicators held relatively stable in Q2 compared with the previous quarter.

From the demand standpoint, the indicators available generally point to a rather unsatisfactory performance by private consumption, while the external sector is seen to be more buoyant. In 2004 Q2 the consumer and retail confidence indicators stabilised, on average, at the level recorded in the opening months of the year, up on the figure for 2003 Q4. Further, retail sales fell back in April and May, on average, in relation to Q1. Conversely, new car registrations increased appreciably. As regards the investment indicators, orders in industry were on a rising trend and the results from the half-yearly investment survey in manufacturing conducted between March and April were favourable. The latter survey entailed an upward revision of the expectations for an increase in investment for 2004 to 3% in real terms from the figure of 2% forecast in the October-November 2003 half-yearly survey. This result is also in contrast to the

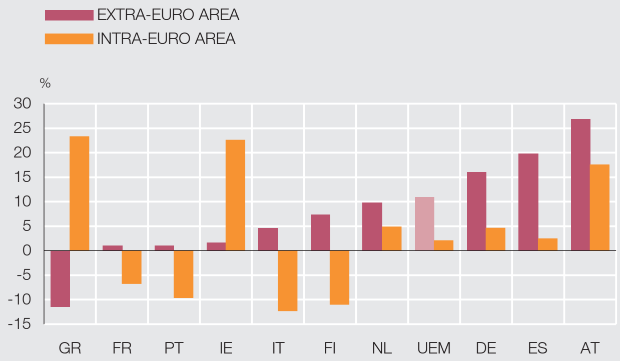
THE BEHAVIOUR OF EURO AREA EXPORTS AND THEIR DETERMINANTS IN THE PERIOD OF EURO APPRECIATION

Since late 2000 the euro has been on a rising path against the currencies of its main trading partners, which has seen its nominal effective exchange rate appreciate by more than 30% in the period to 2004 Q1. During this same period, euro area exports to outside the area have increased by somewhat more than 10%, below the growth of world markets. Across the Member States, the performance of exports to outside the area has differed greatly. Chart 1 shows that Greece has been the only country where exports have fallen, while growth has been positive – albeit to differing degrees – in the remaining countries. This differential behaviour of sales abroad in most of the euro area countries has been due to the confluence of other determinants apart from the exchange rate. These are analysed below.

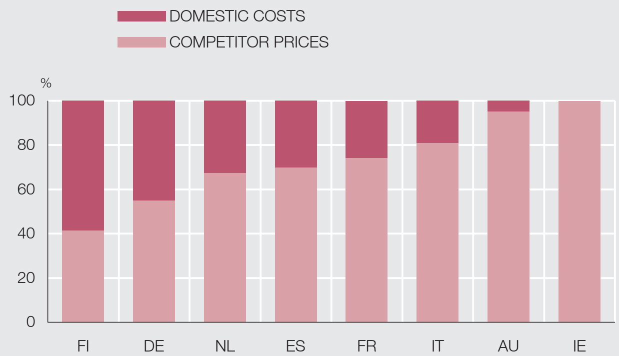
On the supply side, European exporting companies may possibly have been able to attempt to offset the appreciation of the euro and, therefore, the loss of competitiveness by reductions in export prices denominated in the common currency, thereby squeezing profit margins per unit sold in exchange for maintaining market share. The extent to which export prices may have been cut depends on the market power each country has in setting its prices, i.e. the extent to which prices are set in terms of domestic costs or of competitors' export prices. Chart 2 offers estimates made at the Banco de España, using a supply and demand model, of the weights of these two factors in the determination of the export prices of most euro area countries. According to these estimates, notable differences can be seen to exist between the countries, ranging from Finland, which sets its prices in accordance with its domestic costs to the tune of approximately 60%, to Ireland, which sets all its prices in terms of its competitors' prices. Mid-range are three of the area's major countries – Spain, France and Italy – which set 70% of their prices, on average, in accordance with their competitors' prices. Meanwhile Germany, according to these estimates, shows greater market power than the foregoing countries.

Chart 3 displays the change in the euro-denominated prices of extra-euro area exports for most of the euro area countries in the recent period of euro appreciation. It can be seen that the squeeze on prices was, in all cases, far lower than the appreciation of the euro, indicating that exporters have only partly offset the effect of the appreciation with a reduction in their margins. Likewise, no clear relationship is perceptible between Charts 2 and 3, which is why other composition and demand factors may have been highly relevant.

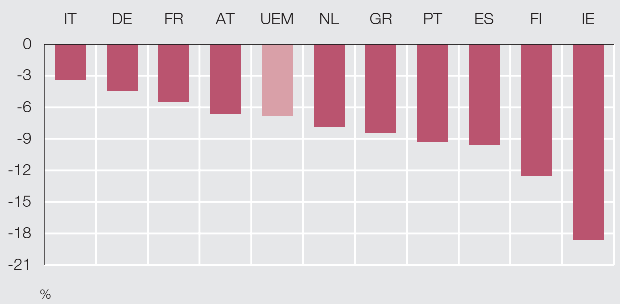
1. GOODS EXPORTS
(OCTOBER 2000 - FEBRUARY 2004 CHANGE)



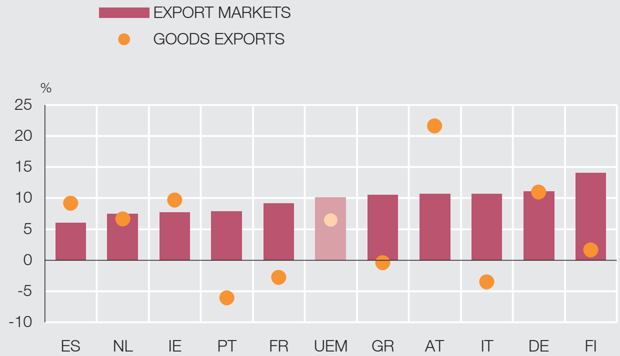
2. WEIGHT OF THE DETERMINING FACTORS OF EXPORT PRICES (a)



3. EXTRA-EURO AREA EXPORT PRICES
(OCTOBER 2000 - FEBRUARY 2004 CHANGE)



4. EXPORT MARKETS (b)
AND TOTAL GOODS EXPORTS (c)



SOURCES: Eurostat, OECD and Banco de España.

a. Estimates taking into account intra- and extra-euro area exports.
b. October 2000 -February 2004 change.
c. 2000Q4-2003Q4 change.

THE BEHAVIOUR OF EURO AREA EXPORTS AND THEIR DETERMINANTS IN THE PERIOD OF EURO APPRECIATION BOX 1

On the demand side, many variables affect sales outside the euro area. The volume of exports may have trended differently in each country in accordance with the intensity of the appreciation of each country's nominal effective exchange rate, with the cyclical position of the export areas targeted and with the reaction of competitors, since it seems reasonable to think that they will also have taken advantage of the appreciation of the euro to increase their prices in their respective currencies and increase their margins, partly cushioning the loss of competitiveness of European exporters. Lastly, the performance of the respective countries' export markets may have differed, thereby exerting a differentiated effect on sales flows outside each Member State. Chart 4 displays the growth of this variable as calculated by the OECD. Although it includes both internal and extra-euro area markets, it is a good indicator of the external demand each country is facing. Highly differentiated performances are observed throughout the period considered, suggesting that the composition of trade by destination has also been a key variable when it comes to justifying the notable divergences in exports in recent years across the euro area members.

investment spending finally reported by corporations in 2003, which fell by 7%. Lastly, the export indicators improved notably in Q2 (orders in industry from abroad and export expectations), in keeping, according to the trade balance, with the expansion in exports to April.

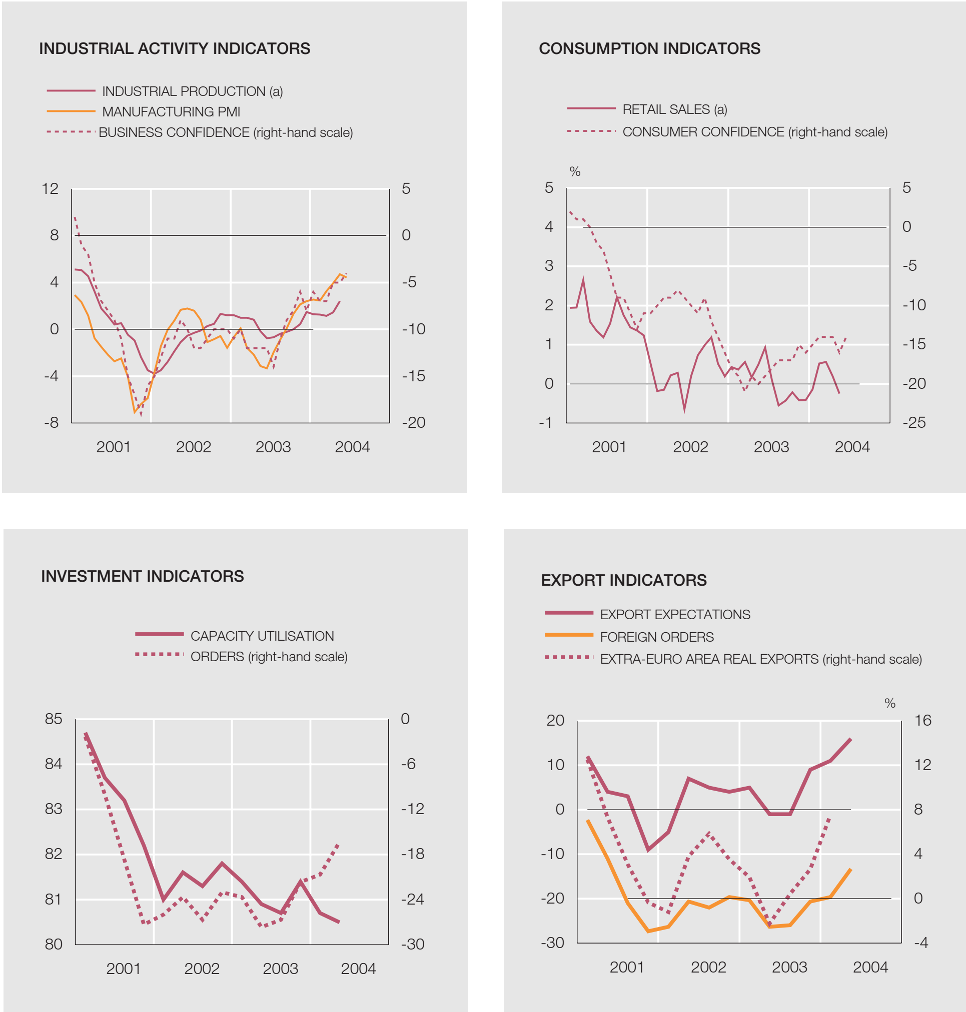
The favourable trend of the indicators of activity has meant an improvement in the outlook for growth for the rest of this year. In this respect, and in terms of the determinants of demand, the increase in foreign export markets, the slight rise in the pace of job creation and of disposable income, and the lax financial conditions for both companies and households all shape a scenario conducive to a continuing path of recovery. Accordingly, the growth forecasts of the main international organisations, both for Q2 and for the year as a whole, appear attainable. Specifically, the European Commission forecasts that the GDP growth rate in Q2 and Q3 will be between 0.3% and 0.7% quarter-on-quarter, which will allow for an increase in GDP of close to 2% in annual average terms. Nonetheless, the absence of clear signs of an improvement in consumption in Q2, and the potential persistence of the slippage seen in government consumption and investment in construction in Q1 casts some doubt on the intensity of the recovery in the European economies. Finally, uncertainty over the course of oil prices in the coming months is, naturally, a further factor of risk.

In June the HICP grew by 2.4% compared with the same month a year earlier, 0.7 pp up on March. Behind this progressive acceleration in prices is, mostly, the hike in oil prices in April and May, and the subsequent impact on the component of the index that reflects energy prices, which grew by 5.9% in June, far above the negative rate of –2% recorded in March (see Chart 11). The other HICP components have held relatively stable during Q2, meaning that the rate of increase of the indicator grouping services and non-energy goods prices has remained relatively steady in the period under analysis, at slightly above 2%. From the standpoint of producer prices, non-energy commodities have become dearer since mid-2003, in line with the increase in worldwide demand. This, along with the rise in energy prices, has borne on the performance of the producer price index, the 12-month rate of change of which (2.4% in May) has been on a rising trend since February, when it posted zero growth.

Turning to price formation on the supply side, unit labour costs eased to a year-on-year rate of 0.9% in 2004 Q1, 0.6 pp down on 2003 Q4. This was thanks to the rebound in productivity, the increase in which was 1%, since compensation per employee increased by 2%, the same rate as the previous quarter. The GDP deflator also grew by 2% in Q1, in line with the increases in previous quarters, whereby the slowdown in unit labour costs has entailed a notable widening of margins (see Chart 10). In view of the gradual pick-up in economic activity and scant job destruction in the economic downturn, job creation will foreseeably be modest,

EURO AREA. REAL INDICATORS

CHART 9



SOURCES: Eurostat and European Commission.

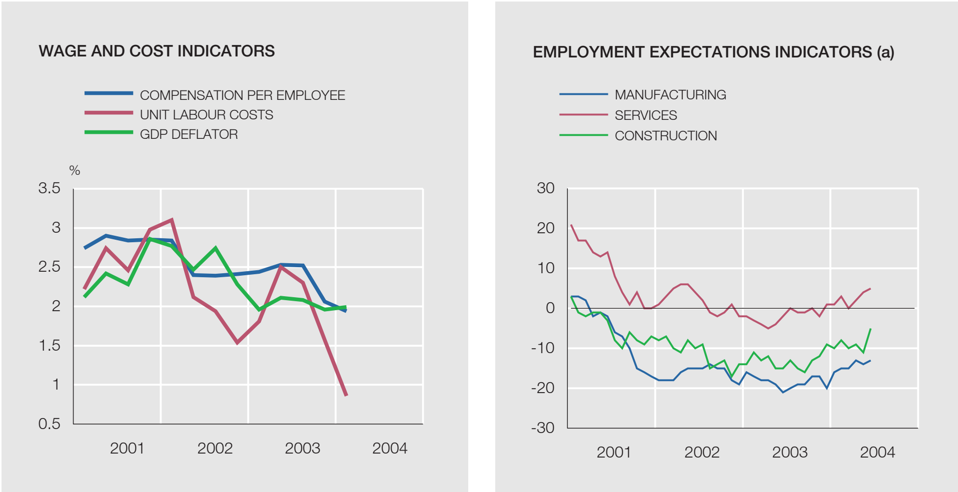
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.

which will make maintaining wage restraint easier and provide for a cyclical increase in productivity, with the subsequent tendency of unit labour costs to undergo small increases. However, according to EU confidence surveys, consumer inflation expectations, though still at low levels, rose significantly in May and June as a result of the hike in oil prices, which is a potential factor of risk for wage moderation.

As regards the external sector, balance-of-payments information for April is available, meaning that only a highly provisional assessment of Q2 can be made. In terms of cumulative balances in the first four months of each year, net flows in the euro area balance on current account posted a surplus of €14 billion in 2004, in contrast to the deficit of €4.5 billion in 2003. The improvement in this balance was the outcome of the increase in the merchandise surplus, which climbed from €23.4 billion last year to €39.1 billion this year, thanks to an expansion in exports of 6.2% year-on-year in nominal terms and of 1.7% in imports. The basic balance, which reports current-account results and net direct and portfolio investment balances, recorded a deficit of €19.3 billion, against a surplus of €28.7 billion last year, as a result of net direct investment outflows.

EURO AREA. WAGE AND EMPLOYMENT INDICATORS
Year-on-year percentage changes

CHART 10



SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators.

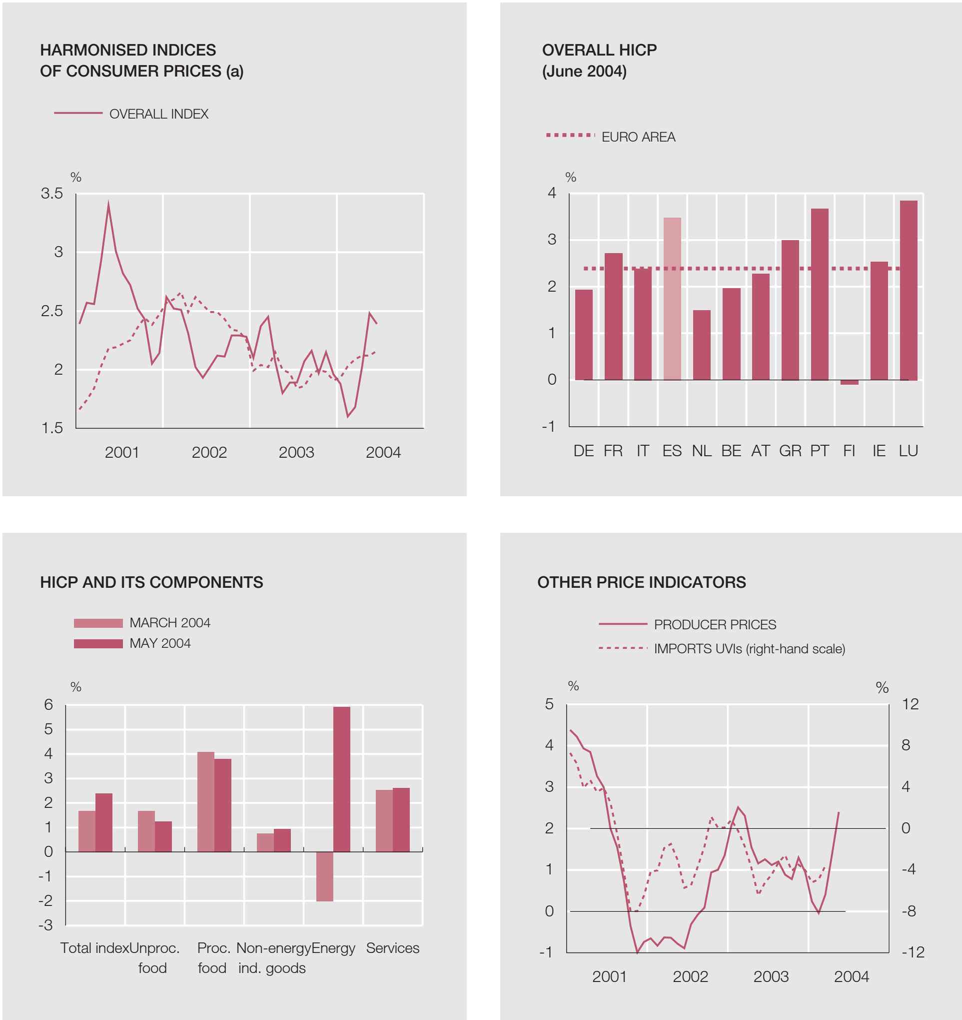
Recent developments in public finances in the euro area countries suggest that the budgetary targets laid down in the related stability programmes will not, at the aggregate level, be met this year either. And this despite the fact (certain exceptions aside) that economic growth is expected not to deviate substantially from the estimates in these programmes. According to the European Commission's spring forecasts, 2004 will close, as did 2003, with a deficit of 2.7% of GDP, 0.4 pp above that resulting from the aggregation of the programme targets (see Table 2). Moreover, according to these forecasts, a total of six Member States might run deficits of over 3% of GDP in 2004.

The notifications in March under the excessive deficit procedure gave rise to fresh developments. Thus, the decline in the Portuguese deficit in 2003 to below the 3% ceiling saw this country's compliance with the Council Recommendation formulated in November 2002, which led to the derogation on 11 May 2004 of the excessive deficit procedure affecting Portugal. The course of the Portuguese deficit in the first four months of the year has been as expected, since greater direct tax revenue has allowed the strong growth of transfers to households to be checked. In the Netherlands, following notification by the Dutch authorities that the budget deficit had exceeded 3% of GDP in 2003, the Commission initiated the corresponding proceedings, leading the ECOFIN Council to decide, on 2 June, that there was an excessive deficit in this country. ECOFIN recommended it be corrected before 2005 and that, before 2 October, discretionary measures entailing a reduction of 0.5% of GDP in cyclically adjusted terms be adopted. The Dutch authorities have already adopted a package of fiscal consolidation measures, the outcome of which will be an estimated reduction in the deficit of 0.6% of GDP.

Furthermore, since the European Commission's spring forecasts anticipated the possibility of the Italian deficit rising to 3.2% of GDP in 2004, the Commission resolved to recommend that the Council issue an early warning to the Italian authorities. In the light of the plan submitted by the Italian authorities, which should enable the deficit to be reduced by 0.6% of GDP this year, the ECOFIN decided on 5 July to reject the Commission's proposal. In any event, even the revised targets might encounter difficulties being met, since they are based on ambitious assumptions about proceeds from real asset sales and on the capacity of the local authorities

EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 11



SOURCES: Eurostat and European Central Bank.

a. There is a break in January 2002 when the series was rebased to 2001.

to control their spending. Lastly, the ECOFIN Council estimated, at this same meeting, that there was an excessive deficit in Greece, and it called on the Greek authorities to put an end to this situation before end-2005 and to submit the necessary measures in this connection prior to 5 November this year. The outlook for 2004 in Greece is very uncertain since, in addition to the provisional nature of the results for 2003, there has been a heavy overrun on spending targets in the first four months of the year because of expanding transfers and public investment which has only been partly offset by the favourable course of tax receipts.

Among the other high-deficit countries, the budget outturn in Germany was unfavourable in the first four months as a result of the adverse course of tax receipts, the decline in which exceeded the estimates made in autumn 2003. This has been due to the composition of economic growth which, being based above all on external demand, has not contributed to the expansion of tax bases and, therefore, of tax takings. Conversely, the growth of spending has been very modest, moving in line with forecasts, thanks to the reduction in the number of public-sector employees, to the moderation of public-sector wage growth and to the cuts in transfers (mainly due to the health system reform). Finally, the French budget outturn in the opening months of the year was as forecast, since the positive impact

GENERAL GOVERNMENT BUDGET BALANCES
OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2000	2001	2002	2003	2004 (b)	2004 (c)
Belgium	0.1	0.3	0.0	0.2	-0.5	0.0
Germany	-1.2	-2.8	-3.5	-3.9	-3.6	-3.3
Greece	-2.0	-1.9	-1.5	-3.0	-3.2	-1.2
Spain	-1.0	-0.4	-0.1	0.3	0.5	0.0
France	-1.4	-1.6	-3.1	-4.1	-3.7	-3.6
Ireland	4.4	1.1	-0.4	0.2	-0.8	-1.1
Italy	-1.9	-2.7	-2.4	-2.5	-3.2	-2.2
Luxembourg	6.3	6.3	2.7	-0.1	-2.0	-1.8
Netherlands	1.5	0.0	-1.6	-3.2	-3.6	-2.3
Austria	-2.0	0.1	-0.4	-1.3	-1.3	-0.7
Portugal	-3.2	-4.4	-2.7	-2.9	-3.5	-2.8
Finland	7.1	5.2	4.3	2.1	1.8	1.7
PRO MEMORIA: Euro area						
Primary balance	3.1	2.4	1.5	0.8	0.7	
Total balance	-1.0	-1.7	-2.3	-2.7	-2.8	-2.3
Public debt	70.4	69.4	69.3	70.5	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 0.03 of GDP have been shaded.
b. European Commission forecasts (spring 2004).
c. Targets of the stability programmes presented between November 2003 and January 2004.

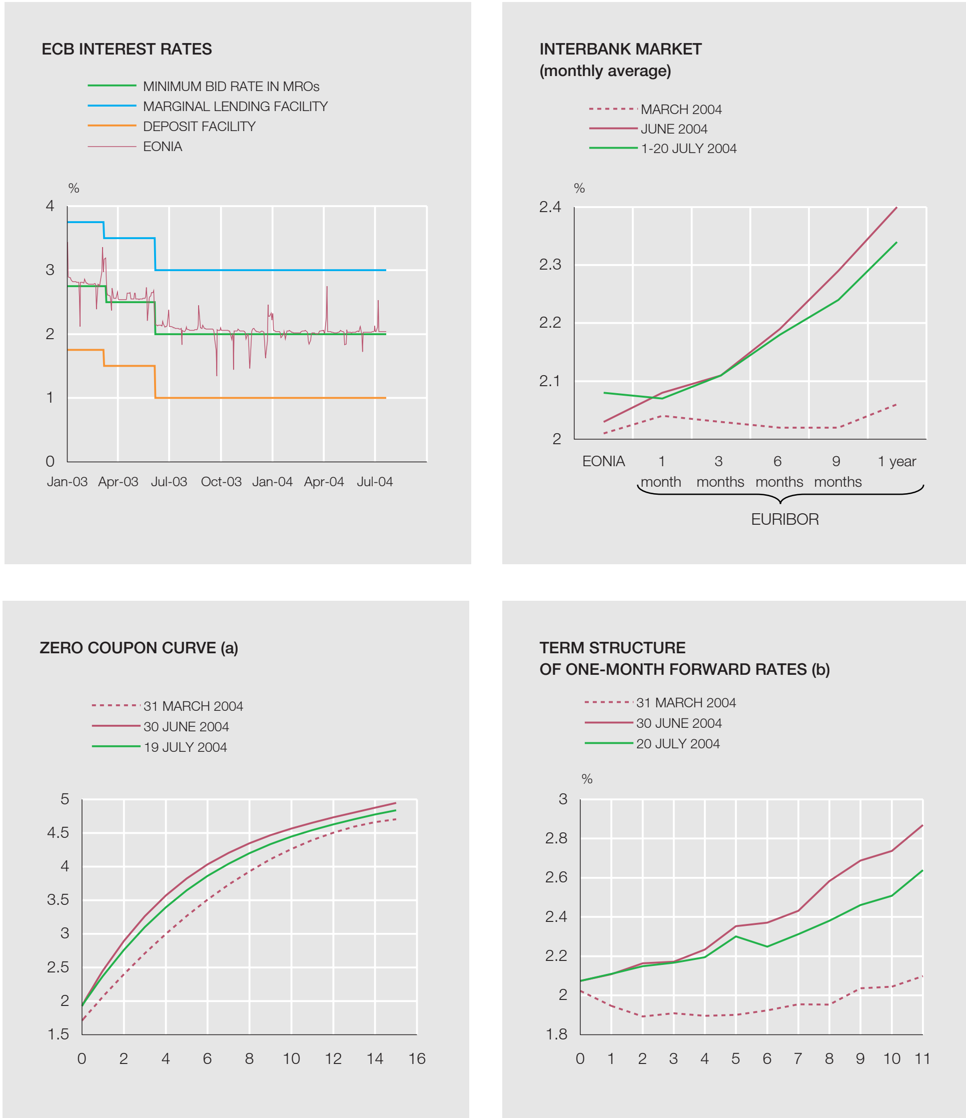
of the favourable trend of activity has enabled the effects of the discretionary decisions adopted to increase spending (measures stimulating consumption and the partial annulment of the previous decision to tighten unemployment benefit eligibility criteria) to be countered.

On 13 July the Court of Justice of the European Communities decided to annul the conclusions of the ECOFIN Council of 5 November 2003 on the excessive deficit procedures initiated against France and Germany. There were essentially two reasons behind this annulment. First, the conclusions contain a suspension of the procedure for reasons unrelated to the provisions of the Treaty. Further, the amendment by the Council of the recommendations previously adopted by it may only be done upon the Commission's initiative. Nonetheless, the ruling rejects the Commission's claim that the Council should have adopted its recommendation establishing that these two countries have not implemented sufficient measures to reduce their deficits. Conversely, the Court highlights the Council's power to support or reject the Commission's initiatives.

This ruling means the fiscal surveillance and discipline mechanisms in the Treaty and in the Stability and Growth Pact remain in force. At the same time, the difficulties encountered in recent years in preserving budgetary discipline in the euro area highlights the need to refine the application of the established procedures (see Box 2). In this respect, the European Commission has begun to outline some suggestions combining the search for incentives for more disciplined behaviour in periods of high growth with the possible introduction of more flexible criteria when the cycle has turned downwards. Further, the European Commission has con-

EURO AREA INTEREST RATES

CHART 12



SOURCES: European Central Bank and Banco de España.

a. Estimated using swap market data.
b. Estimated using Euribor data.

sidered giving a more predominant role to debt levels and to the sustainability of public finances in the long run as another possible means of refining the current surveillance mechanisms.

3.2 Monetary and financial developments

At its meetings during 2004 Q2, the ECB Governing Council considered that the prevailing monetary policy stance remained appropriate for attaining the medium-term price stability target, and was not an obstacle to economic activity. Accordingly, the interest rates on the main refinancing operations, deposit facility and marginal lending facility have held at 2%, 1% and 3%, respectively (see Chart 12).

During Q2, money market interest rates began to rise at terms equal to or above three months. This was as a result of the prospect of a progressive strengthening of economic activity and uncertainty over the future course of oil prices and their potential inflationary effect, whereby expectations of a possible though moderate rise in official interest rates towards the end of the

In recent decades there has been a growing degree of consensus about the advantages of attaining and maintaining sound public finances. In particular, budgetary stability has been proven to help achieve monetary policy targets and to provide for more favourable financial conditions for investment and employment and, therefore, for sustained economic growth. Moreover, balanced public accounts offer leeway to stabilise cyclical fluctuations and they allow fiscal policy to tackle various shocks, such as population ageing, from a more comfortable starting position. In a monetary union there are further arguments that highlight the importance of fiscal discipline and the need for rules to guarantee it. With several countries sharing a single currency, the incentives for discipline diminish. This is partly because the effects of national fiscal imbalances have to be borne by the other Member States (since they can affect variables which are common to members, such as the exchange rate) and partly because financial markets cannot impose sufficient restrictions to prevent these deviations. In Europe's case, for example, interest-rate differentials on public debt markets can be seen to bear some relation to the public debt ratio (and, to a lesser extent, to the deficit), although the size of the differentials is limited, whereby they cannot alone provide sufficient incentives to ensure budgetary stability (see Chart 1). In a monetary union, compliance with fiscal discipline rules provides, moreover, for the necessary co-ordination between the single monetary policy and the national budgetary policies.

In the case of the euro area, the agreed fiscal discipline framework can be found in the EU Treaty (which dates back to 1992) and in the Stability and Growth Pact (SGP), approved in 1997. The Treaty lays down general principles governing this disciplinary framework and the ceilings on the deficit (3% of GDP) and on public debt (60% of GDP), along with the procedure for the surveillance and correction of excessive deficits (EDP). The SGP clarifies some of the provisions of the Treaty and makes them operational, in addition to incorporating the Member States' undertaking to maintain a balanced budget or a budgetary surplus in the medium term.

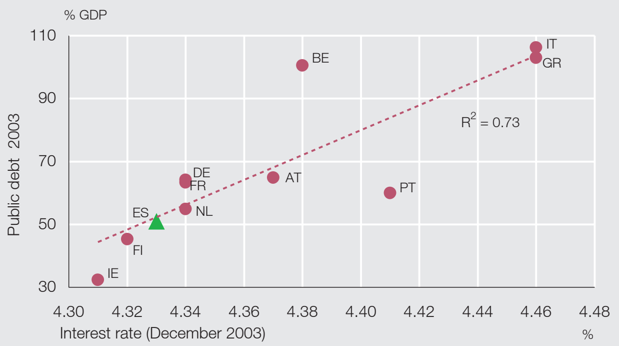
The rules in force led many of the euro area countries which, until the mid-nineties, had displayed a high budget deficit and a growing public debt ratio to considerably reduce their fiscal imbalances prior to the start of monetary union (see Chart 2). After complying with the Maastricht criteria, the drive to continue restoring health to public finances fell off despite the favourable cyclical situation. This meant that the economic slowdown that began in 2001 gave rise to a significant deterioration in the fiscal position of certain countries, which incurred an excessive deficit. The application of the EDP in this setting of weakness has been controversial, prompting conflicts between the ECOFIN Council and the European Commission. The most significant of these was in November 2003 when ECOFIN (i) rejected the Commission's recommendations that France and Germany should correct their excessive deficits by following the procedure laid down in the Treaty; (ii) suspended the EDP in respect of these countries; and (iii) approved, in its place, conclusions that included the undertaking of the respective national authorities to correct their excessive public deficit. In July 2004, the Court of Justice of the European Communities ruled that, although the Council has the power to reject the Commission's recommendations, the conclusions approved are not valid since they open a process of surveillance of national budgetary policies other than that legally established and without the Commission's necessary intervention.

The debate stemming from the application of the SGP has given rise to various analyses and discussions on the means of improving the current fiscal discipline framework. The ruling of the Court of Justice, though it stresses that the Commission is the body that should take the initiative in the process, also highlights that it is necessary to reach consensus on the means of applying the rules and their content.

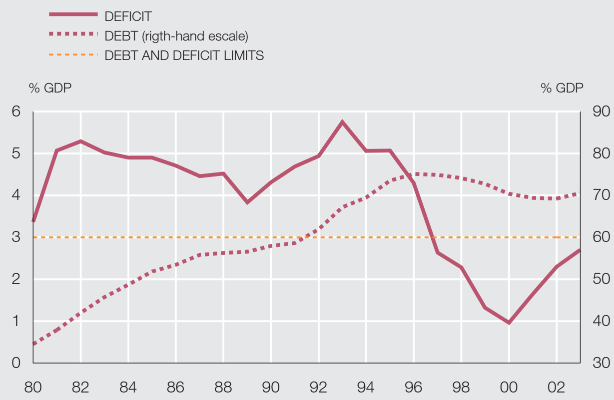
Recently, the European Commission included some ideas in its Public finances in EMU-2004 to clarify and strengthen the application of the SGP. Certain proposals seek to reduce the asymmetry of the fis-

EURO AREA: INTEREST RATES, DEBT AND BUDGET DEFICIT

1. LONG-TERM INTEREST RATES (a) AND PUBLIC DEBT RATIO



2. PUBLIC DEBT AND BUDGET DEFICIT IN THE EURO AREA



SOURCES: European Commission and Banco de España.

a. Public debt interest rates.

cal rules over the course of the business cycle, so that countries have sufficient incentives to pursue a prudent budgetary policy in phases of high growth. Others are aimed at adding greater flexibility to the application of the SGP, allowing, in certain circumstances, deviations from the clause requiring a balanced budget or budgetary surplus in the medium term, or taking into account national economic conditions when setting the degree to which imbalances must obligatorily be corrected. A call is also made to place greater emphasis on the public debt criterion, given its closer connection with the sustainability of public finances. Some of these proposals may be applied without amending the current legal rules, while others may require changes to the SGP.

In any event, while it would be reasonable to study the potential refinement of the content or the practical application of the current rules, the biggest difficulty lies in the limited effectiveness of the mechanisms available for ensuring compliance. This is because national governments are both judge and defendant in this process, since it is the ECOFIN Council which takes the final decisions on this procedure. A hypothetical more flexible application of the current rules seeking to accommodate to a greater extent the particular circumstances of each country, along the lines described above, would appear justifiable from the standpoint of economic rationality. However, one possible drawback is that it would tend to lessen the binding nature of the current rules, by leading their application to be less automatic. This is why the strengthening of the European Commission's powers in the surveillance process appears to be a vital complement for any application of the rules that is to be more tailored to specific national circumstances. The Constitutional Treaty agreed at the June 2004 European Council is a modest step in this direction, as it adds two minor amendments to the framework contained in the Treaty currently in force. First, the text confers on the Commission the power to issue an "early warning" to a Member State that risks incurring an excessive deficit position. Second, a proposal by the Commission about the presence of an excessive deficit in a country may only be rejected by the Council unanimously, whereas the current Treaty requires that a qualified majority of the Council back the Commission's initiative.

year have gradually arisen. Along these lines, the one-month forward rate curves have also reflected similar movements. As regards long-term interest rates on international government bond markets, two salient phenomena have been witnessed in the past quarter: first, from March to early July, significant rises in ten-year government bond yields were seen both in the euro area and, especially, in the United States; second, following a long period in which US long rates were lower than European ones, the sharp increase in rates in the United States in 2004 Q2 has meant that the spread between US and euro area yields has become positive. Finally, on the information available to May, the interest rates set by credit institutions in their lending and deposit operations generally held stable. The interest rate on lending for house purchases tended to stabilise at 4.3% in May (see Chart 13).

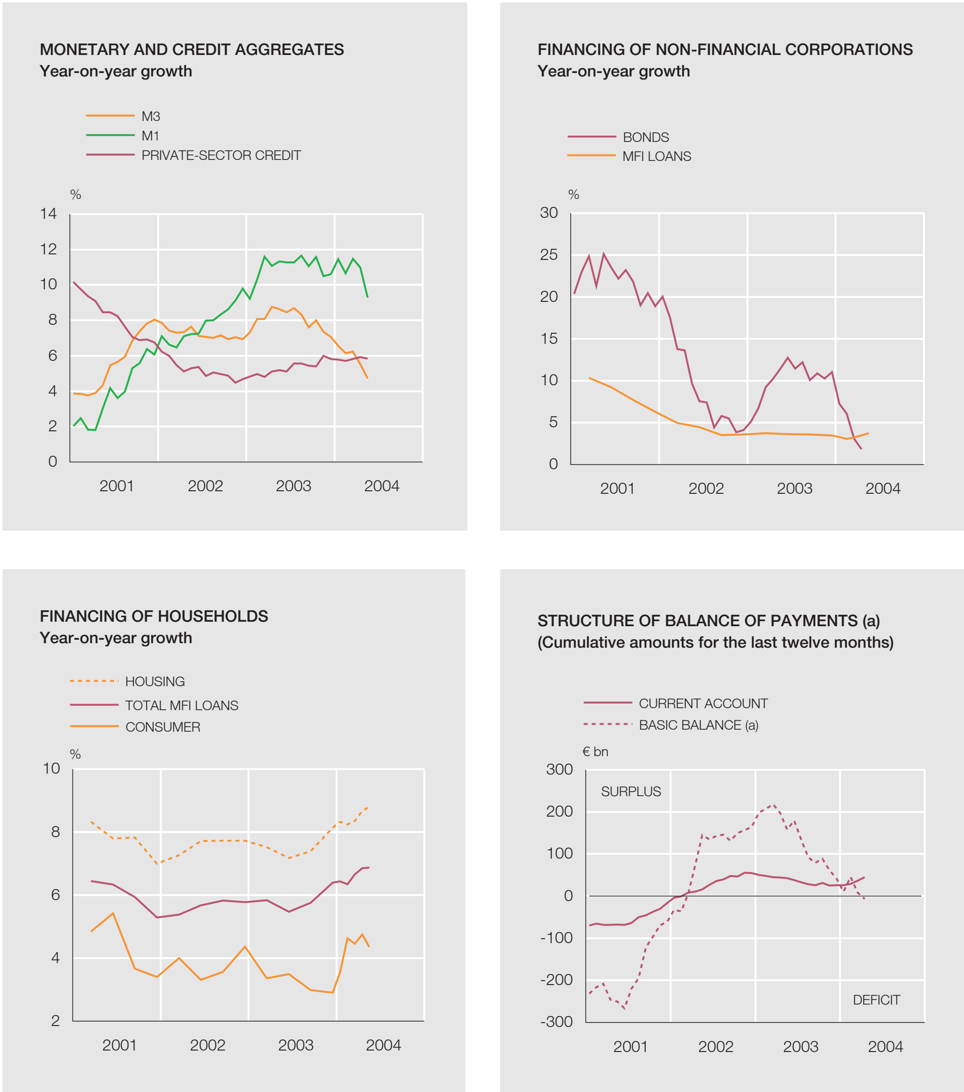
On the foreign-exchange markets, the euro, after depreciating moderately in Q1, appreciated slightly in the following months to somewhat over $1.2 per euro, in line with the exchange rate observed at the start of the year. In nominal effective terms, the euro has held relatively stable in the period from April to July.

During the quarter, equity market prices in the euro area oscillated without a clear trend. In this respect, the broad-based Dow Jones Euro Stoxx index fell back considerably in the first half of July, losing virtually all its gains in the year to date (see Chart 13). The industries posting the most significant gains in Q2 were energy, commodities and the network industries, while the heaviest falls were in technology, telecommunications and the financial sector.

In April and May, the rate of increase of the M3 monetary aggregate fell markedly, following the trend observed since mid-2003 (see Chart 14). In May, the year-on-year growth rate of M3 was 4.7%, almost 1.5 pp down on the rate in March. A new development was the fact that the demand for the most liquid components of M3 also slowed sharply in this period, although it continued to increase at higher rates than the broadest aggregate, insofar as the opportunity

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS

CHART 14



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.

cost of holding very liquid assets remains low. The year-on-year rate of increase of lending to the private sector held stable in April and May, in line with the trend in the previous months. Credit to non-financial corporations quickened slightly in April and May compared with Q1, rising to a rate close to 4%. By contrast, the increase in bank lending to households held steady, since the buoyancy of loans extended for house purchases was offset by a slight slow-down in the financing of consumer goods. In Spain, lending to non-financial corporations and to households has continued to post far higher rates than those in the euro area as a whole.

4 The Spanish economy

As discussed in previous chapters, the international economic picture in the first half of 2004 was shaped by the firming expansion in the United States and Asia, while at the same time the signs of recovery in the euro area tended to strengthen. Against this background, following year-on-year growth of 2.8% in the first quarter of the year, Spain's GDP is estimated to have risen by 2.6%[1] in real terms in 2004 Q2, down 0.2 pp on the previous quarter (although quarter-on-quarter growth seems to have remained at 0.6%). The lower year-on-year growth in Q2 – which, nevertheless, again exceeded the euro area average – was the result of a higher negative contribution from external demand (0.3 pp more negative than in Q1), along with a growth rate of domestic demand that tended to stabilise or to increase slightly (see Chart 15). Noteworthy within domestic demand was the quicker year-on-year pace of gross capital formation (driven by investment in capital equipment and by the contribution from stockbuilding), partly offset by the slowdown in private consumption, although this latter aggregate continued to grow at a sustained rate, underpinned by job creation. In the external sector, both exports and imports of goods and services slowed in 2004 Q2, although imports faltered by less.

From the standpoint of value added, the moderate deceleration of GDP in 2004 Q2 seems to have resulted from less expansionary behaviour of market services (which may reflect, among other things, some impact on tourism by the 11 March attacks in Madrid) and from more stable behaviour of activity in construction and in industry, although there were certain signs of weakness in the latter. Employment is estimated to have grown at nearly 2% in 2004 Q2, clipping a few tenths of a percentage point from the Q1 rate. Employment in the market economy grew slightly faster than in the economy as a whole, although it also showed a slight deceleration; this seems to have been compatible with a recovery in apparent labour productivity, following the contractionary behaviour observed in 2003.

The recovery in labour productivity drove the deceleration of unit labour costs in the opening months of 2004, which is estimated to have lasted through Q2 despite the fact that the QNA continued to show high growth of compensation per employee. Notably, unlike in Q1, the reduction of domestic inflationary pressure in Q2 was not accompanied by favourable developments in import prices. These reflected pressure in the markets for oil and other commodities, against a backdrop of higher stability in the euro exchange rate, and they tended to rise. Partly as a consequence of this, final prices quickened sharply in 2004 Q2 and the inflation rate, measured as the pace of year-on-year GDP growth, rose from 2.1% at the end of Q1 to 3.5% in June.

4.1 Demand

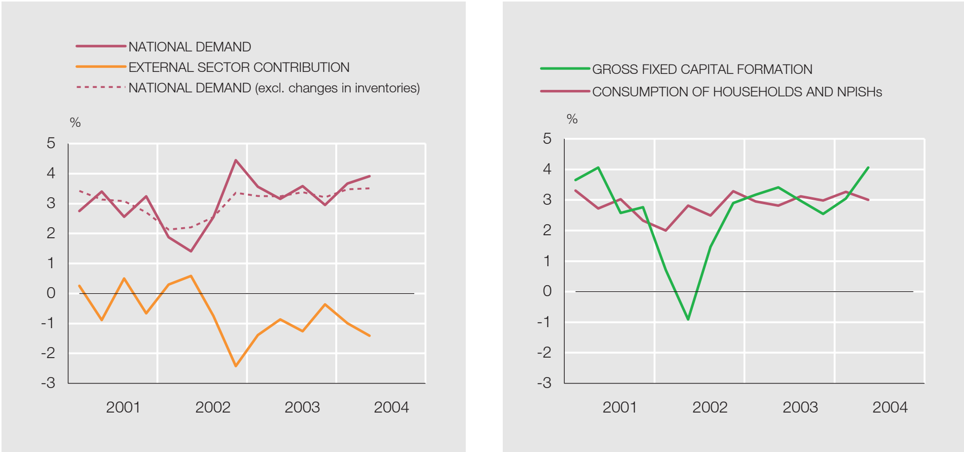
Household final consumption expenditure picked up in 2004 Q1 to a year-on-year growth rate of 3.3% in real terms. The latest information indicates that consumption remained strong in Q2, although its growth moderated somewhat. The firmness of private consumption in the first half of the year was underpinned by the growth in household disposable income and by fresh gains in household net real wealth, against a background of easy financial conditions and improving perception of the economic situation by consumers.

The available indicators nearly all point to a slight deceleration in consumption in Q2 (see Chart 16). The new synthetic indicator of goods and services consumption[2] reflects this dip

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

MAIN DEMAND AGGREGATES (a)

CHART 15



SOURCES: INE and Banco de España.

a. Year-on-year percentage change based on seasonally adjusted series.

extremely tenuously due to the sustained behaviour of the goods component. In particular, consumer durables have continued to grow rapidly, although the rate of expansion of new car registrations moderated in Q2. The retail sales index also slowed in April and May, with the most buoyant component being non-food goods. Similarly, the retail trade confidence indicator reflected less optimism in Q2 and the consumer confidence indicator deteriorated from May, although improving in terms of quarterly average based on sentiment regarding the general economic situation and the possibility of household saving.

As to the determinants of consumer expenditure, it is estimated that household disposable income continued to grow sustainably in real terms and may increase by more in 2004 than in 2003, despite the loss of purchasing power represented by the upturn in inflation in recent months. The contribution of general government to income growth seems to be more expansionary than in 2003, despite the petering out of the positive impact of the personal income tax reform in that year, owing to the growth of social benefits. To this trend in income should be added an increase in household property wealth due both to the growth of house prices and to the expansion of the stock of residential capital. In addition, the financial wealth of households benefited from the stock market rise in the first half of the year.

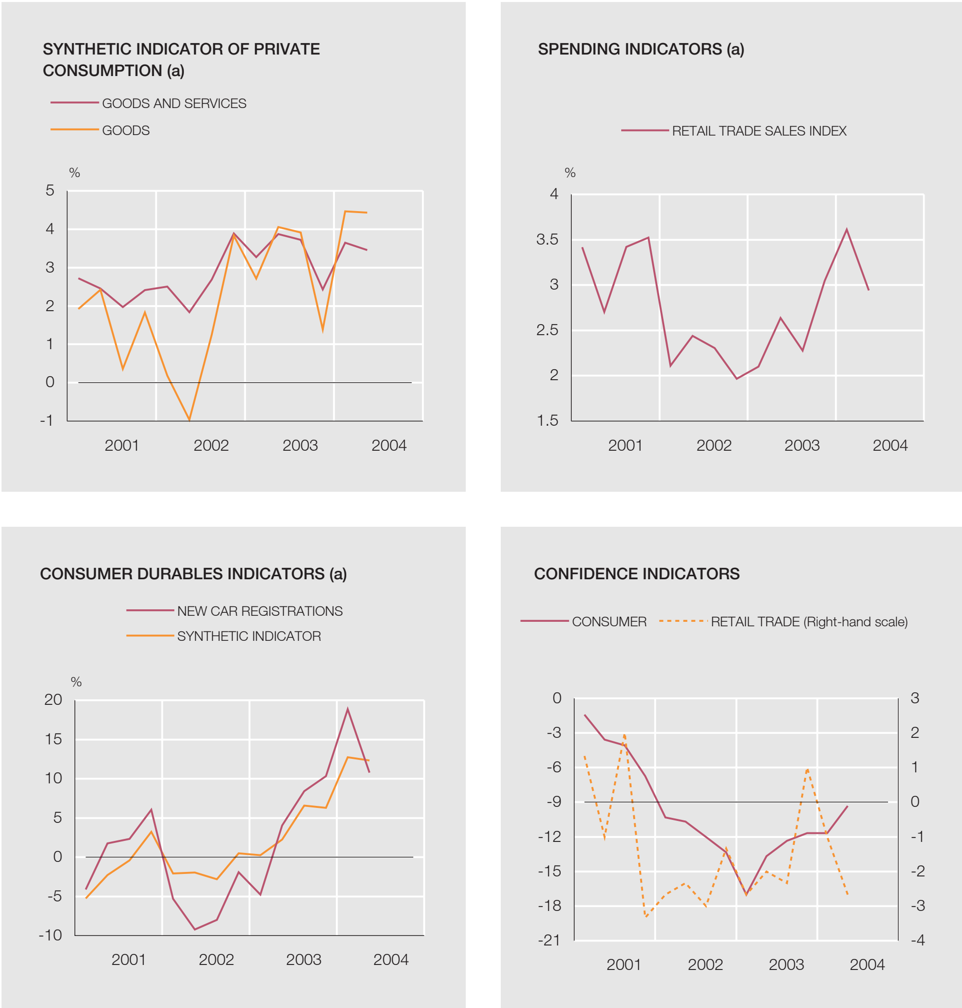
In 2004 Q1 the general government final consumption grew strongly by 4.7% year-on-year, 0.1 pp less than in 2003 Q4. The available economic information, which is still very incomplete, points to a slowdown in this aggregate in Q2 based on the containment of both personnel costs and other final consumption expenditure, according to State budget outturn data.

Gross fixed capital formation picked up in 2004 Q1 to a year-on-year growth rate of 3% in real terms, 0.5 pp higher than in 2003 Q4. This acceleration was due to the higher buoyancy of capital goods investment, which rose by 1.6% year-on-year, and, to a lesser extent, to investment in other products, which was up by 3.8%. The year-on-year growth rate of investment in construction held at 3.6%. The available economic indicators for Q2 point to a fresh acceleration in gross fixed capital formation, underpinned mainly by growth in capital goods investment.

2. The synthetic indicator of goods and services consumption is a new indicator compiled by the Banco de España. Its methodology will be described in an article to be published soon in the Economic Bulletin.

PRIVATE CONSUMPTION INDICATORS

CHART 16



SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.

The information on non-financial corporations up to 2004 Q1 compiled by the Banco de España's Central Balance Sheet Data Office (CBSO), in addition to confirming that activity recovered in this period, underpinned by the behaviour of services, shows that the financial position of firms has continued to improve and provides a good base for investment growth. The CBSO firms continued to post high returns as their personnel costs moderated in an environment of falling financial expenses. Thus gross operating profit grew by 7.2% in 2004 Q1 with respect to the same period of the previous year, while ordinary net profit was up by 17.4%.

The capital goods investment indicators show that the pace of growth in this type of investment rose in 2004 Q2 (see Chart 17). In particular, the indicator of apparent investment in capital goods compiled from still-incomplete information for this period shows growth rates higher than in Q1, underpinned by a very positive contribution from capital goods imports. There was also an improvement amongst the more representative indicators of demand conditions. Thus sentiment regarding industrial orders and those of capital goods producers improved in Q2, despite a minor fall-off in the capital goods business confidence indicator. The increased capacity utilisation in industry and the lesser excess installed capacity are also indicative of a more favourable climate for an upturn in investment.

GROSS FIXED CAPITAL FORMATION

CHART 17

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

a. Year-on-year percentage change based on the seasonally adjusted series.
b. Level of original series.

In 2004 Q1 construction investment grew by 3.6%, the same as in the previous quarter although more moderate than in the middle quarters of 2003. Part of the latest information on construction indeed seems to point to a resumption of the mild deceleration in this component of gross capital formation: the employment indicators for this industry – social security registrations and the number of unemployed – deteriorated in Q2 with respect to Q1, although their performance was more positive than in the second half of 2003. Furthermore, the construction materials production and consumption indicators worsened in the first two quarters of 2004. In any event, the ECIC construction industry survey confirmed that the real value of work by construction firms grew slightly faster in 2004 Q1, due mainly to civil engineering work.

Also, the building starts indicators provide evidence of a sustained growth rate in construction, since the increase in the new buildable floor area – obtained from building approvals signed mainly in 2003 – suggests a continuing high rate of residential building in 2004, although non-residential construction will foreseeably grow more moderately. The slowdown of housing starts in 2004 Q1 may be in anticipation of a deceleration in investment next year. In the case of civil engineering, the value of tenders called by general government and State-owned enterprises picked up notably in 2004 Q1, so significant growth in this type of investment may be expected in the coming quarters.

FOREIGN TRADE
Percentage change on year ago

CHART 18

Sources: INE, Ministerio de Economía, Ministerio de Hacienda and Banco de España.

a. QNA data at constant prices.
b. Deflated seasonally adjusted series.
c. Seasonally adjusted series.

According to QNA results, investment in inventories made a positive contribution of 0.2 pp to year-on-year growth of GDP in 2004 Q1. In Q2, the information provided by the business survey seemed to be consistent with lower stockbuilding of finished products than in the previous quarter. However, the quarter-on-quarter slowdown in stockbuilding seemed to be compatible with a further improvement in its contribution to year-on-year GDP growth.

As stated above, net external demand trimmed 1 pp from year-on-year output growth in 2004 Q1, compared with a contribution of –0.4 pp in the preceding quarter. This was the result of a pick-up in goods and services exports, whose year-on-year growth rate was 4.1%, and of faster growth in imports, which reached a year-on-year rate of change of 6.7% (see Chart 18). The growth of foreign sales in this period was in line with that of world trade, which expanded at rates near 7%, prolonging the accelerating path apparent since the second half of 2003. The most expansionary markets were those of south-east Asia, central and eastern Europe and certain of the major Latin-American countries, driven by the significant growth of the US and Japanese economies. However, the euro area countries, which are Spain's main trading partners, posted growth rates that were still moderate. These circumstances, however, did mean that the increased share in world trade achieved by Spanish exports in 2003 was consolidated, despite the sharp loss of competitiveness of Spanish goods due to the strength of the euro in that period. The available information for Q2 points to an even more contractionary contribution from net external demand, since foreign sales slowed, reflecting in part the high levels reached in the same period of 2003, while imports continued to grow quickly, although at a somewhat lower rate. This behaviour is not consistent with the change in the differential between domestic and external demand, and could thus be a sign of competitiveness problems.

According to the QNA, goods exports grew by 6.2% year-on-year in 2004 Q1, showing a recovery with respect to the previous year. The customs information for April and May indicates that this recovery seems to have been interrupted in Q2, as foreign sales of goods declined by –0.9% in real terms. Given the volatility that characterises trade flows, this figure must be viewed with some caution, although it should be mentioned that this weakness would be consistent with the slowness of the euro area's recovery and with the loss of competitiveness vis-à-vis other markets. In the period January-May, goods exports increased by 3.8%, against 6.2% on average in the previous year. In this period sales to Community markets slowed to 3.5% in real terms, with those to France, Germany and Italy being notably sluggish, while those to Portugal strengthened. Extra-Community exports continued to grow at a relatively fast pace of 7.6% in real terms, although they too slowed. Sales to the main new members of the EU-25 were extremely buoyant, as were those to China and Morocco, while exports to the NICs and the United States continued to be weak. Disaggregation by product group shows that the exports that grew most in the period January-May were those of capital goods (11%), while those of consumer goods slowed, basically due to the unfavourable performance of car and other durable goods sales. Sales of non-energy intermediate goods recovered somewhat in the early months of 2004.

2004 Q1 saw a prolongation of the mild growth in real tourism receipts since the second half of the previous year. However, both the nominal and real tourism indicators, which had reflected a significant recovery of the first two months of the year, flagged notably from March onwards. Q2 was very weak in regard to foreign travellers staying at hotels and, in particular, to overnight stays, the indicator that most closely reflects real tourism expenditure, which in the first six months of the year showed cumulative year-on-year growth rates of 0.3% and –3.3%, respectively. The number of tourists entering Spain, which had recovered somewhat in May, behaved poorly in June, with cumulative growth in the first six months of the year standing at 2.2%. The keynotes by country of origin were a deceleration in UK tourism, a sluggish German market and a sharp recovery in tourism from Portugal. It is likely that these figures partly reflect circumstantial effects still related to the impact of the 11 March attacks in Madrid and to the poor Easter weather. Against this background, the gradually improving confidence of European consumers in the last few months and the expectations of recovery in domestic demand in the second half of the year should soon lead to a recovery of foreign tourism demand. However, whether this industry can get back onto a more buoyant path will depend on its ability to become more competitive. In this connection, the recent worsening of the tourism confidence indicator, which factors in a negative outlook for the summer, seems to be pointing to the need for improvement in this respect. Meanwhile, non-tourism services continued to perform negatively in 2004 Q1, although they declined more slowly than in the previous quarter, as shown by the behaviour of the nominal balance of payments indicator.

The growth rate of imports quickened considerably in Q1 to 7.9% from 4.2% in the previous quarter. Customs data indicate that this trend persisted in April and May (rises of 6% in both months). The growth resulted from a surge in purchases of non-food consumer goods and, in addition, from the strong performance of capital goods. In the first five months of the year, the imports showing the sharpest growth with respect to the previous year's average were purchases of consumer goods (17.3%) and of capital goods (14.1%). Finally, real services imports rose by 0.7% in 2004 Q1, putting an end to their downward course of the second half of the previous year. Within services, tourism grew most (20.2%), while imports of non-tourism services continued to decline, albeit at a slower rate, in line with the improving profile shown by the nominal balance of payments indicator.

4.2 Output and employment

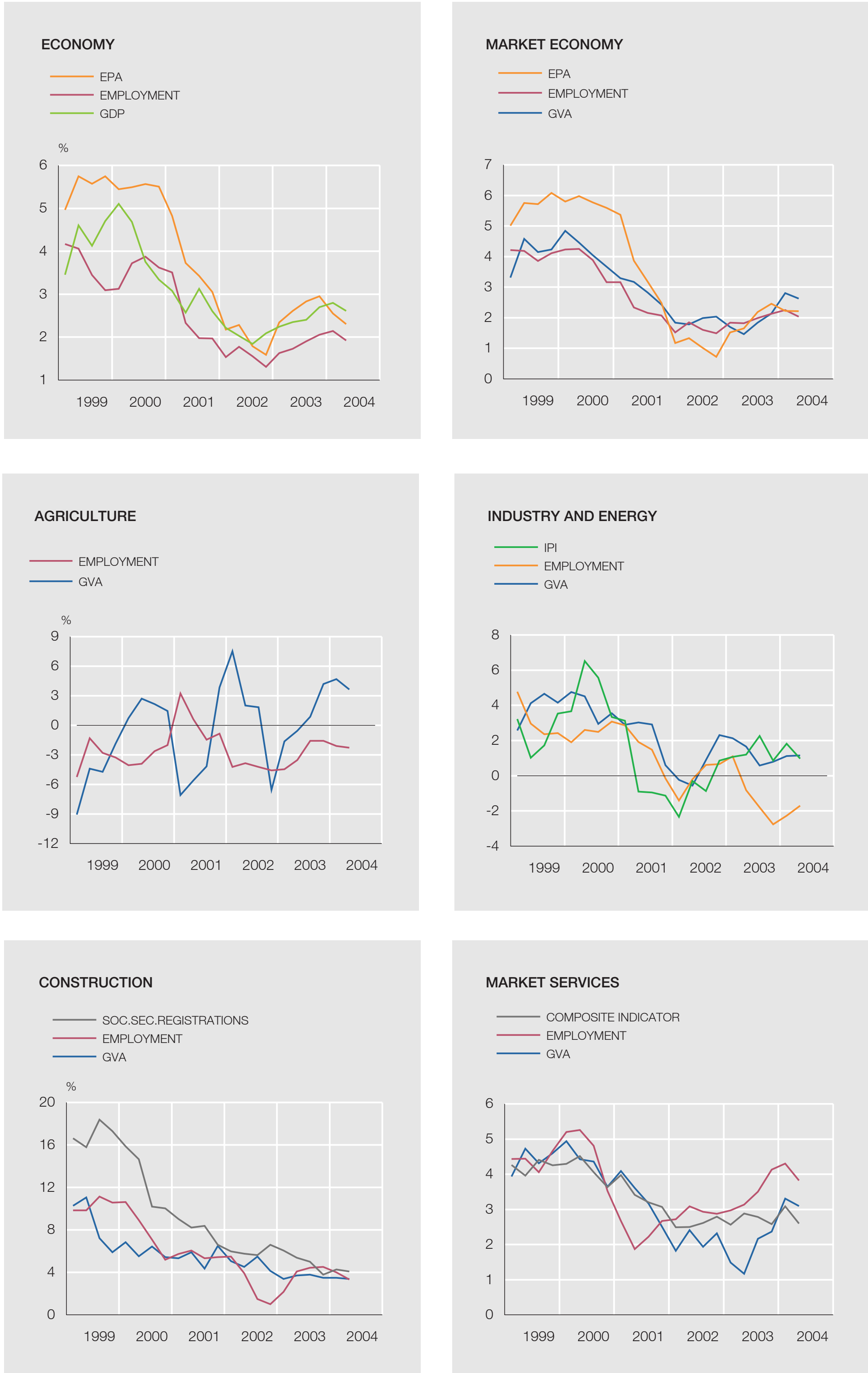
As mentioned at the beginning of this chapter, 2004 Q1 saw a recovery of activity in the main productive branches, with the exception of construction; this improvement seems to have moderated slightly in Q2 (see Chart 19). Fishing and agriculture began 2004 with great vigour, continuing on the accelerating path of 2003. Animal products regained vigour in the opening months of the year, following the slowdown in 2003, and likewise vegetable products. The outlook of the latter has improved substantially since the previous report, given the abundant rainfall in spring, especially in April and May, which was 9% higher than the average historical level; by contrast, June rainfall was scant. However, the various crops fared unevenly: while cereals are progressing well, fruit production has fallen, in some cases, such as almonds, by a considerable amount.

The progressive sluggishness characterising industry and energy since 2003 Q2 ended in 2004 Q1 when value added picked up slightly to year-on-year growth of 1.1%, fuelled by livelier domestic and external demand. This rebound in industrial activity tended, however, to peter out during Q2 in a context of weaker external demand. Although the confidence indicator for the sector improved slightly in Q2 as orders grew, June saw a deterioration; also, the Purchasing Managers' Index has declined in recent months. Meanwhile, the IPI tended to decelerate in April and May, recording lower year-on-year growth than in Q1. All the components of this production index (both intermediate and investment goods production and consumer goods production) contributed to its loss of buoyancy, although their growth rates were uneven. Industrial employment continued to show negative growth, although the rate of decline was lower than in Q1.

In the opening months of 2004, construction retained the buoyancy shown in 2003 Q4, with value added growing at 3.5% year-on-year. It thus continued to be the most buoyant branch of activity, in line with the pattern of recent years. According to the available conjunctural information, the performance of construction in Q2 seems to have been similar to that in Q1. Although the intermediate consumption indicators – apparent consumption of cement and production of construction materials – slowed in April and May, this may have been due to the abundant rainfall in those months, discussed above in relation to agriculture, which hindered construction work; indeed, construction companies consider that weather conditions have become more important as a factor limiting production. Employment indicators also slowed in spring, although unemployment growth moderated notably in June, coinciding with the end of the period of adverse weather. The confidence indicator published by the European Commission recovered in Q2, while the leading indicators heralded relatively expansionary behaviour in this period.

Activity in the services sector picked up in the early months of 2004, continuing the process initiated in the second half of 2003. The year-on-year growth estimated by the QNA for Q1 was 3.4%, 0.7 pp more than in 2003 Q4, which was the result of movements in opposite directions by its two components. Non-market services slowed by 0.4 pp, which left their growth rate at 3.5% and cut short the continuously accelerating path that had characterised them in 2003. The rate of change of market services, however, rose by 0.9 pp to 3.3%. Nonetheless, this upturn in activity did not continue in Q2, according to the most recent information.

GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 19



SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Year-on-year percentage rates based on 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.

The composite market services indicator (ISIS) lost force in that period, while in April and May the number of social security registrations showed slower year-on-year growth than in the first three months. Only the confidence indicator of the sector followed a rising path between April and June. There was a fairly widespread slowdown among the activities that comprise market services. The buoyancy of services to trade and repairs declined, as shown by social security registrations and the retail sales index. Those to hotels and restaurants also saw a loss of buoyancy, which was reflected in slower social security registrations and in the tourism indicators already mentioned above. By contrast, transport, storage and communications showed signs of a certain vigour in Q2, as shown by the indicators of number of travellers. Finally, property, rental and business activities retained the buoyancy reached three months earlier, as inferred from social security registrations, which also rose in the IT and R&D sectors.

Employment growth held steady in 2004 Q1 at 2.1%, in terms of full-time equivalent jobs, thereby breaking the accelerating trend of 2003. Consequently, apparent labour productivity in the economy as a whole grew by 0.6%, in line with the increase seen in 2003. In the market economy, the number of persons employed grew slightly faster in Q1. This, however, was compatible with a recovery in productivity, which was up by 0.5% year-on-year, due to the acceleration of gross value added. The sustained employment growth based on QNA figures in 2004 Q1 does not, however, agree with the employment figures given by the Spanish Labour Force Survey (EPA), according to which growth stood at 2.6%, down 0.4 pp on 2003 Q4. By contrast, the growth of social security registrations held at the end-2003 rate (2.9%). A broader picture of recent changes in the labour market in Spain, comparing it with that in other European countries, is given in Box 3.

From the available information, it is estimated that year-on-year employment growth in 2004 Q2 was somewhat lower than in the previous quarter, enabling a mild recovery in productivity gains despite the minor slowdown in activity. The EPA results for Q2 attest to this, since they show that the number of persons employed rose by 2.3% in this period, 0.3 pp less than in Q1. Social security registrations also slowed in Q2 to 2.6%, while National Employment Office (INEM) hiring statistics showed the same acceleration that had been recorded in the previous quarter, with year-on-year growth close to 14%.

By branch of activity, the National Accounts data for Q1 showed that in certain cases the previously existing trends were broken (see Chart 19). Thus industrial employment continued to fall, but at a more moderate rate, to –2.3%, benefiting from the somewhat more positive performance of value added. On EPA data, in Q2 the fall in industrial employment continued to moderate. In construction, employment ended up reflecting the slowdown in activity seen at the end of 2003, as its year-on-year rate of change fell by 0.5 pp to stand at 4% in the opening months of 2004; this trend continued in Q2. In agriculture, jobs were being shed at an increasing rate throughout the first half of 2004. Finally, in the tertiary branches as a whole, employment grew by 3.5% in Q1, a larger rise than in the previous quarter. The behaviour in market and non-market services differed: the number of persons employed in the former continued the recovery seen in 2003, with a year-on-year increase of 4.3%, while non-market services saw a minor decrease in the rate of change (1.7%). Employment in services slowed in Q2.

The modest slowdown in the number of wage-earners in Q1 (growth of 2.4%) was similar to that reported by the EPA, although less sharp. By contrast, the number of non-wage-earners showed positive rates of change (1%), after having fallen in the previous two years. These opposite trends were also seen in Q2, according to the EPA. Analysis by contract term shows that the slowdown in dependent employment passed through both to employees on perma-

This Box analyses the recent behaviour of the labour market in Spain in comparison with the other European countries, based on the results of the Labour Force Survey, and completes, with updated 2003 data, the article (only in Spanish) on this subject published in the July-August 2003 *boletín económico*. First, it describes the relative behaviour of Spain in terms of participation, employment and unemployment rates compared with the aggregate of the European Union (EU) countries[2], and second, it analyses some of the main differences between Spain and the other European countries in regard to their employment characteristics.

Between 1997 and 2002 Spain narrowed the gap between it and the other European Union countries in terms of participation, employment and unemployment rates, particularly the latter[2]. Thus the 1997 negative participation and employment rate gaps of 6.2 pp and 12.5 pp, respectively, decreased to 4.2 pp and 6.5 pp in 2002. The positive unemployment rate differential was 11.2 pp in 1997, while in 2002 it had decreased to 3.8 pp. The Spanish labour market in 2003 enabled this process of convergence to continue and the differentials narrowed somewhat more. It should be kept in mind that in 2003 the European labour markets were feeling the effects of weak economic activity and practically inexistent job creation, whereas Spain was experiencing a rebound in job creation following the deceleration in 2002.

1. The comparisons are made with the aggregate of the 15 countries belonging to the European Union in 2003 except Spain.
2. It should however be noted that the change in the operating definition of unemployment incorporated into Spanish data in 2001 meant that the upward path of the participation rate was temporarily detained and that the employment rate moved towards those of the Community countries more quickly than it would have in the absence of this methodological change.

Last year Spain's employment rate rose by 1.2 pp to 59.6% of the working-age population, while in the EU it held steady at 64.9%. Given that the employment rate can be broken down into the product of the participation rate and the inverse of the unemployment rate, these statistics show that this behaviour was principally due to faster growth of the participation rate in Spain in 2003, although the unemployment rate also slowed. Specifically, in 2003 the Spanish participation rate grew by 1.3 pp to 67.1%, while in the EU this ratio rose by 0.4 pp to 70.4%, thereby reducing the differential to 3.3 pp. For its part, the unemployment rate grew very slightly in Spain (by 0.1 pp to 11.2%), while worse behaviour was seen in the other EU countries, with growth of 0.4 pp to 7.7%. This behaviour contrasts with 2002, when unemployment grew faster in Spain than in the rest of Europe for the first time since 1997.

Analysis by population group showed that the convergence of employment rates in 2003 was most marked in women and younger workers, although the better relative behaviour in Spain was fairly general. Specifically, in women, although the negative gap in their employment rate still remained high at 11.4 pp, it narrowed by 1.6 pp in 2003 thanks to a more rapidly increasing female participation rate and to the better relative behaviour of unemployment in Spain. In men, the 2003 employment rate of 73.1% was 0.6 pp higher than the average in the other Community countries. Analysis by age shows that in workers below age 30 the employment rate differential was 3.5 pp in 2003, two percentage points less than in the previous year. However, this gap narrowed very modestly among older workers above age 45, for whom the employment rate stood at 54.6%, 5.9 pp below the Community average, meaning that the differential was trimmed by only 0.2 pp. This scant relative improvement reflected the

BEHAVIOUR OF THE LABOUR MARKET IN SPAIN AND THE EU (a)

	1997	2002	2003
Employment rate (%)			
Spain	49.1	58.4	59.6
EU except Spain	61.6	64.9	64.9
Female employment rate (%)			
Spain	34.4	44.0	45.9
EU except Spain	52.5	57.0	57.3
Male employment rate (%)			
Spain	64.0	72.8	73.1
EU except Spain	70.8	72.9	72.5
Employment rate, below age 30 (%)			
Spain	36.9	47.7	48.6
EU except Spain	50.7	53.2	52.1
Employment rate, age 30 to 44 (%)			
Spain	64.4	72.9	73.9
EU except Spain	77.5	80.1	80.0
Employment rate, age 45 or more (%)			
Spain	47.0	53.5	54.6
EU except Spain	56.0	59.6	60.5

	1997	2002	2003
Participation rate (%)			
Spain	62.1	65.8	67.1
EU except Spain	68.3	70.0	70.4
Unemployment rate (%)			
Spain	21.0	11.1	11.2
EU except Spain	9.8	7.3	7.7
Impact of long-term unemployment (%)			
Spain	51.8	34.3	33.9
EU except Spain	47.8	41.2	42.6
Ratio temporary to total employees (%)			
Spain	33.7	31.2	30.6
EU except Spain	10.3	11.1	10.8
Ratio temporary to total employees, below age 30 (%)			
Spain	75.3	64.8	63.8
EU except Spain	32.0	34.8	34.8
Ratio of part-time to total employees (%)			
Spain	8.0	7.9	8.1
EU except Spain	17.3	18.8	19.4

SOURCE: EUROSTAT.

a. Labour Force Survey. Population aged 15 - 64, unless stated otherwise.
b. Not including the Netherlands.

COMPARATIVE BEHAVIOUR OF THE SPANISH LABOUR MARKET IN THE EUROPEAN ENVIRONMENT IN 2003 (CONT.)

BOX 3

progress achieved in the other European countries in this population group, since it was the age group whose employment rate rose last year.

Turning to the impact of long-term unemployment (the proportion of the unemployed that has not worked for more than one year), in 2003 there was a further reduction in Spain, thereby prolonging the trend seen since 1997. This put the ratio at 33.9% of unemployed workers, 8.7 pp below the Community average. The long-term unemployed are among the main beneficiaries of policies to promote permanent employment, and this seems to have notably reduced their weight among total unemployed workers.

Finally, regarding the main characteristics of jobs, in 2003 the difference between Spain and the other Community countries increased as regards the relative importance of part-time employment, and there was a further, although slight (0.3 pp), convergence in temporary work. However, the differences are still large in this respect and the ratio of temporary to total jobs in Spain was practically triple the average in the other European countries. The convergence in 2003 was caused by a reduction in Spain among the group with the highest rates of casual employment – those below 30 years of age – since the ratio decreased by one percentage point in Spain and rose slightly in the EU. In any event, for this age group the gap was 29 pp in the past year. Part-time employment again showed no pick-up in Spain since, although it rose by 0.2 pp in 2003, its weight in total employment (8.1%) is practically the same as in 1997. In comparative terms, since in 2003 the ratio of part-time to total jobs in the other Community countries rose by 0.6 pp, the differential with Spain again rose slightly, this time to 11.3 pp.

nent contracts and to those on temporary contracts. The year-on-year rate of change of the latter was 1.4%, nearly one percentage point less than in Q1. The number of workers on permanent contracts grew by 2.6%, down 0.4 pp on the previous quarter. As a result, the ratio of temporary to total employees decreased by 0.2 pp with respect to 2003 Q2, standing at 30.4% between April and June 2004. The information on INEM contracts coincides partially with these figures, since it shows that in Q2 both permanent contracts and fixed-term contracts increased, which was compatible with an increased weight of permanent contracts in the total. However, the lower proportion of temporary contracts did not give rise to a decrease in labour turnover, which may reflect a shortening in the effective term of these contracts.

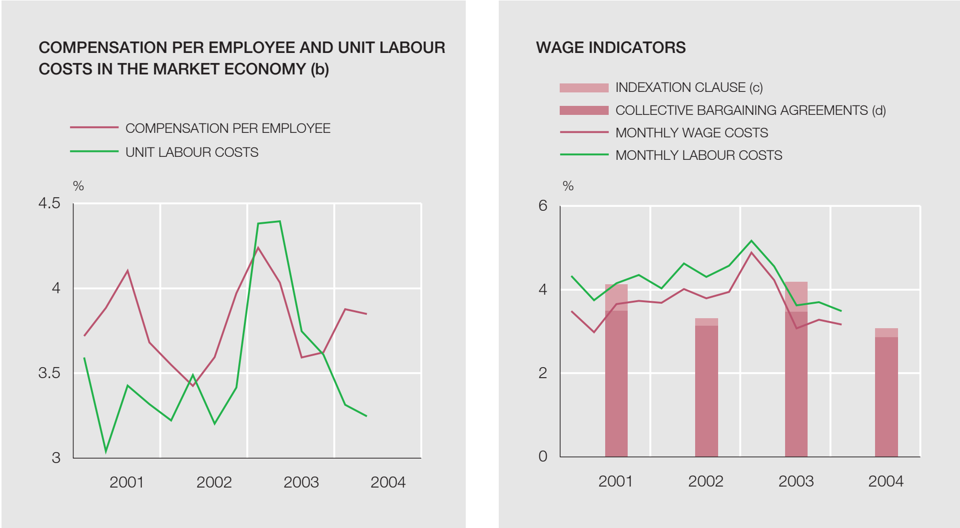
Labour force growth decelerated in the first two quarters of 2004, although remaining at a high level. In year-on-year terms, it grew at 2.1% between April and June, down 0.1 pp on the previous quarter and down 0.5 pp on 2003. Consequently, the participation rate grew more moderately in the first half, at 55.7%, which in any event is 0.8 pp more than in the previous year. The participation rate calculated for the population aged below 65 behaved similarly, stabilising at 69%. The participation rate of women reached 44.5% narrowing the gap with the male rate, although its pace moderated appreciably. Among men, the participation rate grew more moderately, standing at 67.6%. Finally, given the behaviour of the labour force and of employment, the unemployment rate stood at 10.9%, down 0.2 pp on that in spring 2003, thereby making for a milder year-on-year decline. In fact the number of unemployed grew by 0.4% with respect to its level a year earlier. The unemployment recorded in INEM's offices accelerated in Q2, showing year-on-year growth of 2.4%, although the June data represented a significant moderation in the unemployment growth rate.

4.3 Costs and prices

On QNA data, in 2004 Q1 the growth rate of labour costs per unit of value added held steady at 3.5% in the economy as a whole. This was the result of an increase of 4.2% in compensation per employee, similar to that in the previous quarter, and a rise in productivity (calculated in GDP terms) of the same size as in 2003 Q4 (0.6%). In the market economy, however, unit labour costs slowed at the beginning of 2004, as the recovery of apparent labour productivity fully offset the acceleration which, according to the QNA, occurred in compensation per employee (see Chart 20). In Q2, the estimated growth rate of unit labour costs in the market

WAGES AND LABOUR COSTS (a)

CHART 20



SOURCES: Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Percentage change on same quarter a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Previous years indexation clause.
d. Settlement in the year to date.

economy continued to fall, aided by a fresh gain in apparent labour productivity and, possibly, by a certain downturn in the growth of compensation.

The quarterly labour costs survey detected changes in certain features. According to this survey, the average monthly labour cost per employee increased by 3.5% in 2004 Q1, down 0.2 pp on the previous quarter. This variation affected both the wage component and other costs, in such a way as to maintain the difference between the growth rates of these two components: 3.2% and 4.4%, respectively. Analysis by branch of activity showed that labour costs slowed in construction and in market services, growing by 6% and 2.9%, respectively. By contrast, in industry they accelerated to 4.3%, against 3.9% in the previous quarter.

The data on collective labour agreements up to 31 May showed that they incorporated an average wage increase of 2.9%, 0.6 pp less than the increase in 2003 (before including indexation clauses). These agreements now apply to more than 4.7 million workers, most of whom are subject to revised agreements. In newly signed agreements, the number of which grew in May, the negotiated wage growth of 3% is compatible with the Intersectoral Agreement for Collective Bargaining, renewed in 2004.

Although the growth of labour costs held steady in 2004 Q1, the GDP deflator (a measure of domestic cost pressure on final prices) decelerated by two percentage points, showing an advance of 4%, while in the market economy the growth rate of the value added deflator also decreased, standing at 4.2%. Thus the surplus per unit of output in market activities as a whole continued to widen (see Chart 21), although the chart shows that sectoral unit margins are behaving unevenly. In industry the margin per unit of output is estimated to have continued to widen in the first half of 2004, albeit less strongly than at the end of 2003, against a background marked by a decelerating value added deflator and by accelerating unit labour costs. In construction, by contrast, the deflator grew rapidly and steadily, thereby prolonging the expansion of the unit margin. Finally, the growth of the deflator and of unit labour costs in market services tended to converge, putting an end to the stage of narrowing surplus per unit of output seen in previous quarters.

PRICES AND COSTS BY BRANCH OF ACTIVITY (a)

CHART 21

SOURCES: INE and Banco de España.

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

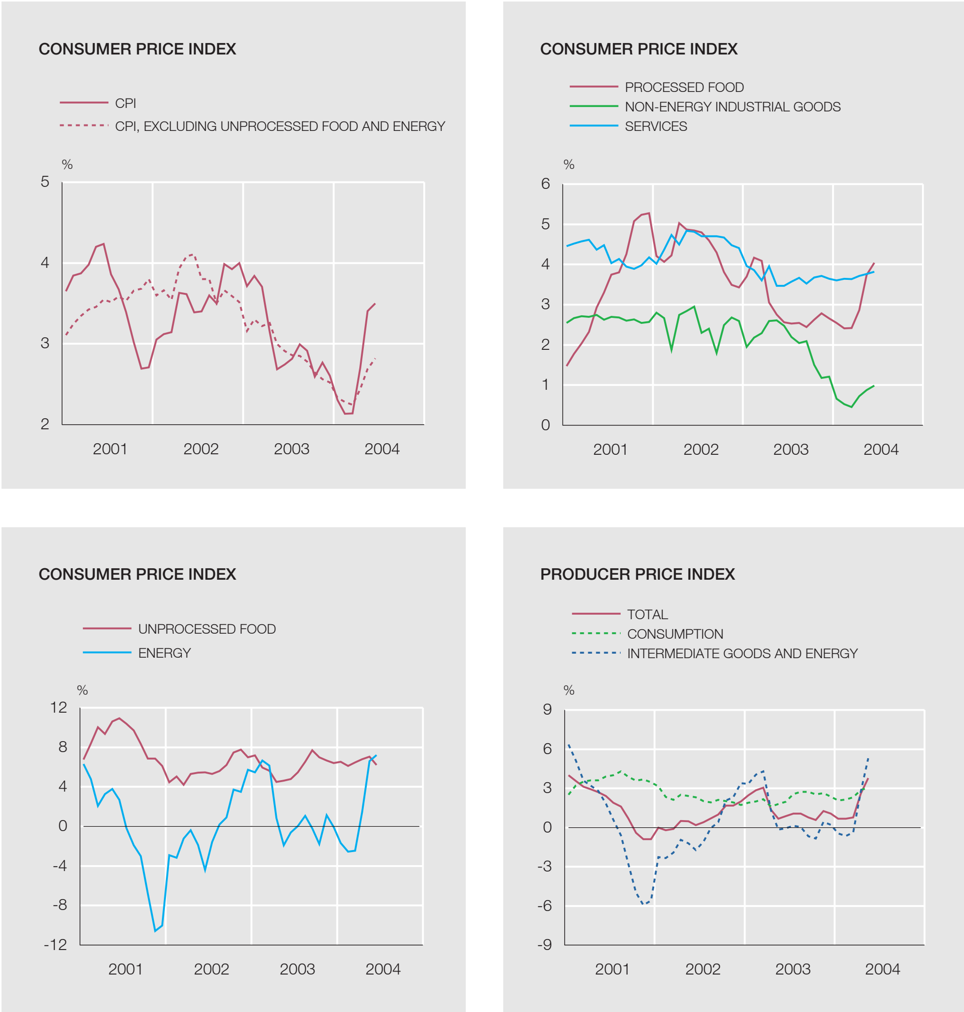
The import deflator, which reflects external pressures on prices, behaved moderately in Q1, resuming the path of falls that characterised it in the middle months of the previous year, aided by the appreciation of the euro. However, in Q2 import prices rose, against a background of greater exchange rate stability and of renewed tension in the oil market. For its part, the final demand deflator slowed in Q1, its year-on-year growth falling by 0.3 pp to 2.9%, and accelerated slightly in Q2 in response to heightened external price pressures.

Among the components of the final demand deflator, the private consumption deflator slowed by 0.3 pp in Q1 to 2.7% in year-on-year terms. This behaviour was less moderate than that shown in the same period by the CPI, the main indicator of these prices. Indeed, year-on-year CPI growth fell to 2.2% in the first three months of the year, against 2.7% in the previous quarter. However, this indicator recouped its buoyancy in 2004 Q2, during which its year-on-year rate increased sharply, standing at 3.5% in June. This deterioration was a result of faster growth of food prices and, in particular, energy prices (see Chart 22). Accordingly, the CPI excluding unprocessed food and energy (one of the customary measures of core inflation) accelerated more moderately than the overall index, its year-on-year rate standing at 2.6% at the end of Q2, only 0.1 pp more than in March.

By contrast, energy prices accelerated significantly. They went from a year-on-year fall of –2.5% in March to an increase of 7.2% in June, reflecting the pressure on oil prices in interna-

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

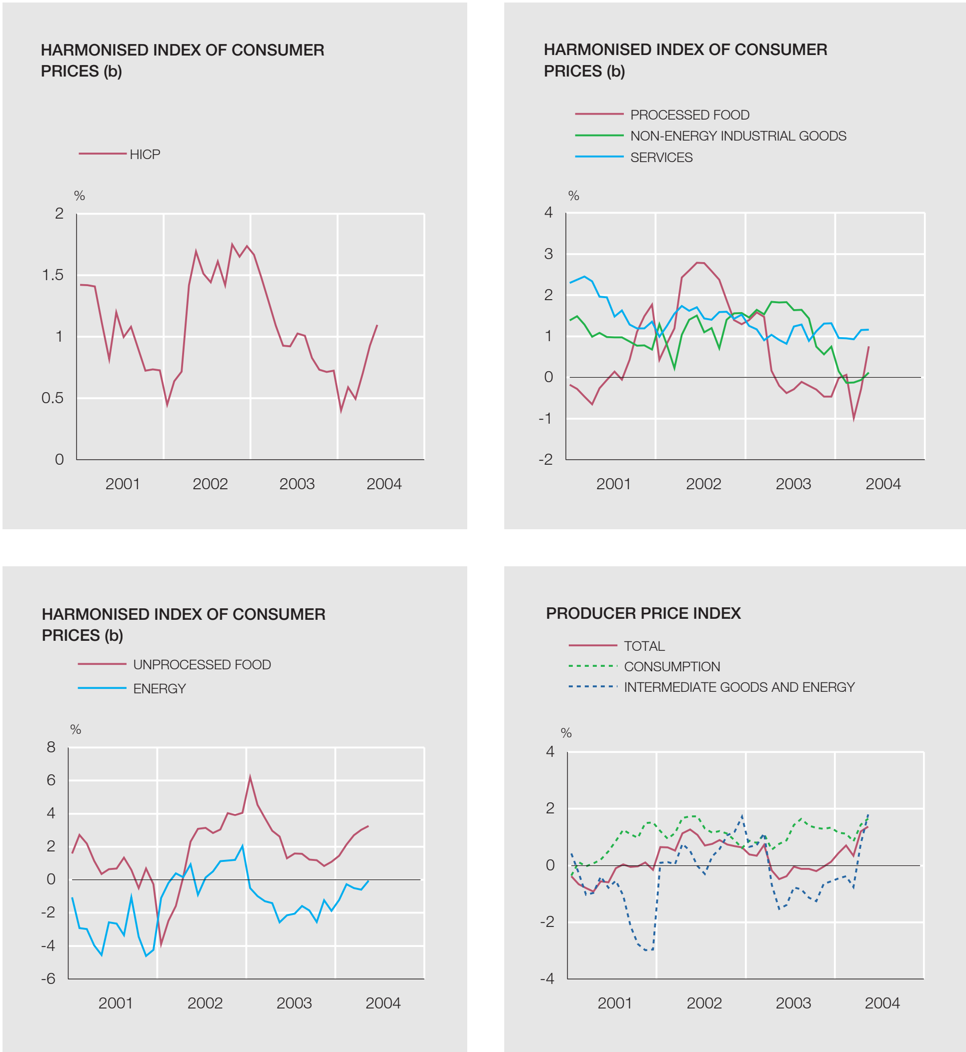
a. Twelve-month percentage change based on the original series.

tional markets, which rose to nearly $40 a barrel. The decrease in gas prices at the beginning of Q2 barely offset the sharp rise in fuel prices. In addition, the effect of these price hikes on the year-on-year rate is magnified because they are being compared with the energy price falls in spring 2003. There was also an acceleration in food prices, particularly those of processed food, basically due to higher tobacco and edible oil prices. Non-processed food prices again became more buoyant after a pause in Q1, holding at an elevated year-on-year rate of nearly 7%. The rate of change of non-energy industrial goods prices rose moderately, standing at 1% in June. Services prices also accelerated slightly, although in this case the year-on-year rate was much higher, since it stood at 3.8% in June.

In line with the CPI, Spanish inflation as measured by the HICP rose by 0.9 pp in Q2, which ended at 3.5%. Since the rise to 2.4% year-on-year in the euro area as a whole was lower, the inflation differential broadened notably to 1.1 pp at the end of 2004 Q2 (see Chart 23). This worsening of the inflation differential was manifest across all components, with the differential broadening most in unprocessed food because its prices accelerated in Spain and slowed in the euro area. The differential also deteriorated considerably in the case of energy and processed food, becoming unfavourable for the Spanish economy, due to the higher price accelera-

PRICE INDICATORS
Differentials vis-à-vis the euro area (a)

CHART 23



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.

tion in Spain. Finally, the differential broadened less in non-energy goods prices and in services prices as a result of their low acceleration in Spain and their stability in the euro area.

The growth of the producer price index (PPI) rose sharply in 2004 Q2, and the year-on-year rate of change was up to 4% in June. This acceleration was partly due to the unfavourable behaviour of energy production prices, to which must be added a baseline effect arising from the substantial falls recorded a year earlier. Other components also deteriorated notably, particularly consumer goods and non-energy intermediate goods. In the euro area, production prices performed unfavourably, albeit to a lesser extent. The year-on-year rate of change of the overall index rose to 2.4% in May, from zero growth in February. The fresh food producer price indicator deteriorated somewhat in 2004 Q2 with respect to the previous three months. Finally, hotel prices held relatively moderate, their year-on-year rate of change standing at 1.1% in June.

4.4 The State budget

The figures released on the State budget outturn up to June 2004, which were compiled by National Accounts methodology, show a deficit of €5.17 billion (0.7% of GDP), compared with

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2003	Percentage change 2003/2002	Budget 2004	Percentage change 2004/2003	Outturn JAN-MAR Percentage change	Outturn 2003 JAN-JUN	2004 JAN-JUN	Percentage change
	1	2	3	4=3/1	5	6	7	8=7/6
1. Revenue	109,655	1.1	110,496	0.8	0.6	48,031	47,670	-0.8
Direct taxes	56,510	1.8	58,087	2.8	-9.1	20,427	19,337	-5.3
Personal income tax	32,824	1.7	31,974	-2.6	-13.0	15,742	13,608	-13.6
Corporate income tax	21,912	2.3	24,109	10.0	…	3,915	4,587	17.2
Other (a)	1,774	-3.7	2,004	13.0	30.5	770	1,142	48.4
Indirect taxes	39,084	2.8	39,836	1.9	3.4	20,948	21,385	2.1
VAT	27,130	5.5	27,490	1.3	3.8	15,352	15,214	-0.9
Excise duties	9,787	-5.4	9,996	2.1	-1.3	4,556	4,960	8.9
Other (b)	2,167	10.6	2,350	8.4	18.1	1,040	1,211	16.4
Other net revenue	14,061	-5.6	12,573	-10.6	23.3	6,656	6,948	4.4
2. Expenditure	113,787	2.4	117,260	3.1	-1.1	54,924	54,407	-0.9
Wages and salaries	18,450	5.1	19,486	5.6	4.1	9,186	9,511	3.5
Goods and services	2,996	5.4	2,740	-8.6	49.0	1,351	1,789	32.4
Interest payments	19,788	4.9	19,047	-3.7	-20.7	9,491	7,638	-19.5
Current transfers	58,078	-0.4	58,859	1.3	6.2	28,526	29,123	2.1
Contingency fund	…	…	2,345	…	…	…	…	…
Investment	7,535	7.0	7,611	1.0	-9.0	3,374	3,310	-1.9
Capital transfers	6,940	7.5	7,172	3.3	6.2	2,996	3,036	1.3
3. Cash-basis balance (3=1-2)	-4,132	…	-6,764	…	…	-6,892	-6,737	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Revenue	110,449	1.9	…	…	-4.5	49,280	48,007	-2.6
Expenditure	112,566	0.7	…	…	5.0	52,068	53,174	2.1
Net lending (+) or borrowing (-) (c)	-2,117	…	-3,470	…	…	-2,788	-5,167	…

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.

€2.79 billion (0.4% of GDP) in the same period of the previous year (see Table 3). Box 4 discusses the budget outturn of the social security system. The fall in revenue slowed in Q2 to 2.6% in cumulative terms, while expenditure decelerated, ending the first half of the year with growth of 2.1%. It should be noted, however, that any comparison with 2003 figures is subject to factors that affect 2003 and 2004 differently. Firstly, in the first half of 2004 VAT and personal income tax refunds were made significantly earlier. Secondly, as regards this latter tax, withholdings from earned income were affected by the change in the timetable for the receipt from general government of tax withheld and by the fact that the reduction prompted by the tax reform did not have an impact on collection in the first two months of 2003.

The cash-basis data on the State budget outturn in the first half of 2004 show that the deficit decreased slightly to €6.74 billion, compared with a €6.89 billion cumulative deficit in the period January-June 2003. This reduction in the cash-basis deficit, which contrasts with the increase budgeted for the year as a whole, arose because expenditure fell somewhat more than revenue. The difference between the behaviour of the cash-basis balance and that based on National Accounts methodology arises mainly from the adjustment due to the differing methods of accounting for interest paid.

SOCIAL SECURITY BUDGET OUTTURN

BOX 4

The Social Security System posted a non-financial surplus of €6.87 billion to April 2004, €619 million (9.9%) higher than that recorded in the same period a year earlier and contrasting with the 9.7% lower surplus projected in the initial 2004 budget (see table below). This came about because receipts grew faster than payments and faster than projected in the budget.

Receipts from social security contributions increased by 7.2% to April. This pace of growth in the first four months of the current year represented a certain deceleration with respect to 2003, despite rates being increased in certain special regimes to finance the broader coverage of sickness. The number of social security registrations up to June 2004 rose by 2.8%, only slightly below the 3% growth recorded in the previous two years.

Expenditure on contributory pensions grew by 6.4% to April, which was below the budgeted rate for the year as a whole. The number of contributory pensions continued to rise very moderately, with an increase of 0.8% to April, slightly lower than budgeted and down on the previous year. Expenditure on sickness rose by 13.1% in the first four months of this year.

Contributions received by INEM (National Employment Office) rose by 7.5% in January, above the budgeted figure of 6.6%, while rebates on contributions in respect of employment-promoting contracts increased by 7% in January, compared with 21.4% in the budgeted projection.

INEM expenditure on unemployment benefits rose by 9.1% to June 2004, against an increase of 5.9% in 2003 as a whole. This was due to an increase in the percentage of coverage, which at 73.4% in April represented a fairly substantial rise on the end-2003 level. Accordingly, the number of beneficiaries grew by 6% in the first four months of 2004, compared with 3.2% average growth in the previous year, while registered unemployment rose by 2.7% to June 2004, practically the same as the 2003 average.

SOCIAL SECURITY SYSTEM (a)
Transfers to regional governments allocated (b)
Current and capital transactions, in terms of recognised entitlements and obligations

EUR m and %

	Budget			Outturn JAN-APR		
	2003	2004	% change	2003	2004	% change
	1	2	3=2/1	4	5	6=5/4
1 Revenue	77,096	82,221	6.6	26,900	28,895	7.4
Social security contributions (c)	72,174	76,753	6.3	25,130	26,932	7.2
Current transfers	4,294	4,672	8.8	1,566	1,688	7.8
Other (d)	628	797	26.8	204	275	34.7
2 Expenditure	73,187	78,691	7.5	20,648	22,024	6.7
Wages and salaries	1,811	1,907	5.3	550	579	5.2
Goods and services	1,403	1,497	6.7	348	370	6.2
Current transfers	69,525	74,775	7.6	19,711	21,027	6.7
Benefits	69,524	74,774	7.6	19,710	21,026	6.7
Contributory pensions	60,024	64,307	7.1	16,911	17,999	6.4
Sickness	4,623	5,312	14.9	1,376	1,556	13.1
Other	4,877	5,155	5.7	1,423	1,471	3.4
Other current transfers	1	1	-8.1	0	0	—
Other (e)	448	512	14.3	39	48	25.2
3 Balance	3,909	3,530	-9.7	6,252	6,871	9.9

SOURCES: Ministerio de Hacienda, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Only data relating to the system, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security funds are not available.
b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.
c. Including surcharges and fines.
d. Excluding surcharges and fines.
e. Reduced by the disposal of investments.

On the revenue side, and given the partial transfer of certain taxes to territorial governments, the analysis of the cash-basis outturn hereafter considers the total revenue raised by the main taxes, including both the portion assigned to the State and that allocated to territorial government, although these figures are not included in Table 3. Thus, in aggregate terms, personal income tax revenue declined by 5.3% in the first half with respect to the same period of 2003. This fall, influenced by the latest personal income tax reform and probably by a larger volume of refunds, was somewhat smaller than in Q1 because of the dilution of the calendar effect in regard to withholdings on earned income. By contrast, the collection of corporate income tax was extremely buoyant up to June. Indirect taxes, for their part, grew at a similar rate to that in Q1, although with more disparate behaviour among their main components. VAT slowed significantly in Q2 and grew more slowly than the budget forecast due to its domestic transactions component, while excise duties picked up to much higher than budgeted growth rates, with tobacco being notable in this regard. Finally, it should also be added that non-tax revenue slowed notably with respect to Q1, due to the transfers received, although it continued to be underpinned by the sharp increase in funds received from the EU.

On the expenditure side, the first half saw a further fall with respect to the same period of the previous year. This decrease in expenditure was basically due to interest payments which, as a result of the public debt maturity schedule, decreased by 19.5% up to June (see Table 3). By contrast, current transfers and, in particular, purchases, despite having slowed in Q2, continued to post higher than budgeted rates of change. For their part, personnel costs and capital transfers also slowed, growing at very moderate rates. Finally, real investments fell more slowly in recent months, drawing nearer to the budget forecast.

4. 5 The balance of payments and capital account of the economy

In the first four months of 2004 the overall balance on current and capital account was a deficit of €7.02 billion, up €3.12 billion on the same period of the previous year (see Table 4). This was basically due to the notable deterioration in the current account deficit, which amounted to €8.74 billion and, to a lesser extent, to the decrease in the surplus on capital account. The unfavourable movements in the current account were produced by the sharp increase in the trade deficit and the fall in the services surplus. The reduction in the income-account deficit and the slight improvement in the current-transfers surplus scarcely offset the deterioration in the other components of the current account.

In the period January-April 2004, the trade deficit rose by €3.22 billion with respect to the same period of the previous year, standing at €13.61 billion. In year-on-year terms, the negative balance increased by 31%, returning to the sharply deteriorating profile that had characterised it in the first three quarters of the previous year. The vigour shown by real flows of imports in the first four months of 2004 (far superior to that of the volume of exports) and the slight worsening in the terms of trade explain this worsening of the trade gap.

On the services account, the first four months of the year saw a surplus of €5.60 billion, down €651 million on the figure recorded in the same period of the previous year. This worsening resulted in a year-on-year decrease of 10.4%, explained by the 2.7% fall-off in the tourism surplus and the 41.7% deterioration in the non-tourism services deficit. Tourism revenue faltered in March and April after a recovery in the early months of the year and, as a result, the year-on-year rate of growth dropped to 2.3% in the first four months as a whole, in line with the unfavourable statistics for the number of tourists entering Spain and, in particular, for hotel overnight stays. Tourism payments rose to 20.6% overall in the first four months of 2004, accelerating still further against a background of improving Spanish consumer confidence and appreciation of the euro.

The deficit on the income account stood at €2.44 billion in the first four months of 2004, a correction of €796 million with respect to the same period of the previous year. Revenue increased

BALANCE OF PAYMENTS: MAIN COMPONENTS (a)

TABLE 4

EUR m

		JANUARY-APRIL	
		2003	2004
CREDITS	Current account	80,365	82,340
	Goods	47,052	48,393
	Services	19,346	19,460
	Tourism	*9,353*	*9,569*
	Other services	*9,993*	*9,891*
	Income	7,316	7,525
	Current transfers	6,651	6,961
	Capital account	2,220	1,969
	Current + capital accounts	82,585	84,309
DEBITS	Current account	86,128	91,079
	Goods	57,439	62,005
	Services	13,093	13,859
	Tourism	*2,015*	*2,430*
	Other services	*11,077*	*11,428*
	Income	10,554	9,966
	Current transfers	5,043	5,250
	Capital account	352	245
	Current + capital accounts	86,480	91,324
BALANCES	Current account	-5,763	-8,740
	Goods	-10,387	-13,612
	Services	6,253	5,602
	Tourism	*7,338*	*7,138*
	Other services	*-1,085*	*-1,537*
	Income	-3,237	-2,441
	Current transfers	1,609	1,712
	Capital account	1,868	1,724
	Current + capital accounts	-3,895	-7,016

SOURCE: Banco de España.

a. Provisional data.

by 2.9% due to buoyant receipts in the non-financial private sector, while continuing to decrease in the other sectors, due to a decline in foreign investment earnings and to the cutbacks in investment itself in recent years. Payments were down by 5.6% due to the decrease in those by the non-financial private sector, in line with the lesser foreign direct investment in Spain last year.

The current-transfers surplus stood at €1.71 billion in the period January-April 2004, an increase of €103 million on the same period of 2003. Receipts were up by 4.7% because of the rise in the flows received from the public sector, particularly from the EU via the European Social Fund, while the Community funds granted to the private sector via the EAGGF Guarantee Fund declined slightly. Payments grew by 4.1% owing to the rise in flows to the EU via the GNP resource and traditional own Funds and to the continuing vigour of remittance payments by immigrants.

Finally, the capital-account surplus stood at €1.72 billion in the first four months of 2004, down €144 million on the same period of 2003. This deterioration (a fall of 7.7% year-on-year) was due to the fall-off in ERDF structural funds from the EU, which usually suffer from delays in the early months of the year. There were, however, increases in Community transfers to the EAGGF-Guidance Fund and to the Cohesion Fund.

5.1 Overview

In 2004 Q2 financial conditions in the private sector were shaped primarily by the behaviour of euro area money market and public debt interest rates, which rose moderately. Thus one-year Euribor increased by 34 bp and ten-year Spanish bond yields were up by a similar amount (38 bp). This meant that, despite the slight reduction in credit risk premia (see Chart 24), there was a certain increase in non-financial corporations' cost of financing via fixed-income securities, which nonetheless remained at relatively low levels. Meanwhile, interest rates applied by credit institutions to households and corporations did not change significantly.

The domestic and international stock markets saw falling prices and rising volatilities in May, a phenomenon linked to the upward trend in oil prices. However, these movements were subsequently corrected, so that at end-June the main indices stood slightly above their end-Q1 levels, while volatilities had recovered the values shown in that period. As a result, the Madrid General Stock Exchange Index rose by 5.3% in the first half, gaining more than the euro area EURO STOXX Broad Index (3.7%) and the US S&P 500 (2.6%). From the beginning of July up to the date this article went to print, however, these three indices have been falling.

Housing market prices continued to rise briskly in 2004 Q1, although showing a slight slowdown which put their year-on-year growth rate at 17.2%. This slight moderation was seen in both new and used houses, being more significant in the former (nearly one-and-a-half percentage points).

Against this background, financing to corporations and households in 2004 Q1 held at high rates of expansion and, in fact, that to households accelerated. The funds continued to be used mainly to finance activity in the property sector. Thus house purchase loans in March grew at a year-on-year rate of nearly 23% and the annual growth of property development loans stood at around 40%. Provisional information for 2004 Q2 points to sustained growth rates of credit to households and corporations.

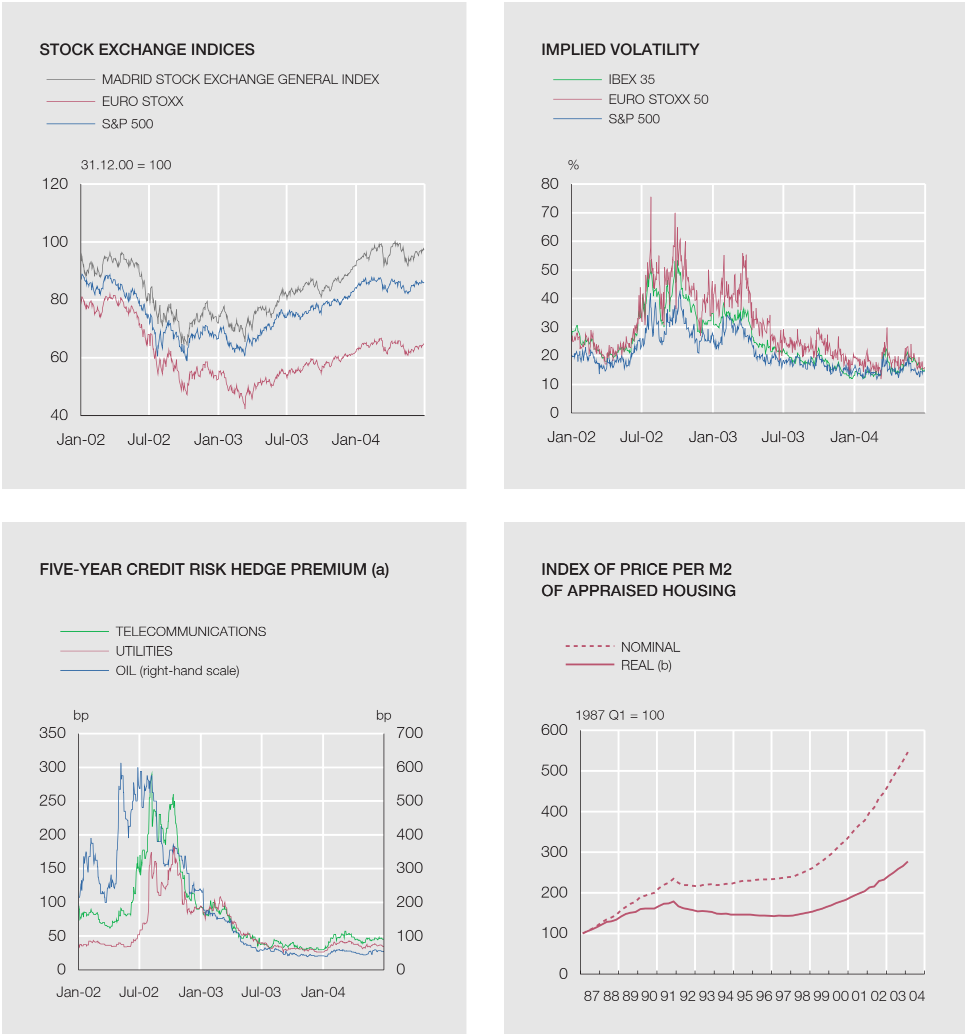
The continued resort to borrowing by households led to further increases in their debt ratios. In line with this increase, there was, for the second quarter running, an increase in the debt burden as a percentage of gross disposable income (GDI) of the sector. Also, although household financial saving recovered slightly to stand, in cumulative four-quarter terms, at 1% of GDP, saving after debt service remained at very low levels. Household net wealth increased as a result of the significant rise in real estate prices. Provisional information for 2004 Q2 indicates that these trends have continued.

In the case of corporations, the financial position indicators generally showed a favourable performance. Thus, although the aggregate debt ratios continued to increase, the interest burden eased slightly and the synthetic indicators measuring how financial position affects investment reflected a mild improvement. Similarly, the financing gap again narrowed and the long-term earnings expectations of listed corporations began to show signs of recovery between April and June in most industries.

Taken as a whole, the available aggregate indicators of the financial position of corporations and households suggest that in the short term it should not, in principle, hinder the recovery of investment from firming and consumption from remaining buoyant. However, certain recent developments relating basically to the levels of indebtedness reached and the notable propor-

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



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 conditios of European firms came into force. The new contract carries lower premia (around 10%)
b. Deflated by the CPI.

tion of debt at variable interest rates, pose certain risks in the longer term. In particular, these developments have made spending decisions more vulnerable to interest rate rises and, especially in the case of households, have reduced their ability to resort to additional increases in financing to sustain further spending decisions.

5.2 Households

Despite the slightly upward behaviour of yields in the euro area money market, the lending rates applied by institutions to households decreased in 2004 Q2 with respect to their March levels. Specifically, the cost of house purchase loans was 3.25% in May, down 14 bp on the March level, while that of consumer and other loans decreased by 8 bp to 6.12%.

The easy financing conditions again encouraged households to resort strongly to external financing, the year-on-year rate of expansion of which increased to nearly 20% in 2004 Q1 (see Table 6). The fresh debt taken on by the sector represented, in cumulative twelve-month terms, 9.9% of GDP, 0.4 pp more than in the previous quarter. This rise resulted from the acceleration of house purchase credit, the growth rate of which stood at 23% in March, the highest in recent years, and from the maintenance of the expansion rate of consumer and

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP	1999	2000	2001	2002	2003				2004
					Q1	Q2	Q3	Q4	Q1
National economy	-1.0	-2.5	-2.2	-1.6	-2.1	-2.0	-2.3	-2.0	-2.1
Non-financial corporations and households and NPISHs	-0.3	-2.3	-3.4	-3.0	-3.5	-3.6	-3.6	-3.7	-3.7
Non-financial corporations	-2.3	-3.4	-4.5	-4.5	-4.6	-4.0	-4.7	-4.6	-4.8
Households and NPISHs	2.0	1.1	1.1	1.5	1.0	0.5	1.1	0.8	1.0
Financial institutions	0.5	0.8	1.6	1.5	1.5	1.4	1.3	1.4	1.5
General government	-1.2	-0.9	-0.4	-0.1	0.0	0.2	0.0	0.3	0.1

SOURCE: Banco de España.

other loans. Provisional information for 2004 Q2 indicates that household debt has continued to grow at this high rate.

With regard to portfolio decisions, investment in assets increased by somewhat more than 0.5 pp relative to GDP, in cumulative twelve-month terms, to stand at 10.9%. Analysis by instrument showed a certain shift towards more risky assets. Thus investment in shares increased to stand, in cumulative four-quarter terms, at 0.9% of GDP. Investment in securities funds (FIM) also tended to rise, and in the first quarter of the year reached the highest values since the beginning of 1999. In cumulative annual terms, it represented 2.3% of GDP, up 0.5 pp on end-2003. This increase was equal to the fall in money market funds, so investment in mutual funds did not show significant changes. Meanwhile, there was a rise of 0.3 pp in the item “Other deposits and fixed-income securities”, basically due to investment in time deposits.

The notable rise in financing received by households meant a further increase in the sector’s debt ratio in terms of its GDI, which stood at around 95% at the end of 2004 Q1 (see Chart 26). The associated debt burden, also relative to its GDI, likewise increased (for the second quarter running), despite the reduction in the fraction relating to interest payment. In addition, although the sector’s financial saving increased slightly (to 1% of GDP, in cumulative four-quarter terms, as shown by Table 5), saving after debt service remained low, at levels similar to those at end-2003. Encouragingly, the latest available microeconomic information, drawn from the Household Expenditure Survey, reflected a certain increase in the percentage of households able to earmark money for saving, as well as a reduction in the proportion of households experiencing great difficulty in making it to the end of the month. Also, household wealth again grew, although due only to house price rises, since net financial wealth held steady (see Charts 25 and 26).

Consequently, the available indicators suggest that the financial conditions of households should not pose an obstacle for consumer buoyancy and residential investment of the sector in the short term. Nevertheless, the low level of saving after debt service allows limited leeway for absorbing possible adverse shocks. The impact that these shocks might have on household spending decisions has been heightened in recent years by the significant increase in the sector’s liabilities, although this may be largely explained by the behaviour of their more usual determinants, such as interest rates, income and wealth (see Table 5). Additionally, the available disaggregated information shows a high dispersion in financial position within the sector, so the financial position of a certain percentage of households is arguably less sound than suggested

FINANCIAL TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS
Cumulative four-quarter data

TABLE 6

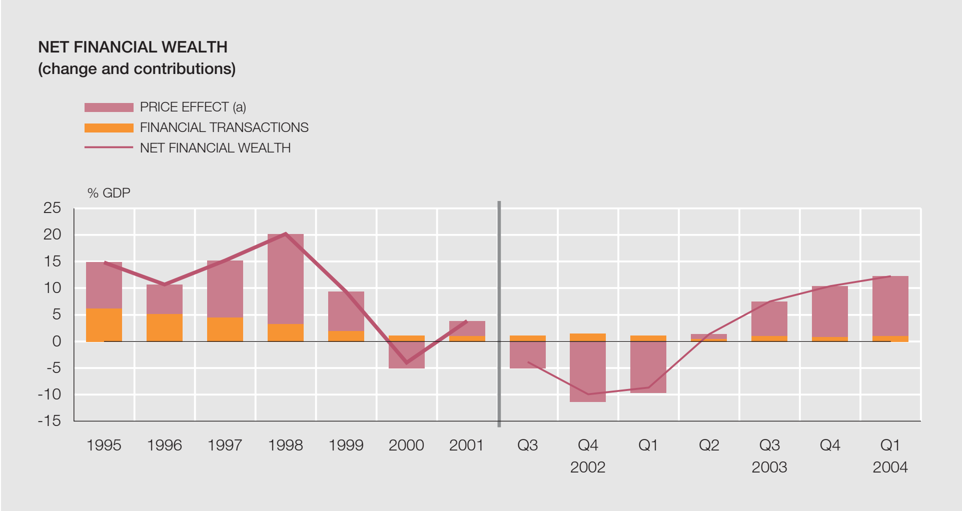
% GDP	2000	2001	2002	2003 Q3	2003 Q4	2004 Q1
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	9.6	7.8	8.8	9.2	10.3	10.9
Cash and cash equivalents	0.9	1.2	3.8	3.9	4.4	4.3
Other deposits and fixed-income securities (a)	6.1	3.4	1.5	-0.2	-0.2	0.1
Shares and other equity (b)	1.5	-0.2	0.8	0.4	0.7	0.9
Mutual funds	-3.3	0.8	0.2	2.0	2.3	2.4
FIAMM	*-1.2*	*1.3*	*0.7*	*0.9*	*0.6*	*0.1*
FIM	*-2.0*	*-0.5*	*-0.5*	*1.2*	*1.8*	*2.3*
Insurance technical reserves	3.5	2.7	2.6	2.5	2.1	2.0
Of which:						
Life assurance	*2.1*	*1.5*	*1.5*	*1.4*	*0.7*	*0.7*
Retirement	*1.1*	*0.9*	*0.9*	*0.9*	*1.1*	*1.1*
Other	0.9	0.0	-0.1	0.6	1.0	1.2
Financial transactions (liabilities)	8.6	6.8	7.4	8.2	9.5	9.9
Credit from resident financial institutions (c)	7.0	5.4	7.2	8.2	9.4	10.0
House purchase credit (c)	*5.4*	*4.8*	*5.2*	*5.6*	*7.2*	*7.8*
Consumer and other credit (c)	*1.6*	*0.6*	*2.1*	*2.5*	*2.1*	*2.1*
Other	1.6	1.3	0.1	0.0	0.1	-0.1
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	26.3	16.4	16.4	17.6	17.2	15.6
Cash and cash equivalents	0.9	1.7	1.6	1.4	0.9	0.6
Other deposits and fixed-income securities (a)	1.2	0.7	1.7	1.7	1.5	0.5
Shares and other equity	14.1	6.1	6.9	7.1	6.8	5.4
Of which:						
Vis-à-vis the rest of the world	*10.5*	*4.6*	*5.1*	*5.6*	*4.6*	*3.2*
Other	10.1	7.9	6.2	7.4	8.0	9.1
Financial transactions (liabilities)	29.7	21.0	20.9	22.3	21.7	20.4
Credit from resident financial institutions (c)	7.5	6.5	6.3	7.0	7.1	7.2
Foreign loans	3.5	4.0	3.0	2.7	2.8	2.4
Fixed-income securities (a)	-0.9	0.0	-0.4	-0.2	-0.2	0.0
Shares and other equity	12.8	5.3	6.0	6.5	5.1	3.8
Other	6.8	5.2	5.9	6.4	6.8	7.0
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (d)	18.1	15.6	14.3	14.9	16.1	16.3
Households and NPISHs	17.3	12.3	15.6	16.6	18.7	19.6
Non-financial corporations	18.7	18.1	13.3	13.7	14.2	13.9

SOURCE: Banco de España.

a. Not including unpaid accrued interest, which is included under "other".
b. Excluding mutual funds.
c. Including securitised loans.
d. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

HOUSEHOLDS AND NPISHs
Cumulative four-quarter data

CHART 25



SOURCE: Banco de España.

a. Includes revaluation and other changes in volume.

by the overall indicators and their consumption or investment decisions are thus comparatively more vulnerable to possible adverse changes such as, for example, an increase in interest rates.

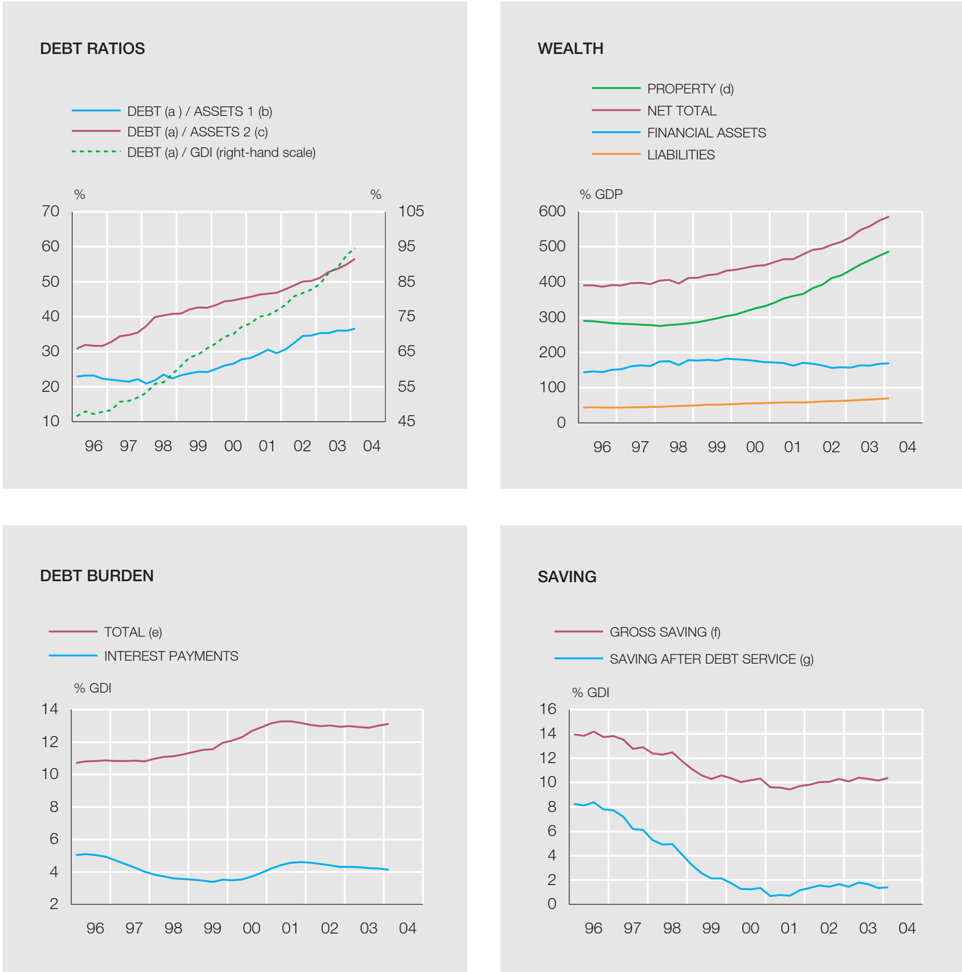
5.3 Non-financial corporations

The financing conditions of corporations continued to be easy between April and June. Thus lending rates held at the low levels of the previous quarter. The risk premia negotiated by firms on the debt markets decreased, although by less than the rise in public debt yields, so the average cost of corporate financing via fixed-income securities grew slightly, although it remained moderate. Finally, the conditions for raising funds on the equity markets did not change significantly in the period as a whole, since at the end of Q2 market prices and their volatilities stood at levels similar to those in March.

Liabilities-side transactions by non-financial corporations amounted, in cumulative twelve-month terms, to 20.4% of GDP, down 1.3 pp on 2003 Q4 (see Table 6). The breakdown by components shows that interest-bearing borrowed funds expanded at a rate of around 14% which, according to the available provisional information, seems to have been been sustained in the second quarter of the year. This borrowing represented 9.6% of GDP. The composition by instrument showed certain differences with respect to the previous quarter. Thus there was further redemption of short-term fixed-income securities, whereas long-term securities showed, in cumulative twelve-month terms, positive net issuance, contrasting with their behaviour since 2000. Overall, the net funds raised via fixed-income securities stood at practically zero. Meanwhile, the volume of funds raised through foreign loans relative to GDP decreased, while those obtained from resident credit institutions continued on the slightly upward trend of the previous quarter. Funds raised through issuance of shares and other equity decreased by 1.3 pp relative to GDP and stood, in cumulative twelve-month terms, at 3.8%. Finally, according to the CBSO quarterly survey, there was a positive, although moderate, change in the debt of large corporations, in contrast to the balance-sheet restructuring undertaken by some of them in 2002 and 2003.

As to branches of production, Q1 saw an increase in the rate of expansion of bank credit in most sectors, that in construction being especially significant with an increase of 5 pp

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 26



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.

in its year-on-year rate of growth. Credit to this sector and to property services was highly buoyant, with growth rates around 20% and 40%, respectively. By contrast, despite the fresh recovery shown by the industrial sector in this period, the loans extended to it again slowed in this period, their rate of expansion in fact dropping to negative values (–1.4%).

The flow of investment in financial assets of non-financial corporations contracted, in cumulative four-quarter terms, to 15.6% of GDP (see Table 6). This decline was apparent in most items and was especially significant in other deposits and fixed-income securities and in shares and other equity. In the latter item, the contraction was basically in foreign stakes (somewhat more than one percentage point).

Net borrowing of corporations in March stood, in cumulative four-quarter terms, at 4.8%, up slightly on end-2003. The financing gap, which measures how much real and permanent fi-

Credit allows households to smooth consumption throughout their life-cycle, as well as to purchase consumer durables or houses, the services of which are prolonged in time and require a relatively high initial outlay of funds. However, any increase in financing represents a higher debt burden and may limit access to fresh funds and make spending decisions more sensitive to changes in financing conditions[1]. Thus higher debt tends to reduce the sector's ability to respond to unfavourable changes in its income, in the value of its wealth or in interest rates, which are particularly significant if household loans are at floating interest rates. For this reason, a high level of indebtedness might, in certain circumstances, contribute to heightening the contractionary effects of the recessionary phase of the cycle or limit the extent of an economic recovery.

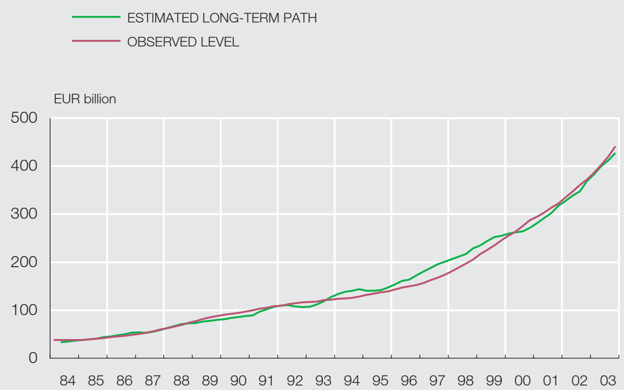
To examine the effect that excessive indebtedness might have on spending decisions, a vector error correction model (VECM) has been estimated for Spanish families[2]. This model provides long-term relationships (or equilibrium paths) for household consumption and credit as a function of income, wealth and financing cost. This approach also sheds light on how adjustments take place when the variables of interest depart from their estimated equilibrium levels.

The results show that the deviations of indebtedness with respect to its long-term determinants imply changes not only in credit, but also in other variables. Thus, as shown in the accompanying table, when the level of credit stands at 1% above (below) its equilibrium path, the related correction takes place primarily by means of an adjustment in the volume of loans. More specifically, debt would decrease (increase) by 0.15% in the immediately following quarter and would continue to do so at this rate - 0.15 pp for each percentage point of disequilibrium - in subsequent quarters until the gap was closed. But, in addition, there would also be falls (rises) in consumption, the rate of change of which would be 0.11 pp for each percentage point of imbalance.

The estimate also shows that the increase in Spanish households' liabilities in recent years is consistent with the changes in their long-term fundamental determinants (see accompanying chart). Therefore, at the present time it does not seem that the level of indebtedness is exercising a significant contractionary effect on consumption. However, if, once the effects of the changes in its determinants have run their course, the trend of recent years continues, the debt assumed by the sector may end up affecting perceptibly the propensity of families to engage in further spending.

1. In this latter respect, see Malo de Molina and Restoy (2004) "Recent trends in corporate and household balance sheets in Spain: macroeconomic implications", Banco de España, Occasional Document no. 0402. **2.** See Martínez, Carrascal and del Río (2004): "Household borrowing and consumption in Spain: a VECM approach", Banco de España, mimeo.

1. CREDIT TO HOUSEHOLDS



SOURCE: Banco de España.

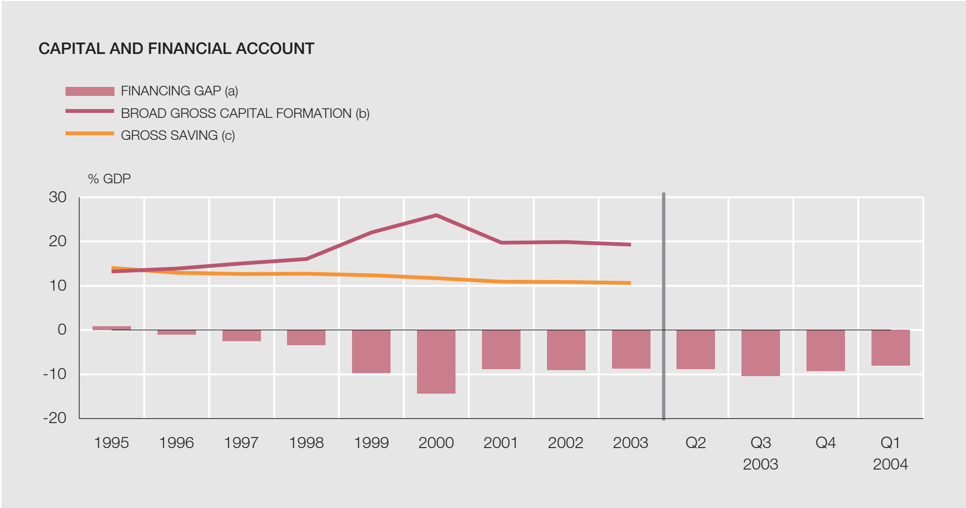
2. ADJUSTMENTS WHEN CREDIT AND CONSUMPTION DEVIATE FROM THEIR EQUILIBRIUM PATH (a)

		Variable that is not in equilibrium	
		Consumption	Credit
Variable that is adjusted	Consumption	-0.35	-0.11
	Credit	—	-0.15
	Income	0.48	—
	Wealth	—	—
	Interest rate	—	—

a. Percentage change in one quarter shown by the different variables when there is a positive deviation of 1% in consumption or credit from its equilibrium path.

NON-FINANCIAL CORPORATIONS
Cumulative four-quarter data

CHART 27



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.

nancial investment differs from gross saving, fell further to 7.9%, more than 1 pp below its level at end-2003 (see Chart 27).

According to the CBSO quarterly survey, the earnings of corporations again performed very favourably in 2004 Q1. Thus ordinary net profit grew by 17.4% in this period, up 4 pp on 2003 Q1. The performance was especially positive in trade, in line with the good behaviour of private consumption, and also in the transport and communications sector. By contrast, in industry this aggregate saw moderate growth (3.4%), below that in the same period of the previous year (12.4%). Total net profit fell by 27.2%, which, however, is not representative of the situation of corporations, since it basically reflects a decline in extraordinary revenue.

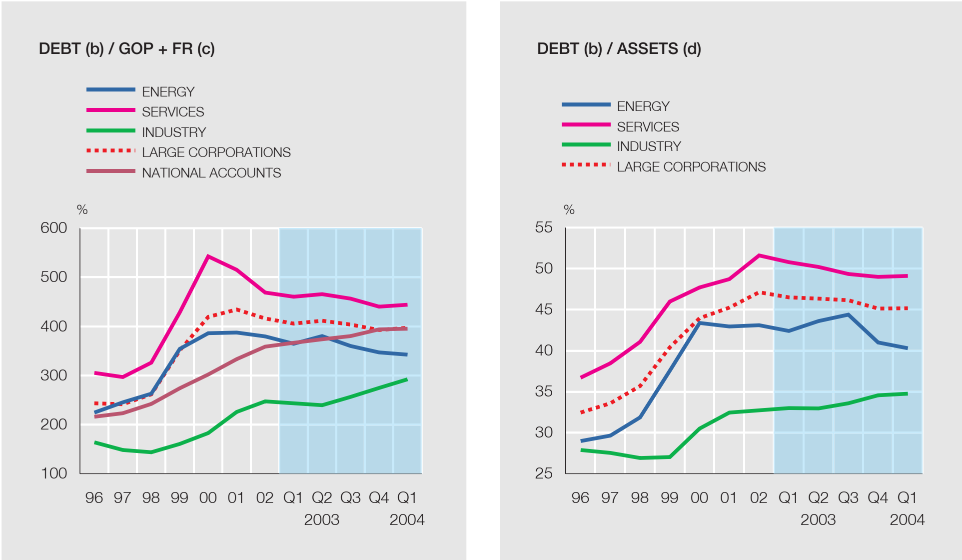
Despite the positive performance of corporate earnings, the continued high borrowing of firms meant that their aggregate debt ratios rose further in 2004 Q1, although the associated debt burden held at moderate levels and, in fact, declined somewhat (see Chart 28 and 29). On CBSO information, the debt ratios of the large corporations held steady, contrasting with their downward path in the last two years, and the total debt burden (interest plus short-term debt) rose slightly, despite the reduction in the part representing interest payment. This rise was seen in all sectors except energy.

The above-mentioned developments in indebtedness, debt burden and corporate earnings led to a decline in the aggregate synthetic indicator of financial pressure on investment, constructed from CBSO information. The employment indicator, by contrast, showed a slight deterioration, although remaining at historically low levels (see Chart 30). In addition, the figures on suspensions of payments and declarations of bankruptcy were positive, there being a decrease in these two items in 2004 Q1, relative both to the same period of 2003 and to 2003 Q4.

Overall, the sound financial position of corporations, along with their improving long-term earnings expectations and the prevailing easy financing conditions, make for a scenario conducive to a progressive firming of the recovery in investment. Thus, as mentioned above, the balance-

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a)

CHART 28

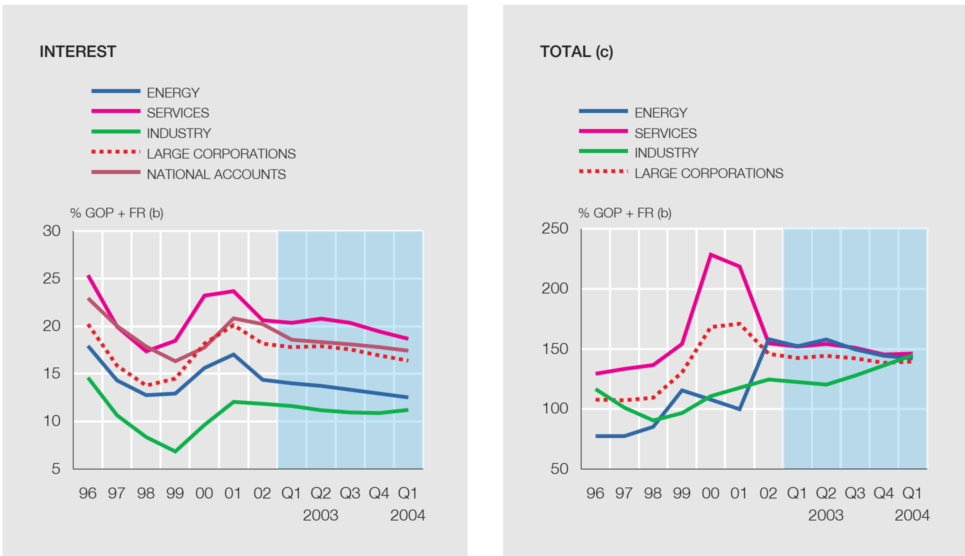


SOURCE: Banco de España.

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.

DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a)

CHART 29

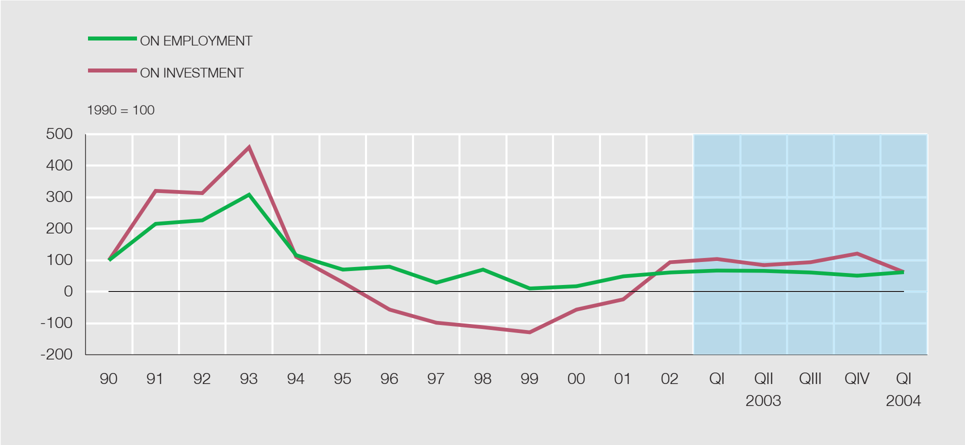


SOURCE: Banco de España.

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.

SYNTHETIC INDICATORS OF FINANCIAL PRESSURE ON NON-FINANCIAL CORPORATIONS (a)

CHART 30

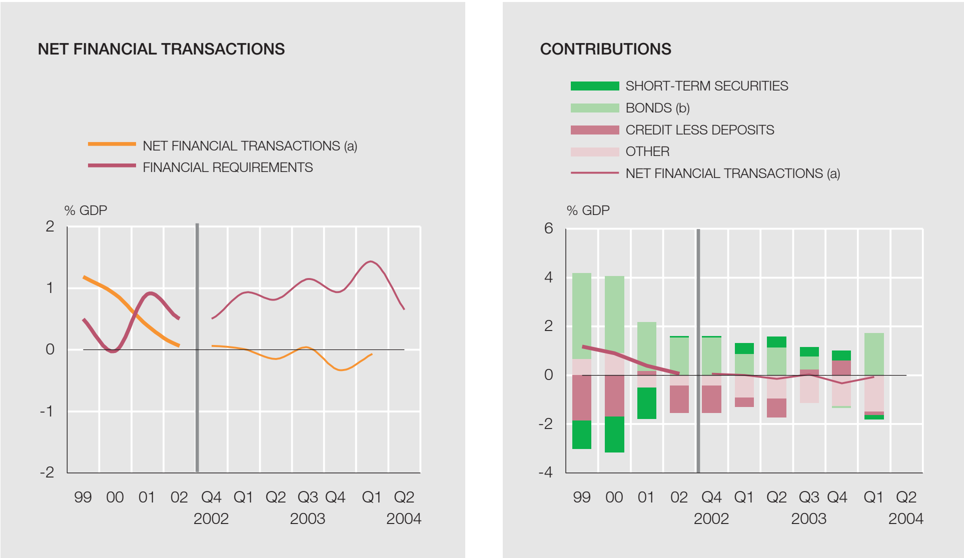


SOURCE: Banco de España.

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

GENERAL GOVERNMENT
Cumulative four-quarter data

CHART 31



SOURCE: Banco de España.

a. Sign changed.
b. Not including unpaid accrued interest, which is included under "other".

sheet restructuring undertaken by large corporations in previous quarters, which created some uncertainty over the prospects of this recovery, does not seem to have continued in 2004 Q1. However, there are persisting risk factors associated with the sector's high indebtedness which make its spending decisions more sensitive to unfavourable changes in its earnings or cost of financing.

5.4 General government

The net balance of the financial transactions of general government in 2004 Q1 was positive and, in cumulative twelve-month terms, stood at 0.1% of GDP, down 0.2 pp on end-2003 (see Chart 31). Similarly, the net issuance of marketable securities by general government was

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP	2000	2001	2002	2003		2004
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-2.5	-2.2	-1.6	-2.3	-2.0	-2.1
FINANCIAL TRANSACTIONS (ASSETS)	25.1	12.2	13.7	15.1	13.6	12.3
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.8	-2.7	3.5	0.4	0.8	1.3
Securities other than shares	3.9	7.2	4.3	7.8	7.1	5.0
Of which:						
Credit institutions	*-0.3*	*2.0*	*0.5*	*4.1*	*3.7*	*3.6*
Institutional investors (a)	*3.7*	*5.4*	*3.5*	*3.5*	*3.4*	*1.7*
Shares and other equity	15.6	5.2	5.3	6.0	4.8	4.7
Of which:						
Non-financial corporations	*10.5*	*4.6*	*5.1*	*5.6*	*4.6*	*3.2*
Institutional investors (a)	*3.2*	*0.5*	*-0.1*	*0.6*	*1.1*	*1.7*
Loans	2.7	2.5	0.6	0.9	1.0	1.2
FINANCIAL TRANSACTIONS (LIABILITIES)	27.5	14.4	15.3	17.5	15.6	14.4
Deposits	6.7	2.8	4.4	6.5	7.5	5.0
Securities other than shares	7.1	3.1	4.5	4.5	5.6	8.9
Financial institutions	*1.1*	*1.5*	*3.3*	*5.5*	*6.7*	*7.6*
Rest of resident sectors	*6.0*	*1.6*	*1.2*	*-0.9*	*-1.1*	*1.3*
Shares and other equity	9.4	4.6	4.2	4.3	0.8	-0.6
Of which:						
Non-financial corporations	*7.7*	*4.1*	*3.5*	*4.1*	*0.9*	*-0.6*
Loans	4.1	4.3	3.5	3.0	3.2	2.8
Other, net (b)	0.2	-0.4	-1.1	-0.8	-1.4	-1.7

SOURCE: Banco de España.

a. Insurance corporations and portfolio investment institutions.
b. Includes the asset-side caption reflecting insurance technical reserves.

also positive (1.6% relative to GDP), since the issuance of medium- and long-term securities offset the decline in the contribution from short-term securities.

Provisional information for 2004 Q2 points to a further net redemption of short-term securities, positive issuance of long-term securities and an increase in the balance of deposits held by the sector. As a result, the general government's *financial requirements*, which represent its recourse to the financial markets and which are a leading indicator of the sector's (dis)saving, have been reduced.

5.5 The rest of the world

The debit balance of the nation's financial transactions increased in 2004 Q1 and, in cumulative twelve-month terms, stood at 2.1% of GDP, against 2% at end-2003. This resulted from the lower saving of general government and the larger financing needs of corporations, which exceeded the increase in net lending by households and financial institutions. As in the previous quarter, both asset and liability flows declined.

Net purchases of foreign assets decreased to 12.3% of GDP in cumulative twelve-month terms, down 0.3 pp on end-2003 (see Table 7). Behaviour across instruments was uneven. Thus while loans and cash and deposits continued on the path of recovery of the previous

NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)
(Q4 data)

TABLE 8

% GDP	1999	2000	2001	2002	2003	2004 (b)
National economy	-29.6	-26.2	-27.0	-30.9	-37.9	-38.5
Non-financial corporations and households and NPISHs	-17.3	-9.4	-10.2	-11.7	-14.7	-14.4
Non-financial corporations	-24.1	-16.7	-17.6	-19.4	-23.2	-23.3
Households and NPISHs	6.8	7.3	7.4	7.7	8.4	8.8
Financial institutions	8.2	8.3	8.6	6.7	-0.7	0.1
Credit institutions (c)	-7.5	-11.6	-13.9	-14.2	-21.9	-20.7
Institutional investors (d)	16.3	20.8	24.3	24.5	27.5	27.6
Other financial institutions	-0.6	-0.9	-1.8	-3.6	-6.3	-6.8
General government	-20.5	-25.1	-25.4	-25.9	-22.5	-24.1

SOURCE: Banco de España.

a. Calculated as the difference between the stocks of financial assets and liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.
b. Q1 data.
c. Defined in accordance with the First Banking Directive.
d. Insurance corporations and portfolio investment institutions.

quarter, purchases of shares and other equity were very similar and there was a significant fall-off in securities other than shares. On provisional balance of payments information to April, foreign direct (permanent) investment contracted considerably (nearly 50%) compared with the same period a year earlier. Portfolio investment abroad also declined significantly (by more than 40%).

On the liabilities side, net flows represented 14.4% of GDP in cumulative twelve-month terms, against 15.6% in the previous quarter. This decline was seen in most investments of non-residents and was especially significant in deposits and in shares and other equity, in which there was a disinvestment in cumulative four-quarter terms. The only increase was in funds invested in securities other than shares (by more than 3 pp relative to GDP). According to balance of payments information, inward foreign direct investment in Spain in the first four months of the year contracted significantly, standing at around 6% of that observed in the same period of 2003, reflecting disinvestment in capital and a significant decline in the flow of financing from non-resident firms to group companies.

Finally, the provisional information on the debit position of the Spanish economy vis-à-vis the rest of the world shows that in 2004 Q1 it stood at 38.5% of GDP, a deterioration of slightly more than 0.5 bp with respect to end-2003 (see Table 8).