QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

The expansion of the world economy has progressively taken root as 2004 has unfolded; generally, however, growth rates are expected to slacken slightly in the second half of the year. The strong increase in oil prices has fed through moderately to the inflation rates of the different economies without the inflationary outlook having so far worsened significantly, and stability prevails on international financial markets. Nonetheless, the persistence of significantly high crude oil prices over the medium-term horizon, as presaged by the futures markets and numerous specialist agencies, might ultimately affect consumer and business expectations and limit growth in the world economy in 2005.

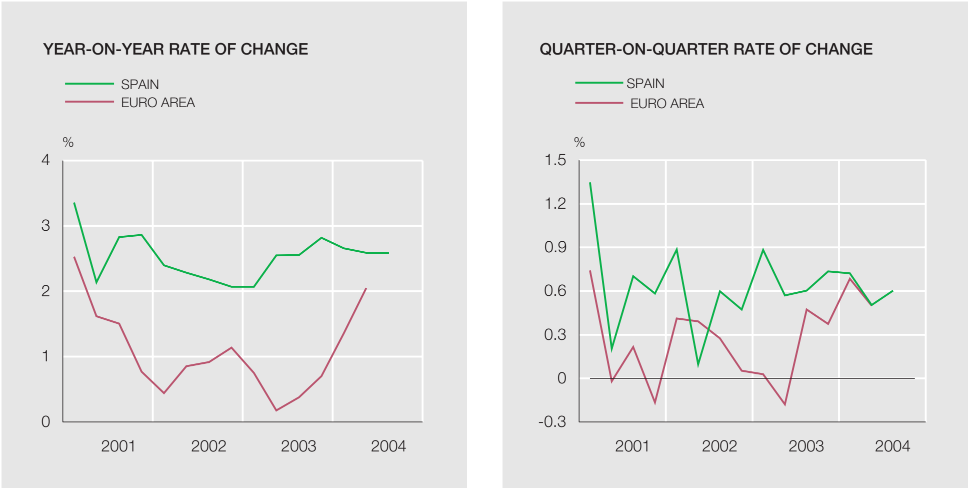
Against this background, the pace of growth in the Spanish economy has remained sustained, similar to that in the first half of the year, without substantial changes in its determinants being perceptible: national demand is driving output growth, while the contribution of net external demand remains very negative. The growing recovery in investment in equipment, which has combined with the ongoing buoyancy of consumption and investment in construction, is the highlight of the latest data, along with the continuing firmness of employment creation. The growth rate of goods exports has stepped up during the year — in relation to the low figures in 2003 and in step with the pick-up on international markets — but their positive contribution has been more than offset by poor tourism results and the notable increase in imports. In terms of sectors, industry and construction have shown the most stable performance.

It is estimated that real GDP growth in the Spanish economy in 2004 Q3 compared with the same quarter a year earlier was around 2.6%, in terms of the seasonally adjusted series, unchanged on Q2. The quarter-on-quarter rate is estimated at 0.6%, 0.1 pp up on Q2. The related change in national demand is expected to exceed, by 0.1 p.p. or slightly more, that of the previous quarter (3.8%), while net external demand should subtract 1.5 pp from output growth, a slightly higher figure than the previous quarter.

The persistent mismatch between supply and demand has ultimately destabilised the oil market and pushed the price of crude oil and its main derivatives upwards to historical highs. On the supply side, the natural disasters in the Gulf of Mexico, the social and labour problems in numerous producer countries and continuing tension in the Middle East have considerably affected available oil stocks. And this has been further compounded by the scant flexibility of production to meet growing demand, especially for specific oil derivatives. The increase in demand has been due to the world economic expansion and, in particular, to the high growth of the major central Asian economies, which are strongly energy-dependent. While it is believed crude prices will ease as some of these destabilising factors abate, clouds remain on the horizon, whereby prices are expected to stay high in the medium run.

Naturally, the growth rates of the different economies' main price indices have — albeit somewhat unevenly, depending on the different levels of dependency and on exchange rate movements — reflected the rise in energy products. That said, the credibility of the anti-inflationary policies pursued by the authorities and the fact nominal stability is embedded as a necessary value for retaining competitiveness are limiting the incorporation of price increases into agents' inflation expectations. Also contributing to this are, in certain countries, productivity gains and, in others, wage moderation. That all helps explain the manifest stability on financial markets, the cuts, in certain cases, in long-term interest rates and the limited nature of second-round effects on wages.

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

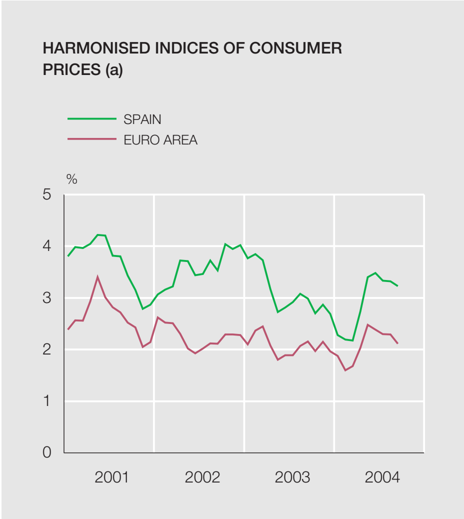
Growth expectations in the US economy have eased as the year has advanced, though they remain particularly high. The strong growth of private investment and productivity gains account for the continuing buoyancy of the US economy, while private consumption has been losing steam, against a background of heavy household debt and doubts about the firmness of employment creation. The latest indicators, almost all survey-based, appear to confirm this diagnosis. In turn, the growing deterioration of external demand and the subsequent increase in the trade deficit may have contributed to the falling trend of the dollar in recent weeks. The gradual upward movements in the federal funds rate to 1.75% in September have not passed through to the longer-dated terms, where there have occasionally been moderate declines.

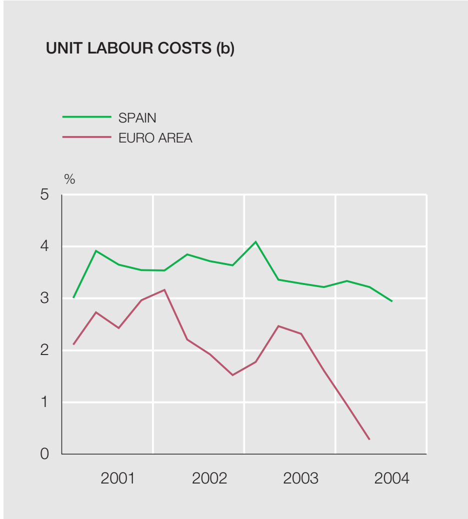
A mildly decelerating trend has also been the keynote in the main east Asian economies, against a fairly widespread expansionary background. In China, the loss of momentum is proving less than intended by the authorities and the inflation rate stands above its projected level. Price increases are likewise discernible in the Latin-American economies, which are growing notably as a result, above all, of the renewed buoyancy of their domestic demand. The region's financial markets are trending favourably, as these countries' sovereign debt issues and yields reveal. Turning to the economies of the new EU members, results have generally been favourable both in terms of growth and the control of inflation, although on the fiscal front progress has not been so widespread.

The euro area is benefiting from the expansion of international markets, while internal spending has not yet firmed sufficiently. This is the outcome, however, of an uneven state of affairs across the Member States. In some, the contribution of external demand is practically the only factor driving activity, while in others, the increase in output is essentially underpinned by the growing buoyancy of domestic demand, which limits the net positive contribution of the external setting. The indicators available for Q3 confirm this diagnosis, and no substantial changes in the growth rate of the area as a whole are expected, although a slightly lower figure than for Q2 should not be ruled out.

The low level of interest rates and the operation of the automatic stabilisers which the European authorities are generally pursuing are what have given form to the expansionary stance of their macroeconomic policies; these, however, do not suffice to consolidate the recovery in

PRICES AND COSTS CHART 2





SOURCES: Eurostat, ECB and INE.

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.

domestic demand. In the case of private consumption, the signs of improvement perceptible in the labour market must take root, and the increase in employment must contribute to dispelling the uncertainty households still harbour when it comes to taking spending decisions, and which could be heightened by the ongoing rise in oil prices. Also, business investment has yet to firm, although here, too, the signs are promising as a result of the continuing favourable financing conditions and the improvement seen in business margins, in the light of contained wage increases and productivity gains.

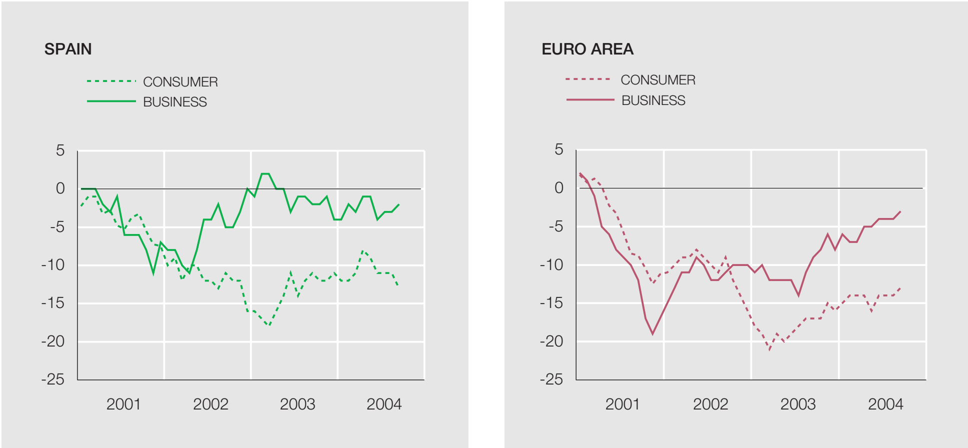
The euro area inflation rate stood at 2.1% in September, food prices having offset the increase in the energy component of the harmonised index. Expectations suggest that the inflation rate will hold at slightly over 2% in the coming months, without relevant second-round effects arising following the increase in energy prices. No doubt contributing to this will be the slowdown in unit labour costs that began in mid-2003. Given the prospect of continuing price stability in the medium run along with a gradual pick-up in the pace of activity, Eurosystem interest rates have remained unchanged at historical lows, providing significant support for the economic expansion in the euro area to firm.

In September, a European Commission communiqué outlined a series of proposals aimed at directing the debate about refining the framework in which fiscal policies in the euro area and in the EU as a whole are pursued. At present, these proposals are being discussed in European fora and will be analysed in the Ecofin Council in the coming months.

In this encouraging external setting and with financing conditions that remain generous, the growth rate of the Spanish economy has stabilised at close to 2.6%, the figure advanced by INE for 2004 Q2 and estimated by the Banco de España for Q3. The latest data show that the rate of change of national demand, excluding stockbuilding, is increasing gradually, as capital goods have moved on to the expansionary path which the other components have broadly been following for several years. The improved international outlook has contributed to restoring — not without some doubt, which remains present — private agents' expectations and

CONFIDENCE INDICATORS

CHART 3



SOURCE: European Commission.

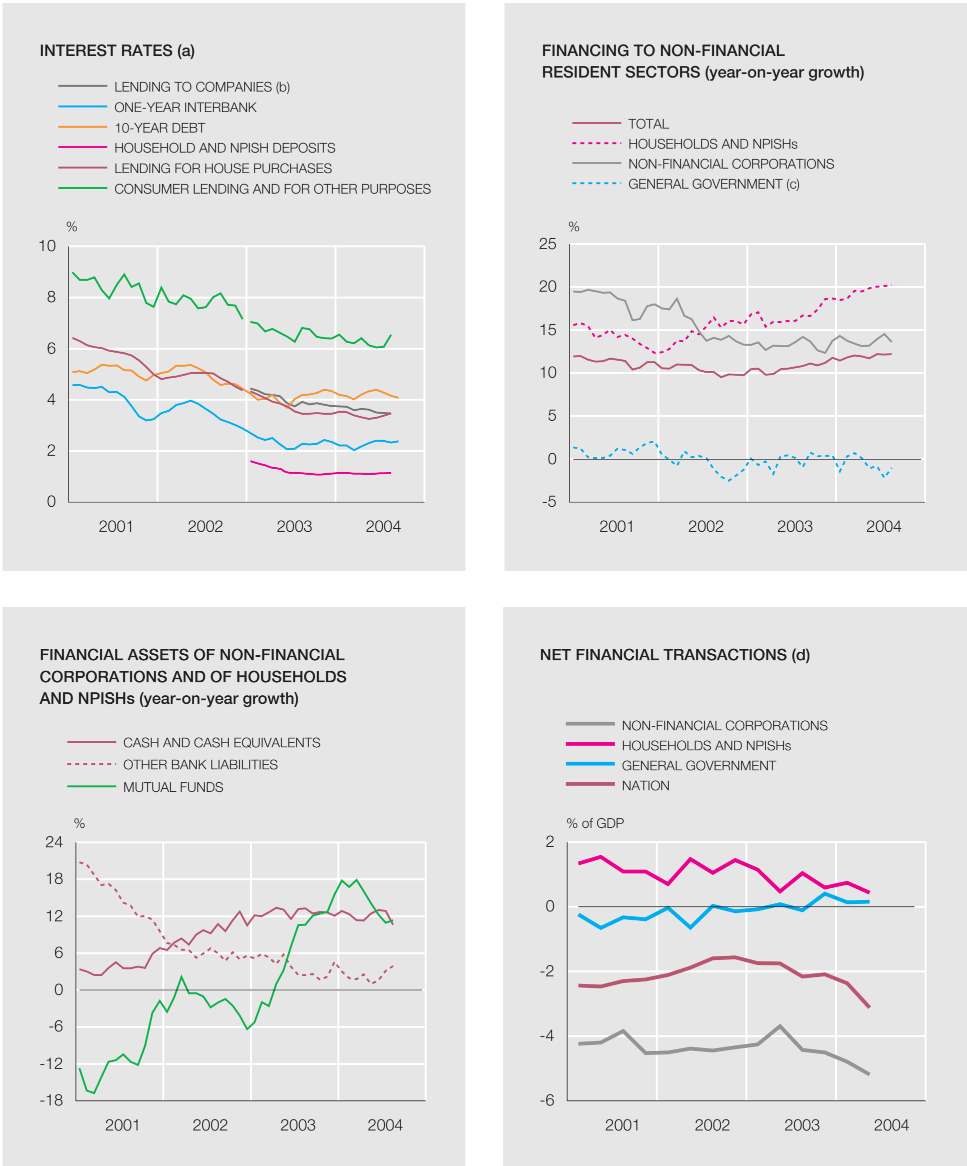
has boosted the growth of goods exports. However, the resilience of imports and the rather discouraging results in the tourist sector (somewhat better in Q3 than in Q2) have sharply restricted output growth. The growing penetration of foreign products in the domestic market, at a far higher rate than that of Spanish products in international markets, and the difficulties besetting the tourist sector should serve as a warning for the problems of competitiveness that might be brewing up. Indeed, these might restrict the pace of real convergence with the euro area countries.

Although some indicators show a slight decelerating trend in private consumption, its growth rate remains substantial, as does that of residential investment. In fact, housing starts have shown renewed life in recent months and, at the same time, house prices continue to rise at very high rates, at around 18% in Q2. Although the growth of household disposable income might be around 3% for the year on average, in real terms, and while employment growth is proving a sound support for household spending, households have continued to resort intensely to debt to finance their consumption and investment flows. On the latest available data, lending to households rose by 20% to August, with the increase in financing for house purchases standing at 24%. This means that households' debt and interest burden as a proportion of their disposable income have continued to rise (the former stands already at around 100%), while saving not earmarked for debt service has continued to decline. Household financial wealth has fallen slightly, on Q2 data, but their net worth has risen as a result of the increase in house prices.

The indicators available for Q3 confirm the pick-up in investment in capital goods, the year-on-year growth rate of which has climbed notably. Brighter expectations in the light of the international outlook and the favourable financial conditions in which businesses are operating are underpinning this recovery. Credit to companies increased by 14% to August and, while the biggest funds have been taken up by the property sectors, the growth of financing to the industrial branches has also been significant. In these circumstances, debt ratios have continued to rise slightly, but the restructuring processes undertaken and the decline in the interest burden and financial pressure shown by various indicators confirm the sound expectations that the recovery in productive investment will take root.

The above-mentioned negative contribution of real net external demand to GDP growth in Q3 is estimated, on the partial information available, to be around 1.5 pp. In the period to August, the growth of goods exports in real terms according to Customs figures was slightly lower than

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.
c. Consolidated financing: net of securities and loans that are general government assets.
d. Cumulative four-quarter data.

that of our markets. On the data for recent months, there was a perceptible modest pick-up in sales to the EU, although it was non-Community exports which continued to be most robust. Imports continue to rise at very high rates across all goods categories, including energy, and purchases of capital goods are particularly strong. The results for the tourist sector in 2004 to date are proving poor, although some signs of improvement have been seen during Q3. In this connection, the competitive pressures of other markets are affecting a sector highly sensitive to price changes, as shown by the strong increase in Spanish tourist outflows to destinations that have become substantially cheaper as a result of the appreciation of the euro.

Employment growth remains very robust, as highlighted by the Q3 indicators. Specifically, the recently published Labour Force Survey has raised the year-on-year rate of change of employment in Q3 to 25%, exceeding the results for the previous quarter. One of the salient features of the data in recent months is the fact that, although the core of job-creation remains concentrated in the market services and construction branches, the process of decline in employment in industrial activities appears to be easing off. This must be built on in the coming months, without detriment to productivity gains, which should respond to a greater extent to genuine increases linked to the growth of investment and to efficiency in factor use, and not to job destruction, as has been the case in recent years. It is the market services branches which continue to post the sharpest declines in labour productivity.

As relatively high wage increases (when compared with those in other euro area countries) are combining with low productivity growth, the difference between the growth of unit labour costs in the Spanish economy and that in the euro area as a whole continues to widen (see Chart 2). This might ultimately impair the economy's competitiveness, especially if the wage indexation arrangements in place provide for the feed-through of energy price increases to wages, amplifying their effects across the economy.

In September the growth rate of consumer prices (measured by the CPI) stood at 3.2%, as the rise in energy prices was offset by a strong slowdown in unprocessed food prices, following a long period of forceful rises which have now been stripped out of the year-to-year comparison. Among the other more stable components, the changes have been relatively insignificant, with the growth of the index aggregating services and non-energy processed goods standing at 2.8%, around which rate it has been fluctuating in recent months. The inflation differential with the euro area countries, measured via the harmonised indices, was 1.1 pp, with a notably persistent difference of the same order of magnitude, for yet another month, between the growth rates of services prices.

In terms of budgetary policy, the key event was the unveiling of the State budget figures for 2005. The forecasts for end-2004, which point to an overall general government deficit of 0.8% of GDP, are influenced by changes in the accounting treatment given to certain expenditure items and by the decision that the State should assume the debt built up by certain public-sector corporations in the past. Both these changes account for the upward revision of the deficit figures and are in response to the plans to increase the transparency of public finances.

It is important that greater transparency should lead to more disciplined behaviour by the general government sector as a whole. This is needed to address the risks facing the Spanish economy — against a background of loose monetary conditions — in respect of competitiveness and household debt.

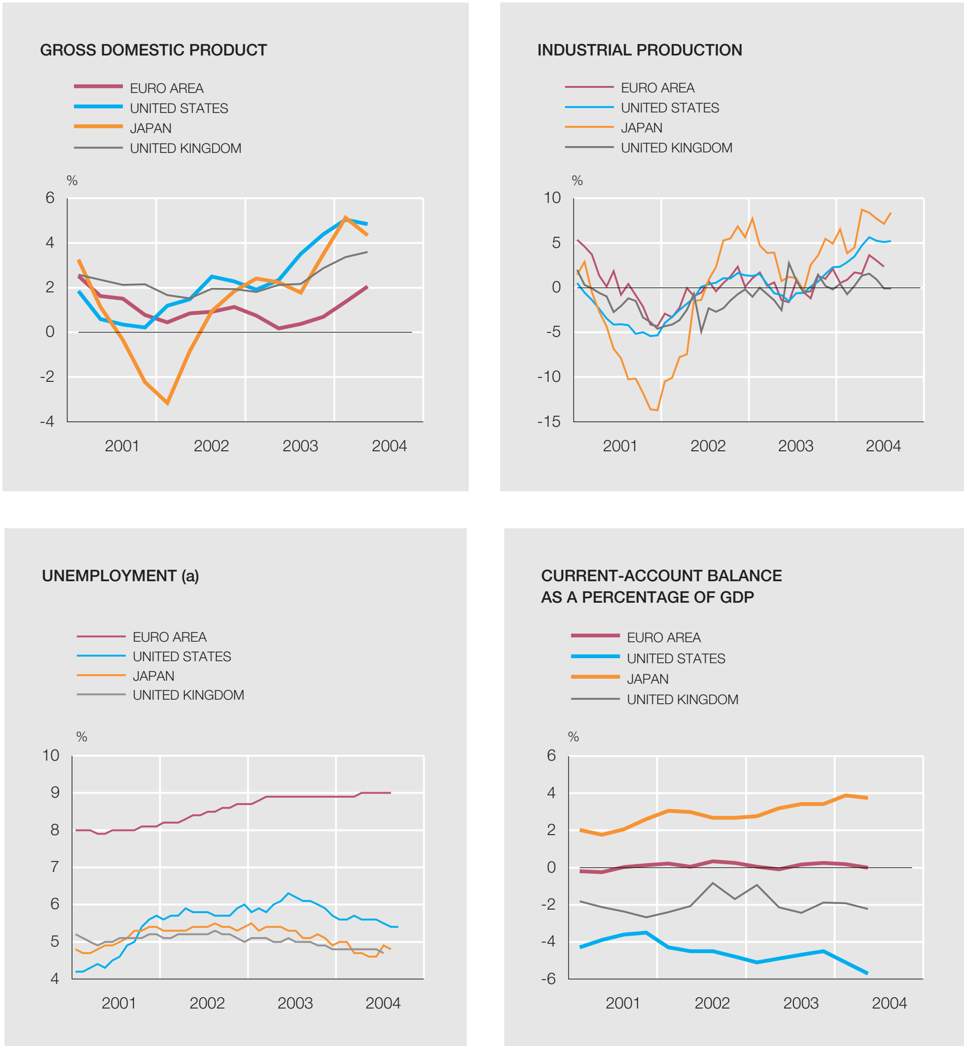
2 External environment of the euro area

Oil prices have been the centre of attention of markets and agents in recent months. From the start of Q3, the price of a barrel of Brent oil increased by 38%, taking it to an all-time high of $51 per barrel in late October, although the prices of heavy crudes posted appreciably lower increases. This rise in price, which has heightened since mid-September, was encouraged by problems arising from the adverse weather in the Gulf of Mexico and by the social and labour instability in other producer countries. Despite these conjunctural factors, the oil prices discounted by the futures markets for end-2006 increased by $10 from the start of Q3, whereby a substantial part of the rise seen in recent months has ceased to be perceived as transitory. With the exception of the markets for crude oil and other commodities, international financial developments were characterised by low volatility on financial markets, which saw declines in the longest-dated interest rates. Also, the equity markets performed relatively favourably, in a period in which US official interest rates gradually tightened to a level more in keeping with the economy's cyclical position. Corporate bonds and emerging markets' public debt, for their part, behaved favourably. On the currency markets, the dollar was once more weak against the euro, which climbed to stand at above 1.27 per dollar.

In the United States, the first Q3 indicators corresponding to July pointed to a strong surge in activity following the slowdown in GDP in Q2. However, as the quarter unfolded the indicators proved less favourable since many lost momentum, partly and possibly as a reaction to the persistent rise in oil prices. These signs of deceleration should not affect GDP growth considerably in Q3, but they increase the uncertainty about developments in the coming quarters. The labour market does not contribute to dispelling these doubts. In September, employment grew by 96,000 jobs, far below expectations and below the employment created in the spring months. On the prices front, the outlook is not so far a cause for concern. The September CPI stood at 2.5% year-on-year, down from 3.3% at the end of Q2, although the underlying measure climbed to a 12-month rate of 2%, the highest since November 2002. Moreover, in the initial stages of production the rates of increase of prices are higher: the underlying rate for intermediate goods increased by 7.8% in September on a year earlier. Regarding the external sector, the latest trade balance data (which run to August) confirm the last three months as those with the biggest all-time deficit recorded, above $50 billion monthly in each. Behind these recent negative developments is the forceful expansion of imports, which were growing at 20.7% year-on-year in August, driven by the increase in the energy bill.

Japan saw its GDP growth rate slow in Q2 to 4.2% year-on-year, compared with 5.9% in Q1, raising doubts about the soundness of the Japanese recovery. However, into Q3 the pace of activity appears to be somewhat higher than in the preceding quarter. While the supply-side and employment indicators offered moderately positive signs, the demand indicators were less robust. In August, the growth of industrial output accelerated (9.7% year-on-year) along with that of machinery orders (5.4%), and expectations improved, as shown by the Tankan business confidence index for Q3. On the demand side, personal income fell back in August (-1.6% year-on-year) and, in September, consumer confidence deteriorated slightly. The labour market continued to trend favourably in August, creating 290,000 jobs. That lowered the unemployment rate to 4.8% (4.9% in July). Consumer prices posted a 12-month rate of decline of 0.2% in August (–0.1% in July), on a par with underlying inflation (-0.2% in July), which testifies to the difficulties of overcoming price deflation. Conversely, wholesale prices increased at a year-on-year rate of 1.8% in September (1.7% in August), driven by the rise in oil and coal prices.

MAIN MACROECONOMIC INDICATORS CHART 5
Annual rates of change



SOURCES: Banco de España, national statistics and Eurostat.

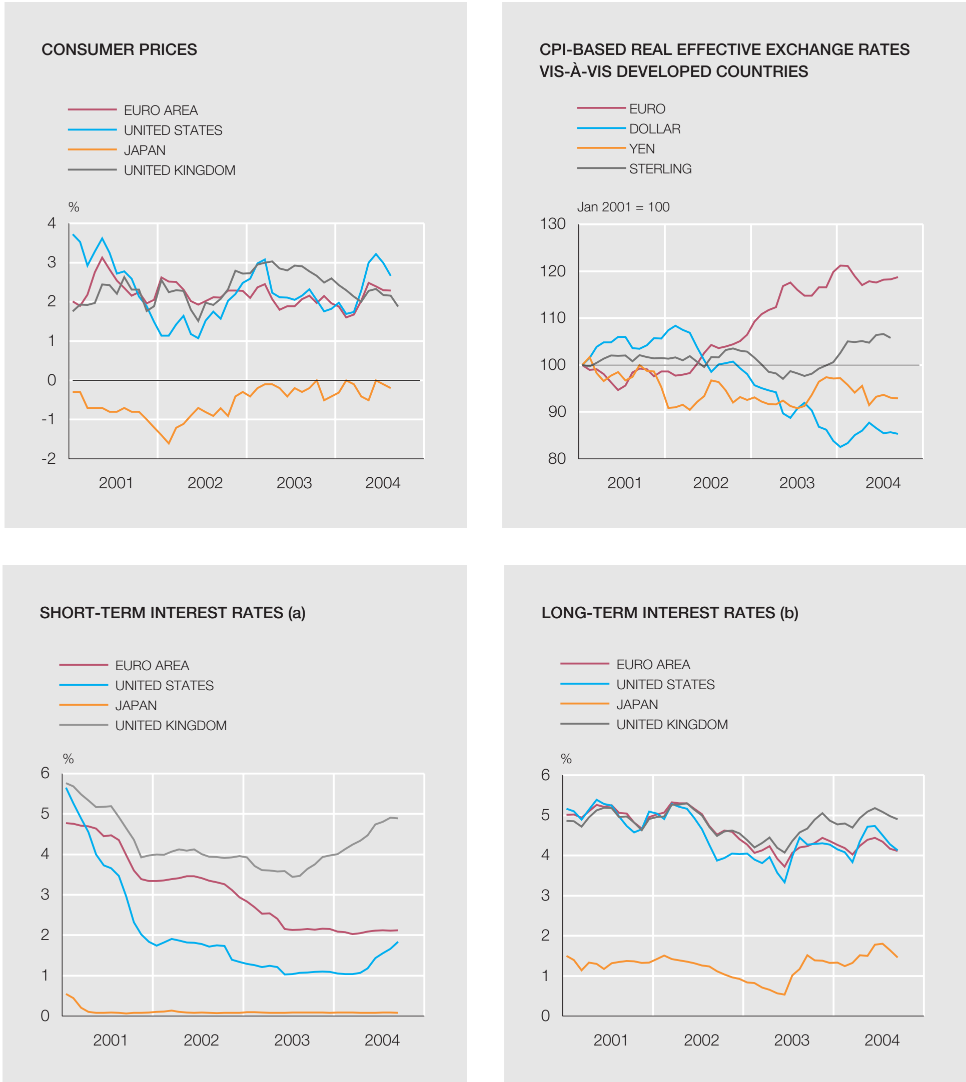
a. Percentage of the labour force.

After having grown at a year-on-year rate of between 3% and 4% in recent quarters (3.6% in Q2), the UK economy has shown signs of slowing in recent months. There were signs of a moderation in house prices, while mortgage loans fell off notably. Further, the index of retail distribution in September posted its worst figure in over a year, presaging a slowdown in consumption which, however, is not yet apparent in retail sales data. And finally, on the production side, there was a fresh decline in industrial activity in August, and the PMI manufacturing index in September was the worst since July 2003. All these developments have not impacted the labour market, where employment has continued to increase, up to a rate of 0.8% in August compared with a year earlier. Adding to this is the strong slowdown in the (harmonised) CPI from 1.3% in August to 1.1% in September, far below the central target (2%) of the Bank of England, which held its official rates at 4.75% at its September and October meetings following the 25 bp rise in August. The trade balance, with a deficit of £4 billion in August, continued to worsen.

In the new EU Member States, GDP growth remained robust in 2004 Q2, standing at over 4% in almost all of them. Of particular note was the high growth - of above 6% year-on-year

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



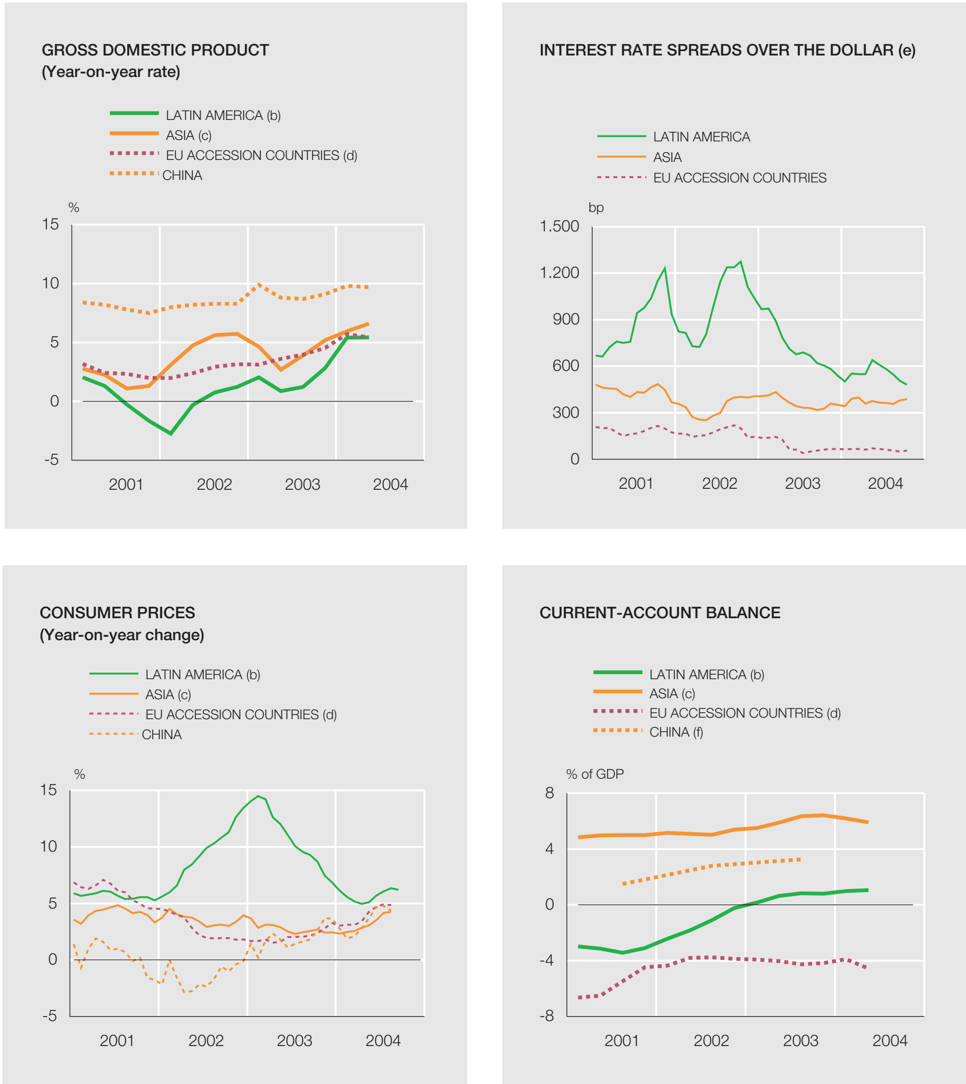
SOURCE: Banco de España.

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

- in the Baltic States and Poland. The indicators for Q3 showed sizable increases in industrial output and in exports in the main countries of the region. Prices have recently begun to ease, after rising mid-year due in part to the liberalisation of certain administered prices and to the rise in indirect taxes, further to EU accession. Against this background, official interest rates, following the increases mid-quarter in Poland (from 5.75% to 6.5%) and in the Czech Republic (from 2.25% to 2.5%), have held stable since August, and even fell by 1 pp in Hungary to 10.5%. Regarding the fiscal situation, the deficit targets for 2004 set in the Convergence Programmes look as though they will be met in almost all cases, with the notable exception of Hungary, which has already overshot its initial deficit target for the entire year, revising it upwards from 4.6% of GDP to 5-5.3% of GDP. The new Member States' financial markets have held relatively steady, with the key development being the appreciation against the euro of the exchange rates of those countries which let their currencies fluctuate, especially Hungary and Poland. The currencies of the new Member States belonging to ERM II (Slovenia, Estonia and Lithuania) held stable around their central parities.

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregate of the different areas has been calculated using the weight in the world economy of the countries comprising them, 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 EU acceding country data relate to Hungary and Poland. The Asia aggregate does not include China.
f. Annual data.

In the main south-east Asian economies, the Q3 data on activity and exports generally revealed something of a slowdown in relation to the notable buoyancy in Q2. That said, the pace of growth remained firm in most of them, with the exception of South Korea, where the sluggishness of private consumption persists. The gradual increase in inflation rates in all the economies in this area continued, prompted basically by the rise in energy prices. This has begun gradually and adversely to affect the consumer and business confidence indices in several countries. In China, the restrictive administrative measures implemented by the authorities from the start of the year have slowed the economy's growth rate in Q3, albeit only moderately. Chinese GDP growth in Q3 was thus 9.1% year-on-year, compared with 9.6% the previous quarter. However, despite the restrictive measures and the slowdown in the growth of the money supply and of bank lending, the 12-month inflation rate dipped by barely 0.1 pp (to 5.2%) in September, owing to the strong increase in food prices.

In Latin America, the behaviour of the financial markets held firm throughout the quarter, meaning that sovereign spreads resumed similar or lower levels than those at the end of January 2004. The indicators for Q3 continued to confirm the strength of activity seen in the first two quarters of the year and reaffirmed the growing weight of domestic demand as an engine of growth in the region. Nonetheless, the acceleration in activity, along with the rise in energy prices, prompted an increase in inflation in virtually all countries, which induced a tighter monetary policy stance in many cases. As a result, at their September meetings, the Bank of Chile increased its reference interest rate by 25 bp to 2%, and the Bank of Mexico raised the "corto" for the seventh time this year. The Bank of Peru, at its October meeting, raised its benchmark interest rate by 25 bp to 3%, and the Bank of Brazil, at its September and October meetings, raised the SELIC by 25 bp and 50 bp, respectively, to 16.75%. In Argentina, following several months of intense negotiations, the government managed to reach an agreement with the AFJP (retirement and pension fund managers) over the securities currently subject to suspension of payments. This agreement marks a step forward towards finalising the debt rescheduling process.

Q3 saw the continuation of the period of activity growth initiated in the euro area in mid-2003, underpinned by strong world economic expansion, favourable monetary and financial conditions and the more moderate rise in unit labour costs, which is allowing profit margins to recover. The persistence of the factors that spurred GDP growth in the first half of 2004 therefore makes for a scenario conducive to continued recovery in the second half, although a pick-up in the growth rate cannot be expected, as had been envisaged some months ago. In fact, the future of this scenario is threatened by a number of risks, including most notably the uncertain economic effects of the sharp rise in oil prices and the still-faltering start to cyclical recovery in certain European economies. As regards inflation, in summer the rate of change of the HICP progressively declined, since the favourable behaviour of food prices offset the continuing high growth rates of the energy component. However, the resumed escalation of oil prices from mid-September may delay the reduction of euro area inflation below the 2% target, despite wage moderation and a notable rise in productivity.

As far as fiscal policy is concerned, all the signs seem to indicate that in some countries the budget deficit will continue to exceed the upper limit set by the Treaty on European Union. The available indicators suggest that the budget deficit of the area as a whole will not decrease in 2004, which is a cause for concern given the improvement in the economic cycle.

3.1 Economic developments

According to the second euro area National Accounts estimate, in 2004 Q2 the area's quarter-on-quarter GDP growth rate was 0.5% (0.2 pp lower than in the previous quarter), which represented a fresh acceleration of the year-on-year growth rate that raised it to 2% (see Table 1). Hence the more buoyant activity seen in recent quarters remained evident. Although somewhat more moderately than in the early months of the year, the external sector contributed positively to growth, adding 0.2 pp to the quarter-on-quarter rate of change. This was the result of a sharp pick-up in exports driven by strong world economic growth which, nevertheless, was partly offset by an also notable increase in imports. Domestic demand (excluding inventories) continued to be somewhat weak, with no clear response to the stimulus arriving from abroad. Thus its contribution to quarter-on-quarter growth was 0.3 pp, similar to that in 2004 Q1. Notable within domestic demand was the slowdown of private consumption growth to 0.3%, following a rate of 0.7% in the previous quarter, and, working in the opposite direction, the higher growth of government consumption. Investment remained flat as a result of the poor performance of construction, while investment in equipment was more buoyant and grew at 0.7% (against –0.5% in Q1). Finally, stockbuilding made a zero contribution to the quarter-on-quarter GDP growth of the euro area (see Chart 8).

National Accounts analysis by country shows significant disparity of economic behaviour (see Box 1). With the exception of the Netherlands and Greece, the euro area countries saw positive growth, albeit with notable differences in its composition. Countries such as Germany and Italy (with quarter-on-quarter rates of 0.5% and 0.3%, respectively) reported weak domestic demand, and growth was mainly underpinned by the strength of the external sector. In Germany in particular, consumption rose by only 0.1% (following zero growth in the previous quarter) and investment, although it improved with respect to the previous period, again fell – this time by 1% – as a result of the prolongation of the contractionary path of construction. In another group of countries which includes France and Spain (with growth rates of 0.7% and

EURO AREA ECONOMIC INDICATORS

TABLE 1

	2003				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3 (a)	Q4 (b)
GDP								
Year-on-year growth	0.7	0.2	0.4	0.7	1.4	2.0		
Quarter-on-quarter growth	0.0	-0.2	0.5	0.4	0.7	0.5		
European Commission forecasts (c)							(0.3; 0.7)	(0.3; 0.7)
IPI (d)	1.0	-0.8	-0.2	1.3	1.0	2.8	*1.8*	
Economic sentiment	90.5	91.4	94.2	97.7	98.8	100.0	100.5	
Industrial confidence	-11.0	-12.0	-11.4	-7.3	-6.7	-4.7	-3.7	
Manufacturing PMI	49.3	47.1	49.1	52.0	52.8	54.4	53.9	
Services confidence	-5.7	-2.0	5.3	10.3	10.7	11.4	11.3	
Services PMI	48.9	47.9	51.9	56.7	56.0	55.2	54.4	
Unemployment rate	8.8	8.9	8.9	8.9	8.9	9.0	*9.0*	
Consumer confidence	-19.3	-19.3	-17.3	-16.0	-14.3	-14.7	-13.7	
HICP (d) (e)	2.4	1.9	2.2	2.0	1.7	2.4	2.1	
PPI (d) (e)	2.3	1.3	0.9	0.9	0.4	2.4	*3.1*	
Oil price in USD (e)	30.3	27.6	27.1	29.9	33.8	35.3	43.3	49.5
Loans to the private sector (d) (e)	4.8	4.6	4.9	5.6	5.3	6.0	6.5	
Euro area ten-year bond yield	4.2	4.0	4.2	4.4	4.2	4.4	4.2	4.0
US-euro area ten-year bond spread	-0.22	-0.32	0.09	-0.05	-0.11	0.28	0.14	0.15
Dollar/euro exchange rate (e)	1.090	1.143	1.165	1.263	1.222	1.216	1.241	1.261
Appreciation/Depreciation of the euro (e)	3.9	9.0	11.1	20.4	-3.2	-3.8	-1.7	-0.2
Dow Jones EURO STOXX Broad index (e)	-12.9	2.9	4.1	18.1	1.9	3.7	1.5	3.4

SOURCES: Eurostat, ECB and Banco de España.

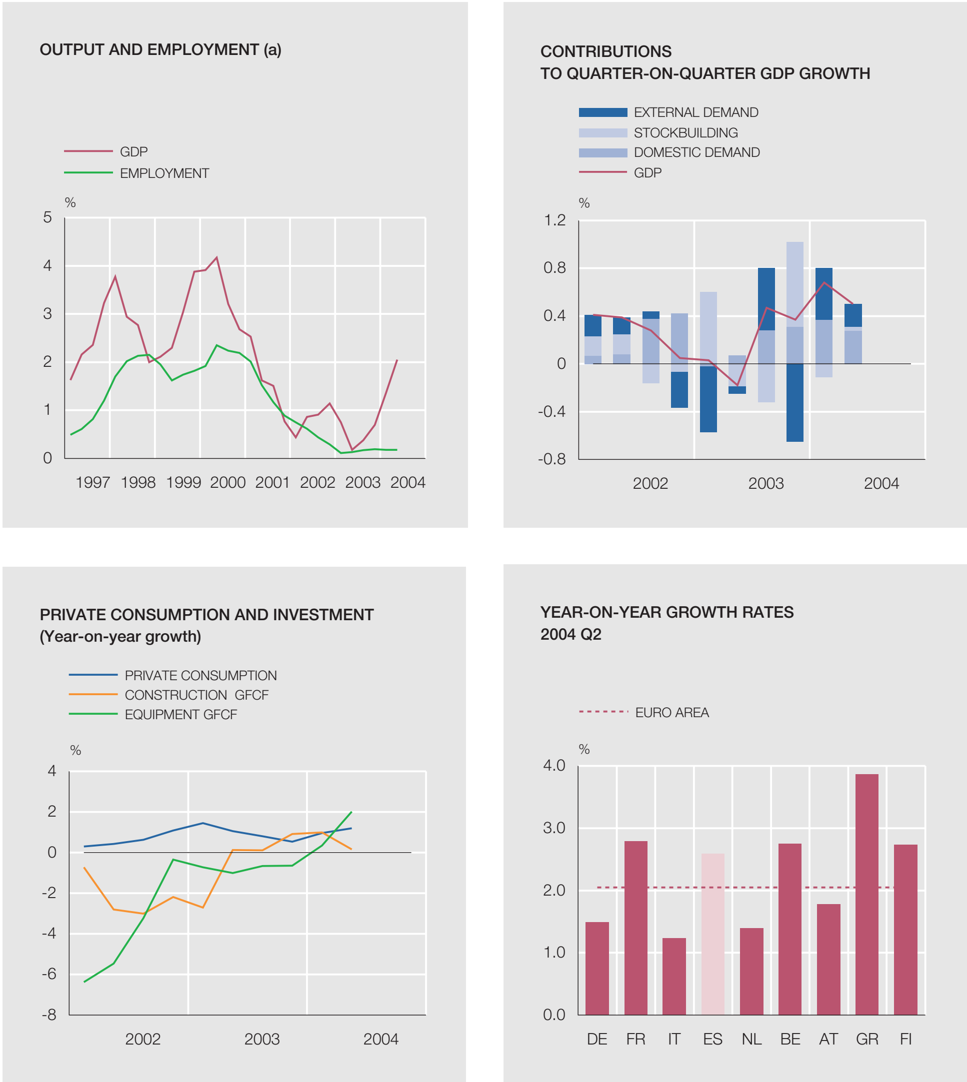
a. The information in italics does not cover a full quarter.
b. Information available up to 21 October 2004.
c. Quarter-on-quarter growth forecasts.
d. Year-on-year growth.
e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

0.5%, respectively), domestic expenditure was much more buoyant, while foreign demand contributed negatively to the expansion of output.

By branch of production, the quarter-on-quarter growth rate of value added in the euro area economy, which held steady at 0.7%, was underpinned by the strength of industry and, secondarily, of services, the other branches showing more moderate growth. As to the labour market, employment remained practically stagnant in Q2, recording, as in the opening months of the year, a year-on-year change of 0.2% as a result of job destruction in industry and in construction and of rising employment in services. Given the accelerating pace of activity in the euro area, this employment behaviour led to a notable rise in the year-on-year growth of productivity to 1.9%, up 0.7 pp on the previous quarter. The unemployment rate remained steady at 9% from April to August.

The available information on indicators in Q3 points to unchanged or slightly slower GDP growth compared with the first half of the year (see Table 1 and Chart 9). As regards the supply indicators, the industrial production index decreased by 0.1% in the period July-August with respect to the Q2 average, and its year-on-year growth rate also decreased. The confidence indicators generally remained at levels very similar to those of the preceding quarter. Thus, the industrial confidence indicator compiled by the European Commission improved slightly on average during Q3 (thanks to the favourable assessment of order books), in contrast to the Purchasing Managers' Index for manufacturing industry, which nonetheless remained above the level of 50, which is compatible with the expansionary behaviour of the economy. Construction

EURO AREA NATIONAL ACCOUNTS CHART 8



Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

confidence also rose slightly in the summer months, while the confidence indicators for the services sector barely changed.

On the demand side, the most recent indicators still do not reflect a firm increase in private consumption. Thus, while on average the consumer confidence indicator was somewhat better in 2004 Q3 than in the preceding quarter, the retail confidence index was slightly down. Retail sales in July and August stood on average at the same level as in Q2 and new car registrations performed negatively in that period. As regards investment indicators, firms improved their assessment of industrial order books and capacity utilisation increased, although there was a certain fall-off in their assessment of installed capacity (see Box 2). Finally, the indicators of the external sector signal that its contribution to growth will hold steady, with both the export order books and the export expectations remaining favourable since, although they declined slightly in Q3, they stand at high levels.

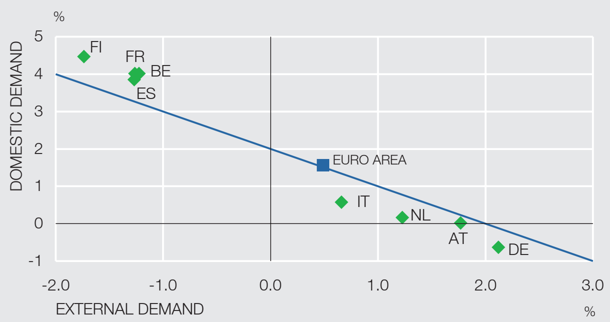
In September the HICP grew year-on-year by 2.1%, down 0.3 pp on June. This decline in the inflation rate conceals uneven behaviour by the more volatile components of the HICP (see

The economic activity of the euro area has been recovering during the past year, with year-on-year growth of 2% in 2004 Q2. This rate of expansion is the result of fairly uneven behaviour among countries. Some, such as France, Spain, Belgium and Finland, posted rates above 2.5%, while others, such as Germany and Italy, grew much more slowly than this. A notable feature of the disparities between these two groups of countries was the difference in the respective contributions of domestic and foreign demand to output, as can be seen in Chart 1 (in which the thick line represents the points at which GDP growth is equal to 2% – the euro area average –). Thus, in the countries whose economic activity has expanded more weakly, the contribution of foreign demand has been much greater than in the more buoyant economies, while in the latter, GDP growth has been underpinned by domestic demand.

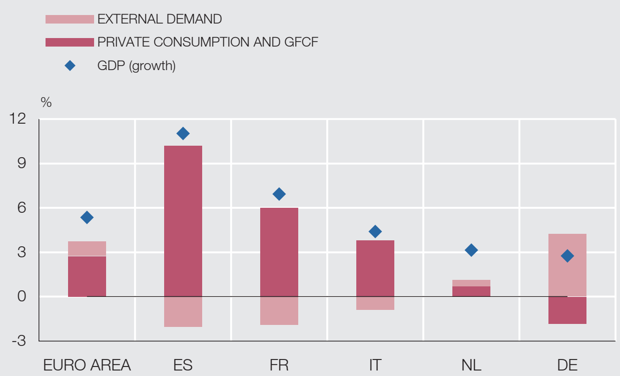
The very different rates of expansion of activity in these two groups of countries and the uneven contributions by foreign and domestic demand are not phenomena exclusive to the most recent economic situation. Since the current cyclical slowdown commenced in the euro area in 2000 Q2, the area's GDP has grown by 5.3% in cumulative terms (see Chart 2). This aggregate growth masks widely differing behaviour among the area's five largest economies, since the rates in Spain and Germany are 11% and 2.8%, respectively, with France, Italy and the Netherlands at intermediate levels (6.9%, 4.4% and 3.1%). This same order of the five countries is seen in the contribution of domestic demand and, with an opposite sign, in the contribution of foreign demand to growth.

In a monetary union there are adjustment mechanisms which, in principle, should contribute to correcting macroeconomic divergences, one of the most prominent of which is that working through changes in external competitiveness. The countries whose domestic demand is performing most weakly should experience lower cost and domestic price pressure, and therefore a gain in competitiveness that will drive exports and, further down the track, domestic demand. However, the effectiveness of this mechanism depends, among other factors, on the degree of nominal wage stickiness, which may make the process costly and lengthy and even prevent it from taking place. In this connection, it is of interest to analyse changes in competitiveness in the three economies (among the larger ones considered here) whose cumulative growth in the period of reference was below the euro area average. Chart 4 shows how the German economy made notable competitiveness gains (as measured by relative changes in its unit labour costs) in the period under consideration, which explains the notable contribution of its exports to output growth. A look at the Netherlands and Italy, however, shows that this process of improved competitiveness is not automatic. In the case of the Netherlands, the slowdown in relative unit labour costs only commenced after a sharp slowdown in activity, while in Italy, despite the prolonged period of economic weakness and the substantial loss in competitiveness, its relative wages continue to show no signs of deceleration. This seems to have resulted in Italian exports making a scant contribution to output growth in the last four years.

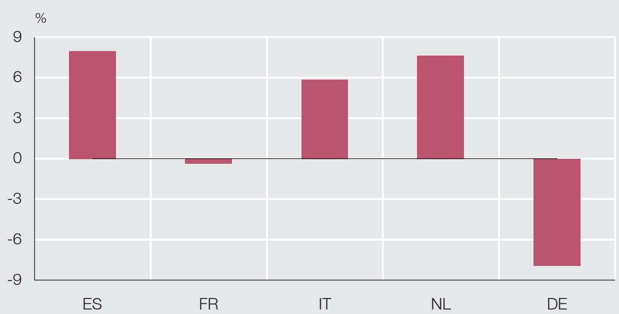
1. CONTRIBUTIONS TO THE GROWTH OF DOMESTIC AND EXTERNAL DEMAND (2004 Q2)



2. CUMULATIVE GROWTH AND CONTRIBUTIONS (a)



3. CUMULATIVE GROWTH OF ULC WITH RESPECT TO THE REST OF THE AREA (a)

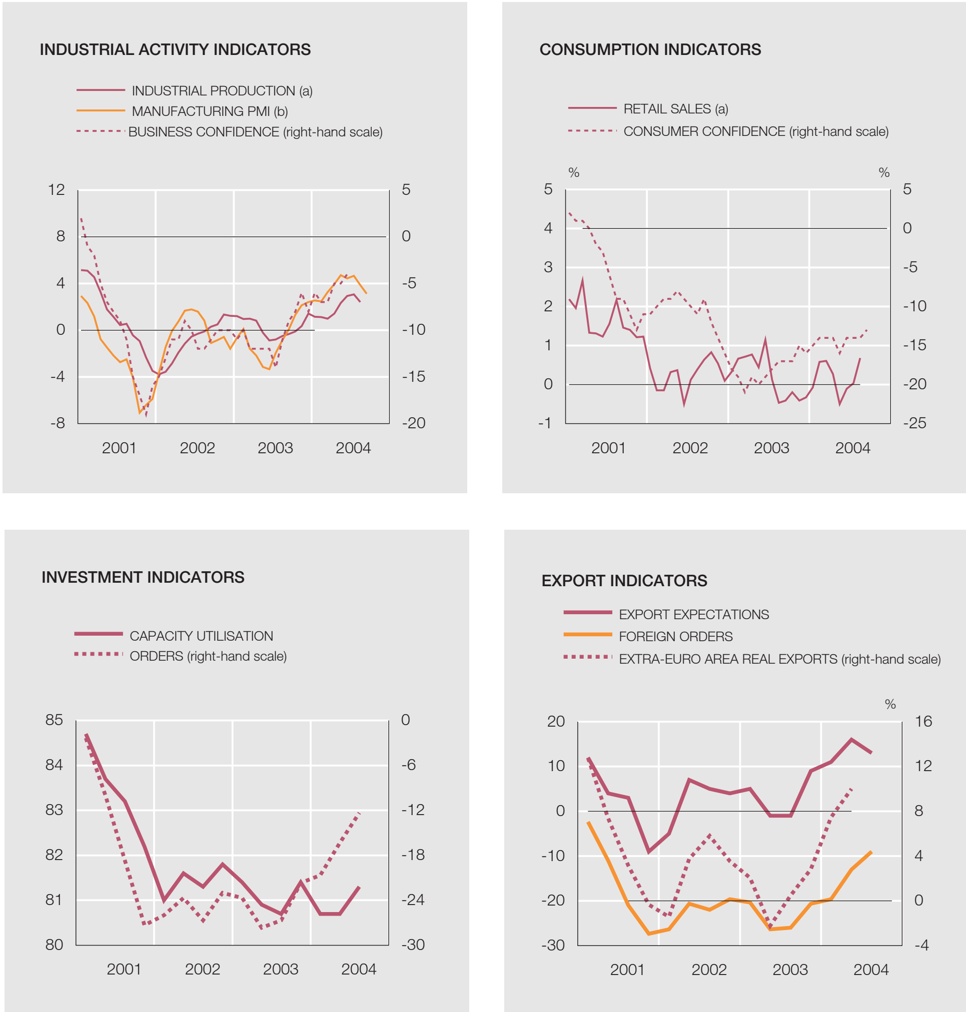


SOURCE: Eurostat and Banco de España.

a. Cumulative growth from 2000 Q2 to 2004 Q2.

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.
b. Normalised data.

Chart 10). Thus, while energy prices again accelerated (up to growth of 6.4%), in line with the oil price escalation, food prices fell in September by 1.5% year-on-year, due largely to the base effects deriving from their high growth rates a year earlier when Europe was hit by a heat wave. Therefore, underlying inflation, as measured by the year-on-year growth of the HICP excluding unprocessed food and energy (given their more volatile nature), held relatively steady at 2.1% (down 0.1 pp on June) as a result of the persistence shown by the inflation rate of services, of the steady growth rate of the prices of non-energy industrial goods and of the slowdown in processed food prices. Producer prices continued to accelerate because of the further notable rise in oil prices, along with that in commodity prices, which continued to show high year-on-year growth despite falls in recent months. Thus the year-on-year rate of change of the producer price index rose in both July and August, up to 3.1%.

As regards price formation on the supply side, the notable rise in productivity growth in 2004 Q2 and the wage moderation seen in that period (with a year-on-year increase in compensation per employee that held steady at 2.1%) gave rise to a significant slowdown in the growth of unit labour costs (to 0.3%) and to a recovery in profit margins. The sluggishness that has continued to beset the European labour market to date (with employment expectations indica-

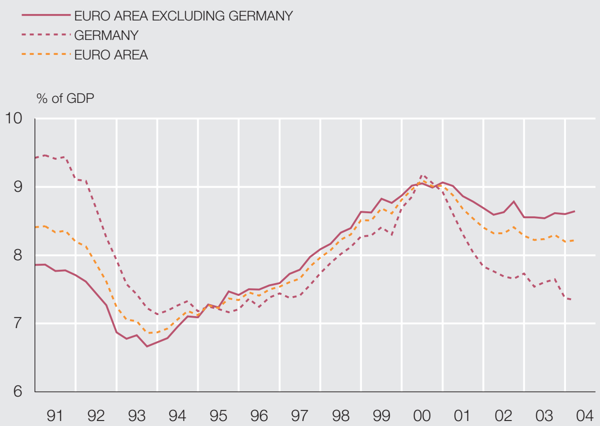
Investment in equipment (which includes machinery and computer hardware, among others), despite its relatively low weight in GDP, exerts a notable influence on the behaviour of output both in the short term (due to its high volatility and its marked procyclical nature) and in the long term (given that it enables capital accumulation and the incorporation of technological progress into productive processes, which leads to improvements in productivity and in the economy's potential GDP). The available evidence seems to indicate that investment in equipment generally moves contemporaneously with GDP. In addition, given its procyclical nature, in the initial stages of a cyclical recovery, such as that currently being seen in the euro area, it will foreseeably expand more briskly than output.

The recent behaviour of these two variables in the euro area has been similar, with year-on-year growth of 2% in 2004 Q2, thus bringing to an end the stage dating from the beginning of 2001 in which the year-on-year change in investment in equipment was lower than that in output (and even negative in many quarters – see Chart 1). As a result, during this last cyclical slowdown, the share of investment in equipment in the GDP of the euro area as a whole progressively declined from 9.1% in 2000 to a low of 8.2% in 2004 Q1 (see Chart 2).

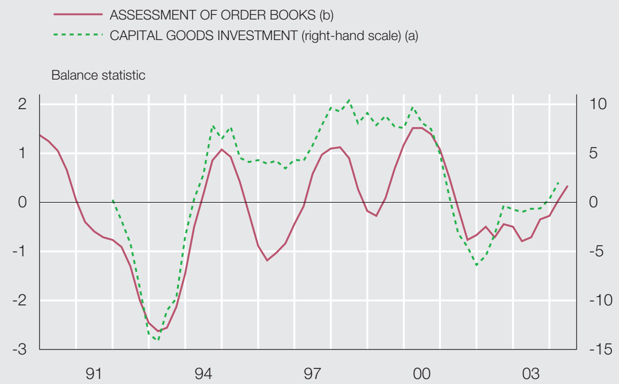
The loss of weight of this investment component is, however, lower than that recorded in the recession of the early 1990s, which amounted to 1.5 percentage points of GDP. Also, it is noteworthy that in the most recent cyclical trough the importance of investment in equipment relative to GDP in the euro area was nearly the same as in the cyclical peak of the early 1990s. A look at individual countries softens somewhat the weakness of this variable, because the results are significantly affected by the lack of investment buoyancy in Germany. If a euro area aggregate that does not consider Germany were analysed, it would be seen that, for example, as early as 2004 Q2 investment in equipment grew more quickly than output (3.4% against 2.3%). In fact, in this group of 11 countries, the share of investment in equipment in GDP has been recovering slightly since 2003 Q3. It therefore seems that investment in equipment in the euro area is starting to respond to the favourable monetary and financial conditions and to the improved business margins.

1. ACTIVITY AND INVESTMENT IN CAPITAL GOODS

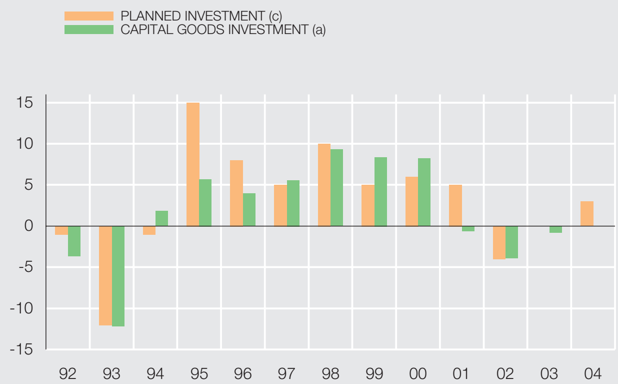
2. WEIGHT OF CAPITAL GOODS INVESTMENT IN GDP



3. ASSESSMENT OF ORDER BOOKS



4. PLANNED INDUSTRIAL SECTOR INVESTMENT



SOURCES: European Commission and Eurostat.

a. Annual percentage change.
b. Normalised series.
c. Change in investment volume with respect to the previous year; projected rate in Q2.

The potential demand for investment can be proxied by the degree of utilisation of installed capacity (insofar as a high use of this capacity may lead it to be expanded) or by firms' expectations as to the future demand for the goods and services they produce (which can be measured, for example, by the assessment made by firms of their order books). This latter indicator is plotted in Chart 3, which shows its high correlation with changes in investment in equipment and the substantial improvement since the beginning of 2003. Finally, Chart 4 shows the findings of the Industrial Investment Survey conducted half-yearly by the European Commission. Specifically, it depicts the outcome of the survey conducted in Q2 of each year, in which manufacturing sector firms are asked about their expectations of the change in investment for the current year. As can be seen in the chart, after two years in which no increase in investment was planned, the expectation in 2004 is for a slight increase of around 3%.

Accordingly, the outlook is moderately favourable for the behaviour of investment in equipment in the euro area, although certain factors of uncertainty (such as the extent of oil price rises) may discourage or delay investment decisions.

tors that have improved only slightly) is conducive to the continuing moderation of wage growth, as indicated by the wage settlement data available for Q3 (see Chart 11).

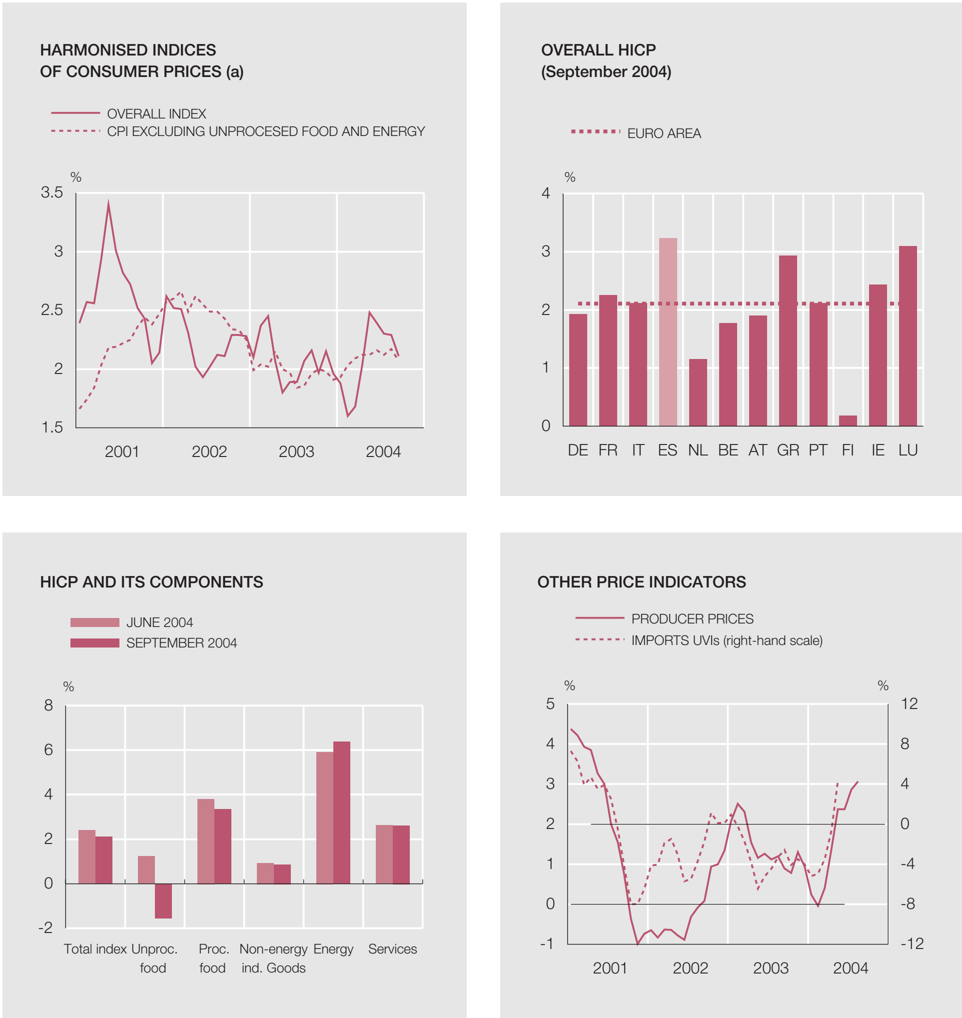
The only information on external sector developments in 2004 Q3 is the balance of payments figures for July, which permit only a tentative analysis of changes. The net current account balance of the euro area for the first seven months of the year amounted to €25.6 billion, compared with the deficit of €1.2 billion recorded in the corresponding period of 2003. This notable improvement was basically due to the increased surplus on the goods balance (up from €56.4 billion in 2003 to €75.9 billion in 2004) since, although the cumulative net flows of the services balance also showed a surplus, this was lower than in 2003. Another factor that helped to improve the current account balance was the lower deficit on the income balance. The sign of the basic balance (which, along with the current account balance, includes net direct and portfolio investments) changed from 2003 to 2004: whereas from January to July 2003 there was a surplus of €42.9 billion, the corresponding period of 2004 showed a deficit of €40.6 billion. This was mainly due to a notable fall in capital inflows into the euro area aimed at direct investment in the year to date.

Based on all the foregoing, it seems likely that euro area GDP growth in Q3 and Q4 will stand in the middle or lower half of the forecast range published by the European Commission, which places the quarter-on-quarter rate of change of GDP between 0.3% and 0.7% in each of these two periods. This would be compatible with annual average growth slightly below 2%, which is below the IMF forecast but consistent with that of other international institutions. However, the future poses certain downside risks derived from the international environment, as a consequence of the uncertainty associated with the oil price escalation and its possible influence on agents' confidence and of the persisting macro-financial imbalances in some economic areas. On top of these downside risks, there is the uncertainty generated by the lack of dynamism still apparent in the euro area's domestic demand and the possibility that the oil price hike will pass through to final prices and to wage demands, and affect the economy much more strongly. The scant buoyancy of domestic demand is the result of the disappointing growth in this aggregate in certain countries. However, it is foreseeable that also in these countries the relative strength of foreign demand will finally pass through to more buoyant growth in investment (in line with the favourable financial conditions of firms, the good business outlook and recovering margins) and in consumption, as employment progressively responds to the economic upturn.

On the fiscal side, the notifications by the Member States in September within the framework of the Excessive Deficit Procedure confirmed that the budget deficit of the euro area as a

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

CHART 10



SOURCES: Eurostat and European Central Bank.

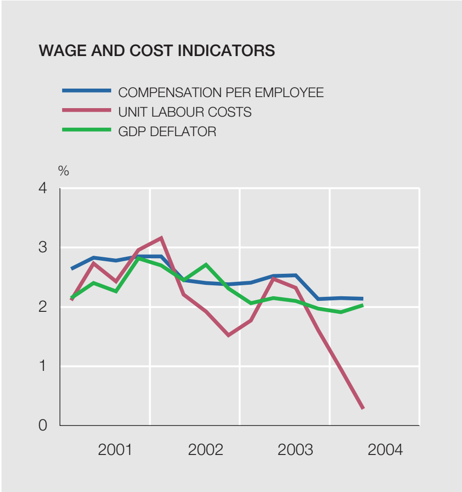
a. There is a break in January 2002 when the series was rebased to 2001.

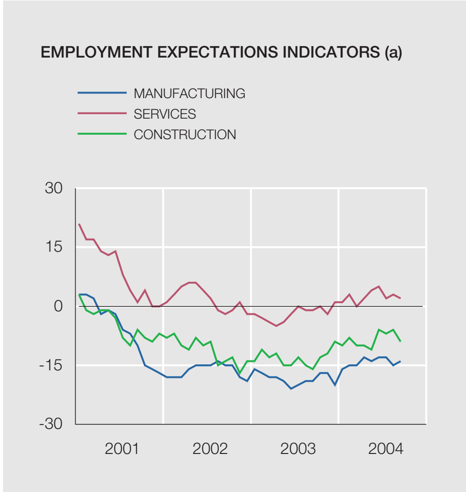
whole amounted to 2.7% of GDP in 2003. The significant upward revision of Greece's recent budget deficits (to 4.1% of GDP in 2000, 4.2% in 2001, 3.7% in 2002 and 4.6% in 2003) was the most remarkable new development in this round of notifications. The revision, which was approximately 2 pp of GDP in each of these four years, was due, among other factors, to the fact that the original accounting for military expenses and interest payments was incomplete and to the overestimated Social Security surplus. These developments underlined the need for accurate information to be obtained promptly on the true situation of the Member States' public finances, in order to preserve the effectiveness and credibility of euro area budget discipline mechanisms.

The fiscal imbalances are not expected to be corrected this year, so the budget deficit could stand at levels slightly worse than those of the previous year (see Table 2). Thus the targets set in the stability programmes (which result in an aggregate deficit of 2.3% of GDP) would not be met at an aggregate level. Unlike in the past three years, this time the deviation cannot be attributed to a more unfavourable economic trend than anticipated when the programmes were drafted. In addition, the imbalance will foreseeably exceed 3% of GDP in various euro area countries. Within these countries, Germany does not expect the deficit to be corrected sig-

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

CHART 11





SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators.

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

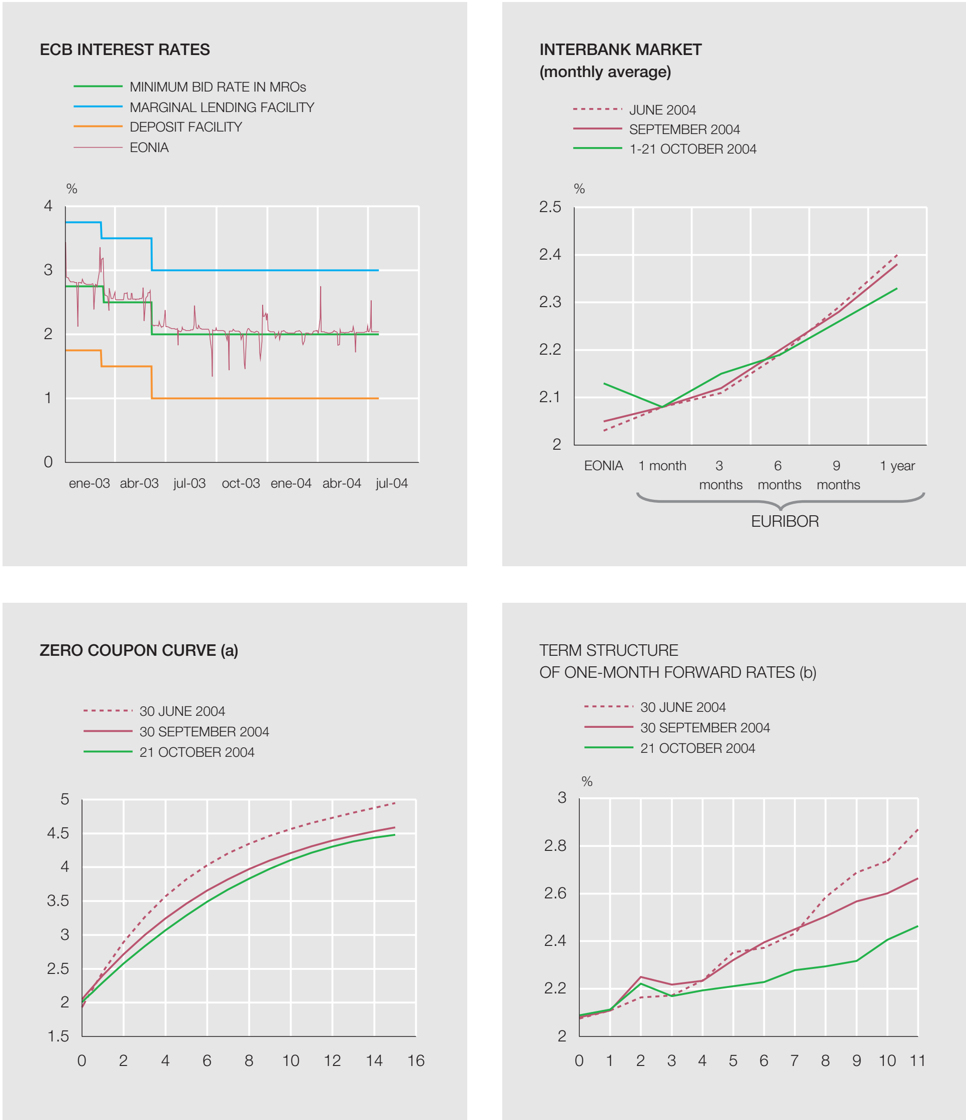
% of GDP

	2000	2001	2002	2003	2004 (b)	2004 (c)
Belgium	0.2	0.4	0.1	0.4	-0.1	0.0
Germany	-1.2	-2.8	-3.7	-3.8	-3.9	-3.3
Greece	-4.1	-4.2	-3.7	-4.6	-5.5	-1.2
Spain	-1.0	-0.5	-0.1	0.4	-0.6	0.0
France	-1.4	-1.5	-3.2	-4.1	-3.7	-3.6
Ireland	4.4	0.9	-0.2	0.1	-0.2	-1.1
Italy	-1.8	-2.6	-2.3	-2.4	-3.0	-2.2
Luxembourg	6.0	6.4	2.8	0.8	-0.8	-1.8
Netherlands	1.5	-0.1	-1.9	-3.2	-2.9	-2.3
Austria	-1.9	0.3	-0.2	-1.1	-1.3	-0.7
Portugal	-3.1	-4.4	-2.7	-2.8	-2.9	-2.8
Finland	7.1	5.2	4.3	2.3	2.3	1.7
PRO MEMORIA: Euro area						
Primary balance	3.1	2.3	1.3	0.7	0.5	
Total balance	-1.0	-1.7	-2.4	-2.7	-2.9	-2.3
Public debt	70.4	69.4	69.4	70.7	71.1	

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 (autumn 2004).
c. Targets of the stability programmes presented between November 2003 and January 2004.

EURO AREA INTEREST RATES CHART 12



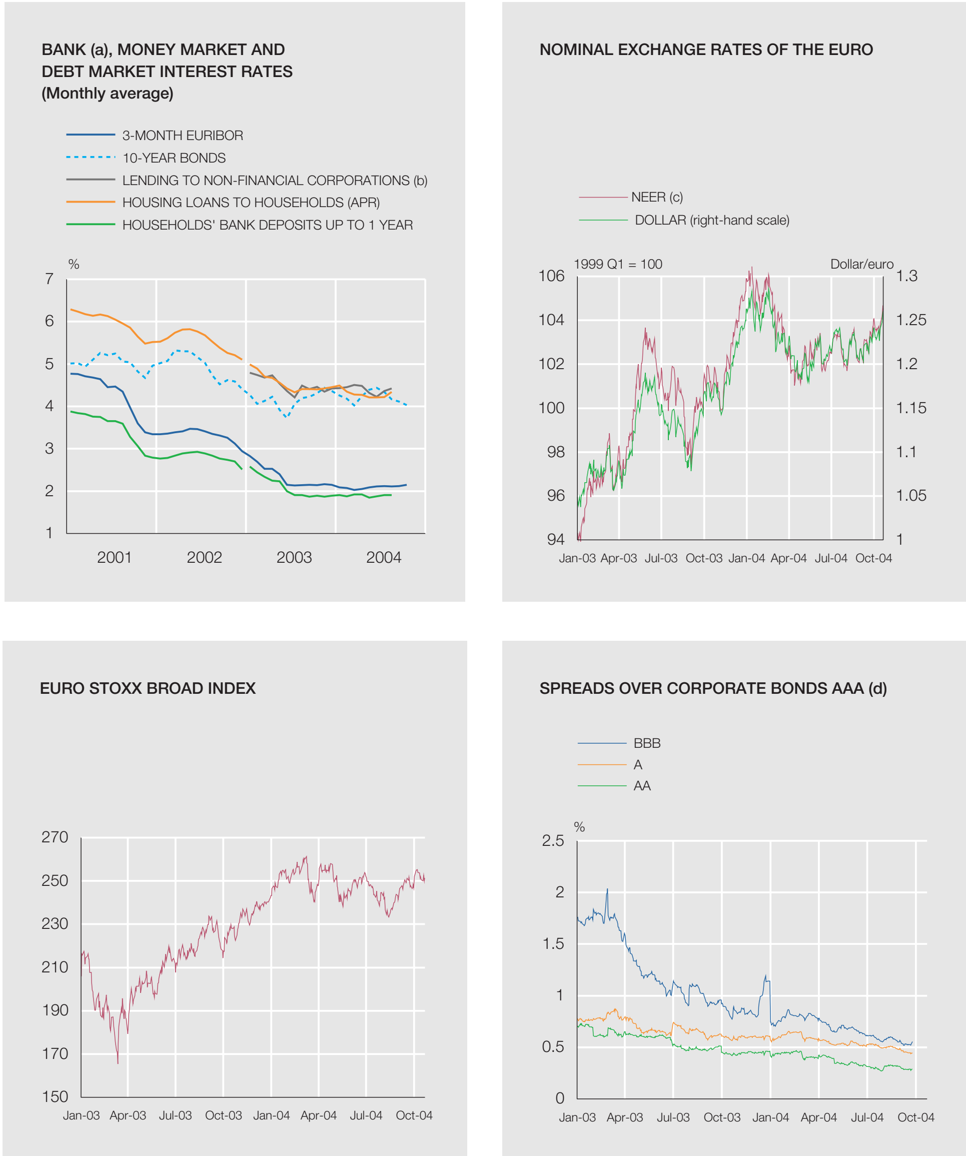
SOURCES: European Central Bank and Banco de España.

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

nificantly in 2004, given the unlikelihood that the improvement in the health system accounts resulting from the reforms in this sub-sector will suffice to offset the impact of the adverse trend in the tax bases on overall receipts. By contrast, the budget outturn figures available in France point to higher-than-expected tax takings, although their impact on the general government balance will be partly countered by drift in the social security system. Finally, the Greek deficit may exceed official forecasts in 2004 as a result of the adverse trend in tax receipts and of deviations in primary expenditure.

Most of the countries are already preparing their budgets for 2005. The strategy designed in Germany is based on controlling primary expenditure on government consumption and transfers to households and on combating tax fraud. Moreover, the final phase of the income tax cuts will come into force in January. In France the projected deficit of 2.9% of GDP will be achieved thanks to temporary measures worth 0.4% of GDP and to holding central government expenditure unchanged in real terms. In addition, the draft budget contains some minor

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX CHART 13



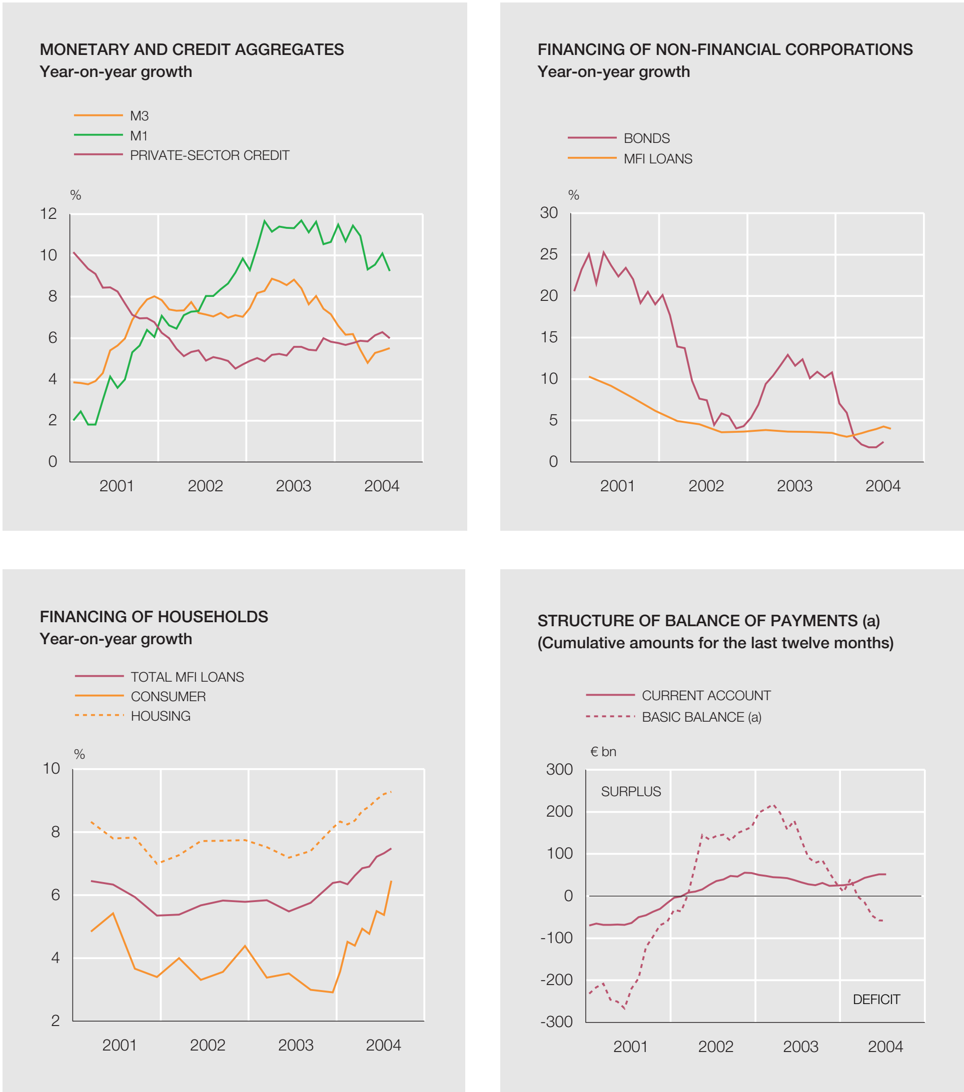
SOURCES: Banco de España and European Central Bank.

a. Data drawn from new statistics on interest rates compiled by the ECB for new operations.
b. Interest rates over five years.
c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

reductions in tax pressure, including corporate income tax rate cuts, improved tax treatment of first home purchases and an increase in the minimum inheritance tax exemption. In Italy the projected deficit will be 2.7%, due equally to the freezing of real expenditure and to the application of temporary measures. Finally, in Holland the projected deficit for 2005 is 2.6%. In this case, the budgets contain an increase in income tax and in tobacco excise duty, as well as a reform of unemployment benefits designed to stimulate reincorporation of the unemployed into the labour market.

Finally, the proposals of the recent European Commission Communication aimed at improving the application framework of EU fiscal policies include notably the following. First, the refocusing of the definition of a nearly balanced or surplus budget position so as to take into account key aspects of each country's specific situation, such as its level of debt and its implicit liabili-

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.

ties, its potential growth, its public investment and the existence of budget reforms to improve the quality of the sector's accounts. Second, the European Commission is considering the idea that more importance should be given to public debt in the monitoring of a country's fiscal situation. For this purpose, it will have to specify what constitutes a satisfactory pace of debt ratio reduction in those countries in which this variable exceeds the reference level of 60% of GDP. Finally, the Commission has also suggested the possibility of reconsidering the role attributed to the behaviour of economic activity in the application of the excessive deficit procedure.

3.2 Monetary and financial developments

In its 2004 Q3 meetings, the Governing Council of the ECB decided not to change the monetary policy stance, considering that it remained consistent with achieving the objective of price stability in the medium term. Consequently, the interest rates on the main refinancing operations, deposit facility and marginal lending facility remained steady at 2%, 1% and 3%, respectively. This low interest rate level thus contributed to strengthening the process of recovery of domestic demand in the euro area.

In summer, money market interest rates were fairly steady (see Chart 12). By contrast, forward rate curves showed a downward movement between June and September at terms of more than six months, although expectations persist of a moderate rise in official interest rates in the future. On the information available up to August, the interest rates set by credit institutions in their lending and deposit transactions did not change significantly and they continue at historically low levels (see Chart 13).

Ten-year government bond yields trended downward in 2004 Q3 in both the euro area and the US, although the sharper fall in the US narrowed the positive spread between the US long-term interest rate and that in Europe. The parallel movement in long-term interest rates in the two areas suggests that, to an increasing extent, the factors that determine the expectations as to future interest rates in one of the economies (basically due to changes in the outlook for activity growth or prices) also affect the conditioning factors of the other region. Against a backdrop of rising oil prices, the decrease in long-term rates is somewhat anomalous, since it seems to show that this phenomenon can affect growth prospects more than inflation expectations.

On the foreign-exchange markets, the euro exchange rate also showed steady behaviour in summer, although a certain tendency to appreciate since mid-September has taken it to a level of nearly USD 1.26 per euro at the date this Bulletin went to press. The nominal effective exchange rate of the euro recorded only slight fluctuations, although in the last few weeks it has appreciated by nearly 2%. Over the summer the euro area equity markets continued to lack any clear trend. In mid-October, the cumulative return thus far in the year of the Dow Jones Euro Stoxx broad index was 3.4%, down slightly on end-June.

The M3 monetary aggregate accelerated somewhat in Q3, with a year-on-year rate of change of 6% in September (see Chart 14). Credit to the private sector continued to grow steadily, and the year-on-year growth rate for September stood at 6.3%. However, this is the result of uneven behaviour in household and corporate credit. Thus lending to households continued to accelerate, both in consumer credit and, principally, in loans for house purchases, which in September were up by 8% year-on-year. However, credit to non-financial corporations showed a slower rate of growth. Furthermore, despite the decrease in spreads between corporate debt and government debt, firms only had moderate recourse to bond issuance. This raises some doubts as to whether firms are able or willing to finance fresh investment projects, although it may also be a sign of the strength of corporate self-financing sources. In Spain, lending to households and non-financial corporations continued to show very high growth rates, twice those in the euro area as a whole.

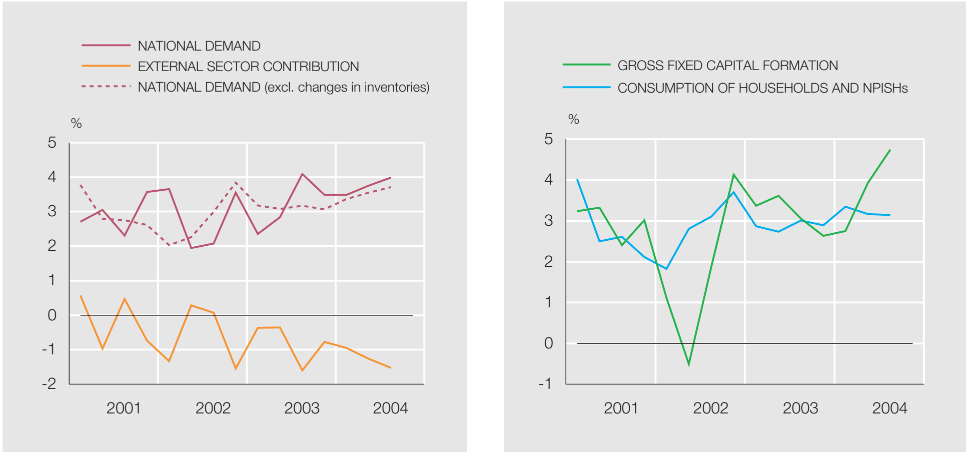
Some days prior to the publication of the Quarterly National Accounts (QNA) for 2004 Q2, INE revised the National Accounts estimates for the Spanish economy for the period 2000-2003, resulting in slightly higher GDP growth, in real terms, for these years. The QNA for Q2 included these new estimates, which entailed a change in the quarterly profiles for recent years and a slight – in this case downward – revision of real GDP growth in 2004 Q1 (from 2.8% to 2.7%). On the basis of these figures, the QNA estimates for Q2 showed that domestic demand in this period increased at a real year-on-year rate of 3.8%, 0.3 pp up on Q1. The source of this greater buoyancy of demand was the take-off in investment in capital goods, following the slackness of this variable in previous quarters, against the background of a sustained rise in both private and government consumption and in investment in construction. The negative contribution of external demand was significantly greater, as a result of the strength of imports accompanying the pick-up in domestic spending and weaker exports, where the fall-off in tourism revenue was particularly influential. Overall, the year-on-year growth rate of real GDP declined by 0.1 pp in Q2 to 2.6%.

The information available for Q3 reveals that domestic demand remains considerably buoyant, outpacing the rate of increase recorded in the previous quarter and underpinned by the acceleration in gross fixed capital formation. Consumption would have grown at a rate close to that recorded in Q2. However, it is estimated that the negative contribution of the external sector to growth may have been 1.5 pp in the summer months, as imports continued to grow sharply – since the pick-up in investment in capital goods continued – and the performance of exports scarcely improved (see Chart 15). As a result of these movements, real GDP is estimated to have stabilised during the summer at a rate of 2.6% year-on-year.

From the standpoint of value added, the slight slowdown in Q2 was mainly evident in the contraction of agricultural activity and in the loss of momentum of market services. Conversely, the performance of overall industrial activity was favourable, against a backdrop of recovery in investment in capital goods and the ongoing buoyancy of consumption. Construction was once again the most dynamic branch, despite slowing slightly in Q2. The economic indicators for Q3 do not show significant changes in these trends: in particular, activity in the primary sector underwent a fresh cut in the summer months and the growth rate of market services eased further, while the rate of increase of value added in overall industrial activities tended to stabilise. Turning to employment, the modest slowdown witnessed in Q2 came to a halt in the summer months, when the decline in industrial employment was appreciably corrected, and there was continuing intense job creation in construction and services.

The stability of the estimated growth rate for employment in Q3 has entailed the extension of the low growth path for apparent labour productivity. Productivity gains have been particularly small in the market economy, where services activities have continued to generate jobs at a rate higher than that of value added. Given these developments, unit labour costs have continued to increase at a rate of over 3%, and only in the industrial branches have they behaved more moderately. Nonetheless, the notable increase in final prices and the as yet moderate growth in import prices have enabled rising costs to be absorbed without bringing to a halt the ongoing widening of margins. In this respect, mention may be made of the intensity with which unit surpluses in construction are continuing to grow; moreover, although to a lesser extent, margins have also widened in the industrial branches. Among the indicators of final prices, the CPI quickened slightly in the summer months, mainly as a result

MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

of dearer oil imports, the effect of which on the overall index was partly offset by cheaper food.

4.1 Demand

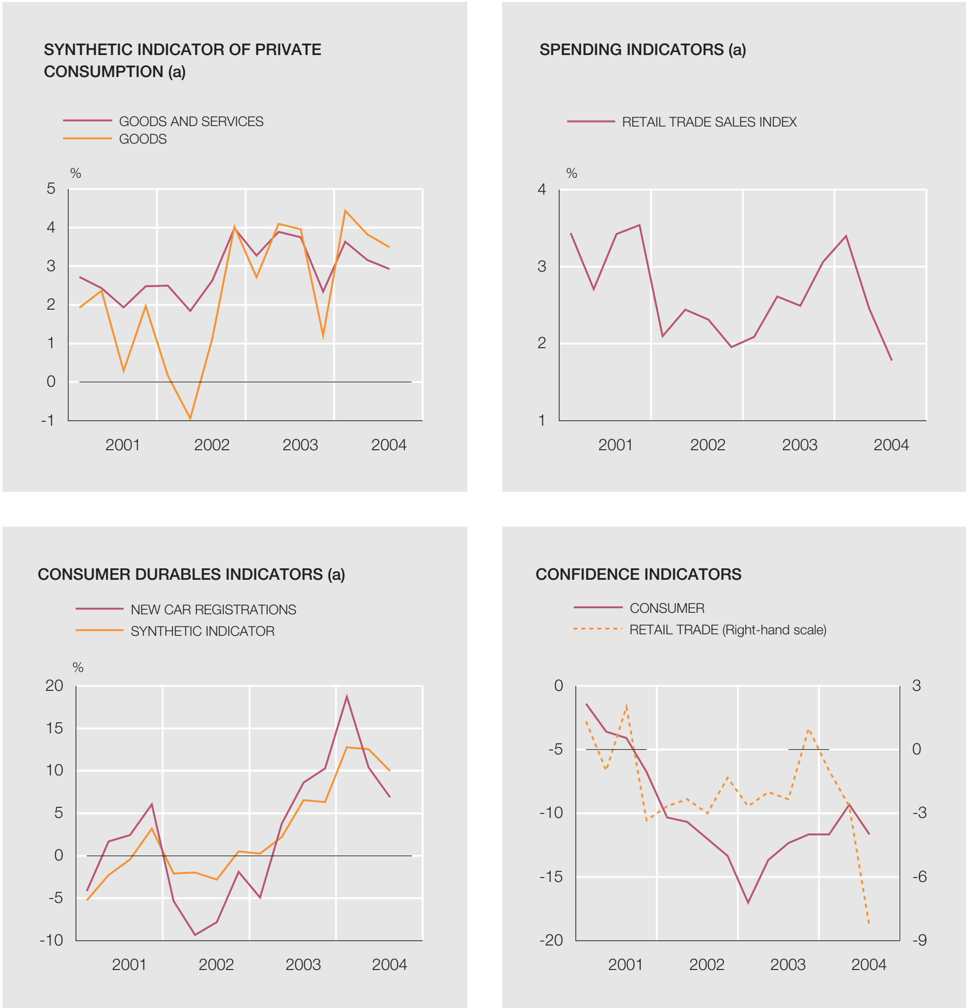
On QNA estimates, the pace of household final consumption spending eased slightly in 2004 Q2, placing the related year-on-year growth rate at 3.2% in real terms. The latest information would suggest that this mild slowdown has continued during Q3. Contributing to the firmness which private consumption spending has been showing, underpinned by the expansion of household disposable income, are the gains in net real wealth in this sector and the continuing generous financing conditions which, overall, are checking the recovery in the household saving ratio and increasing the level of household debt.

As earlier mentioned, the indicators available suggest scant moderation in the rate of increase of consumption in Q3 (see Chart 16). The new synthetic indicator of consumer goods and services moved on a mildly slowing profile in this period, more intensely so in the case of goods and, in particular, consumer durables, the substantial buoyancy of which eased during Q3. This partly reflects the slight loss in momentum of new car registrations to September. Among the remaining indicators related to household spending, the overall index of retail sales lost steam in July and August, in line with the deterioration shown by the retail trade confidence indicator to September. The consumer confidence indicator also fell back in September, after having held stable for three months running. The slide here was due to worse expectations over unemployment and the possibility of saving.

However, the main determinants of private consumption continue to trend favourably. The growth of household disposable income in real terms is underpinned by the ongoing increase in employment and by the relatively expansionary contribution of general government: despite the petering out of the positive impact of the personal income tax reform in 2003, the acceleration in benefit payments linked to unemployment and to pensions has added to this contribution. Household wealth continues on the up, mainly as a result of the rising value of property assets, to which house price increases are contributing. Financial wealth has trended much more moderately than in the first half of the year owing to the adverse impact of the rising trend of oil prices on stock market prices during the summer. Against a background marked, moreover, by the low cost of financing, the saving ratio may have fallen slightly. And this, along with the increase in residential invest-

PRIVATE CONSUMPTION INDICATORS

CHART 16



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

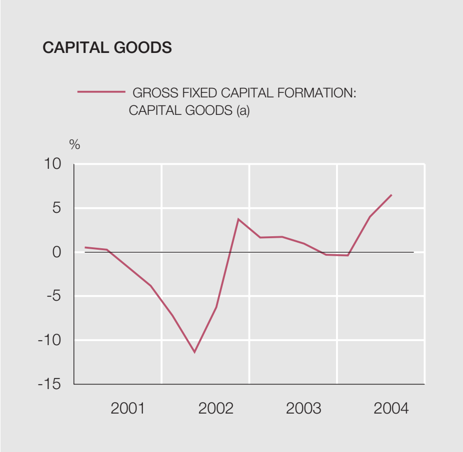
a. Year-on-year percentage change based on the seasonally adjusted series.

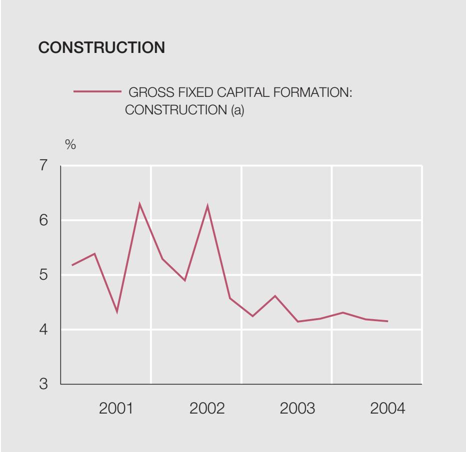
ment referred to later in this report, has placed household lending capacity at a very low level.

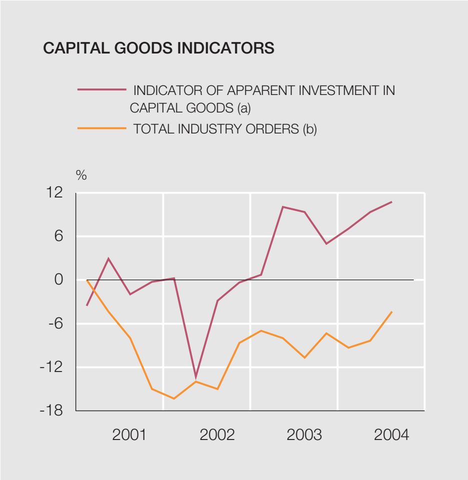
In 2004 Q2, the growth rate of general government final consumption held at 4.3% year-on-year. For Q3, based on the trend of personnel costs provided by the State budget outturn (the only information available to date), no significant changes are expected in the pace of this aggregate.

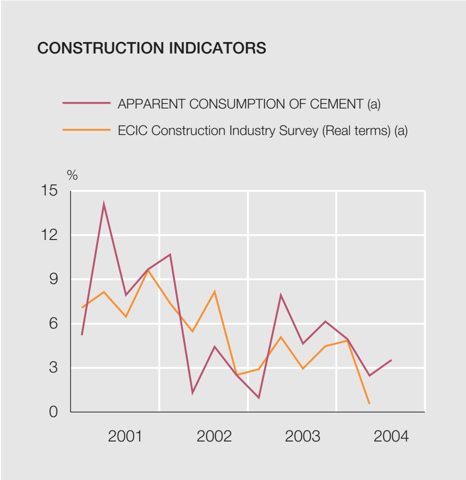
Gross fixed capital formation quickened significantly in 2004 Q2, growing at a year-on-year rate of 3.9%, 1.2 pp up on the increase posted in Q1. This was the result of the notable pick-up in investment in capital goods, which increased by 4% in real terms, after having been flat in the two previous quarters. The other two components of gross fixed capital formation, namely construction and investment in other products, registered growth rates of 4.2% and 2.9%, respectively, very similar to those of the previous quarter. The estimates for Q3 show a maintenance of these trends, with a fresh acceleration in investment in equipment, making this the most buoyant component of demand, and the continuing expansionary momentum of investment in construction, at a rate similar to that recorded in the first half of the year.

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.

The turnaround in investment in capital goods seen in Q2 would have firmed in the summer months, according to the indicators available (see Chart 17). In particular, the indicator of apparent investment in capital goods, compiled with as yet incomplete information for Q3, shows an accelerated growth profile to which imports of this type of good have contributed significantly. Also, surveys of capital goods producers' orders reveal a substantial improvement in August, a favourable trend seen also in the assessment of orders for industry as a whole. Capacity utilisation has increased slightly in Q3, while the proportion of companies that consider they have excess capacity has fallen, with both these indicators testifying to the presence of a favourable climate for investment.

The information on non-financial corporations, compiled by the Banco de España Central Balance Sheet Data Office, indicates that Spanish companies' activity grew at a sustained rate until 2004 Q2, based on the ongoing expansion of firms whose main activity is in the services sector – especially those relating to the distribution trade – and on the recovery of industrial corporations. The rise in activity was accompanied by a moderate increase in personnel costs, improved financial revenue and fresh cuts in financial costs. This meant ordinary net profit was very favourable and profit ratios high. As a result of this generation of resources, some of the more indebted companies were able to reduce their debt levels, and the business sector has been able, in general, to position itself advantageously with a view to undertaking new investment plans, as the uncertainty over the expansion of the world economy dispels.

On QNA estimates, the year-on-year growth rate of investment in construction fell by 0.1 pp in Q2 to 4.2%, though this variable remained the most buoyant component of domestic demand. This robustness is not in line with the significant slowdown that quarter in the Construction Industry Survey (ECIC) compiled by the Ministerio de Fomento, which is the main reference indicator for measuring both activity in the branch and expenditure on these products. The year-on-year growth rate of the value of work undertaken by construction companies, according to the Survey, was 0.6% in Q2, following the increase of 4.8% observed in Q1. This sudden loss of momentum affected the various types of construction work, although the slowdown in the case of civil engineering work was particularly sharp and should be interpreted with caution until confirmed by additional information. Other indicators of construction activity weakened to some degree in the spring months, albeit not with the intensity shown by the ECIC, but the latest data point to renewed vigour in Q3. Thus, the production of certain materials used in construction and the apparent consumption of cement have, on information to August, picked up following their more moderate growth in Q2, and the indicators of employment in construction have trended similarly.

The growth of construction in recent quarters has been largely underpinned by the highly favourable behaviour of house-building, derived from the sharp increase in housing starts that took place in 2003. According to building permits and approvals, the surface area of residential building to be built increased by 20% last year; and according to housing starts figures, an all-time high of over 620,000 units was reached in 2003 as a whole, whereas 330,000 houses have been started in the first half of 2004. As to the outlook for residential investment in the coming quarters, it should be borne in mind that the surface area to be built further to architect association approvals to July grew by 10% year-on-year which, given the average period between approval and the start of the work and the average time taken for execution of this type of work, would mean a slight moderation could be projected for next year following an increase in 2004 which might exceed that posted in 2003. The outlook for non-residential building on the basis of work approvals suggests a continuation of the contractionary profile. In the case of civil engineering work, public sector procurement showed renewed vigour in June and July, with growth of 11.2% being recorded between January and July. That would point to a greater increase in this type of work in 2005.

On QNA estimates for 2004 Q2, net external demand subtracted 1.3 pp from GDP growth in this period, widening the negative contribution of the previous quarter by 0.3 pp (see Chart 15). The growth of real goods and services exports eased to 4.7% year-on-year, down from 5.5% in Q1. Meanwhile, real flows of imports continued to quicken, up to 8.1% year-on-year compared with 7.8% in the previous quarter. With the full set of short-term economic information on foreign trade for Q2 available, the deterioration in net external demand in this period can be confirmed, and might even be sharper than that which the QNA figures reflect. As discussed at the start of this section, the as yet incomplete information available for 2004 Q3 points to the maintenance of a high negative contribution in this period, since the acceleration in goods and services imports would have offset the pick-up in exports from their scant buoyancy the previous quarter.

In any event, the behaviour of exports in recent quarters has come about against a backdrop of notably buoyant world trade, which has intensified as the improvement in the US economy and in the main Asian countries firmed. The countries of the euro area, Spain's principal market, also showed significant momentum, at least during Q2. The loss of competitiveness that built up in 2003

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.

against the developed countries, and which only lessened slightly in the first half of 2004 thanks to the trend of export relative prices, would be checking progress by Spanish sales abroad. On the imports side, the strength of purchases of consumer and capital goods is underpinned by the expansionary behaviour of these final demand components and by the decline in their prices in euro. Intermediate goods imports have also picked up, in line with the strength of industrial activity.

As to the recent behaviour of the foreign trade indicators, goods exports in real terms, the year-on-year growth rate of which slowed in 2004 Q2 to 2.2% according to Customs figures deflated by the related UVIs, rebounded somewhat in July and August when they posted a year-on-year increase of 9.5% (see Chart 18). Given the volatility characterising these flows, the data should be assessed with some caution, especially bearing in mind that the trend of the indicator projects a slightly declining path. Over the course of the first eight months of the year, goods exports grew by 5.7%, somewhat down on the average figure for the previous year (6.2%). In terms of regions, exports to Community[1] markets quickened slightly during this

1. The former EU 15.

period to a rate of 4.4% in real terms, compared with 3.9% in 2003. Real exports outside the Community continued to progress at a high rate of 8.7%, though this was slightly down on 2003. In this latter group, sales to Japan and to the rest of the Asian continent were notably buoyant, and those to Latin America picked up; however, exports to the central and eastern European countries lost momentum and those to the United States remained very moderate.

Real tourism revenues slipped by 2.2% in Q2, according to QNA figures, following their flatness throughout the previous year and in the opening months of 2004. This decline was accompanied by a 2% fall in exports of other services, bearing notably on the overall export performance. Both nominal and real tourism indicators reflected fairly negative results in Q2 which, though they eased to some extent during the summer, are not solely attributable to one-off factors such as the terrorist bombings of 11 March or the sporting events in Portugal. Other more structural factors have had an influence on the poor tourism results of late, such as the progressive loss of competitiveness against the eastern Mediterranean countries, which compete with Spain in the same sun and beach segment. On the latest available information, the sluggishness of the indicators of visitors lodged in hotels and overnight stays has tended to ease during Q3, although over the first nine months of the year as a whole, both reflect a rather poor performance: foreign visitors lodged in hotels increased by 0.9% and overnight stays fell by 2.4%, revealing a reduction in the average stay by tourists in hotels, as well as a reduction in their average spending. The indicator of tourists entering Spain increased by 1.4% on average in the summer months, meaning the growth in 2004 to date stands at 1.9%. Of note this year has been the slowdown in British tourism (the United Kingdom is the biggest supplier of tourists for Spain), the ongoing slackness in recent years of the German market and the decline in French tourism. In the coming quarters, the impact on tourism of the expected pick-up in the main European countries might be countered by the higher prices arising from the hike in crude oil prices and by the adverse trend of price competitiveness.

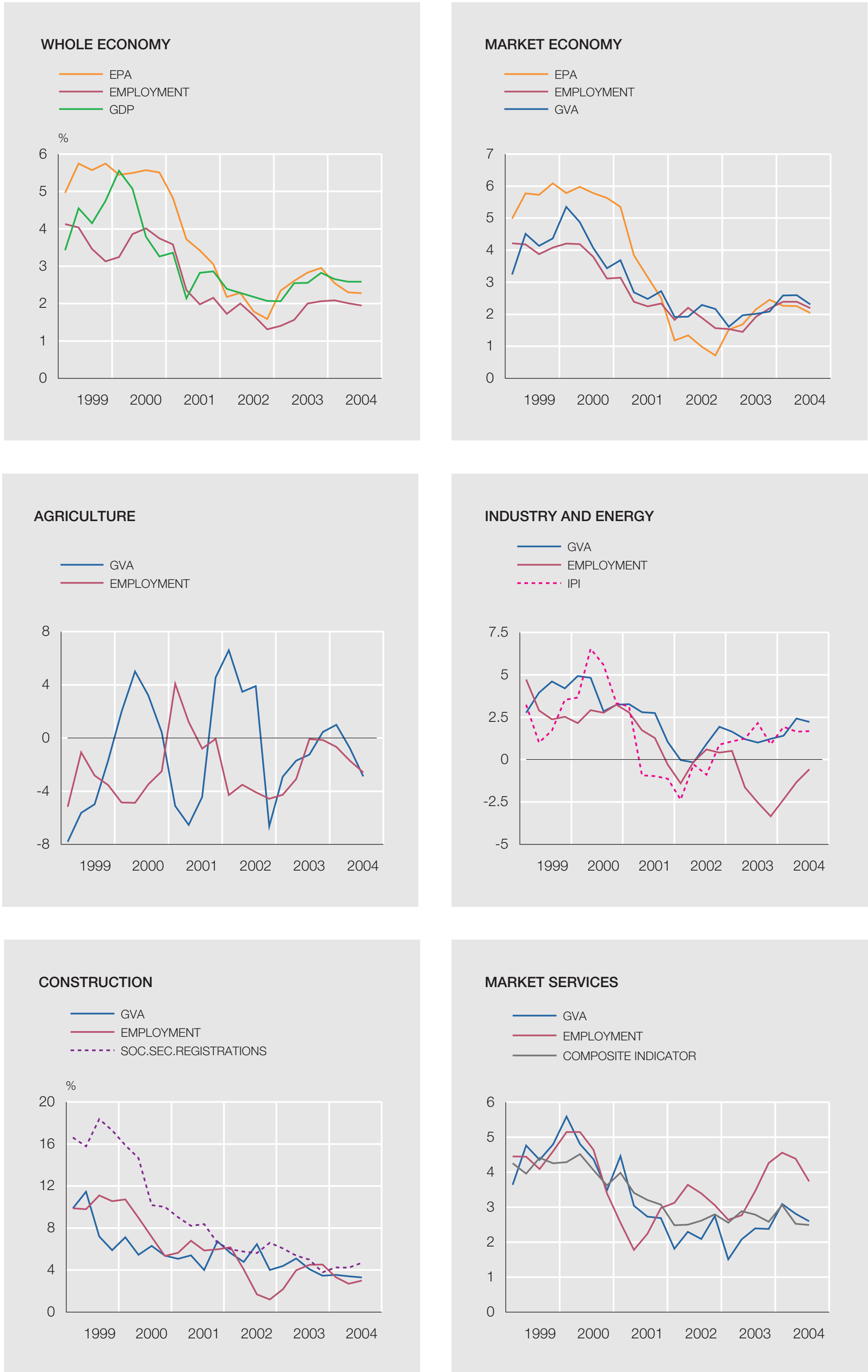
Real goods imports were notably robust during 2004 Q2, according to deflated Customs figures. This buoyancy heightened in July and August at a rate of 15.1%, projecting notable growth for Q3 as a whole. During the two summer months there was a most significant increase in imports of capital goods. Their growth exceeded 30%, partly because of the influence of certain extraordinary purchases relating to naval transport material and earth-moving machinery. Purchases of non-energy intermediate goods also picked up, while consumer goods imports grew sharply. During the first eight months of the year as a whole, the real increase in imports was 11.2%, up on the related average for the previous year. Real imports of services posted growth of 3.4% in Q2 on QNA figures, the outcome of the slackness in purchases of non-tourist services (–0.4%) and of the dynamism of Spanish residents' consumption outside our borders (20.2%). This dynamism is partly influenced by the low levels observed a year earlier, coinciding with the war in Iraq, although it is also underpinned by the same factors accounting for the growth of private consumption and by the strength of the euro.

4.2 Output and employment

From the supply standpoint, it is estimated that the growth of value added in the market economy, after holding stable in the first half of 2004, slowed mildly in Q3, making itself particularly felt in agriculture and in market services (see Chart 19). Value added in agriculture worsened notably in Q2, resulting in a decline of 0.8% year-on-year which may have intensified during the summer. These poor results came about despite the favourable weather conditions, marked by heavy rainfall, during the spring. Production in the case of most crops grew very moderately, with the exception of cereals, which rose considerably. Fruit production fell substantially, while expectations about the olive harvest point to a return to its historic levels, far off the highs reached in 2003. Lastly, products of animal origin – milk and eggs – moved on a

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.

slowing path. Foreseeably, at least in the short run, value added in this branch will continue to move at a negative year-on-year rate.

The period 2004 Q2 saw a reinvigoration of the industry and energy branch, whose value added had been posting low and virtually stable growth rates during the previous quarters. On QNA figures, activity in this branch accelerated by 1 pp to 2.4% year-on-year, driven mainly by the above-mentioned recovery in investment in capital goods. It is estimated that growth may have eased slightly in Q3, despite the fresh rise in domestic demand. This was partly due to a base effect on the growth of value added in energy which, in 2003, was propelled by the high consumption brought on by the August heatwave. The short-term indicators for industry have emitted somewhat more uneven signs in Q3, although on the whole they confirm the recovery in industrial activities. The results of the industrial production index in July and August point to a slight slowdown for the quarter as a whole, while intermediate goods imports advanced significantly in these same months and orders in industry picked up during the quarter. However, the confidence indicator for the sector worsened in relation to Q2, following the profile of the expected trend for output, while employment continued to shrink, albeit at a less sharp rate than in the spring.

Value added in construction slowed by 0.2 pp in Q2 to a year-on-year rate of 3.4%. As discussed in the previous section on analysing investment in construction, the strength of this sector has been underpinned in recent months by the rise in residential building, while non-residential building has moved on a contractionary trend as, temporarily, civil engineering works may have done. The indicators available for Q3 do not, in any event, shows signs of a significant weakening.

On QNA estimates, the acceleration in activity in the services branch in 2004 Q1 did not run into Q2; in that period services slowed by 0.3 pp to 2.9% year-on-year. The loss of steam was common to the two related components, although somewhat more moderate in the case of non-market services. The rate of increase of market services was cut by 0.3 pp to 2.8%. The information in the short-term indicators points to a further loss of vigour in Q3. The composite market services indicator (ISIS) showed a slight loss of momentum in the July-September period, while the opinion-based surveys evidenced a deterioration in business confidence with regard both to the assessment of the present situation and the outlook for the future. Nonetheless, Social Security registrations quickened in the summer after having fallen off in the previous quarter.

Developments in the respective market services activities differed considerably, although there was a notable slowdown in wholesale and retail trade, witnessed in the slight slide in Social Security registrations to August and in the loss of steam in the retail sales index. The hotel and catering trade also weakened in Q3, as seen in the slowdown in Social Security registrations; nonetheless, the sound performance of national tourism provided for a recovery in August, according to the indicators of overnight stays in hotels. Among the remaining services branches, real-estate, rental and business services activities (the latter including IT and R+D) proved very dynamic, as testified by the related Social Security registrations. The transport, storage and communications branch also trended favourably overall, especially in postal services and telecommunications, while air transport growth remained modest, in line with that observed in Q2.

On QNA estimates, employment – measured in terms of full-time equivalent jobs – slowed by 0.1 pp in Q2 but increased by 2.0% on the same quarter a year earlier. Since this moderation in employment was matched by a slight slowdown in GDP, apparent labour productivity growth held at a modest rate of 0.6% year-on-year, in line with its pattern since the summer of

2003. The growth rate of employment is estimated to have held at around 2% in Q3, while productivity gains remained at the same rate as in the first half of the year. In the market economy, both employment and value added sustained stable growth rates (2.4% and 2.6%, respectively) during the first six months of the year, meaning that apparent labour productivity posted a scant year-on-year rate of 0.2%, without any improvement in this connection being estimated in Q3 (see Chart 19).

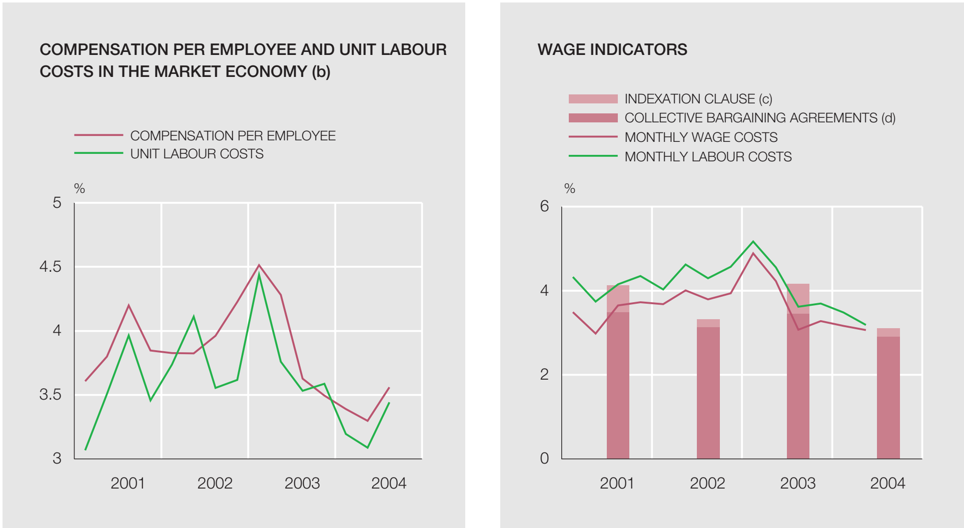
The main employment indicators slowed more sharply in 2004 Q2 than QNA figures had estimated: the year-on-year growth rate of employment according to the EPA (Spanish Labour Force Survey) fell by 0.3 pp (from 2.6% to 2.3%) and growth in the number of Social Security registrations dipped from 2.9% to 2.6% from Q1 to Q2. However, both indicators showed a clear recovery in the summer months. Registrations quickened by 0.1 pp (to 2.7%) and the increase in employment according to the Q3 EPA was 2.5%. The INEM data on employment contracts signed continued to show very high growth moving on a slightly accelerating path in the three quarters of 2004 to date, reflecting the high job turnover present in the Spanish labour market.

As can be seen in Chart 19, the growth of employment in QNA terms slowed in Q2 in all branches of activity, with the exception of industry (excluding energy) where job destruction eased appreciably. This resulted in apparent labour productivity growth of 3.8%, down on the figure for Q1 (4.4%). The EPA data for Q3 indicate that this moderating trend did not intensify in the summer, whereby productivity in this branch continues to expand. In construction, employment rose by 2.7% in Q2, lowering its rate of increase in year-on-year terms. This slowdown allowed a slight pick-up in apparent productivity gains which would not have been sustained in Q3, for which period the employment indicators point to greater job creation, a trend confirmed by the EPA data. Finally, a substantial differential was maintained in services between the rate of increase in employment in the market-oriented and non-market branches. In the former, employment remained robust, increasing by 4.4% in Q2, 0.2 pp down on Q1, while in the latter the rate of change of employment declined by 0.4 pp to 0.5%, extending the slowing path embarked upon in mid-2003. A fresh slowdown in employment in the market services branches had been estimated for Q3, with the EPA figures evidencing a flat, though still high, rate of increase. Finally, in agriculture, the process of net job destruction heightened in Q2, having extended throughout the summer months, although the EPA data point to moderation.

The slight slowdown in employment on QNA data for Q2 was concentrated among dependent employees, with the related year-on-year growth rate standing at 2.0%, 0.2 pp down on Q1. For the self-employed there was an increase of 2.1%, an acceleration of 0.5 pp on the opening months of the year. This more prominent role of self-employment had also been detected in the EPA, somewhat more intensely so: dependent employment increased by 2.2% in Q2, marking a deceleration of 0.6 pp, while the numbers of self-employed grew by 2.6%, more than 1 pp up on Q1. In Q3 both groups grew by 2.5% according to EPA figures, signifying that the slowing path of dependent employment has, for the moment, been checked. Regarding the composition of this group, in respect of contract duration, both permanent and temporary employees slowed in the first half of 2004, albeit with the former proving more resilient. The Q3 data, however, reveal a notable rise in temporary employees, with growth of 4.1% (1.4% in Q2), and a further slowdown in the case of permanent employees (from 2.6% to 1.8%). This uneven development prompted a significant increase in temporary employees in relation to total workers, with the proportion rising to 31.2%, this representing the first year-on-year increase in this proportion since 2000. With regard to working-day length, there has been divergence throughout the year, with a continuous slowdown in full-time employees but a rising

WAGES AND LABOUR COSTS (a)

CHART 20



SOURCES: Instituto Nacional de Estadística, 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 year's indexation clause.
d. Settlement in the year to date.

path for part-time workers, with the proportion of such workers in relation to total employees climbing to 8.5% in Q3, almost 1 pp up on a year ago. INEM information shows that the weight of permanent hires has held virtually stable over the first nine months of the year, while part-time contracts have gained in weight, their rates in 2004 to date increasing to 22.8%, although the biggest rise has been in fixed-term contracts.

The labour force, though it remained very robust in Q3, saw its year-on-year growth rate slow once again from 2.1% in the spring to 1.8%, due to the fact that the number joining the labour market (129,100) was the lowest since 1998. This also meant that the rise in the participation rate, which stood at 56% in the summer period, was slightly lower than usual for the time of year, as a result of which the year-on-year figure was 0.7 pp up. The breakdown by sex shows that the participation rate increased in the quarter for both men and women, to 68% for men, and to 44.7% for women. In both instances, and as is the case with the aggregate rate, the increase is smaller than that observed in the same period a year earlier. As job-creation exceeded the increase in new working population entrants, there was a notable reduction in unemployment in Q3 (61,300 fewer unemployed than in the previous quarter), whereby the unemployment rate dipped by 0.4 pp to 10.5%. This fall is the biggest decline in unemployment for this time of year over the last five years. In year-on-year terms, the reduction in the unemployment rate intensified (0.6 pp down on a year earlier). The registered unemployment data confirm the EPA results, as developments proved more favourable in Q3 (an increase of 1.1%) than in Q2 (when unemployment increased by 2.4%).

4.3 Costs and prices

On QNA figures, the growth rate of labour costs per unit of value added dipped very slightly in Q2 to 3.1%, both in the economy as a whole, where the related cut was 0.2 pp, and in the market economy, where the slowdown amounted to only 0.1 pp (see Chart 20). These developments were in line with the 0.1 pp cut in the rate of increase of compensation per employee – to 3.8% in the economy as a whole and to 3.3% in the market economy – and with the 0.1 pp increase in the growth of productivity for the economy as a whole (measured as value-

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.

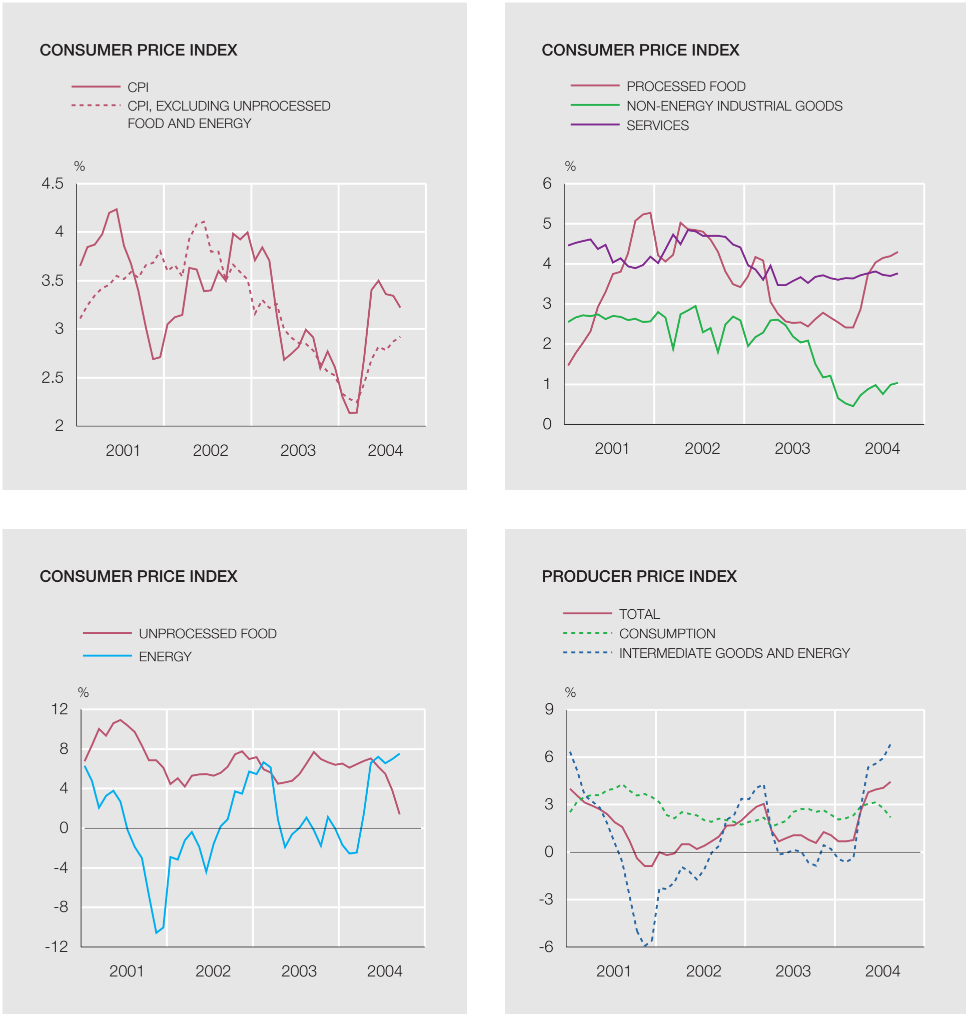
added per employee), while in the market economy the change in productivity held stable. It is estimated that labour costs per unit of value added would have risen in Q3, in step with the increase in compensation per employee, without productivity having changed significantly.

The QNA estimate of the slowdown in compensation per employee in the market economy for Q2 was on a lower scale than that reflected in the ETCL (quarterly survey of labour costs), which placed the year-on-year increase in monthly labour costs per employee at 3.2%, 0.3 pp down on Q1. In respect of the different components, both wage costs and non-wage costs slowed, although the latter did so to a greater extent (0.9 pp), decelerating to 3.5%. The wage component posted growth of 3.1%, 0.1 pp less than in Q1, although with differing developments across the different branches of activity: the biggest slowdown was in industry, followed by construction (the sector with the biggest year-on-year increase), while labour costs in services quickened.

Drawing on information from collective bargaining agreements recorded to 31 August, wage settlements stood at 2.9%, 0.6 pp less than in 2003, before including the wage indexation clauses. These agreements already affect almost 6 million workers and most are revised agreements. In the case of the latter, wage settlements stood at 2.9%, while in newly signed agreements the related rate was 3.0%. These figures are close to the ceiling implicit in the renewed Inter-Confederal Collective Bargaining Agreement entered into in 2003, which entailed main-

PRICE INDICATORS (a)
Spain

CHART 22



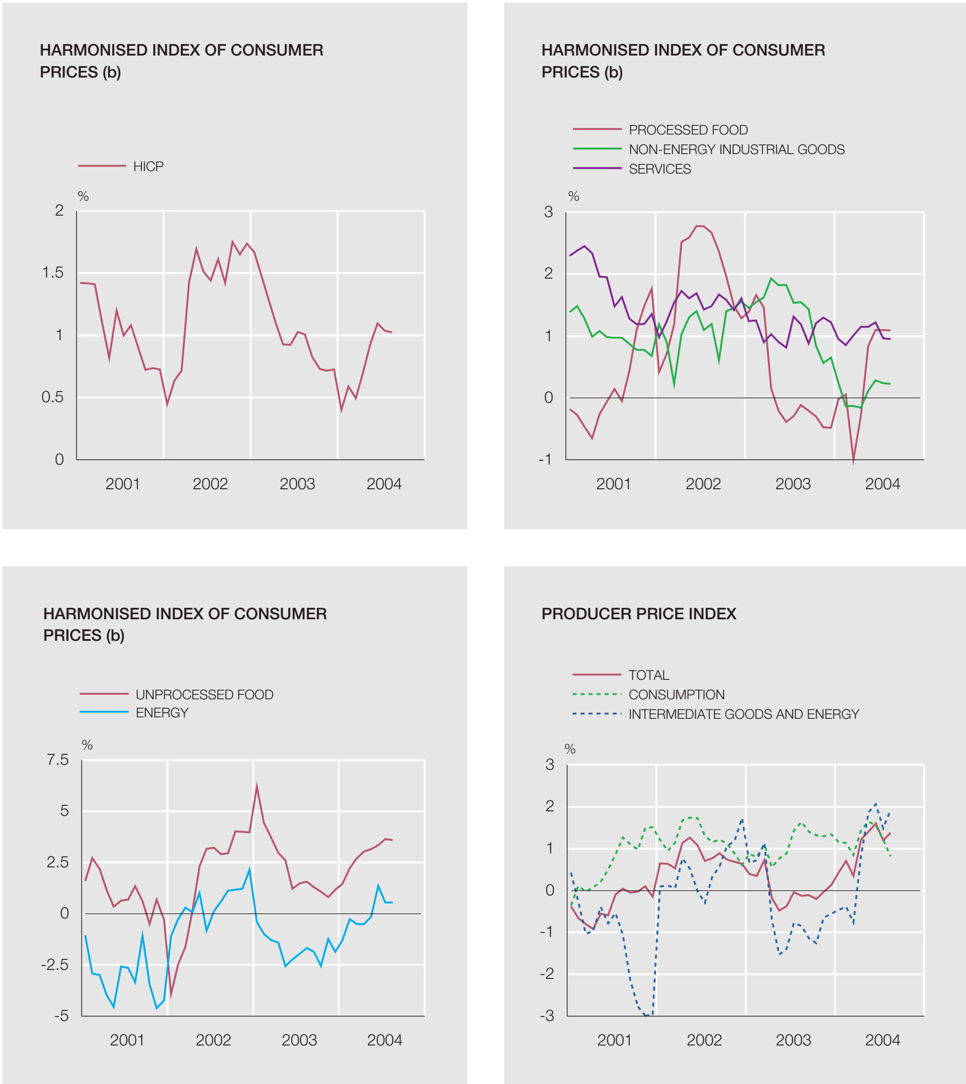
SOURCE: INE.

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

taining the wage rate-setting arrangements whereby increases are determined by adding a differential warranted by productivity gains to the official inflation forecast (2%). As has habitually been the case, wage increases agreed at company level (2.4%) were below those reached in agreements of a wider scope (3.0%). In 2004, the proportion of agreements including wage indexation clauses will be around 80%, a similar percentage to 2003. However, it is estimated that their impact on wages in 2005 will exceed that observed in 2004 (around 0.2 pp), given the more unfavourable trend of inflation. The incorporation of the recent rise in inflation into newly signed agreements that are yet to be finalised might pose an additional risk.

The slowdown in unit labour costs in Q2 did not translate into a greater easing in value added deflators, as a result of the more expansionary behaviour of operating margins (see Chart 21). Specifically, the value-added deflator for the economy as a whole increased by 3.8% in Q2, 0.1 pp higher than in Q1, while for the market economy the related rate was 3.9%, up from 3.7% in the first quarter. The unit surplus posted year-on-year growth of around 5%, consolidating the widening of margins initiated in Q1 after their more moderate behaviour last year. In the main branches, this made for an ongoing widening of margins in industry and, especially, in construction, and an easing of the narrowing of margins that has been seen in services.

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.

The indicators available for Q3 broadly confirm the patterns of the previous months. The growth of the deflator in the services and construction branches is tending to stabilise, but the acceleration discernible in industry and energy is dragging the market economy deflator up. Something similar is happening with unit labour costs (the only ones moving on a rising trend are in the industrial branches), whereby there are no relevant changes in margins.

The GDP deflator stood at 3.7% in Q2, 0.1 pp up on Q1, in line with the above-mentioned trend of the value-added deflator. Nonetheless, the final demand deflator quickened by 0.7 pp to 3.3% as a result of the considerable rise in imported goods prices, against a background of strong purchases abroad. Specifically, the imports deflator posted growth of 2.5% in Q2, compared with –0.3% in Q1, essentially reflecting pressures in the oil market.

The private consumption deflator quickened by 0.4 pp to 2.9% in Q2, a much more moderate performance than that observed in the CPI, the main indicator of final prices, the growth of which stood at 3.2% in this same period, 1 pp above the related rate for Q1.

In Q3, the year-on-year increase in consumer prices practically stabilised at a rate of 3.3% (0.1 pp down on the September figure). This was the outcome of the highly differing behaviour of some of its components, with the slowdown in unprocessed food prices offset by the upward momentum of energy prices and, to a lesser extent, of processed food prices, which took the CPI excluding fresh food and energy to a year-on-year rate of 2.9% for the period on average.

Energy prices have been the most inflationary component these past months. Their 12-month rate of change increased by 2 pp from Q2 to Q3, up to 7%. Heating and vehicle fuel prices embarked on an upward trajectory in August which has yet to turn down. Natural gas prices increased in July, and that of butane did so at the start of Q4. All these developments reflect the pressures of crude oil prices on international markets, which have been rising throughout Q3 and stood above $47 per barrel in late September, up from $35 in early July. The increase in processed food prices in June was also notable, tending subsequently to stabilise. This was largely determined by the behaviour of olive oil prices.

Conversely, there was a notably strong deceleration in unprocessed food prices, the 12-month growth rate of which fell by almost 5 pp from June to September. During these months the increases in the prices of eggs and certain meats a year earlier were stripped out of the index, while there was a considerable slowdown in the rising trajectory of fruit and vegetable prices. The 12-month growth of non-energy industrial goods prices held fairly stable, at below 1%, the same as services; however, in this latter case the rate of increase is particularly high, at around 3.7%. In recent months the items relating to tourism and the hotel and catering trade have trended somewhat more moderately.

The growth rate of the HICP for Q3 on average was 3.3%, virtually unchanged on the previous quarter. Euro area-wide inflation held at 2.3%, meaning the differential in September was slightly wider than 1 pp in September (see Chart 23). The deterioration seen in the related differential for goods was offset by the slight narrowing of the services differential. There was a significant widening between the growth rates of food prices, since the slowdown in the Spanish economy, while significant, was less than that in the euro area as a whole. The differential also widened in the case of industrial goods, owing to the fact that the acceleration in energy goods prices was sharper in Spain.

The producer price index continued to increase gradually during Q3, with its year-on-year growth rate rising to 4.6% in September compared with the figure of 3.4% for Q2 on average. The marked deterioration in energy and intermediate-goods producer prices largely account for this development. Consumer-goods prices behaved more moderately and capital-goods prices accelerated slightly. The performance of producer prices in the euro area was similar, with their 12-month growth rate standing at 3.1% in August, 1 pp above the average for Q2.

4.4 The State budget

In late September the government submitted the draft State budget for 2005, which sets a target for the year of attaining a surplus of 0.1% of GDP, in line with the provisions of the Pluriannual Programme of Budgetary Stability 2005-2007. The draft budget estimates that the year 2004 will close with a deficit on general government non-financial transactions, in National Accounts terms, of 0.8% of GDP, compared with the balanced budget initially projected. This discrepancy is mainly due to a series of adjustments made between the budgetary accounts and National Accounts (which had not been taken into account in the 2004 budget), and the assumption by the State of the debt of RENFE (the State-owned Railway Company) as part of the restructuring of the railway system. In respect of the sub-sectors, the central

SOCIAL SECURITY BUDGET OUTTURN

The Social Security System posted a surplus of €6.94 billion in 2004 in the period to July, 10.9% up on the same period in 2003. That places it in line with the outturn to April, but runs counter to the strong reduction in the surplus resulting from comparing the initial budget for 2004 with the outturn of the previous year[1] (see adjoining table). Both revenue and expenditure slowed in recent months. In the case of revenue, this deceleration was due, above all, to the different timing of certain interest received[2] (which is in the table included under "Other"), and the growth of total revenue stood at 6.9%. The slowdown in expenditure arose chiefly from temporary disability benefits and its growth rate stood at 6.3%, somewhat below the figure budgeted.

Receipts from social security contributions held at a growth rate of 7.1%, which is something of a slowdown on the trend maintained during 2003, despite the increase in the rates for certain special regimes[3]. The number of Social Security registrations increased by 2.7% to September 2004, only slightly below the 3% growth recorded in the two previous years.

Expenditure on contributory pensions continued to grow at a rate of 6.5%, below budget, though substantially up on the growth for 2003 as a whole. The number of contributory pensions continued to trend very moderately, increasing by 0.7% in the period to July, somewhat below the projected figure and the growth recorded the previous year.

Contributions received by INEM rose by 7.4% in 2004 in the period to March, above the budgeted projection of 6.6%, while rebates on contributions in respect of employment-promoting contracts increased by 8.2% to April, in contrast to the 21.4% growth budgeted.

Expenditure on unemployment benefits increased by 8.9% to August, against 5.9% in 2003 as a whole. Behind this rise lay the increase in the eligibility ratio, which stood at 73.8% in July 2004, substantially up on the end-2003 level. The number of beneficiaries thus grew by 5.7% in 2004 to July, compared with average growth of 3.2% the previous year. Meanwhile, registered unemployment showed an increase of 2.5% to September, virtually unchanged on 2003 as a whole.

1. This reduction is due to the fact that, as in previous years, revenue relating to contributions is highly under-estimated in budgetary forecasts. 2. In July 2003, interest revenue arose on government debt securities assigned to the Reserve Fund, while in 2004 the revenue in this connection arose in February and April. 3. These increases in rates are linked to financing the greater coverage for temporary disability or sickness.

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

EUR m and %

	Outturn	Budget		Outturn JAN-APR	Outturn JAN-JUL		
	2003	2004	% change	% change	2003	2004	% change
	1	2	3=2/1	4	5	6	7=6/5
1 Revenue	82,503	82,221	-0.3	7.4	47,468	50,762	6.9
Social security contributions (c)	77,332	76,753	-0.7	7.2	44,329	47,489	7.1
Current transfers	4,267	4,672	9.5	7.8	2,697	2,899	7.5
Other (d)	904	797	-11.9	34.7	441	374	-15.3
2 Expenditure	73,511	78,691	7.0	6.7	41,208	43,821	6.3
Wages and salaries	1,777	1,907	7.3	5.2	1,009	1,072	6.2
Goods and services	1,496	1,497	0.1	6.2	732	784	7.1
Current transfers	69,788	74,775	7.1	6.7	39,309	41,816	6.4
Benefits	69,787	74,774	7.1	6.7	39,308	41,816	6.4
Contributory pensions	60,151	64,307	6.9	6.4	33,931	36,140	6.5
Sickness	5,154	5,312	3.1	13.1	2,681	2,883	7.5
Other	4,481	5,155	15.0	3.4	2,697	2,793	3.6
Other current transfers	1	1	3.0	—	0	1	—
Other (e)	451	512	13.7	25.2	158	148	-6.0
3 Balance	8,992	3,530	-60.7	9.9	6,259	6,941	10.9

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.

government deficit will rise to 1.8% of GDP (owing to the aforementioned adjustments and to the cancellation by the State of its outstanding debt with the Andalusia regional government), while the regional governments (thanks to this latter payment) and Social Security Funds will run respective surpluses of 0.2% and 0.8% of GDP, with local governments maintaining a balanced budget.

The draft State budget for 2005 provides estimates of State revenue and expenditure, in cash-basis terms, for the year 2004 (see Table 3). According to the outturn projection, the State will post a slightly smaller deficit than that initially forecast, as a result of above-budget growth in revenue and of lower interest payments which, overall, will offset the upward deviation of primary expenditure. This will come about mainly due to the increase in current transfers linked to the cancellation of the Andalusia regional government debt and in the goods and services caption.

On National Accounts methodology, the State posted a surplus in 2004 to end-September of €845 million (0.1% of GDP) on its non-financial transactions. This was above the surplus of €214 million euro in this same period the previous year (see Table 3), due to growth in revenue of 3%, somewhat higher than the 2.2% growth in expenditure. In both cases, but especially in that of expenditure (due to the above-mentioned accounting adjustments), the actual growth rates to September are below the forecast for the year as a whole offered by the outturn projection, which points to a State deficit of €14.28 billion (1.8% of GDP).

In cash-basis terms, the State budget outturn to September resulted in a deficit of €2.51 billion (0.3% of GDP), compared with the deficit of €6.42 billion (0.8% of GDP) recorded during the same period in 2003. These figures mark an improvement on the public finances to June, as a result of an acceleration in revenue and of the practical stabilisation in the decline in expenditure. Revenue thus increased by 4.0%, compared with the decline of 0.8% to June, while expenditure fell by 1.0%, compared with the reduction of 0.9% in the first half of the year.

To analyse revenue, there is information on total tax takings raised by the State and by the territorial governments. This latter information is not included in Table 3 but is more illustrative for evaluating tax takings. The total revenue figures indicate that both direct and indirect taxes quickened appreciably in Q3, unlike other revenue. Personal income tax takings increased by 1.5% to September, compared with the 5.3% decline in the first half of the year, as the effect of speedier refunds and other asymmetrical effects that took place in the first six months compared with the same period in 2003[2] were progressively offset during Q3. In this respect, the outturn projection figure for tax takings implies a further acceleration in personal income tax in the second half of the year to growth of 3.0%. The growth rate of corporate income tax (17.2%) remained high following the settlement of the final tax payable, although in the closing months of the year it might slow if the outturn projection (13.1% for the year as a whole) holds. Turning to indirect tax, the growth of VAT takings, also affected by speedier refunds in the first half of the year, quickened in Q3 to 8.5%, in line with the annual close of the outturn projection. Conversely, the rate of increase of excise duties fell in the summer months (reflecting the freeze on rates) to 4.3%; other revenue also slowed in Q3 and underwent a decline of 3.0% in September.

2. First, withholdings in the opening months of 2003 were higher since they did not reflect the reform of personal income tax and, further, the change in the calendar for revenue from certain general government sectors in 2003 raised revenue from withholdings for that year.

STATE BUDGET OUTTURN

TABLE 3

EUR m and %

	Outturn 2003	Percentage change 2003/2002	Outturn projection 2004	Percentage change 2004/2003	Outturn JAN-JUN Percentage change	Outturn		Percentage change
						2003 JAN-SEP	2004 JAN-SEP	
	1	2	3	4=3/1	5	6	7	8=7/6
1 Revenue	109,655	1.1	111,116	1.4	-0.8	76,532	79,592	4.0
Direct taxes	56,510	1.8	57,531	1.8	-5.3	37,525	39,189	4.4
Personal income tax	32,824	1.7	30,549	-6.9	-13.6	23,532	22,591	-4.0
Corporate income tax	21,912	2.3	24,773	13.1	17.2	12,722	14,907	17.2
Other (a)	1,774	-3.7	2,209	24.5	48.4	1,271	1,691	33.0
Indirect taxes	39,084	2.8	40,930	4.7	2.1	29,269	30,959	5.8
VAT	27,130	5.5	28,466	4.9	-0.9	20,406	21,715	6.4
Excise duties	9,787	-5.4	9,889	1.0	8.9	7,266	7,388	1.7
Other (b)	14,061	-5.6	12,655	-10.0	4.4	9,738	9,445	-3.0
Other net revenue	14,061	-5.6	12,655	-10.0	4.4	9,738	9,445	-3.0
2 Expenditure	113,787	2.4	117,754	3.5	-0.9	82,955	82,105	-1.0
Wages and salaries	18,450	5.1	19,415	5.2	3.5	13,334	13,919	4.4
Goods and services	2,996	5.4	3,454	15.3	32.4	1,966	2,383	21.2
Interest payments	19,788	4.9	17,888	-9.6	-19.5	16,203	13,689	-15.5
Current transfers	58,078	-0.4	62,364	7.4	2.1	42,162	43,049	2.1
Contingency fund	…	…	…	…	…	…	…	…
Investment	7,535	7.0	7,629	1.2	-1.9	4,966	4,712	-5.1
Capital transfers	6,940	7.5	7,004	0.9	1.3	4,324	4,352	0.7
3 Cash-basis balance (3=1-2)	-4,132	…	-6,638	…	…	-6,424	-2,513	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	110,449	1.9	115,972	5.0	-2.6	77,581	79,888	3.0
Uses	112,566	0.7	130,251	15.7	2.1	77,367	79,043	2.2
Net lending (+) or borrowing (-) (c)	-2,117	…	-14,279	…	…	214	845	…

SOURCE: Ministerio de Economía y 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.

On the expenditure side, current spending quickened slightly during Q3, offsetting the slower pace of capital expenditure. Notably, the goods and services heading continued to post higher growth (21.2% to September), although the outturn projection anticipates a moderation in these expenses in Q4, and wages and salaries also quickened to a rate of 4.4% in September. Interest payments, the profile of which is determined by the timing of government bond redemptions, quickened notably in Q3 (although their rate remained negative), a trend which should continue in the closing months of the year according to the outturn projection. The growth rate of current transfers held firm during Q3 at 2.1%, although a strong acceleration in this expenditure is estimated for the end of the year owing – as mentioned earlier – to the cancellation of the debt with the Andalusia regional government. Finally, capital expenditure[3] slowed in this quarter, especially real investment, the rate of which dipped to 5.1%, although the outturn projection estimates a correction of this trend in the closing months.

3. It should be borne in mind that the assumption by the State of RENFE's debt, referred to in the main body of the text, is considered as a financial transaction in the budget outturn, and with no impact therefore on either this expenditure or the cash-basis balance. SEC 95, however, treats the assumption of this debt as a non-financial transaction and, therefore, as impacting capital expenditure and net State borrowing/lending.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 4

EUR m

		JANUARY-JULY	
		2003	2004
CREDITS	Current account	144,665	149,848
	Goods	83,464	87,400
	Services	38,654	38,265
	Tourism	*20,600*	*20,495*
	Other services	*18,054*	*17,769*
	Income	12,867	13,820
	Current transfers	9,681	10,363
	Capital account	5,018	5,142
	Current + capital accounts	149,683	154,990
DEBITS	Current account	155,301	169,414
	Goods	102,999	114,038
	Services	23,441	24,837
	Tourism	*3,898*	*4,715*
	Other services	*19,544*	*20,122*
	Income	19,918	21,312
	Current transfers	8,943	9,228
	Capital account	582	544
	Current + capital accounts	155,883	169,958
BALANCES	Current account	-10,637	-19,567
	Goods	-19,535	-26,638
	Services	15,213	13,428
	Tourism	*16,702*	*15,781*
	Other services	*-1,489*	*-2,353*
	Income	-7,052	-7,492
	Current transfers	738	1,135
	Capital account	4,436	4,598
	Current + capital accounts	-6,200	-14,968

SOURCE: Banco de España.

a. Provisional data.

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

In the first seven months of 2004, the balance on current and capital account resulted in a deficit of €14.97 billion, €8.77 billion up on the same period a year earlier. This was due to the notable widening in the current-account deficit to €19.57 billion, since the surplus on capital transactions increased slightly. The unfavourable performance of the current account came about due to the strong rise in the merchandise deficit, the deterioration in the surplus on services and the widening of the deficit on income, while the surplus on current transfers increased substantially.

In the January-July 2004 period the trade deficit widened by €7.1 billion to €26.64 billion in relation to the same period a year earlier. Expressed as a year-on-year rate, the deficit increased by 36.4%, accentuating the markedly deteriorating profile characterising it during the first three quarters of the previous year. The robustness of real import flows, far greater than that of exports, combined with the worsening terms of trade are what account for the marked deterioration in the trade deficit.

As regards services, the surplus to end-July stood at €13.43 billion, €1.78 billion down on the same period in 2003. This deterioration made for a year-on-year decline of 11.7%, which was attributable to the 5.5% reduction in the tourism surplus and to the deficit on non-tourist services. The buoyancy of tourism revenues in the opening months of the year was checked in the wake of the terrorist bombings on 11 March, and this item has fallen uninterruptedly since April, in line with the unfavourable performance of the sector. Tourism payments rose to 21% in the January-July period, intensifying the accelerating profile initiated in late 2003, against the background of restored normality in the worldwide geopolitical environment, driven by the improvement in consumer confidence and the strength of the euro.

The income deficit stood at €7.49 billion in the period January-July 2004, signifying an increase of €441 million on the same period a year earlier. The widening of the income deficit was the result of the behaviour of the resident private sector, especially the financial sector, while the general government deficit was marginally corrected. In the case of the financial sector, the widening of the income deficit was due to the increase in payments linked to fixed-income instruments, especially to covered bonds, and in the case of the non-financial private sector the deterioration of the balance was the outcome of the increase in payments associated with direct and portfolio investment, relating to the distribution of dividends by resident corporations.

The surplus on the balance of current transfers stood at €1.13 billion during the period under study, €398 million up on the same period in 2003. Revenue increased by 7%, the result of the rise in flows received from the public sector, especially EU flows relating to the European Social Fund, while Community funds for the private sector in connection with the EAGGF-Guarantee fund declined slightly. Payments grew by 3.2% owing to the increase in those earmarked for Community coffers via the GNP resource and traditional own Funds, and to the momentum maintained by emigrants' remittance payments.

Finally, the surplus on capital account was €4.6 billion, €162 million up on the same period in 2003. Despite this improvement, net capital transfers from the EU, which is the biggest item in quantitative terms, declined in this period as a result of the fall-off in ERDF structural funds and in the EAGGF-Guidance Fund, while Cohesion Fund flows trended favourably.

5 Financial developments

5.1 Overview

In 2004 Q3, the decisions of the non-financial private sector continued to be taken against a background of generous monetary and financial conditions. Interest rates remained at very low levels, although their behaviour varied across instruments. In the euro area money market there were scant changes over the period as a whole and one-year EURIBOR stood in September at 2.38%, 2 basis points (bp) down from June. Public debt yields fell; that on the Spanish ten-year bond reached 4.08%, a decline of 31 bp from the previous quarter. By contrast, the interest rates applied by credit institutions to firms and households rose somewhat during the same period, although, on average, they remained at lower levels than in 2003. Meanwhile, the cost of financing via fixed-income securities fell, as a consequence of the decline in both the yield on public debt and in the risk premiums demanded (see Chart 24).

On domestic and international stock markets prices fell significantly in the first half of August, a movement associated with the surge in oil prices. Subsequently, there commenced a recovery that was cut short at the end of September, against a background of further oil price rises. Despite this, as at the cut-off date for this article, the Madrid Stock Exchange General Index had risen by 8% since the beginning of the year. This performance was better than that of the euro area EURO STOXX broad index, which rose by 3% over the same period, and that of the US S&P 500, which was little changed from its end-2003 level. At the same time, implied price volatility remained at low levels, despite the tension in the oil market.

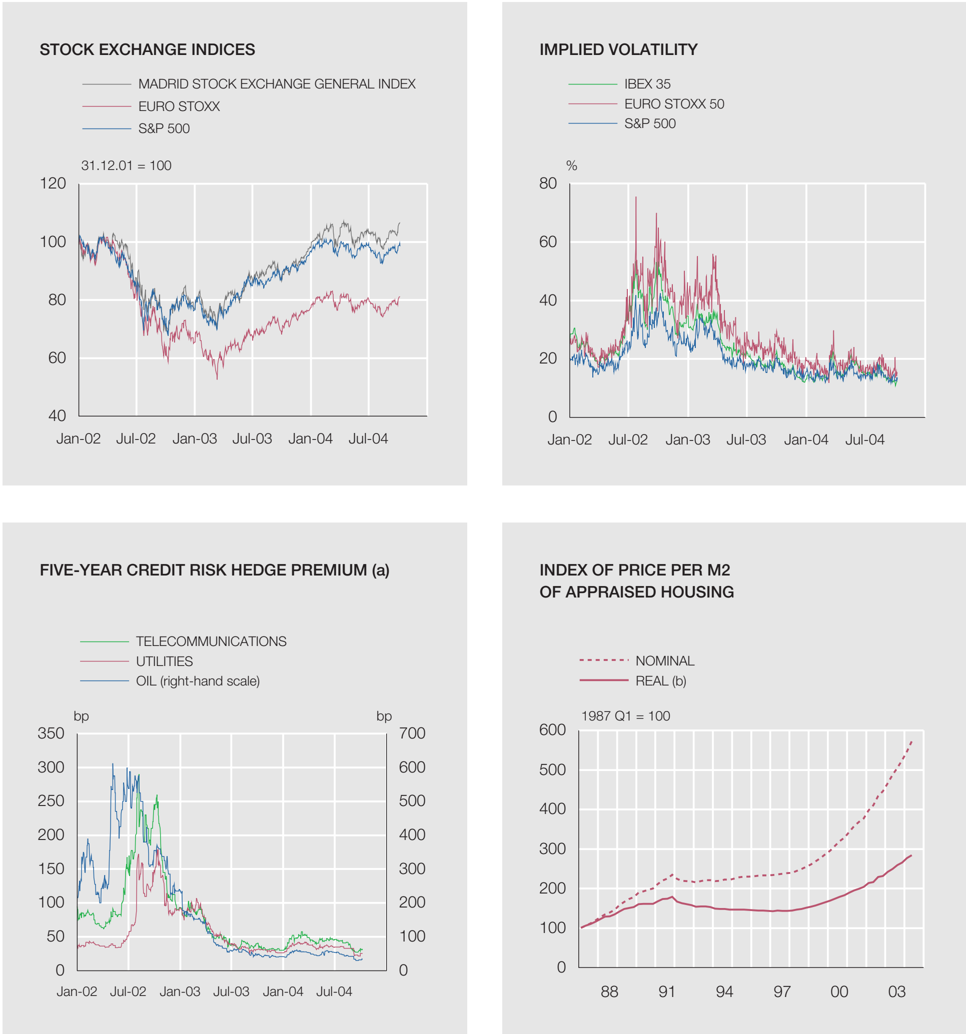
In the housing market, the Q2 data did not confirm the slight slowdown in prices observed between January and March. Thus, between April and June, the value of property continued to grow at an annual rate of more than 17%, with some differences according to the type of housing. In the case of used housing, the rate of growth moderated for the second quarter running, to 17.7%, while the price of new housing rose by 16.7% in relation to the same period of the previous year, more than one percentage point up on the rate recorded in March.

Against this background, financing to the non-financial private sector and, in particular, households remained highly buoyant, driven again by the behaviour of the property sector. Thus, the annual growth rate of loans to households for house purchase rose slightly, to stand in June at somewhat more than 23%, and bank lending to property services accelerated to a rate of more than 43%. In both cases, these figures represent highs for the past few years. The provisional Q3 information does not show any significant change in the behaviour of household and corporate borrowing.

The rise in household liabilities was accompanied by a further contraction in saving after debt service, which remained at very low levels, and entailed an increase in debt ratios and in the debt burden relative to the annual gross disposable income (GDI) of the sector. In addition, in June, household net financial wealth, measured in terms of GDP, was slightly below its March levels, although the net wealth of households continued to follow the rising path of recent years, as a result of the upward trend in property prices.

The overall financial position of households remained solid and is no obstacle to the sector's spending retaining its current tempo over the next few quarters. However, the margin available to absorb possible shocks of an adverse nature has continued to narrow, given the decline in the different savings indicators. At the same time, the ongoing rise in indebtedness continues to raise the sensitivity of household consumption and investment decisions to unfavourable

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

changes, such as an increase in interest rates. Also, it should not be forgotten that the dispersion of the distribution of debt among the population suggests that the vulnerability of some groups of the population is comparatively higher than the aggregate indicators would suggest.

In the case of corporations, however, the recent developments in their financial situation have been more favourable. Although their net borrowing and aggregate debt ratios remained on an upward path in Q2, the debt burden arising from interest fell slightly and the synthetic indicators show a decline in the financial pressure on employment and, to a greater extent, on investment. In addition, the available microeconomic information seems to confirm that the rebuilding of balance sheets by large corporations may have been concluded, while the expected profits of listed companies improved, albeit not across all sectors and terms[1].

1. Box 4 offers an initial analysis of the relationship between this indicator and the capital investment of non-financial corporations.

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP	1999	2000	2001	2002	2003			2004	
					Q2	Q3	Q4	Q1	Q2
National economy	-1.0	-2.5	-2.2	-1.6	-1.8	-2.2	-2.1	-2.4	-3.1
Non-financial corporations and households and NPISHs	-0.3	-2.3	-3.4	-2.9	-3.2	-3.4	-3.9	-4.0	-4.8
Non-financial corporations	-2.3	-3.4	-4.5	-4.3	-3.7	-4.4	-4.5	-4.8	-5.2
Households and NPISHs	2.0	1.1	1.1	1.4	0.5	1.0	0.6	0.7	0.4
Financial institutions	0.5	0.8	1.6	1.5	1.4	1.3	1.4	1.5	1.5
General government	-1.2	-0.9	-0.4	-0.1	0.1	-0.1	0.4	0.1	0.2

SOURCE: Banco de España.

The generosity of the financing conditions for non-financial corporations, their solid aggregate financial position, the recovery in analysts' expectations regarding the long-term profits of listed firms, the signs of improvement in industry and the indications that the rebuilding of balance sheets by large companies may have been concluded make up a positive scenario from the viewpoint of growth of productive investment. However, the high levels of debt are a risk factor, insofar as adverse developments such as a rise in interest rates or a decline in profit may have a significant impact on the sector's spending decisions.

5.2 Households

Financing conditions for households remained generous in Q3. Although the lending rates applied by credit institutions to new business rose, the levels reached are still below the average levels in 2003. In terms of purpose, the upward movement was most intense in the case of consumer and other loans, the cost of which reached 6.54% in August, a rise of 50 bp from June. In the case of loans for house purchase, there was an increase of 17 bp, to 3.46%.

The macroeconomic and financial background remained conducive to the expansion of external financing. Between April and June, household demand for credit stood, in cumulative four-quarter terms, at 10.6% of GDP, 0.6 pp higher than in March (see Table 6). These developments continued to reflect the behaviour of lending for house purchase, which represents around 70% of total lending to households and has displayed a smoothly accelerating profile over the year, to reach an annual growth rate of more than 23% in June. Financing for consumption and other purposes, by contrast, grew at significantly lower rates, of around 13%. Provisional Q3 information suggests that household debt has remained buoyant.

As for portfolio decisions, between April and June household investment in financial assets was, in cumulative twelve-month terms, equal to 11.4% of GDP, 0.4 pp higher than in March. Investment was directed, somewhat more intensively than in previous months, towards the most liquid assets (basically, cash and deposits), which reached 5.3% of GDP, as against 4.5% in the previous quarter. By contrast, investment in mutual fund shares and in shares and other equity, excluding mutual fund shares, did not change significantly, standing at 2.2% and 1% of GDP, respectively.

The high rate of growth of household liabilities meant that debt ratios remained on the upward path that has characterised them in recent years, so that the value of debt stood in June at around 99% of the sector's GDI (see Chart 26). The associated debt burden increased again for the third consecutive quarter, to 13.4% of GDI, although the interest

TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS TABLE 6
Cumulative four-quarter data

% GDP

	2000	2001	2002	2003	2004	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	9.6	7.8	8.8	10.1	11.0	11.4
Cash and cash equivalents	0.9	1.2	3.8	4.4	4.3	4.5
Other deposits and fixed-income securities (a)	6.1	3.4	1.5	-0.2	0.2	0.8
Shares and other equity (b)	1.5	-0.2	0.8	0.8	1.0	1.0
Mutual funds	-3.3	0.8	0.2	2.3	2.3	2.2
FIAMM	*-1.2*	*1.3*	*0.7*	*0.6*	*0.1*	*0.0*
FIM	*-2.0*	*-0.5*	*-0.5*	*1.7*	*2.3*	*2.2*
Insurance technical reserves	3.5	2.7	2.6	2.1	2.0	1.9
Of which:						
Life assurance	*2.1*	*1.5*	*1.5*	*0.7*	*0.7*	*0.8*
Retirement	*1.1*	*0.9*	*0.9*	*1.1*	*1.1*	*0.9*
Other	0.9	0.0	-0.1	0.8	1.2	1.1
Financial transactions (liabilities)	8.6	6.8	7.3	9.5	10.3	11.0
Credit from resident financial institutions (c)	7.0	5.4	7.2	9.3	10.0	10.6
House purchase credit (c)	*5.3*	*4.8*	*5.1*	*7.2*	*7.8*	*8.3*
Consumer and other credit (c)	*1.6*	*0.6*	*2.1*	*2.1*	*2.1*	*2.3*
Other	1.5	1.3	0.1	0.2	0.4	0.4
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	26.2	16.4	16.4	17.1	15.7	16.1
Cash and cash equivalents	0.9	1.7	1.6	0.9	0.6	1.3
Other deposits and fixed-income securities (a)	1.2	0.7	1.7	1.5	0.7	0.0
Shares and other equity	14.1	6.1	6.8	6.7	5.3	5.4
Of which:						
Vis-à-vis the rest of the world	*10.5*	*4.6*	*5.1*	*4.6*	*3.2*	*3.6*
Other	10.1	7.9	6.2	7.9	9.1	9.3
Financial transactions (liabilities)	29.6	21.0	20.8	21.6	20.5	21.3
Credit from resident financial institutions (c)	7.5	6.5	6.3	7.0	7.1	7.7
Foreign loans	3.5	4.0	3.0	2.8	2.4	2.3
Fixed-income securities (a)	-0.9	0.0	-0.4	-0.1	0.0	-0.1
Shares and other equity	12.8	5.3	6.0	5.0	3.7	3.5
Other	6.7	5.2	5.8	6.9	7.3	7.9
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (d)	18.1	15.6	14.3	15.8	16.0	16.6
Households and NPISHs	17.3	12.3	15.6	18.7	19.5	20.1
Non-financial corporations	18.7	18.0	13.3	13.8	13.4	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.

COMPANY PROFIT EXPECTATIONS AND INVESTMENT DECISIONS.

BOX 4

Investment decisions hinge, among other factors, on the comparison between the expected return on the project and the opportunity cost of the funds invested. Thus, to explain the path and future prospects for business capital formation, it may be useful to analyse variables related to the expected return on new capital acquired. The expected long-term profits of stock-market analysts compiled by the Institutional Brokers Estimate System for listed companies, offer an approximation of this concept. However, it should be noted that such expectations are those of analysts and not of the companies and that, consequently, they are opinions on average returns and not the marginal ones, which are strictly the relevant ones in this context.

The adjoining charts show, for the period 1997-2003, the average growth expectations for long-term profits and the investment/capital ratio of the main Spanish non-financial companies listed on the stock exchange[1]. The left-hand chart shows, for each year of the sample, the average value of these two variables for all the firms considered. As expected, a clear positive relationship can be seen between these two variables. The results for 2001 and, in particular, for 2000 are particularly significant, when the substantial volumes of investment undertaken coincided with high rates of growth of expected profits. Also, in 2003 the low net acquisition of capital co-existed with a decline in the returns anticipated by analysts. The right-hand chart also shows average values for the variables in question, but in this case calculated over time and for each sector[2]. The relationship is also a positive one, although weaker than in the previous analysis.

This analysis, based on simple temporal and cross-sectional correlations between the indicator of long-term profit expectations and investment, offers evidence that the former contains some information with respect to the latter. Accordingly, and with the appropriate caveats given the absence, for lack of information, of a deeper analysis of the relationship between these two variables, the recovery in the indicator during 2004 may help to explain the recent increase in the buoyancy of productive investment.

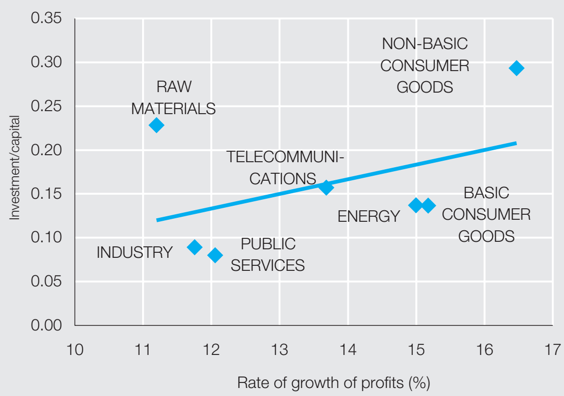
1. The aggregate variables are obtained from the sum of the individual data weighted according to the total capital of each firm.

2. The sectoral data have been obtained as the sum of the various firms belonging to each productive sector, weighted by their capitalisation.

LONG-TERM PROFITS AND INVESTMENT/CAPITAL RATIO

1. TEMPORAL ANALYSIS

2. CROSS-SECTIONAL ANALYSIS

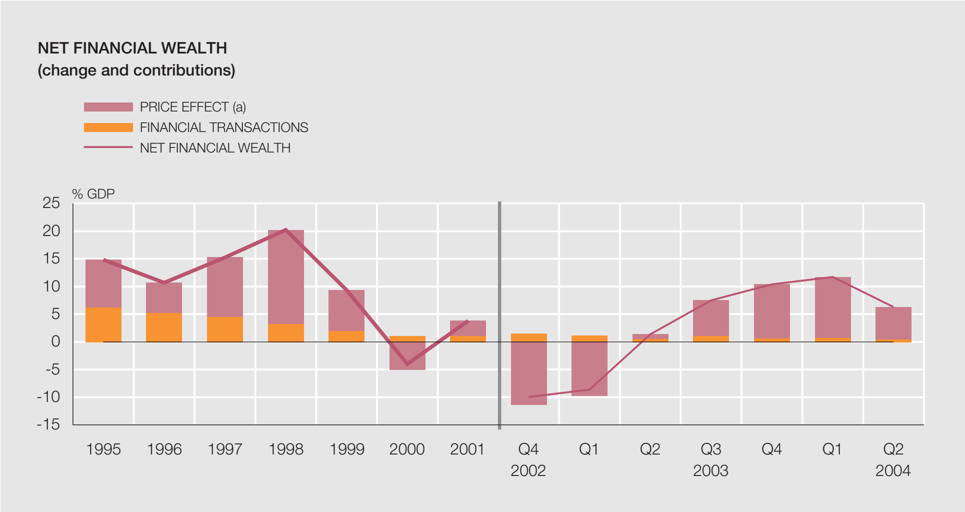


SOURCE: IBES

component was unchanged at 4.1%. As a result, the sector's ability to save after deducting financial obligations (saving after debt service) fell to very low levels (0.7% of GDI). Also, net financial transactions in Q2 were negative, so that, in cumulative four-quarter terms, financial saving fell to historically low levels: 0.4% of GDP (see Table 5). This contraction was reflected in a decline in financial wealth from March, although this variable continued to display positive year-on-year growth rates. Household net wealth, however, continued to rise on account of the upward trend in house prices (see Chart 25 and 26).

HOUSEHOLDS AND NPISHs
(cumulative four-quarter data)

CHART 25



Source: Banco de España.

a. Includes revaluation and other changes in volume.

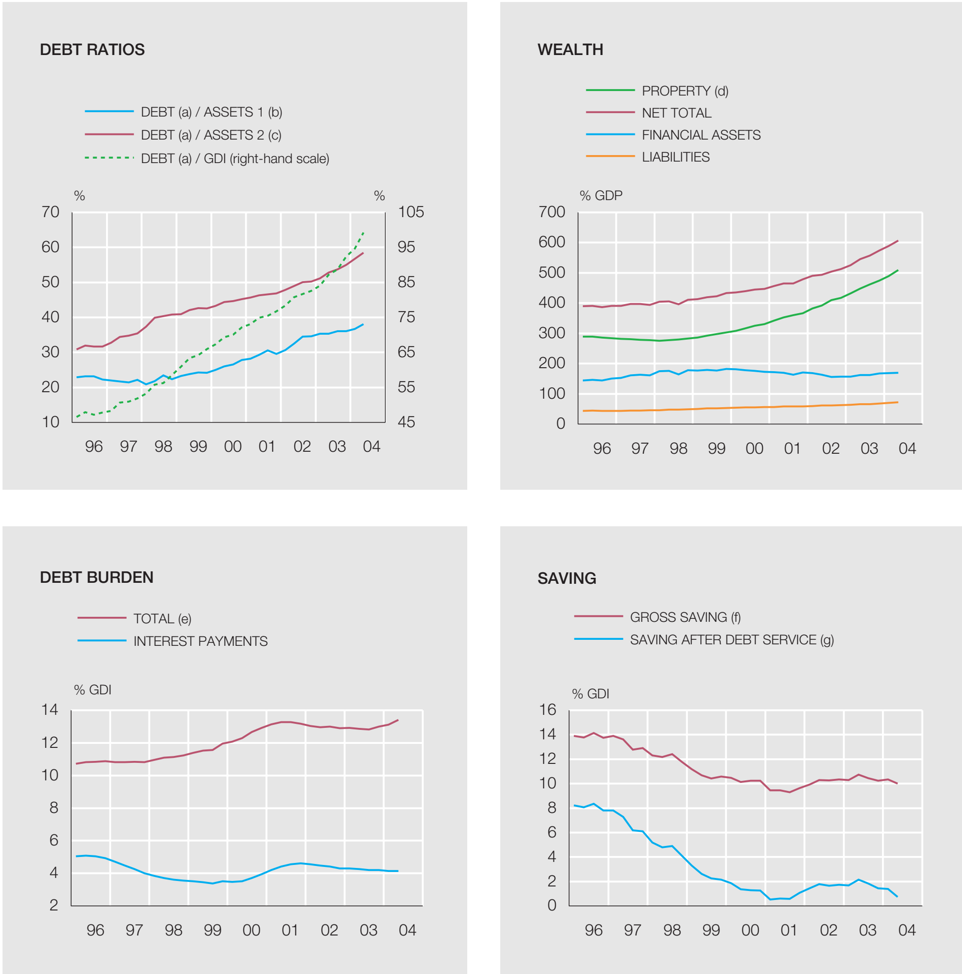
Despite the decline in saving in aggregate terms, the latest Household Expenditure Survey data for Q2, indicated an increase in the number of households declaring that they are able to devote funds to saving, to 37.4%, the highest level since mid-2002. This was compatible, however, with an increase in the proportion of household units declaring that they have problems making ends meet (more than 12%).

5.3 Non-financial corporations

Financing conditions for corporations also remained generous in Q3. Lending rates were little changed and therefore stayed at low levels, below those in 2003. The cost of new credit, for an amount of more than EUR one million, stood at 2.88%, having fallen by 21 bp between July and August. During the same period, the rate on loans up to EUR one million increased by 6 bp, to 4.21%. On fixed-income markets, the cost of financing fell, reflecting the decline in the yield on public debt and in the risk premiums demanded. Finally, the conditions for raising funds on equity markets showed no significant changes, given that prices and their volatility held relatively stable.

Against this background the sector's liabilities-side transactions, between April and June, were buoyant. In cumulative twelve-month terms, they reached 21.3% of GDP, up 0.8 pp from the previous quarter (see Table 6). By component, the annual growth rate of interest-bearing external borrowing rose to around 14%, a rate that, on the provisional information available, was sustained between July and September. The breakdown by instrument shows that the sector made net repayments of – mainly long-term – fixed-income securities, without there being any evidence that firms were resorting to issuance through subsidiaries abroad. In fact, the importance of the flow of financing via external loans continued to fall, to 2.3% of GDP. By contrast, the importance of credit raised from resident institutions continued to rise. The funds obtained through this channel reached 7.7% of GDP, up 0.6 pp from the previous quarter. Meanwhile, the issuance of shares and other equity fell again, to reach, in cumulative twelve-month terms, 3.5% of GDP. Finally, according to the Central Balance Sheet Data Office (CBQ), the volume of the debt of large corporations increased for the second consecutive quarter, which may indicate that the rebuilding of balance sheets undertaken by certain firms in 2002 and 2003 has been completed.

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 26



SOURCE: Banco de España.

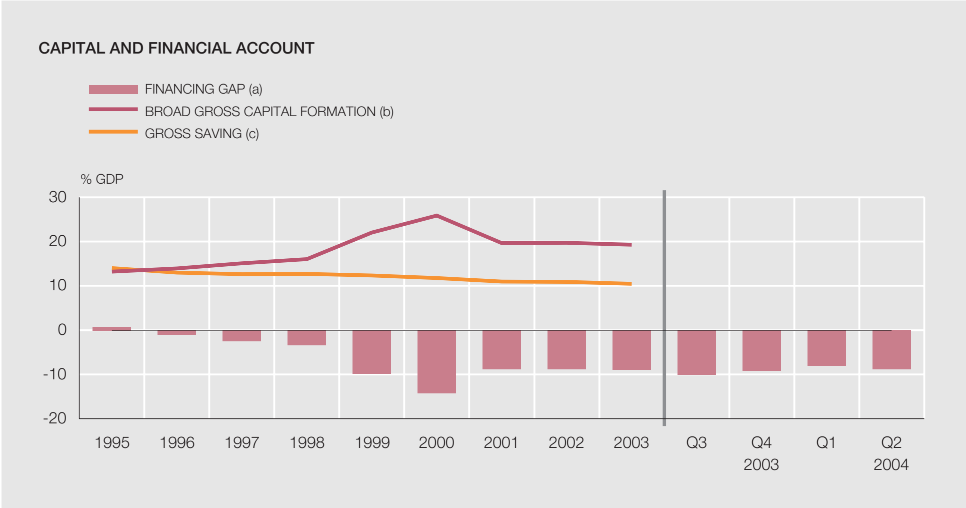
a. Includes bank credit and securitisation.
b. Assets 1 = Total financial assets - "other".
c. Assets 2 = Assets 1 - shares - shares in FIM.
d. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.
e. Estimated interest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

The breakdown by productive activity of the main source of financing of the sector, namely credit from resident institutions, shows a significant acceleration in funds granted to construction and services between April and June. This greater buoyancy was particularly intense in the case of property services, where the growth was around 43% in year-on-year terms, up three percentage points from March, although there was also an increase in the rate of growth in other services. In industry there was a moderate recovery in bank borrowing, in line with the improvement in the activity of this sector, although in year-on-year terms there continued to be a slight contraction.

As regards the net acquisition of financial assets, in Q2, non-financial corporations increased the volume of their investments, which in cumulative four-quarter terms reached 16.1% of GDP (see Table 6). This behaviour was common to most items, but not to the aggregate of other deposits and fixed-income securities, owing to the lower acquisition of short-term securities by credit institutions.

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.

The result of the assets and liabilities-side transactions was a significant increase in the sector's net borrowing which, in cumulative twelve-month terms, reached 5.2% of GDP, up 0.4 pp from March. Meanwhile, the financing gap, which approximates the net funds necessary to undertake the gross capital formation and the permanent financial investment abroad, increased by even more (0.8 pp), to 8.8% of GDP (see Chart 27).

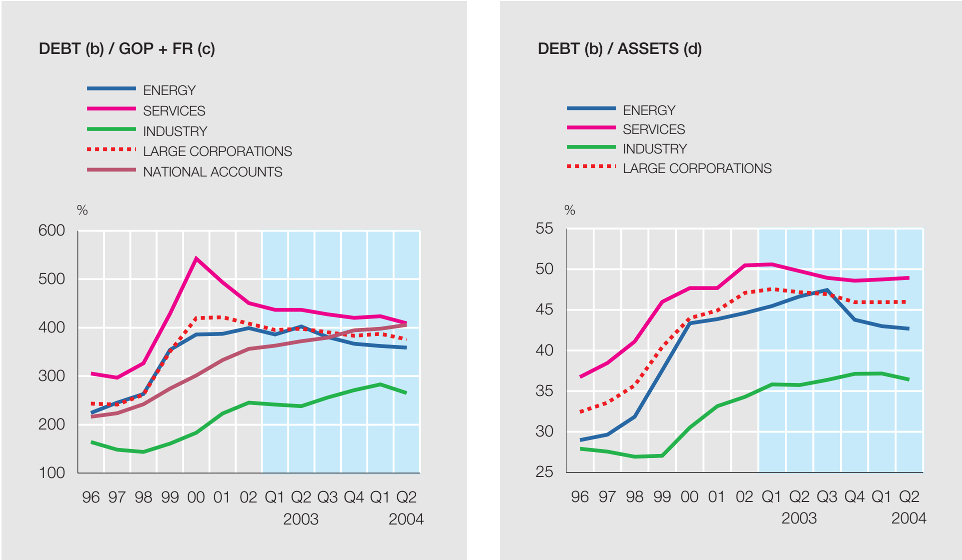
The financial results of the corporations reporting to the quarterly survey of the Central Balance Sheet Data Office (CBQ) continued to improve in Q2. Ordinary net profit increased in the first half by 22.5%, over 10 pp more than in the same period of the previous year, although a significant part of this change is attributable to the positive impact of lower financial costs and, in particular, higher financial revenue (dividends) from foreign subsidiaries. As a result, the ordinary return on equity was 10.7% in the first half, as against 9% in the same period a year earlier, an improvement that was seen across all the productive branches, although most strongly in services and industry. By contrast, net profit fell, in year-on-year terms, reflecting the less favourable behaviour of extraordinary revenue.

Despite the corporations' solid financial results, their recourse to borrowing meant that the aggregate debt ratios continued to rise in Q2, although the debt burden arising from interest declined slightly, as a consequence of the cumulative fall in the cost of financing over the last twelve months, to 17.2% of the gross operating surplus (to which financial revenue is added; see Charts 28 and 29). By contrast, according to the CBQ, the slower rate of growth of external financing of the major firms, together with the favourable trend in profits, led to a slight contraction in the ratio of debt to profits, while the debt burden also fell.

The behaviour of the debt, debt burden and profitability of the corporations reporting to the CBQ led to a reduction in the aggregate synthetic indicators of financial pressure on employment and, to a greater extent, on investment (see Chart 30).

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a)

CHART 28

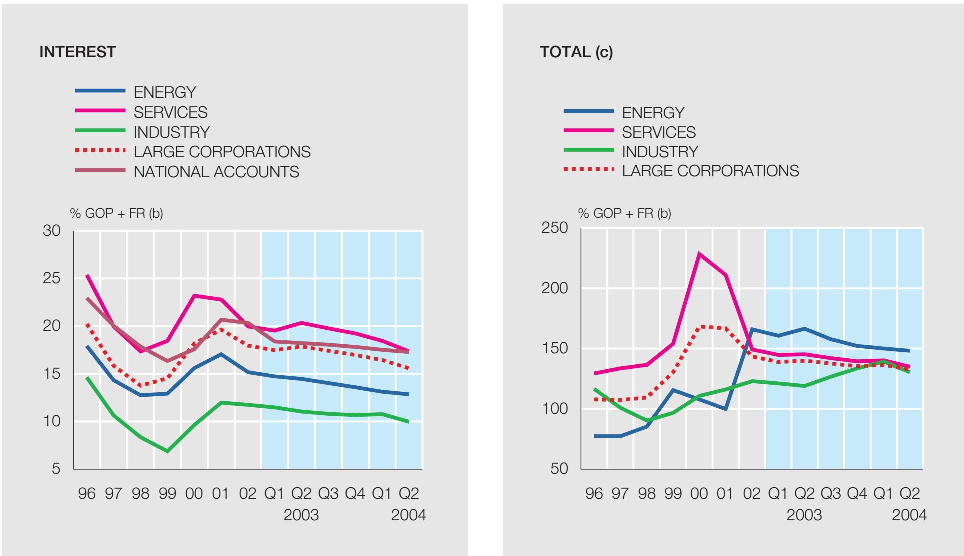


SOURCE: Banco de España.

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

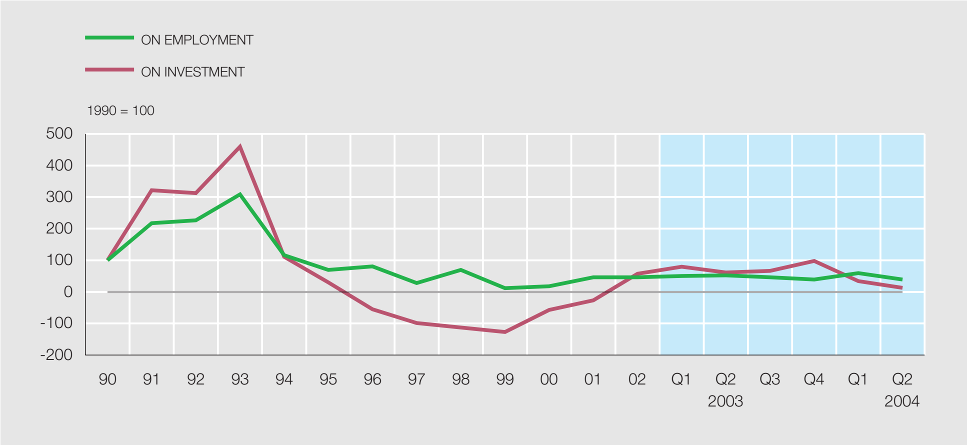


SOURCE: Banco de España.

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

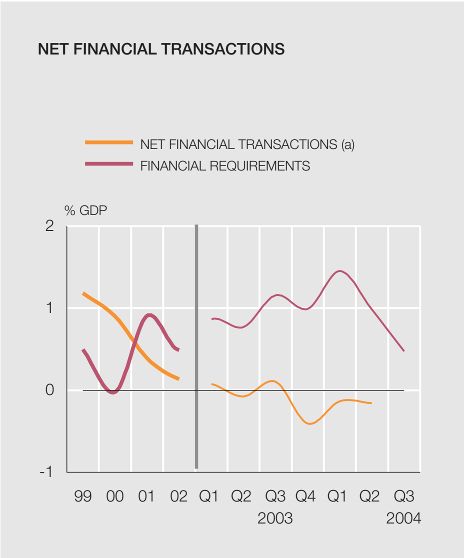


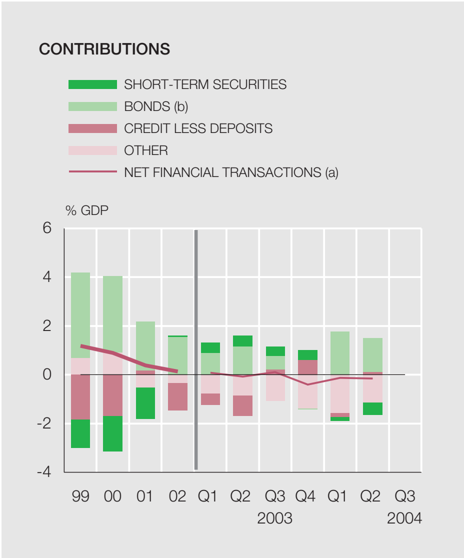
SOURCE: Banco de España.

a. A higher (lower) value than 100 denotes 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".

5.4 *General government*

In 2004 Q2, there was a slight increase in the positive balance of the net financial transactions of the general government sector, in cumulative twelve-month terms (see Chart 31). By sub-sector, Social Security ran a surplus, while the central, regional and local governments all recorded positive net borrowing.

The breakdown by instrument of financial transactions shows positive net issuance of long-term securities, amounting to 1.4% of GDP, largely offset by the net redemption of short-term securities equivalent to 0.5% of GDP, and by a so-called “other” component that basically includes the purchase of public debt by the Social Security Reserve Fund.

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP

	2000	2001	2002	2003	2004	
				Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-2.5	-2.2	-1.6	-2.1	-2.4	-3.1
FINANCIAL TRANSACTIONS (ASSETS)	25.0	12.2	13.7	13.5	12.1	13.7
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.8	-2.7	3.5	0.8	1.3	2.7
Securities other than shares	3.9	7.2	4.3	7.0	4.8	4.3
Of which:						
Credit institutions	*-0.3*	*2.0*	*0.5*	*3.7*	*3.6*	*3.3*
Institutional investors (a)	*3.7*	*5.4*	*3.5*	*3.4*	*1.3*	*0.7*
Shares and other equity	15.6	5.1	5.3	4.7	4.7	5.5
Of which:						
Non-financial corporations	*10.5*	*4.6*	*5.1*	*4.6*	*3.2*	*3.6*
Institutional investors (a)	*3.2*	*0.5*	*-0.1*	*1.1*	*1.7*	*1.8*
Loans	2.7	2.5	0.6	1.0	1.2	1.2
FINANCIAL TRANSACTIONS (LIABILITIES)	27.5	14.4	15.3	15.6	14.4	16.8
Deposits	6.7	2.8	4.4	7.5	5.0	7.0
Securities other than shares	7.1	3.1	4.5	5.6	8.9	9.5
Financial institutions	*1.1*	*1.5*	*3.2*	*6.7*	*7.6*	*8.2*
Rest of resident sectors	*6.0*	*1.6*	*1.2*	*-1.1*	*1.3*	*1.3*
Shares and other equity	9.4	4.6	4.1	0.8	-0.6	-1.5
Of which:						
Non-financial corporations	*7.7*	*4.1*	*3.5*	*0.9*	*-0.6*	*-1.0*
Loans	4.1	4.3	3.4	3.2	2.8	2.8
Other, net (b)	0.3	-0.4	-1.2	-1.4	-1.6	-0.9

SOURCE: Banco de España.

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

Provisional 2004 Q3 information points to a reduction in the financial requirements indicator, which shows the sector's recourse to the financial markets and can be taken as a pointer to the behaviour of general government (dis)saving. This led, in cumulative twelve-month terms, to a reduction in the issuance of bonds and to a redemption of short-term securities, as well as an increase in deposits (net of credits).

5.5 The rest of the world

In 2004 Q2, the net borrowing of the Spanish economy increased, in cumulative twelve-month terms, to 3.1% of GDP. The deterioration in the balance of the nation's financial transactions was basically the result of lower financial saving by households and corporations, given that there was no significant change in the behaviour of the other sectors (see Table 5).

The net acquisition of external assets increased to 13.7% of GDP, in cumulative twelve-month terms, up 1.6 pp from Q1 (see Table 7). This was the result, as in previous quarters, of an increase in flows to deposits and a decline in those to securities other than shares. Also, purchases of shares and other equity, especially by non-financial corporations, recovered to levels exceeding those seen in recent years. According to provisional balance-of-payments data, the rate of decline in direct investment abroad has begun to moderate; between January and July the volume of transactions was only slightly down on the same period a year earlier.

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	-38.0	-39.4
Non-financial corporations and households and NPISHs	-17.3	-9.4	-10.2	-11.6	-14.7	-13.4
Non-financial corporations	-24.1	-16.7	-17.6	-19.3	-23.2	-22.0
Households and NPISHs	6.8	7.3	7.4	7.7	8.5	8.6
Financial institutions	8.2	8.3	8.6	6.5	-0.8	-2.3
Credit institutions (c)	-7.5	-11.5	-13.9	-14.3	-22.0	-22.5
Institutional investors (d)	16.3	20.7	24.3	24.4	27.5	28.1
Other financial institutions	-0.6	-0.9	-1.8	-3.6	-6.3	-7.9
General government	-20.5	-25.1	-25.4	-25.8	-22.4	-23.7

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. Q2 data.
c. Defined in accordance with the First Banking Directive.
d. Insurance corporations and portfolio investment institutions.

On the liabilities side, net capital inflows amounted to 16.8% of GDP, in cumulative twelve-month terms, as against 14.4% in the previous quarter. This increase was observed in most instruments, but not in shares and other equity. Non-residents made net sales of shares and other equity equal to 1.5% of GDP, with listed shares accounting for a large proportion of such sales. An increasing and significant part of foreign investment in Spain was in the form of deposits and securities other than shares issued by financial institutions (in particular, interbank deposits and bonds issued by credit institutions). At the same time, according to the balance of payments, capital inflows in the form of direct investment continued to fall; in the period January to July they amounted to only 25% of those in the same period of 2003. By instrument, flows of direct investment were basically concentrated in property, since non-residents made capital divestments and inter-company financing shrank to very low levels.

Finally, provisional information available shows that, in 2004 Q2, the debit position of the Spanish economy vis-à-vis the rest of the world stood at 39.4% of GDP, a decline of more than one percentage point from end-2003 (see Table 8).