1 Overview

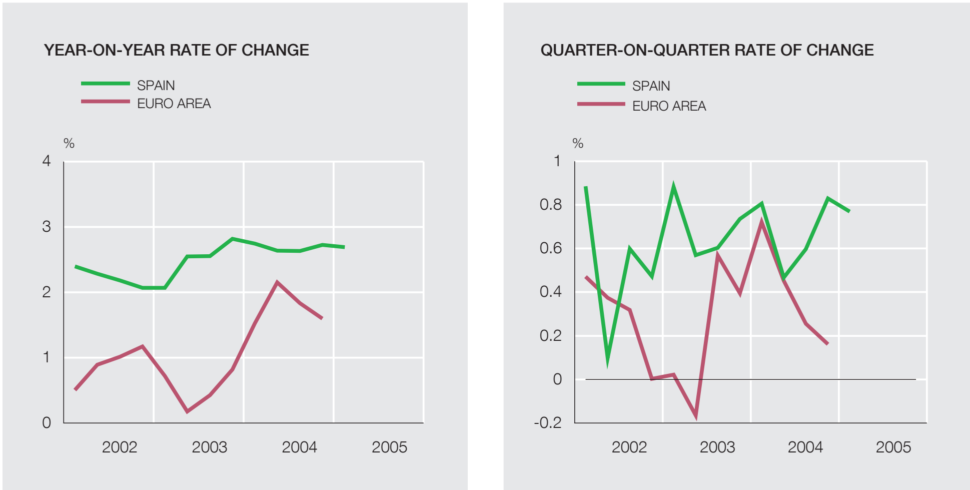
The Quarterly Report on the Spanish Economy presented in this Bulletin is released under special circumstances owing to the imminent re-basing of Spanish National Accounts (CNE). The analysis draws on the 1995 base year series available, meaning that the estimated quarterly growth rates of GDP and of its main components will be obsolete once the current series are revised.

INE will release the new estimates of the main macroeconomic aggregates for the CNE 2000 base during May, as a result of which the Quarterly National Accounts (QNA) for 2005 Q1 will, on their release on 25 May, be according to the new base. There is sufficient information to predict that the revision of the time series of the macroeconomic variables will be most significant and will affect both the levels of the aggregates and the growth rates estimated, to date, for recent years. Indeed, the main results of the new EPA (Labour Force Survey), which is a basic statistic for the new CNE 2000, are already known (see Box 1 for a summary). The estimates of employment and working population of the EPA, which include the population projections updated on the basis of the 2001 census and the "Padrón Continuo" (a continuously updated municipal population census), entail a substantial upward revision of employment growth. For instance, the growth of numbers employed in 2004, which the previous EPA placed at 2.5%, is now 3.9%. Moreover, the scale of the revisions is on a rising course throughout the 1996-2004 period, proving particularly considerable as from 2002. With these figures, the CNE 2000 base may be expected to establish significantly higher employment and, therefore, GDP growth for the most recent years than that available under the current 1995 base. While it is possible that the cyclical pattern of GDP, in terms of accelerations and decelerations, will be less affected than its level of growth, revisions here cannot be ruled out either and may be more substantial in the most recent periods since they are estimated, naturally, with less accuracy.

In these conditions, the quantitative estimates based on the projection of the former CNE base offer but a tentative value of the main trends and should be interpreted bearing in mind that they will foreseeably be revised upwards in the coming weeks when the new series are released.

Given these caveats, and drawing on the economic information available, the Spanish economy is estimated to have begun the year 2005 growing at a similar, though slightly higher, rate than that at the end of 2004, furthering the trend of mild recovery seen in the closing months of 2004 (see Chart 1). Specifically, GDP would have grown at a year-on-rate of 2.8%, in terms of the CNE 1995 base series (a rate which, under the new base, will be revised upwards by a similar amount to that by which the rates for the closing quarters of 2004 are revised). Domestic demand has continued to show forceful momentum during this period, underpinned by household spending and business investment, which has sustained the course of recovery shown in the second half of 2004. Nonetheless, the pull exerted by the external sector has remained equally intense, against the background of the sizable and accumulated appreciation of the euro, although this process has not continued in the opening months of the year. From the standpoint of the supply-side of the economy, while certain indicators of activity have shown signs of turning down somewhat in Q1, the employment figures continue to point to vigorous growth and to the maintenance, therefore, of a sound rate of increase in sectors such as construction and services. The impact of the further hike in oil prices, which took place as from February, has fed through to prices, meaning that the CPI posted a 12-month rate of change of 3.4% in March.

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

On the external front, the world economy, following confirmation of the easing of global growth in the second half of 2004, has begun 2005 with a more sustainable rate of expansion than that of the previous year, when it is estimated to have grown by more than 5%, while world trade did so at a rate of close to 10%. The contribution of the various geographical regions to this slowdown, which has come about against a backdrop of somewhat less accommodating economic policies than in the past, has not however been uniform. The developed countries – both the United States and Japan and the euro area – have, though maintaining notable differences, seen their activity slow, while in the emerging economies – most notably China and Latin America – dynamic growth has not abated. In any event, the United States and China remain the driving force of world growth. Inflationary pressures continue to be contained, in general, although in the main developed countries the influence on consumer prices of the rise in oil prices is perceptible, especially following the recent hike, and in many emerging countries price pressures have likewise been detected. The financial markets have shown stable behaviour, with low long-term interest-rate levels that are particularly noticeable in the case of United States, where they have scarcely reacted to the rises applied and expected in short-term rates. On the stock markets, the year began with rises, although in recent weeks there has been an across-the-board decline in prices.

The outlook for 2005 has world growth holding at the levels at which it began the year, although an additional slowdown tied to the impact of dearer oil cannot be ruled out. Indeed, certain discrepancies among the forecasting agencies are discernible as to whether, beyond the coming quarters, a fresh rebound in activity is to be expected or, conversely, whether a more moderate rate will continue to be the case. In this respect, the factors of risk clouding the international economic outlook remain substantial. The first derives from oil prices, especially following the recent rises which the futures markets have swiftly factored into their prices, which remain at over $50 per barrel of Brent until the end of the year. There is considerable uncertainty about the possibility of additional rises which, undoubtedly, are linked to the strength of demand, but whose potentially dampening effects might be sharper in the European countries. Global financial imbalances and, in particular, the borrowing requirements of the United States have, far from being corrected, increased in recent months. This would be conducive to a continuing depreciation of the dollar, without it being possible to exclude an

On 30 March 2005 INE presented a revision of the EPA (Labour Force Survey) 2005 figures for the period 1996-2004 further to the updating of population projections on which the Survey is based. The new data entail a considerable increase in the total population estimated by EPA and, therefore, of the total figures for the working age population, the employed and the unemployed. This Box briefly summarises the changes made by INE on the occasion of this revision, and it discusses consequences for the main labour market magnitudes. Also, on 29 April, INE presented estimates for 2005 Q1 in which, in addition to the changes indicated, other methodological modifications were incorporated. As the latter are not included in the annual figures for the period 1996-2004, they are not discussed in this Box.

The population projections are the basis of the surveys that INE addresses to households. In this respect, the availability of the population figures according to the 2001 census and of the updates from the Municipal Census of Inhabitants (statistical records that include the population changes undergone by the Spanish economy in recent years) has led to a revision of the previous EPA (EPA 2002) estimates, which were still based on the 1991 Population Census. To this end, INE has re-weighted the sample data of the survey so that they properly reflect recent population trends and, in particular, the sharp growth recently in the immigrant population. To do this, the extrapolation factors used to transform the sample results into population data have been re-calculated, and the nationality variable has been introduced into the sample calibration process. This latter process is conducted to ensure that the EPA properly reflects not only the changes in the total population but also the structure by age, by geographical region and, and on the basis of this latest revision, by individuals' nationality. Adding the nationality variable enables the EPA to estimate more accurately the differential behaviour of the immigrant population in the labour market in terms, for instance, of their concentration in specific regions, trades or sectors of activity.

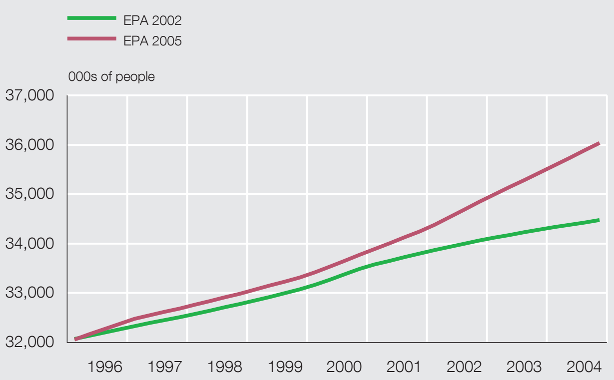
Chart 1 shows the scale of the changes recorded after this revision. According to the new data, the population aged over 16 recorded in 2004 Q4 exceeded the previous estimate by 1,564,000 people, owing to the sizable upward revision of the foreign population (1,515,900). The weight of the foreign population relative to the population aged over 16 stood at 7.6% as at end-2004 (compared with the previous estimate of 3.5%). The increase in the base population has naturally entailed substantial revisions of the main labour market aggregates: working age population, the employed and the unemployed. Regarding the labour force, the new figures assume 1,116,999 people more, 964,700 of whom are employed, and 152,200 unemployed. In relative terms, the greater number of immigrants in the labour market has made for a somewhat higher participation rate (0.7 pp) of 56.7%, a higher rate of employment, which stands at 50.8% (0.5 pp more), and a slightly higher unemployment rate (0.2 pp) of 10.6%. The biggest increase in the population is centred on the last four years, which is reflected too in the greater buoyancy of the main labour market magnitudes over this period.

The accompanying table compares the year-on-year growth rates of the main variables respectively estimated by EPA 2002 and EPA 2005. It shows how, with the new data, the labour force grew by 3.3% in 2004, 1.2 pp up on the previously estimated growth, albeit maintaining a profile of moderate deceleration. On the whole, the annual average growth of the labour force between 2001 and 2004 has been revised upwards by 1 pp to 3.7%. The revision of employment has been on a similar scale: in the past four years annual average growth has risen by 1.1 pp to 3.8%, and in 2004 by 1.4 pp to 3.9%.

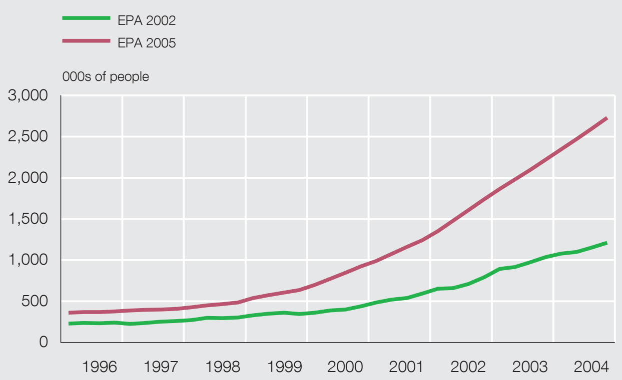
The sectoral composition of employment has also been affected by the revision, owing to the concentration of immigrant employment in specific sectors (mainly construction and services). The total numbers employed in construction at end-2004 were estimated as 237,100 more, and there were 534,400 more employed in services, representing upward revisions of 11.3% and 4.8%, respectively, on the previous level. In terms of recent developments, employment grew by 7.2% in the construction sector in 2004, practically twice the previous estimate (3.7%), evidencing moreover an accelerating profile in relation to

EPA 2005 AND EPA 2002 COMPARED

TOTAL WORKING AGE POPULATION (a)



FOREIGN WORKING AGE POPULATION (a)



SOURCE: INE.

a. Over 16 years of age.

2003 which had not previously been seen. In services, the growth rate of employment increased by 0.9 pp to 4.5% in the period 2001-2004, with a similar impact on market services (the distributive trade, and the hotel and catering trade mainly) and non-market services (owing to the significance of domestic service). Finally, it is worth mentioning that the composition of the growth of employment according to other job characteristics, such as contract duration or type of employment contract, has also been altered with the release of the new EPA figures. The weight of temporary and part-time employment in job creation would thus have been greater in the most recent period. Consequently, temporary employees as a proportion of total employees stood at 32.4% in 2004 (30.6% according to EPA 2002), and part-time employees as a percentage of the total at 9.1% (8.9% under EPA 2002), this variable having been less affected by the changes.

The unemployment figures have been revised to a lesser extent, although the growth in the number of unemployed was somewhat greater in the two years spanning 2002-2003, according to the new figures, and the decline recorded in 2004 (–1.3%) was down on that previously estimated (–2.5%). Overall, according to the new estimates, the unemployment rate in 2004 is slightly higher (by 0.2 pp) than that previously estimated.

EPA 2005 AND EPA 2002 COMPARED
Year-on-year rates of change

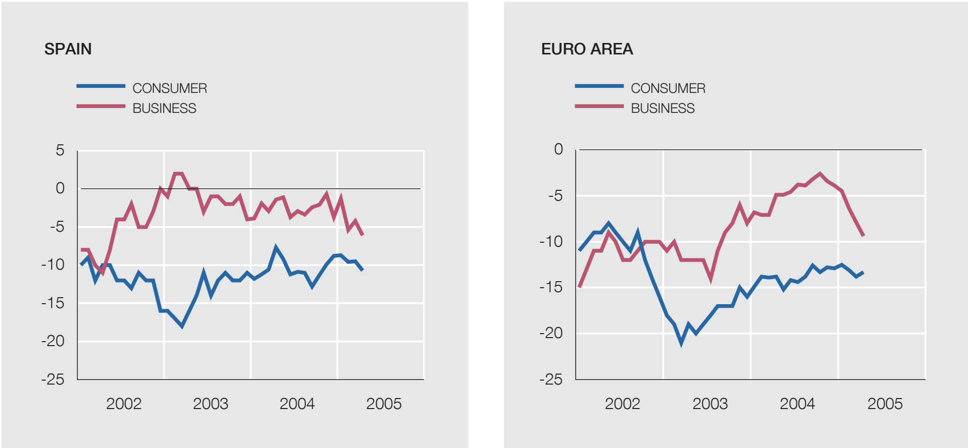
%

	EPA 2002					EPA 2005				
	2001	2002	2003	2004	Average 2001-2004	2001	2002	2003	2004	Average 2001-2004
POPULATION AGED OVER 16	1.1	0.8	0.7	0.6	0.8	1.4	1.6	1.7	1.7	1.6
WORKING POPULATION (a)	3.1	3.0	2.6	2.0	2.7	3.5	4.1	4.0	3.3	3.7
EMPLOYMENT	3.7	2.0	2.7	2.5	2.7	4.1	3.0	4.0	3.9	3.8
By branch of activity:										
Agriculture (1)	0.7	-5.7	-2.0	-2.4	-2.3	1.6	-4.8	-0.5	-0.2	-1.0
Industry (2)	3.1	-0.4	-1.0	-0.8	0.2	3.1	0.4	0.3	0.3	1.0
Construction (3)	7.8	3.4	3.7	3.7	4.7	8.9	5.5	6.1	7.2	6.9
Services	3.6	3.2	4.1	3.7	3.6	3.9	4.1	5.1	4.7	4.5
Market services (4) (b)	3.3	2.2	3.5	4.0	3.3	3.6	3.3	4.5	4.9	4.1
Non-market services (b)	3.9	4.9	5.0	3.2	4.2	4.3	5.5	6.2	4.3	5.1
MARKET ECONOMY (1+2+3+4)	3.7	1.0	2.0	2.3	2.2	4.1	2.2	3.3	3.8	3.3
UNEMPLOYMENT (a)	-1.9	11.4	2.1	-2.5	2.3	-1.5	13.2	4.0	-1.3	3.6
MEMORANDUM ITEM (levels as %):										
Participation rate (a) (c)	52.9	54.0	55.0	55.8	54.4	53.0	54.3	55.5	56.4	54.8
Temporary/total employment ratio (d)	31.7	31.0	30.6	30.6	31.0	32.2	31.8	31.8	32.4	32.1
Part-time/full-time employment ratio (d)	8.1	8.2	8.3	8.9	8.4	8.1	8.3	8.4	9.1	8.5
Unemployment rate (a) €	10.5	11.4	11.3	10.8	11.0	10.6	11.5	11.5	11.0	11.1

adjustment entailing stronger corrections, with rises in interest rates and more marked changes in growth patterns across the different economic areas, a possibility that would significantly affect the securities markets.

The US economy began the year with notable strength, although from March onwards it has shown signs of easing off, in terms of sales and job creation. That said, expected growth for the year as a whole is around 3.5%. A rise in the inflation rate has become discernible, firming expectations that the Federal Reserve will make fresh interest-rate rises. In Asia, the sluggishness of the Japanese economy was confirmed, as reflected in the drastic cut in its growth prospects for 2005 to a rate of around 1%. The exact opposite is the case in China. There, oil prices have not had any perceptible effect on growth and an increase of 8.5% is expected for this year, very close to that of 9.5% last year. And the Chinese authorities have shown no sign

CONFIDENCE INDICATORS CHART 2



SOURCE: European Commission.

of altering their dollar-anchored exchange rate policy. Finally, the Latin American economies are maintaining significant momentum, against a background of low sovereign debt spreads and low risk premia, despite a rebound as from March 2005.

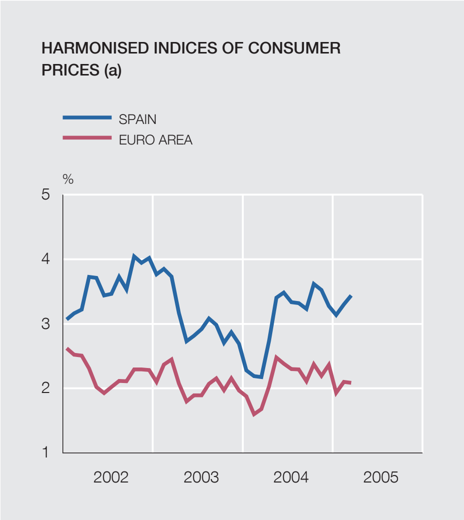
The close of 2004 once again highlighted the weakness of the internal growth patterns characterising the euro area economy. Without the momentum of external demand, which sustained the increase in spending in the first half of the year, GDP growth fell markedly in the second half of the year to quarter-on-quarter rates of around 0.2%, giving rise to annual average growth of 1.8%. The information available for the opening months of 2005, though consistent with a recovery in the pace of activity, also casts some doubt on whether growth rates close to potential have conclusively taken root. In particular, the confidence indicators turned downwards somewhat in the period to April (see Chart 2).

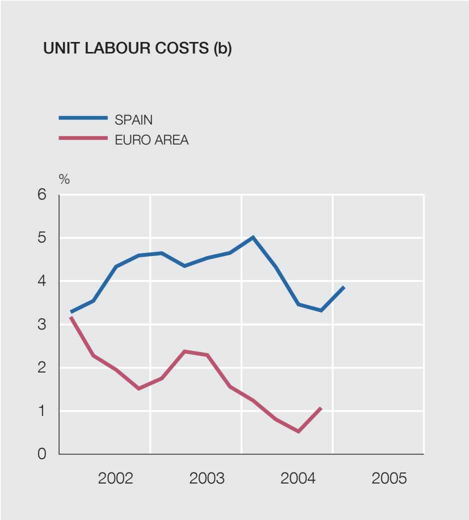
Certain conjunctural factors help explain these results such as, for instance, the cumulative appreciation of the euro – which no doubt had a bearing on the deterioration in the net external balance as from the summer – or the loss of purchasing power linked to dearer oil, which has conditioned the rise in consumption. However, there are also more structural factors – such as lower job generation capacity or scant productivity gains – holding back agents' confidence, hampering the full feed-through to the region's economy of the expansionary impulses from abroad and from the favourable financial conditions in place. In any event, there continue to be notable differences in behaviour across the various countries making up the euro area, differences that have even tended to widen in recent quarters: countries such as Germany, Italy or the Netherlands have seen reductions in GDP and, in the odd case, in domestic demand, while other economies such as France or Spain have witnessed high growth rates underpinned by domestic spending.

The low growth of the euro area countries has been conducive to containing cost – and, in particular, wage – pressures in the region, restricting the inflationary impact of dearer oil. In fact, although the inflation rate is holding at slightly over 2% (see Chart 3), non-energy consumer prices are trending substantially below this level at around 1.5%. In these circumstances, the ECB Governing Council has not appreciated the presence of significant inflationary pressures and has held official interest rates at the historically low level they reached in June 2003. Monetary conditions in the euro area thus remain propitious to greater momentum in expenditure.

PRICES AND COSTS

CHART 3





SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

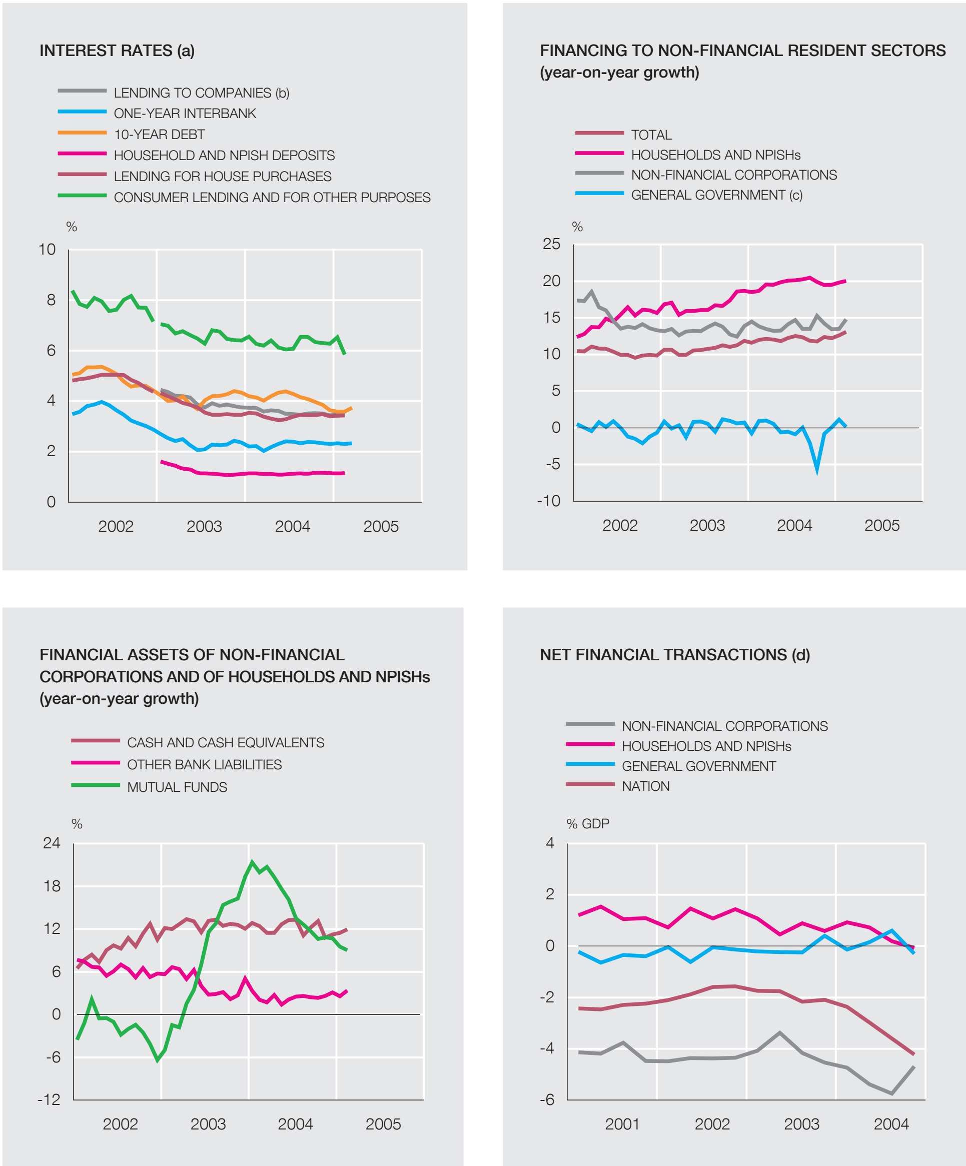
Slow economic growth has hindered the maintenance of healthy budgetary positions in several Member States, meaning that the degree of compliance with the fiscal rules established in the Stability and Growth Pact (SGP) has generally been low and prone to a substantial loss of credibility. In this setting, the reform of the SGP recently approved by the European Council involves, on one hand, the introduction of greater economic rationality in the rules of the Pact, which should in principle be conducive to compliance therewith. But it also entails less automatism, greater discretionarity and less transparency in its application, without the control mechanisms having simultaneously been reinforced. Accordingly, it is particularly important that the governments that have approved this reform should comply with the commitments they have entered into and thereby help to restore the credibility of the fiscal framework.

The March European Council also revised the Lisbon strategy, which frames the main efforts of the EU countries to make co-ordinated headway in structural reform, which is particularly needed to exit the current low-growth environment. The revision has helped simplify procedures and has clarified, along the right lines, the general objective of all this strategy, which is to be geared towards promoting employment and productivity. Nonetheless, no progress has been made on the specific quantification of the objectives, and fulfilling them continues to depend essentially on the Member States' willingness to speed through reform.

Within the euro area, developments in the Spanish economy continue to be different, as Spain has maintained a more robust rate of increase in GDP than the euro area as a whole. As can be seen in Chart 1, the growth differential even tended to widen in the second half of 2004. In 2005 Q1, when GDP was estimated to have increased at a slightly higher rate than in 2004 Q4 (2.8% in terms of the CNE 1995 base), no significant changes in the growth pattern of the Spanish economy have been perceived. Loose monetary and financial conditions (see Chart 4), against a background of stable interest rates and the notable rise in real estate asset values (house prices increased by 17.4% in 2004, departing from their long-term fundamentals), and high employment-generating capacity continue to underpin the growth of domestic demand.

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCES: 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.

Nonetheless, the competitiveness problems of the economy on several fronts continue also to weigh down trade results and to fuel the external imbalance.

Household spending quickened significantly in 2004, underpinned by the above-mentioned conditions. The economic information indicates that private consumption began the current year with similar momentum to that at end-2004, closing with a year-on-year rate of 3.5% on QNA 1995 base estimates. Although household disposable income may be expected to slow moderately this year, as the effects of the last personal income tax reform cease to operate, the expectations of an increase in income, based on job creation, remain high. Further, the wealth gains arising from the sound behaviour of the securities markets and, principally, from the strong growth of property prices continue to exert an expansionary effect on spending, acting to bring about a decline in the saving ratio. Moreover, these same factors largely account for the trend of residential investment which, as may be inferred from the increase in housing starts in 2003 and 2004, strengthened over the course of last year, commencing 2005 at a notable pace. The sharp growth of credit to households at the outset of 2005, with a fresh acceleration in funds intended for house purchases (up 24% in Q1), confirms the buoyancy of spending and illustrates the additional pressure experienced by the financial position of the sector, whose sensitivity to adverse income or wealth shocks has increased. In this respect, both the household debt ratio and the household financial burden have, as a percentage of disposable income, further increased.

Fixed capital investment began 2005 with an extension of the recovery it showed over the course of 2004. Based on the continuing buoyancy of residential investment, construction is being driven, moreover, by the pick-up in public works now the phase of low procurement in the first half of 2004 has been put behind. Investment in equipment has also shown signs of rising further in the opening months of this year, following its notable recovery in the second half of 2004, when it ran at a double-figures rate of expansion. The buoyancy of corporate productive investment is based on the sound behaviour of its main determinants: financing conditions are favourable, profitability is high and, despite the increase in debt, the indicators of financial pressure have tended to ease. In these circumstances, the outlook for demand is the main factor that may regulate the intensity of the investment drive. However, other factors, such as the appreciation of the euro and, in general, the difficulties in respect of competitiveness, might also influence business decisions by exerting pressure on the results of the companies most exposed to foreign trade.

On this latter point, the information for the opening months of 2005 confirms the patterns of behaviour observed in the second half of 2004, when the negative contribution of net external demand to GDP growth stood at around 2 pp. Goods exports fell moderately in year-on-year terms in January and February, reinforcing the trend deceleration they had been showing, while the favourable behaviour of the indicators of the number of tourists visiting Spain is not feeding through in full to receipts, owing to the decline in spending per visitor. The losses in price competitiveness that have built up over the past two years, an expansion in world trade whose source is far removed from the markets on which Spanish products are traditionally targeted and other more structural factors, relating to the pattern of Spanish trade specialisation, have all combined in this progressive deterioration in sales abroad. The gains in the competitiveness of foreign products on the domestic market, along with the persistent expansion of domestic demand, which is now greater in investment goods, have provided for the sustained growth of goods imports, which have scarcely eased in relation to 2004. And a further factor is the forceful increase in residents' tourism payments abroad. Overall, the negative contribution of the external sector to growth in Q1 is estimated to have been close to that of the previous quarter (–1.9 pp in QNA 1995 base figures).

From the standpoint of value added in the economy, activity in industry appears to have been confirmed to be moving on a moderate rising path in 2005 Q1, after the course of recovery it followed for most of 2004 came to a halt in the closing months of last year. Meanwhile, activity in market services is also moving at a relatively contained pace, despite the fact that job generation capacity in this sector remains very high. At opposite ends of the scale are the construction and agriculture branches, the former characterised by its notable buoyancy and the latter evidencing a significant contraction in its value added. Under the current circumstances, assessing employment trends is particularly complex in view of the change in the EPA figures mentioned at the start of this report. Within growth levels notably higher than the QNA 1995 base estimates, the profile of numbers employed according to the new Survey estimates is similar to that of the National Accounts figures in recent years, and it also moves on a mildly recovering path in 2004 Q4. From this perspective, the information to 2005 Q1, even with the interpretation difficulties arising from the methodological changes made, points to an additional pick-up in employment, such that the path of low productivity gains would have extended for another quarter, without major changes.

As regards costs and price formation, wage bargaining for 2005 is unfolding on a similar footing to that of previous years, with the related trade union/employers' association agreement having been renewed. The agreed increase (at 2.85% with figures to March) is some way off the figure of 3% reached in 2004, although the gap might narrow depending on how consumer prices trend. Nevertheless, a greater impact of the indexation clauses – currently present in most agreements – is expected in relation to last year, giving rise to a certain acceleration in compensation per employee at the start of 2005. In sum, a significant easing of labour costs is not expected, despite the fact the related growth rate is diverging from that of the euro area (see Chart 3). Against this backdrop of domestic cost pressures, to which those arising from dearer oil should be added, consumer prices in the Spanish economy have risen at the start of the year, posting a 12-month growth rate of 3.4% in March, after ending 2004 at 3.2%. Among the various components, those which most rose – in addition to energy and certain foods – were services, whose prices are growing at close to 4%. While inflation may be expected to moderate, in the absence of new external shocks, the inflation differential with the euro area might remain at over 1 pp in the coming months.

Public finances showed more favourable than initially expected results at end-2004, no doubt assisted by the resilience of domestic spending and the high job creation in the economy. This placed Spain as one of the few Member States to have met the commitments undertaken in the SGP. Given the design of fiscal policy for 2005, a less expansionary effect on spending may be expected this year, leading to a surplus at the end of the year in line with SGP undertakings. The scant information available for the opening months of 2005 is in step with this projection.

In short, the limitations of the information available in the face of the imminent re-basing of National Accounts hamper making any specific diagnosis of the situation of the Spanish economy at the start of 2005. However, the information for 2005 Q1 indicates that the essential features of the growth pattern followed in recent years by the Spanish economy – notwithstanding any new elements that the forthcoming CNE 2000 base figures might provide – has continued into 2005. In particular, there are still no clear signs that the main imbalances generated in the prolonged phase of strong growth have begun to be corrected. In this respect, there remains a patent need to undertake reforms conducive to a pick-up in productivity gains and that allow the losses in competitiveness to be curbed. The recent approval of the plan to invigorate the economy and promote productivity *(Plan de Dinamización y Fomento de la Productividad,* by its Spanish name) is an important step in this direction, and should be complemented by a systematic application of the measures approved and by continuity in the reform drive.

2 External environment of the euro area

International economic developments in the first four months of 2005 were marked by a sharp rise in the price of oil, to 54 dollars a barrel for Brent at the end of April, more than 30% up from end-2004, against a background of high volatility. The main explanatory factors here are the upward revisions to oil demand forecasts and, recently, the fall in inventories of crude and refined petroleum products in the United States.

Other notable international financial market developments in this period were the fluctuations in the dollar against the euro and the movements in long-term interest rates in the United States. Having started the year by regaining some of the ground lost at the end of 2004, the dollar tended to depreciate from mid-February, owing to the increasing sensitivity of the markets in the face of widening global imbalances (in particular, the US external deficit), and also because of the statements by certain Asian central banks regarding possible currency diversification in the management of their international reserves. This movement was accompanied by a significant increase in long-term interest rates in the United States, which did not occur in the euro area or Japan. Following the rise in official US interest rates, the trend changed; the dollar began to appreciate while long-term interest rates began to fall. Towards the end of April this trend intensified, stock markets fell significantly and the spreads on the high-yield segment of the US corporate bond market widened, having previously performed very positively.

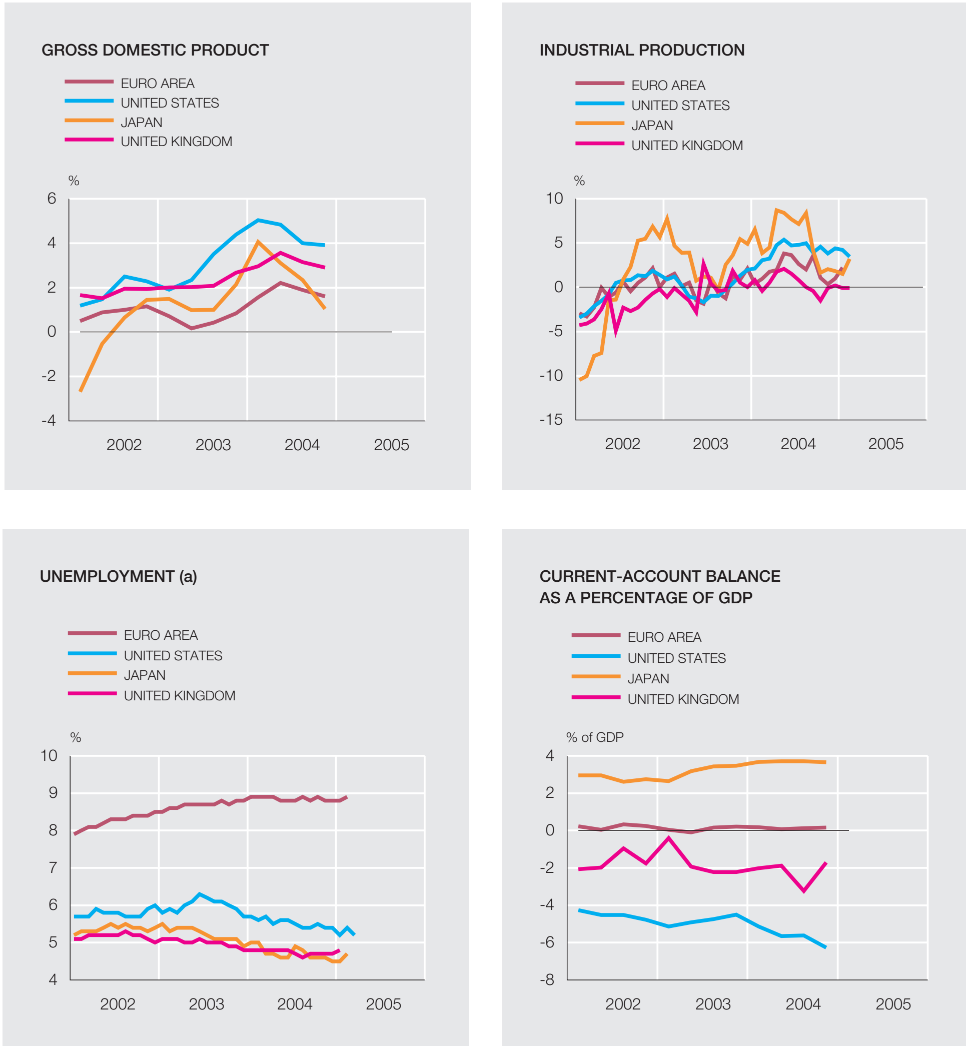
Emerging markets, from mid-March, saw significant increases in sovereign debt differentials, accompanied by exchange rate depreciation against the dollar and stock market losses. However, this behaviour has improved in the last few weeks, and exchange rates and bond spreads have stabilised.

In the *United States,* the high rate of growth in domestic demand and the further deterioration in the external imbalance were notable. The final estimate of GDP growth for 2004 Q4 was an annualised quarter-on-quarter rate of 3.8%, entailing growth of 4.4% for the year as a whole. However, the outlook is for moderation in growth in 2005 Q1, partly as a result of the rise in the price of oil and the upward revision to expectations of future oil prices, as well as the expected negative contribution from the external sector. Moreover, the March employment data were relatively poor, with a significant loss of buoyancy in the rate of job creation. Also, there was some weakness in the March retail sales figures and in capital goods orders in February, while consumer confidence indicators fell, in what appears to be a downturn from early 2005. As for price developments, the CPI rose in March by 0.6% (3.1% year-on-year) and the underlying index by 0.4% (2.4% year-on-year). These worse-than-expected data show an acceleration in inflationary pressures. Producer prices also accelerated slightly in March to 4.9% (year-on-year), from 4.7%. The trade deficit in February reached an all-time high of 61 billion dollars, which is only partly explained by the rise in oil prices.

In Japan, economic activity indicators deteriorated virtually across the board, a clear setback after the very positive signs in January. Relative to the previous month, there were significant declines in industrial production, the coincident and leading composite indicators, retail sales and household spending. In addition, the confidence of the large manufacturing firms (according to the quarterly Tankan survey) deteriorated sharply in Q1 and the labour market worsened in February, with lower year-on-year growth in job creation and a rise to 4.7% in the unemployment rate. Deflationary pressures mounted in February, with consumer prices falling by 0.3% in the general index and 0.4% in the underlying index (year-on-year rates).

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

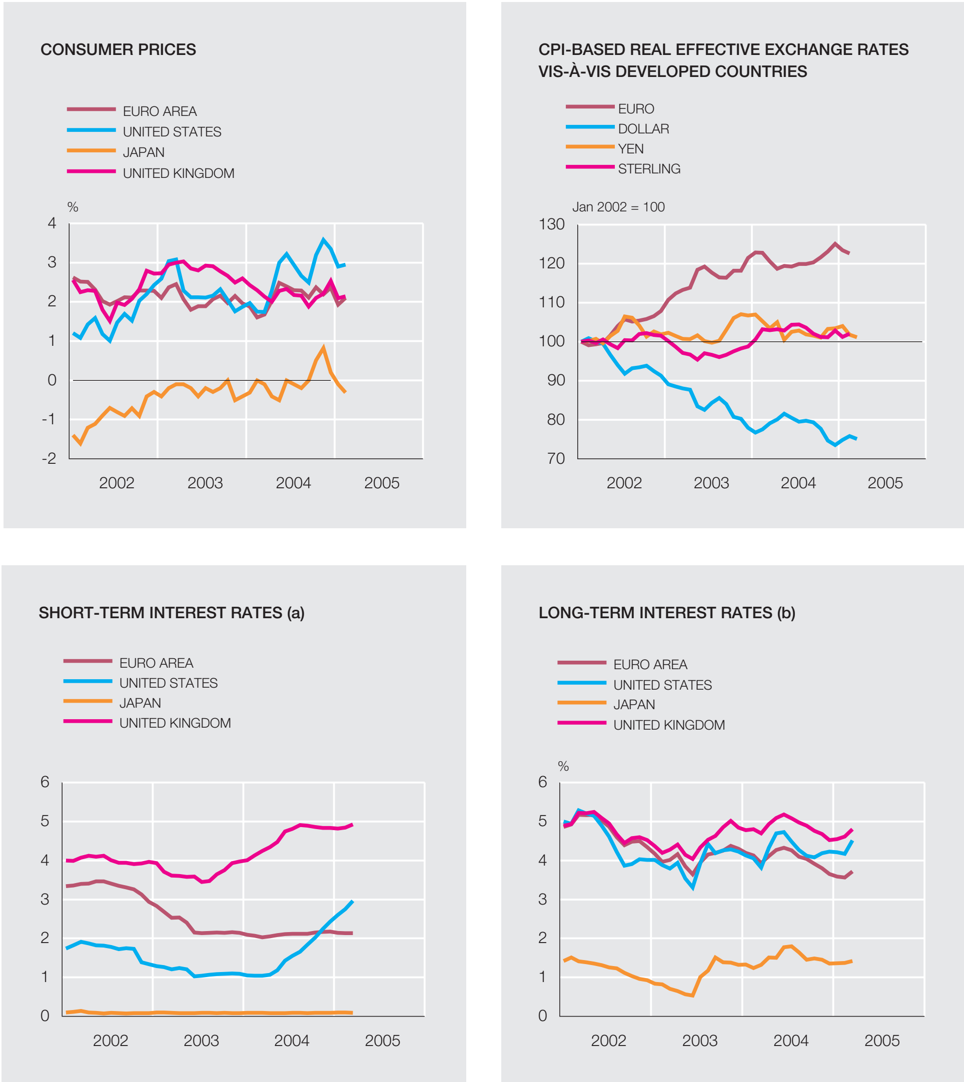
a. Percentage of labour force.

In the *United Kingdom,* the available activity indicators, such as the purchasing managers' index and industrial production, suggest that the growth rate of 2004 Q4 (0.7% quarter-on-quarter) was sustained. Some relatively weak data have been observed, such as the slowdown in consumption in 2004 Q4 and the unexpected rise in unemployment in March, but these contrast with the rise in the rate of employment to 75% (the highest level since 1975) and the 0.3 percentage point rise in wage growth to 4.7% year-on-year. Consumer prices, meanwhile, rose by 1.9% year-on-year in March, as against 1.6% in February, and producer prices accelerated by 0.1 percentage point to 2.8%. The most positive aspect was the slowdown in house prices to year-on-year rates of below 10% in March.

In the *new EU Member States,* GDP growth in Q4 was robust, although in some countries slightly down on previous quarters, especially in Poland and in the Baltic countries. Their public finances seem to have improved in 2004, albeit from very high deficit levels; in five of the ten new members the budget deficit is still above 3% of GDP. The activity and consumption indicators for 2005 Q1 point to a mild slowdown in these countries, with growth rates in industrial production, exports and retail sales below those of last year. As for prices, the trend moderation

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

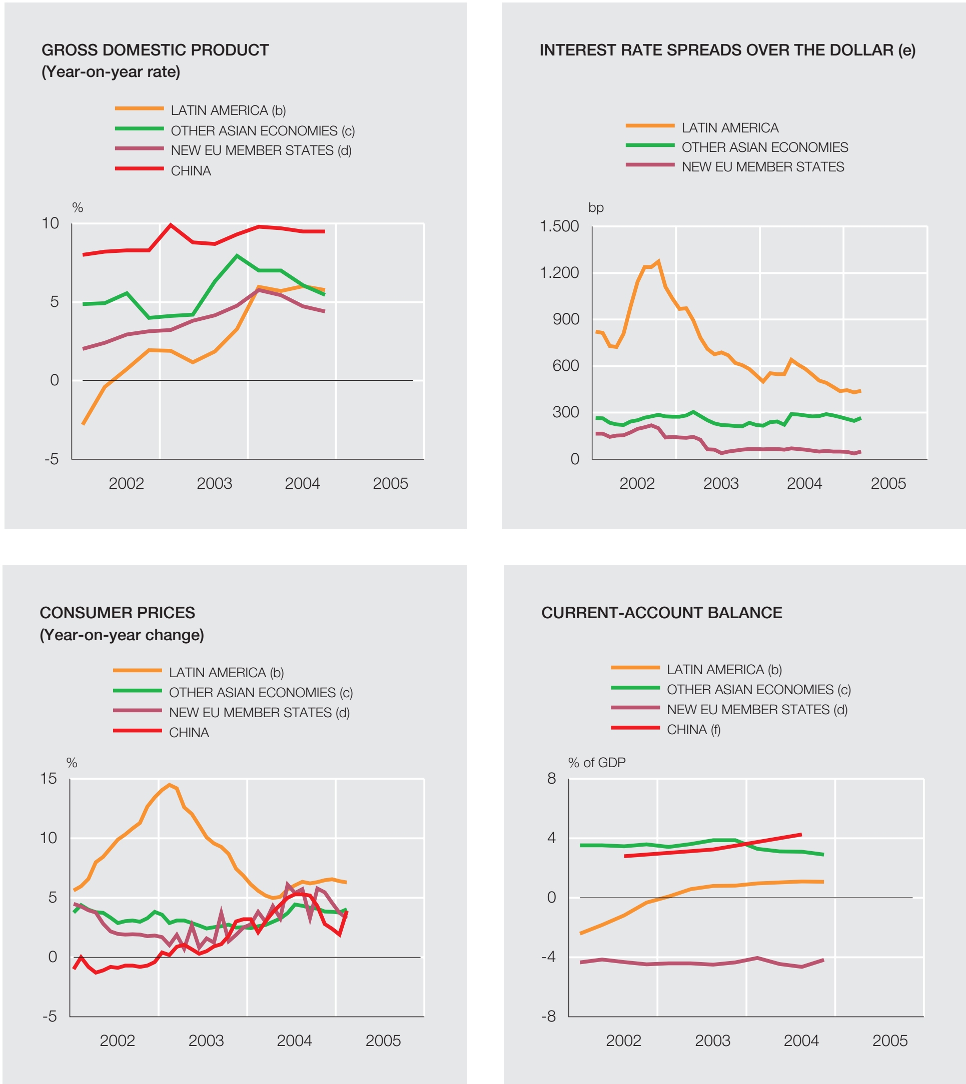
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

continued, largely due to the falls in food prices arising from the base effect caused by the rise in indirect taxes last year, to bring them into line with EU levels. This background of good inflation figures, and the strong appreciation of the main currencies of the region in 2004, enabled official interest rate reductions to continue in countries like Hungary, Poland, the Czech Republic and Slovakia. Finally, the currencies of the new Member States that participate in the Exchange Rate Mechanism (ERM II), the Slovenian tolar, the Estonian kroon and the Lithuanian litas, held steady around their central parities, without significant tensions.

In the *main Asian emerging economies,* there was notably strong growth in China, where GDP grew by 9.5% year-on-year in Q1, the same rate as in 2004 Q4. The buoyancy of foreign trade was conducive to this growth, exports growing in 2005 Q1 at a rate of 35%, while imports grew at around 12%. Industrial production slowed slightly in March (from 16.5% to 15.1%), while the strength of retail sales was sustained. The rate of activity in the other main South-East Asian economies remained robust in January and February. Market developments in the region showed greater stability than in other emerging areas, without significant exchange rate or stock market losses. Moreover, the deterioration in bond spreads was less sharp and occurred later than in other emerging regions.

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregates for the different areas have been calculated using the weights of their constituent countries in the world economy, according to IMF information.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The Asia aggregate does not include China.
f. Annual data.

Latin America achieved GDP growth of 5.9% in 2004, very similar to the year-on-year rate in Q4. The strength of the activity indicators was sustained in Q1, although exports slowed somewhat in most countries. Price developments varied from country to country. On the one hand, inflation rose in Argentina to 9.1% in March, from slightly above 6% at the end of 2004, while in Brazil it accelerated marginally to 7.5%, causing the upswing in official interest rates to continue. On the other hand, in Mexico there were signs of lower inflationary pressures, although the year-on-year rate of 4.4% in March was above the central bank's target range. The region's financial markets were volatile from mid-March, with pronounced increases in sovereign spreads and sharp exchange rate depreciations, particularly in Brazil, though both these variables began to improve from 15 April.

The information available on economic developments in the euro area in the first few months of 2005 points to a moderate quickening of activity, underpinned by the buoyancy of world demand and by the recovery of capital investment against an expansionary financial background. Nevertheless, the still shaky course of certain economic indicators and the persistence of oil prices at levels near $50 per barrel cast doubt on whether the euro area will move onto a path of sustained growth in the coming months. As for prices in the early months of the year, the growth rate of the HICP dropped to 2.1% in March. This was mainly a result of specific factors such as the petering out of the effects of rises in certain administered prices and indirect taxes agreed on a year earlier, although the moderation in labour costs and the strength of the euro exchange rate may also have contributed to easing inflationary pressure. In any event, the persistence of high oil prices is delaying the reduction of inflation below the targeted reference of 2% contained in the ECB's definition of price stability.

The euro area's lack of buoyancy in terms of growth, against a backdrop of highly favourable financial conditions and of continued vigorous external demand, highlights the need to undertake structural reforms to raise the potential growth capacity of the European economy. In this respect, last March the European Council proposed an updated strategy to be followed in the coming years to enable more flexible application of structural reforms in the euro area, the content of which is described in Box 2. At the same time, the European Council approved a number of changes to the Stability and Growth Pact to enhance its rationality without affecting the degree of budgetary discipline to be imposed by it. Although some positive results have been achieved in both cases, they did not seem to signal a greater determination by the European authorities to address the structural problems and strengthen fiscal discipline.

3.1 Economic developments

According to the second euro area National Accounts estimate for 2004 Q4, the euro area GDP grew by 0.2% quarter-on-quarter, which was 0.1 pp less than in the previous quarter and down on the increase recorded in the first half of the past year (Table 1). In year-on-year terms, output rose by 1.6%, so the rate of change in 2004 as a whole was 1.8% (Chart 8). As regards the breakdown of growth, the contribution to GDP of domestic demand excluding inventories rose to 0.5 pp in Q4, thanks to a significant recovery in private consumption following the sluggishness recorded in the preceding two quarters. Gross fixed capital formation continued in 2004 Q4 at the relatively robust pace of 0.6%, since the lower momentum of capital goods was offset by the higher buoyancy of construction. The contribution of net external demand to output was negative, although less so than in the previous quarter, as a result of a more marked slowdown in imports than in exports. Finally, the change in inventories subtracted 0.2 pp from GDP growth, after the strong inventory building in the preceding quarter.

The breakdown of National Accounts by country in Q4 reveals very uneven quarter-on-quarter growth rates. While Germany and Italy recorded a contraction in output of -0.2% and -0.4%, respectively, the GDP of France and Spain expanded vigorously at rates of 0.9% and 0.8%. In the first two countries, private consumption performed very weakly and in Italy there was also a notable contraction in investment and in exports. By contrast, in the second pair of countries both consumption and investment were fairly buoyant.

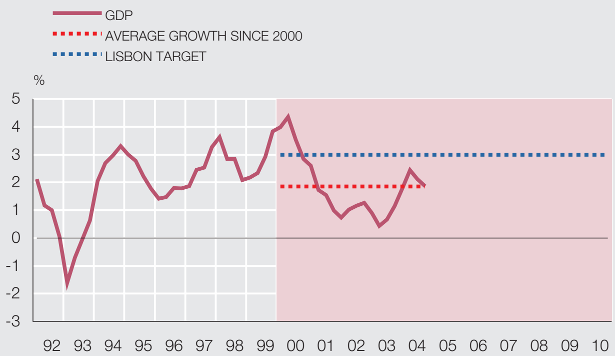
By branch of production, the lower growth of value added in the euro area economy in Q4 was a result of the sharp slowdown in industry, since there was a clear recovery of value added in construction and, to a lesser extent, in services. The labour market continued to show a weak

In view of the EU's modest results in terms of economic growth and job creation during the 1990s, a broad consensus emerged on the need to undertake structural reform in the product and factor markets and in the social protection systems, so as to make the environment more apt for innovation, employment, saving and investment. This consensus was crystallised in the Lisbon European Council in March 2000, which decided on an ambitious programme of reforms aimed at transforming the EU into the "most competitive and dynamic knowledge-based economy in the world". It was estimated that the application of policies to spur productivity and raise the employment rate would achieve average GDP growth rates of 3%.

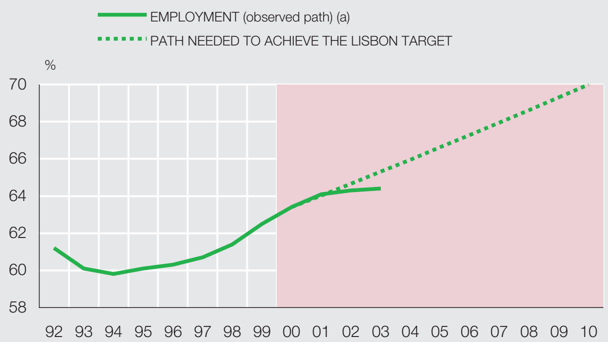
The aims of the so-called *Lisbon Agenda* called for measures in areas of economic policy that are primarily the competence of the Member States, so it was decided to address the reforms in a manner featuring co-ordination between countries. In a geographical area with a high level of integration, this co-ordination is necessary because a policy implemented by one country affects the other countries and because a certain degree of supranational feeling may be conducive to the adoption of reforms that at national level normally encounter resistance from the interested lobbies and that the authorities are reluctant to pay for, because their cost is immediate while their benefits tend to be perceived in the longer term. In particular, the so-called *open co-ordination method* was adopted, which involves a voluntary co-operation mechanism based on assessment of each Member State's progress as gauged by a set of qualitative and quantitative structural indicators relating to the ultimate objectives. The European Council decided to devote its spring meeting to assessing progress towards the objectives, its intention being that the collective pressure of this annual revision would encourage adoption of the reforms. In this respect, the Commission's role was limited to disseminating information on the progress made by each State and to acting in its areas of competence, including particularly those aspects of goods and services market deregulation relating to completion of the single market.

It is difficult to assess the impact that adopting this reform strategy will have on the ultimate objectives, both because the policies that would have been applied in the absence of the strategy are unknown and because the effects of the reforms may take time to manifest themselves. Nonetheless, there is a broad consensus that the progress made to date has been insufficient. As shown by the charts, the average growth of the EU 15 since the launch of the strategy has been nearly one percentage point below the target of 3%, which has made it more difficult to close the gap in GDP per capita with respect to the US. The closing of this gap requires an acceleration both in the rate of employment growth and in labour productivity. Some progress has been made on the first of these variables, but the intermediate target of 67% in 2005 and the target of 70% in 2010 seem to be a long way off. In addition, certain countries seem to show an inverse relationship between the employment rate and increases in labour productivity. However, the examples of Ireland, the United Kingdom

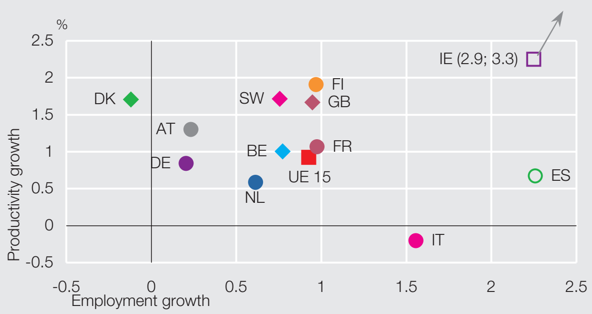
1. YEAR-ON-YEAR GDP GROWTH



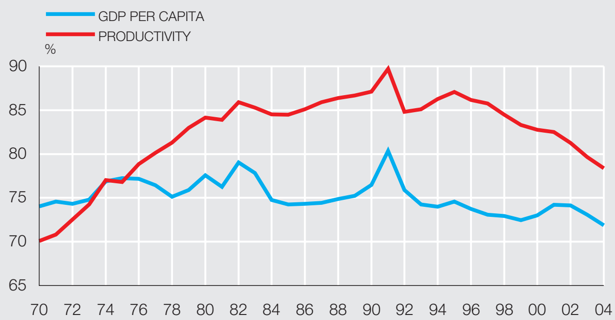
2. EMPLOYMENT RATE



3. AVERAGE YEAR-ON-YEAR GROWTH OF EMPLOYMENT AND PRODUCTIVITY 2000 - 2004



4. GDP PER CAPITA AND PRODUCTIVITY OF THE EU WITH RESPECT TO THE USA



SOURCES: EUROSTAT, Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2005, http://www.ggdc.net.

a. At the present date there are no 2004 data.

and certain Scandinavian countries show that it is possible to achieve sound growth simultaneously in both these variables through policies designed to promote the creation and dissemination of innovation and, in general, through policies that make it possible to accelerate the growth of total factor productivity, which makes it all the more evident that there is a need for policies focused on promoting the knowledge society.

The March 2005 European Council examined the results obtained in the five years elapsed since the launch of the Lisbon strategy, taking into account a report prepared by a group of experts headed by Wim Kok and a Communication from the European Commission. Both documents are fairly critical of the status of the reforms, attributing this scant momentum of reform to the absence of a clear definition of priorities in the strategy, to a lack of co-ordination of agents and policies and, finally, to an insufficient commitment by the Member States to implementing the reforms. The European Council reaffirmed the importance of the objectives of the Lisbon Agenda, and measures were therefore proposed to step up the rate of adoption of reforms, simplify the strategy and help monitoring and co-ordination. Thus the new strategy will centre on the economic side and, within this, on the matters having a greater impact on employment and productivity. To enhance the degree of commitment of Member States to the objectives, the governments are to prepare *national action programmes* by the end of 2005, which must be debated with the social partners to enable the greatest possible consensus on the reforms. However, the demands made on the Member States regarding the specific deadlines and targets suggested by the Kok report and the European Commission have been toned down. Simultaneously, the European Commission will play a greater role in designing policies and in monitoring their application, which will lead, inter alia, to the preparation of a report setting forth the measures required at supranational level. Finally, in order to simplify the current policy co-ordination mechanisms and achieve a more integrated assessment of the various processes under way, the current national and Commission reports on reform in the goods and capital markets, employment, pensions and social cohesion will be merged into a single document.

Although this reformulation of the Lisbon Agenda is intended to accelerate the rate of structural reform in the EU, it is uncertain to what extent it will spur governments to act more decisively, given that the European Council has adopted a less ambitious approach than that initially proposed by the aforementioned reports. In this respect, the recent experience on application of the Stability and Growth Pact casts some doubt on the firmness of the national authorities' resolve to take the required measures.

pace of job creation which left the year-on-year rate at 0.7% and, accordingly, the year-on-year change in apparent labour productivity decreased by 0.5 pp with respect to the previous quarter, to stand at 0.9%.

The performance of the most recent indicators signifies, at overall level, a slight rise in the pace of expansion of GDP in 2005 Q1. As far as supply indicators are concerned, the industrial production index was up by 0.2% in January and February with respect to the average in 2004 Q4 and the year-on-year rate of change stood at 0.6% in February. The qualitative indicators drawn from confidence surveys in services and construction showed average levels for the quarter similar to those in 2004 Q4. The confidence index compiled from the European Commission's industry surveys, however, worsened notably, moving in the opposite direction to the indicator based on the Reuters Purchasing Managers' Survey for manufacturing industry, which held steady in the period under review (Table 1). Nonetheless, the relative stability of confidence indicators masks a gradual deterioration during the quarter, which was particularly marked in March and casts doubt on how activity will behave in the coming months.

The available demand side indicators do not show a substantial pick-up in any aggregate, although they are consistent with the steady growth rates observed in private consumption and investment. Thus retail sales, which is the monthly indicator most closely correlated with private consumption, improved in January and February, and the European Commission's consumer and retail trade confidence indicators held steady in the early months of the year (Chart 9). By contrast, new car registrations, which account for somewhat less than 5% of private consumption, worsened notably with respect to the previous quarter. Although the information drawn from economic indicators is more imprecise in the case of demand for capital goods, the deterioration in the assessment by firms of their order books might be signalling a certain slowing of the mo-

EURO AREA ECONOMIC INDICATORS

TABLE 1

	2003		2004				2005	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1 (a)	Q2 (b)
GDP								
Year-on-year growth	0.4	0.8	1.5	2.2	1.8	1.6		
Quarter-on-quarter growth	0.6	0.4	0.7	0.5	0.3	0.2		
European Commission forecasts (c)							(0,2;0,6)	(0,3;0,7)
IPI (d)	-0.4	1.4	1.1	2.9	2.6	1.0	1.4	
Economic sentiment	94.1	97.6	98.6	99.9	100.6	100.9	99.0	
Industrial confidence	-11.0	-8.0	-7.0	-5.0	-3.7	-3.3	-6.3	
Manufacturing PMI	49.1	52.0	52.8	54.4	53.9	51.4	51.4	
Services confidence	5.3	10.7	11.3	11.7	12.0	11.0	10.7	
Services PMI	51.9	56.7	56.0	55.2	54.4	52.9	53.1	
Unemployment rate	8.7	8.8	8.9	8.8	8.8	8.8	8.8	
Consumer confidence	-17.3	-16.0	-14.3	-14.3	-13.7	-13.0	-13.3	
HICP (d) (e)	2.2	2.0	1.7	2.4	2.1	2.4	2.1	
PPI (d) (e)	0.9	0.9	0.4	2.4	3.3	3.6	4.2	
Oil price in USD (e)	27.1	29.9	33.8	35.3	43.3	39.7	53.3	51.3
Loans to the private sector (d) (e)	4.9	5.5	5.3	6.0	6.5	7.1	7.6	
Euro area ten-year bond yield	4.2	4.4	4.2	4.4	4.2	3.8	3.7	3.6
US-euro area ten-year bond spread	0.09	-0.05	-0.11	0.28	0.14	0.36	0.67	0.87
Dollar/euro exchange rate (e)	1.165	1.263	1.222	1.216	1.241	1.362	1.296	1.297
Appreciation/Depreciation of the euro (e)	11.1	20.4	-3.2	-3.8	-1.7	7.8	-4.8	-4.8
Dow Jones EURO STOXX Broad index (e)	4.1	18.1	1.9	3.7	1.5	9.9	4.3	1.1

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available up to 19 April 2005.
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.

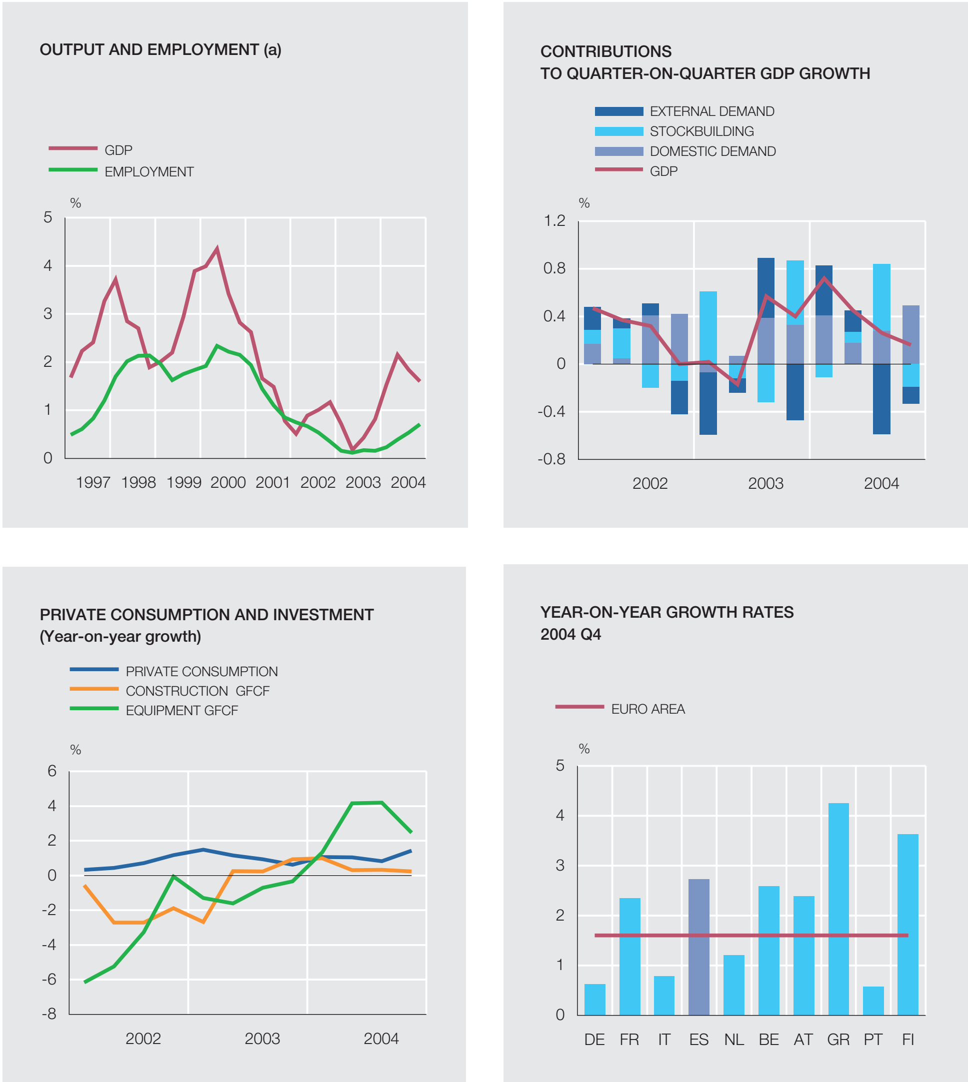
mentum shown in previous quarters by this component of investment. However, the behaviour of other indicators also relating to capital goods is more favourable. Thus the degree of capacity utilisation remained unchanged from summer 2004 at levels exceeding those of previous quarters and in line with the historical average. Meanwhile, the mild upward trend of credit extension to non-financial corporations initiated in mid-2004 continued in early 2005. The behaviour of exports to non-euro area countries in January and February valued in nominal terms was similar to that in the previous quarter according to provisional Eurostat information. However, the assessment of export order books and the export expectations disclosed by the European Commission's quarterly survey worsened with respect to 2004 Q4. Finally, Q1 employment indicators compiled from confidence surveys and the unemployment rate up to February held relatively stable, making it foreseeable that employment will proceed at a relatively weak pace.

In sum, it seems likely that euro area output in 2005 Q1 will continue to expand at a moderate rate, albeit somewhat higher than in the last half of 2004. This would be in line with the range estimated by the European Commission, which puts the rise in GDP at between 0.2% and 0.6% in Q1. However, because of the lower growth in the second half of 2004 and the scantly defined information provided by short-term indicators, the European Commission revised downward by 0.4 pp the expected output growth for 2005 as a whole with respect to the autumn 2004 forecast, leaving it at 1.6%.

In this respect, the deterioration in confidence indicators in March, the hesitant course of domestic expenditure, the uncertainty regarding the euro exchange rate and the possibility that

EURO AREA NATIONAL ACCOUNTS

CHART 8



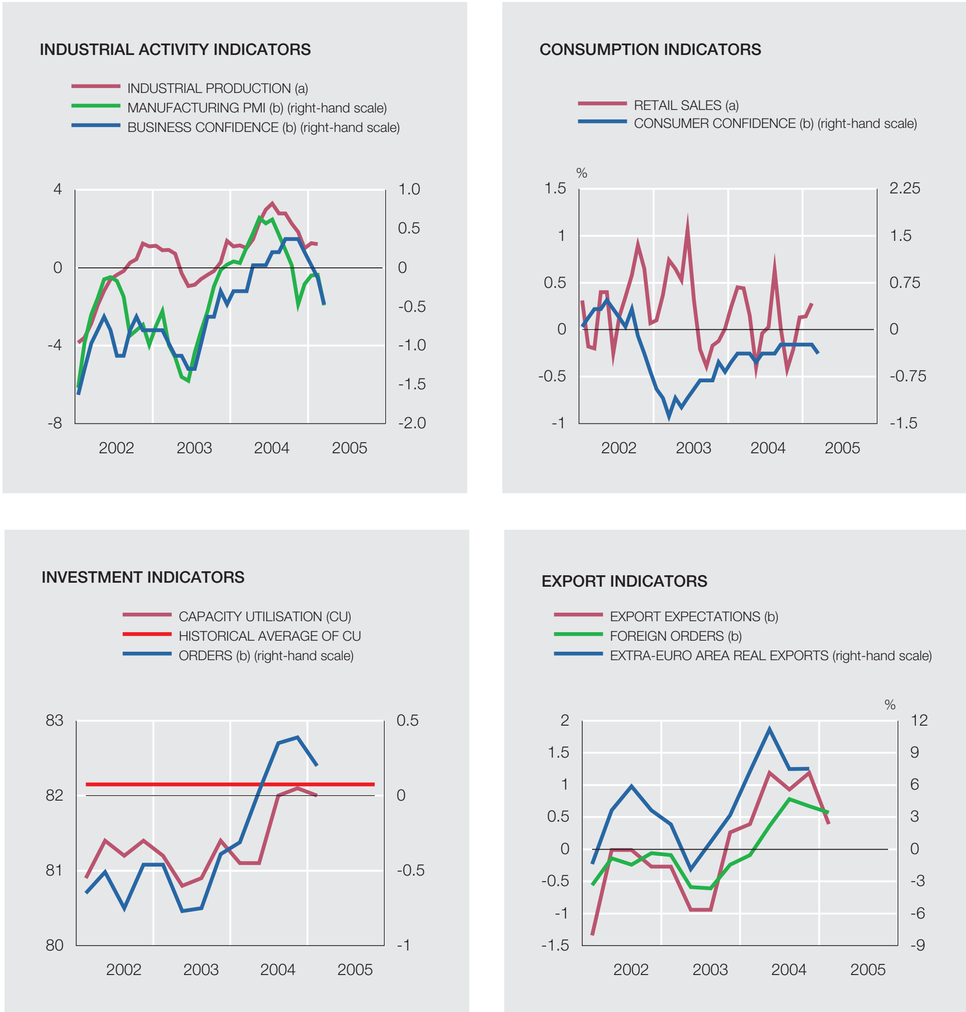
Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

the effects of the accumulated appreciation have yet to be fully manifested in trade flows, as well as the persisting high oil prices, cast doubt on the strength of the economic expansion to be seen in the area in the coming months. Aside from the direct effects that the price rises in production inputs are having on the activity of economies, it is possible that energy price increases are also negatively affecting the confidence of agents, delaying or discouraging their spending decisions and reducing (through their impact on inflation) the purchasing power of household income. However, in a setting of continued highly favourable financial conditions in which business margins have grown as a result of the moderate trend in unit labour costs, it would be reasonable to expect investment and job creation to be more buoyant, which would help to strengthen household consumption.

Since December 2004, inflation in the euro area, measured in terms of the year-on-year rate of change of the harmonised index of consumer prices (HICP), has decelerated by 0.3 pp to 2.1% in March (Chart 10). This is explained by the behaviour of processed food and, to a lesser extent, of non-energy industrial goods and of services, owing to the petering out of the base effects derived from certain measures introduced a year ago in certain countries, such as

EURO AREA. REAL INDICATORS CHART 9



SOURCES: Eurostat and European Commission.

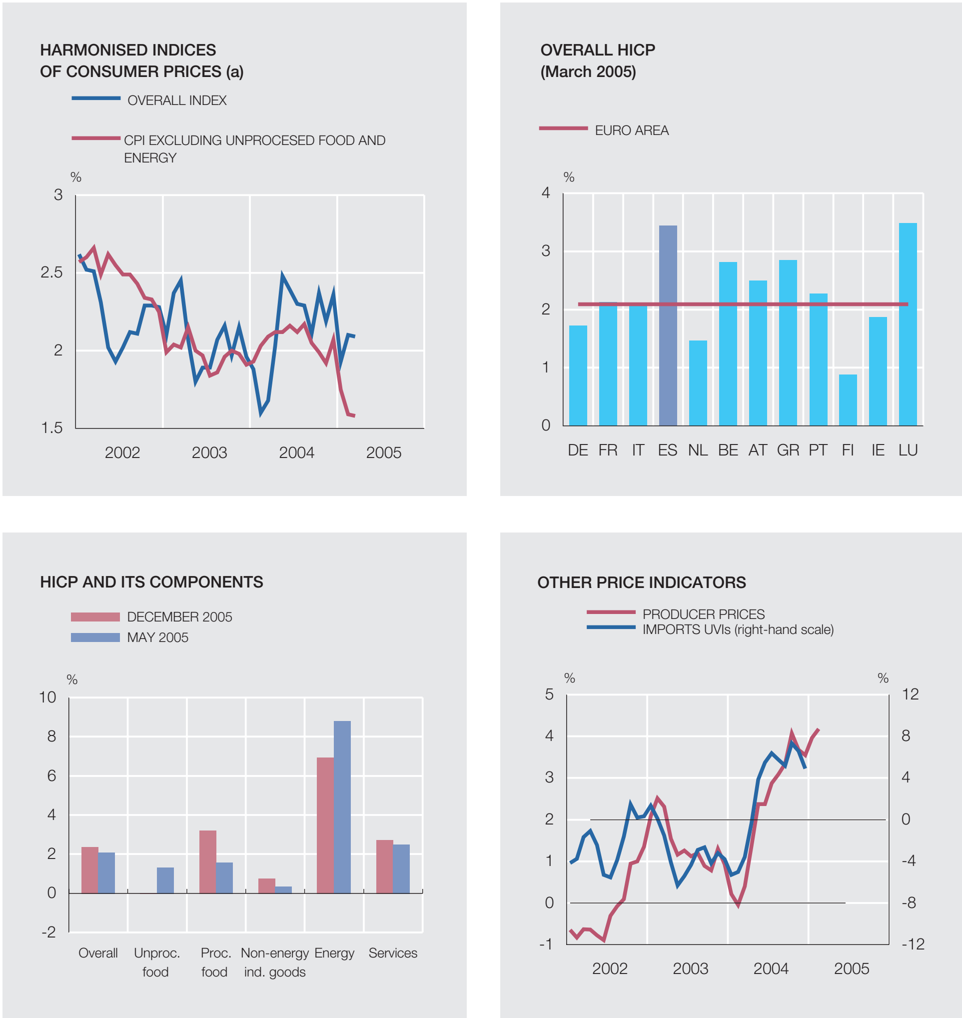
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.

tobacco excise tax rises in France and Germany in January and March 2004, respectively, and that deriving from the health care financing reform in Germany. As a result, the rate of change of the index made up of the most stable components (HICP excluding unprocessed food and energy) fell by 0.5 pp in the first quarter of the year to stand at 1.6% in March, the lowest level reached by this index in the last four years. The prices of the more volatile components rose in Q1 due, in the case of unprocessed food, to the adverse weather conditions, while energy prices suffered the impact of the oil price escalation. The year-on-year growth rate of industrial prices was 4.2% in February, up 0.7 pp on December 2004, largely as a result of the crude oil price rises.

From the standpoint of domestic price formation, in 2004 Q4 unit labour costs grew more slowly than the GDP deflator and, as a result, business margins again widened (Chart 11). Despite the sharp increase in energy prices, the risk of inflation does not seem high, given the excess capacity of certain countries, the wage moderation that is expected to continue in the coming months in view of the scant buoyancy of the labour market, and the recovery in corporate profits, which is conducive to a limited pass-through of production costs to prices. Nevertheless, the possibility that oil prices may remain at current levels for a lengthy period

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.

introduces the risk of an upturn in the future course of prices, since it casts some doubt on whether wages will continue to behave moderately, which is crucial for limiting the second-round effects on inflation.

As to fiscal policy, in March the European Council decided on the content of the reform of the Stability and Growth Pact, thereby culminating the process of discussion initiated after summer last year. Box 3 details the changes made and assesses their possible consequences. However, both the description of the new rules and the assessment thereof are tentative, pending final agreement on the new wording of the legal texts constituting the Pact.

In 2004 the aggregate general government deficit of the euro area countries stood at 2.7% of GDP, 0.1 pp less than in 2003. This minor improvement was made possible by lower interest payments and, as a result, the primary surplus held unchanged at 0.6% of GDP. When adjusted for the effects of the business cycle, this figure continues to show virtually no change, so it can be concluded that fiscal policy in the past year was approximately neutral in the euro area. By country, the deficit exceeded the reference level established in the Treaty in Greece (6.1% of GDP) and in Germany and France (3.7% in both cases), while in Italy it stood pre-

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. Normalised data.

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2002	2003	2004 (b)	2004 (c)	2005 (b)	2005 (d)
Belgium	0.1	0.4	0.1	0.0	-0.2	0.0
Germany	-3.7	-3.8	-3.7	-3.3	-3.3	-3.0
Greece	-4.1	-5.2	-6.1	-1.2	-4.5	-3.7
Spain	-0.3	0.3	-0.3	0.0	0.0	0.1
France	-3.2	-4.2	-3.7	-3.6	-3.0	-2.9
Ireland	-0.4	0.2	1.3	-1.1	-0.6	-0.8
Italy	-2.6	-2.9	-3.0	-2.2	-3.6	-2.7
Luxembourg	2.3	0.5	-1.1	-1.8	-1.5	-1.0
Netherlands	-1.9	-3.2	-2.5	-2.3	-2.0	-2.6
Austria	-0.2	-1.1	-1.3	-0.7	-2.0	-1.9
Portugal	-2.7	-2.9	-2.9	-2.8	-4.9	-2.8
Finland	4.3	2.5	2.1	1.7	1.7	1.8
MEMORANDUM ITEM: Euro area						
Primary balance	1.2	0.6	0.6		0.6	
Total balance	-2.4	-2.8	-2.7	-2.3	-2.6	
Public debt	69.5	70.8	71.3		71.7	

SOURCES:European Commission, national stability programmes and Banco de España.

a. As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. European Commission forecasts (spring 2005).
c. Targets of the stability programmes presented between November 2003 and January 2004.
d. Targets of the stability programmes presented between November 2004 and March 2005.

In autumn 2004 the European Commission commenced the process of reviewing the institutional framework governing the fiscal policies of the Member States of the euro area and of the EU as a whole. This review, inspired by the accumulated experience in applying the rules thus far in existence and, in particular, by the institutional problems arising in the course of the excessive deficit procedures initiated against Germany and France, culminated in the ratification by the European Council on 22 and 23 March of the agreement reached some days previously by the ECOFIN Council to amend the Stability and Growth Pact.

First, the approved text postulates a series of actions to stimulate institutional commitment to fiscal discipline. These include improving the reliability of budgetary statistics, using realistic macro-economic forecasts in the preparation of stability programmes, applying national budgetary rules supplementing the provisions of the Pact and obtaining the commitment of the incoming governments to the budget targets of the outgoing governments. The reform also introduces certain changes both to the part of the Pact that seeks to encourage sound policies in favourable cyclical situations, in order to limit the risk of serious budget deterioration in a cyclical downturn (what has come to be called the ”preventive arm”), and to the part of the Pact that deals with correcting excessive deficits (“corrective arm”). Thus the changes decided on for preventive purposes are as follows:

1. Definition of the medium-term objective. So far, each Member State has been required to maintain a position that, on average, is close to budget balance throughout the business cycle. The reform introduces country-specific medium-term objectives which, in any event, have to provide sufficient leeway to avoid violating the deficit limit of 3% of GDP. Thus the medium-term objective of countries with low debt and high potential growth will be a cyclically-adjusted deficit net of temporary measures that is equal to 1% of GDP. For countries in the opposite situation, this objective will be a surplus or budget balance. Also, in the future, the definition of these objectives will take into account any implicit liabilities (i.e. those derived from the budgetary cost of population ageing), once the Council has agreed on a methodology to make it possible.

2. Adjustment path to the medium-term objective. As a general rule, the annual improvement in the cyclically-adjusted balance net of temporary measures should be 0.5% of GDP. However, the pace of approach to the objective should be faster in favourable cyclical situations and vice versa.

3. Role of structural reforms in relation to medium-term objectives. Structural reforms with clear positive effects on the long-term sustainability of public finances will justify temporary deviations from medium-term objectives and thus a lower rate of approach to them.

The main changes for corrective purposes are as follows:

1. Clarification of the circumstances in which a deficit exceeding the reference value temporarily by a narrow margin can be considered ”exceptional”. Previously, as a general rule GDP had to decline by at least 2% in a given year. From now on, a negative rate of increase in output will be sufficient.

2. Consideration of ”other relevant factors” in the various steps of the procedure. These factors, which must be taken into account in assessing minor temporary excesses over the reference value, will include, in particular, the potential growth rate, the prevailing cyclical conditions, the application of structural and political reforms to foster technological innovation, government investment, consolidation efforts in cyclical upturns and the level of expenditure on international aid and any fiscal burden relating to the process of European Union.

3. Pension system reforms. The costs relating to the introduction of a public capitalisation system will be taken into account in assessing an excessive deficit situation.

4. Public debt. A qualitative assessment will be made on whether a country with a debt ratio exceeding 60% has made sufficient progress in reducing it.

5. Time period for correcting an excessive deficit. As a general rule, an excessive deficit should be corrected in the year following that in which it is identified. However, this period may be extended by one year depending on the other relevant factors listed above and reviewed again subsequently should any adverse events with a clear budgetary impact take place.

One aspect of the new rules that should be viewed positively is the greater economic rationality of the Stability and Growth Pact, which manifests itself in three main ways: first, medium-term objectives are distinguished by country and cyclically-adjusted balances net of temporary measures are used to assess compliance with objectives and with the adjustment path towards them; second, the relaxation of the requirement that only a fall in output exceeding 2% of GDP exempts a deficit temporarily exceeding 3% of GDP from being considered excessive; and, finally, the possibility that the time period for correcting an excessive deficit may be extended if, after having taken effective measures, a country’s economic performance is unfavourable. Having said this, the rules are now more complex and their application is less automatic because of an increase in the number of factors that must be considered in both the preventive part and the corrective part and because of the Council’s discretionary powers in assessing them. As a result, from now on it will be more difficult to ensure that the new rules are applied transparently and that countries are treated equally.

The changes in the rules that cause most concern are those relating to the excessive deficit procedure. In particular, the likelihood that a deficit exceeding 3% of GDP may not be judged to be excessive has increased because of the inclusion in the agreement of a long list of exempting factors that are not fully defined. Moreover, it is also now more likely that these same factors may be used to justify an extension of the deadline for correcting an excessive deficit. The only thing that makes these aspects of the agreement less negative is that the exempting factors will only apply if the excess is temporary and small. In addition, although the greater weight afforded to considerations relating to the debt ratio and to the sustainability of public finances is a positive aspect of the reform, it is very likely that the failure to reflect them in quantitative objectives will mean that they will not enhance the incentives to improve the financial position of general government.

In short, taken as a whole, the new rules, although they contain positive elements, raise doubts about their ability to guarantee budgetary discipline in the euro area. However, for the time being any assessment must necessarily be provisional, because the specific legal form that the reform will take is not yet known. A final agreement in this connection will foreseeably take place in the coming weeks, following the European Council's invitation to the Commission to submit proposals promptly in this respect. In any event, it is crucial that the new framework be applied as strictly as possible and that the countries show a greater commitment to comply with it than in the past. In this respect, the delicate budgetary situation of certain Member States, which not only have high deficits, but also have resorted extensively (in order to submit less unbalanced accounts) to temporary measures and to transactions whose conformity with current accounting standards is being analysed, constitute a new acid test for the current framework of fiscal discipline.

cisely at the reference level and in Portugal and the Netherlands it was very close to it. Both Italy and Portugal, however, undertook ad hoc operations to contain their deficit, the effects of which are merely temporary. In addition, the Eurostat press release on the Excessive Deficit Procedure notifications expressed reserves about whether the figures provided by Greece, Italy and Portugal in recent years conform to current accounting rules, so the deficits of these three Member States may soon be revised.

According to the European Commission's spring forecasts, the deficit will decrease by 0.1 pp of GDP in 2005, whereas the cyclically adjusted primary surplus will improve by 0.2 pp, which points to a moderately contractionary stance in fiscal policy in the current year. By country, it is estimated that the deficits of Portugal, Greece, Italy and Germany will exceed 3% of GDP.

As regards Italy, in the light of these forecasts and of the high likelihood that its 2004 deficit will be revised to stand clearly above 3% of GDP, in mid-April the Commission announced that it would initiate an excessive deficit procedure before the end of June. Despite these unfavourable developments, the Italian government had, before it was dissolved, announced its intention to cut income taxes promptly. In Portugal the unfavourable performance of public finances might also lead to the initiation of an excessive deficit procedure, depending on the content of the updated stability programme to be presented by the authorities shortly. In late March, Greece presented a new stability programme with consolidation measures for 2005 which envisages both cuts in government expenditure and an increase in receipts. Under this programme, the deficit in 2006 will stand at 2.9% of GDP, which would comply with the Council's decision in February to ask the Greek authorities to adopt measures to lower the deficit below 3% of GDP in 2006. Finally, Germany may run into difficulty in meeting its commitment to achieve a deficit of 2.9% of GDP in 2005 because of the unfavourable performance of economic activity.

3.2 Monetary and financial developments

The ECB Governing Council meetings in the first four months of the year considered that the current monetary policy stance was compatible with a favourable outlook for price stability and in line with the slow growth of activity. Consequently, the rates applied in the main refinancing operations, deposit facility and marginal lending facility were held unchanged at 2%, 1% and 3%, respectively.

EURO AREA INTEREST RATES

CHART 12

SOURCES:European Central Bank and Banco de España.

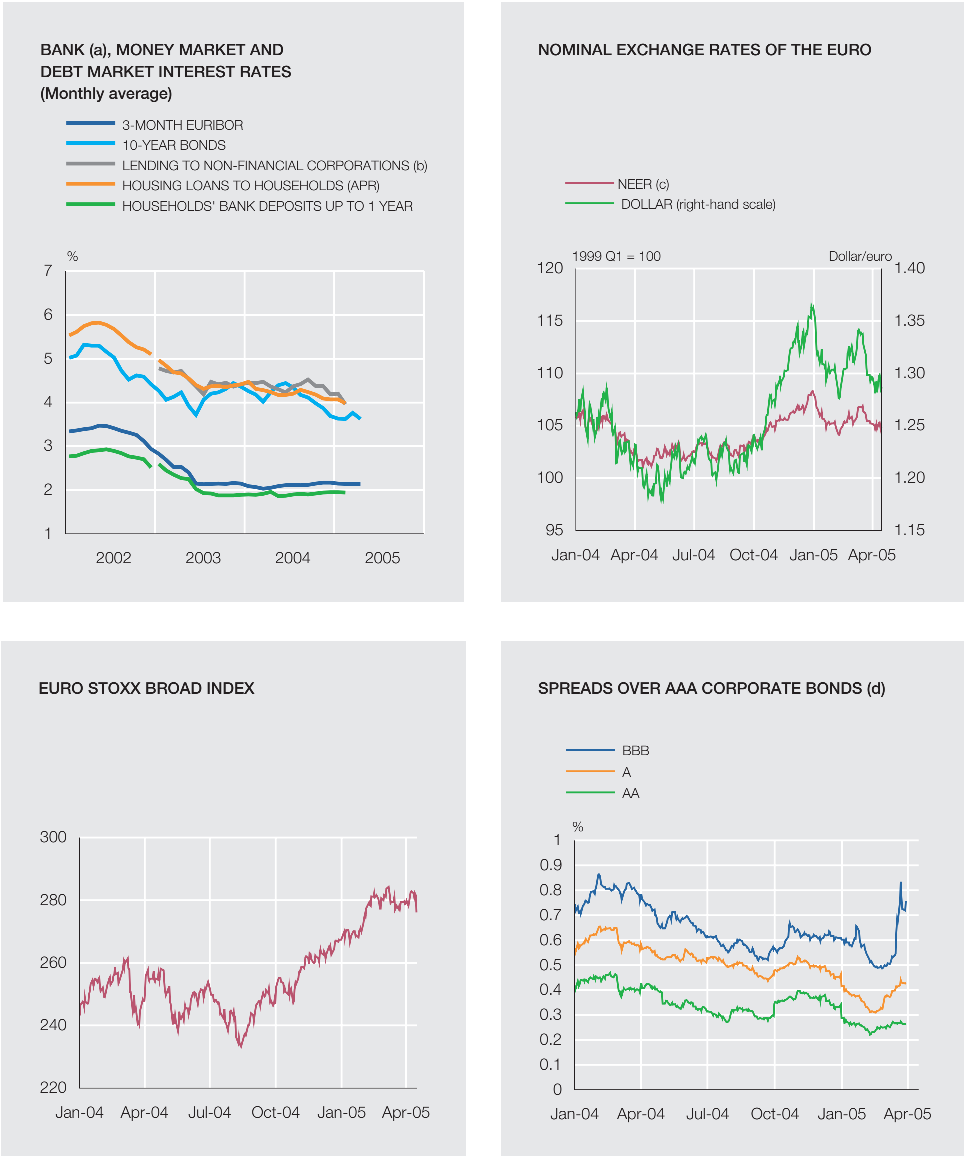
a. Estimated using swap market data.
b. Estimated using Euribor data.

During the first three months of the year, money market interest rates held steady. However in mid-April there was a moderate downward shift in the yield curve, indicating a containment of the expectations of a rise in the official interest rates prevailing in the early months of the year (Chart 11). On the debt markets, ten-year yields continued at historically low levels, below 4%. On information to February, the interest rates applied by credit institutions to their lending and deposit transactions were also generally unchanged. Thus, for example, interest rates on house purchase loans to households in February stood at 4%, slightly lower than three months earlier. Finally, in the private fixed-income markets, the spreads on corporate bonds generally tended to narrow, and in March reached historical lows (Chart 13). However, in the last few days these spreads on lower-rated bonds have widened to the levels prevailing at the beginning of the year.

The recovery of euro area equity markets under way since mid-2004 came to a standstill at the start of March and market prices fell in April, dropping by the end of the month to levels com-

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX

CHART 13



SOURCES: Banco de España and European Central Bank.

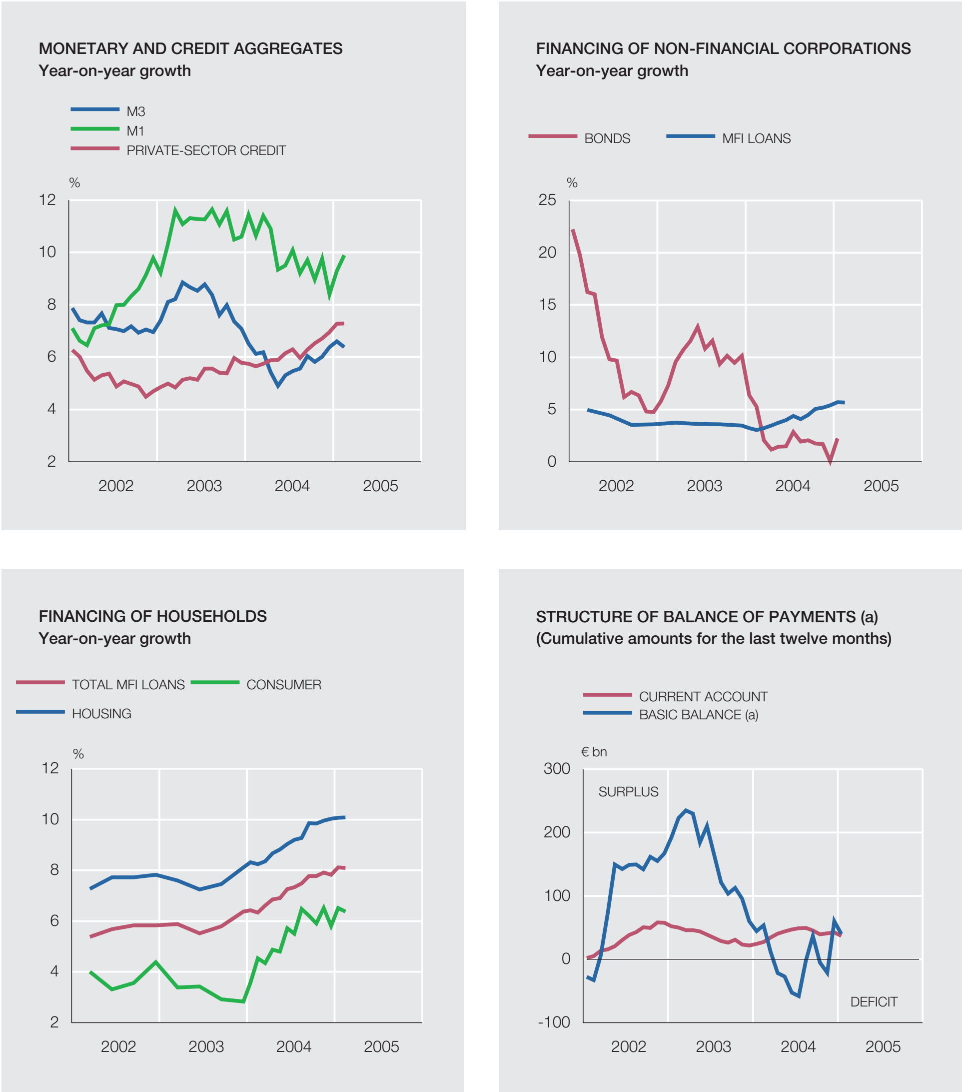
a. Data drawn from new statistics on interest rates compiled by the ECB for new business.
b. Interest rates over five years.
c. Nominal effective exchange rate index. Narrow group of trading partners defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

parable to those prevailing at the beginning of the year. The reason for these developments very probably lies in the oil price rises, insofar as they herald higher production costs for firms and hence lower profits, as well as uncertainty over the impact that lower US growth may have on the euro area.

In early 2005 the euro depreciated against the main currencies from the highs reached at the end of the previous year, when its exchange rate against the dollar stood at USD 1.36/€. In Q1 and April to date, the euro depreciated by 5.5% against the dollar, perhaps owing to the postponement of the expected recovery of the European economy and to the wider interest rate spreads between the US and the euro area. In nominal effective terms, the loss in value of the euro with respect to the dollar (and to the Asian currencies tied to the dollar) was partially offset by appreciation against the currencies of various new member countries of the EU and, as a

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.

result, the nominal effective exchange rate at end-April stood at around 3% lower than at end-December 2004.

In March the year-on-year growth rate of the M3 monetary aggregate was 6.5%, somewhat higher than in 2004 Q4. M1 was the most buoyant component, with year-on-year growth of around 9.3%, due to robust demand for cash and for sight deposits. In early 2005 credit to the private sector continued to expand gradually at a year-on-year rate of 7.5% in March, reflecting the more buoyant behaviour of credit to households (up by 8%) than of that to firms (up by 6%). House purchase loans to households continued to grow at the relatively high year-on-year rate of 10%. Finally, in Spain credit to the private sector continued to increase at a much higher pace, standing above 18%.

Before embarking on an in-depth analysis of the behaviour of the Spanish economy in 2005 Q1, the note of caution sounded at the beginning of section one of this report should be recalled. This analysis is based on the QNA figures currently available, which correspond to the CNE base year 1995. However, the INE plans to rebase the Spanish national accounts to the year 2000 this May, so that when the official estimates for 2005 Q1 are published, these will refer to the rebased QNA. The CNE with base year 2000 will incorporate the new Spanish labour force survey (EPA) estimates that have just been published, which use the population projections based on the 2001 census and the "Padrón Continuo" (a continuously updated municipal population census). The magnitude of the differences in the growth rates of the population and employment between these new estimates and the former EPA, for the period 2001-2004, makes one suspect that the upward revisions to the figures for output and employment growth in recent years, according to the CNE with base year 2000, may be significant. In short, the analysis and assessment of the Spanish economic situation in this report, which are consistent with the latest data published by the INE with base year 1995, can only approximate qualitatively the sense of the official estimates published for Q1.

On the basis of the information available, it is estimated that in 2005 Q1 the Spanish economy extended the smooth recovery seen in the second half of 2004, achieving year-on-year GDP growth of 2.8%, in real terms, with contributions from national demand and the external sector also in line with those observed in that period, of 4.7 pp and –1.9 pp, respectively (see Chart 15). That said, the composition of national demand would have been somewhat different from at the end of 2004, with a slowdown in government consumption, following the notable rise seen last year, and a further expansion of equipment investment, which would have reached year-on-year growth rates of the order of 11%. Meanwhile, the high growth rates of both construction and private consumption stabilised at around 5% and 3.5%, respectively. External demand continued to make a strong negative contribution to growth, against the background of a slowdown in goods and services exports and a vigorous rise in imports.

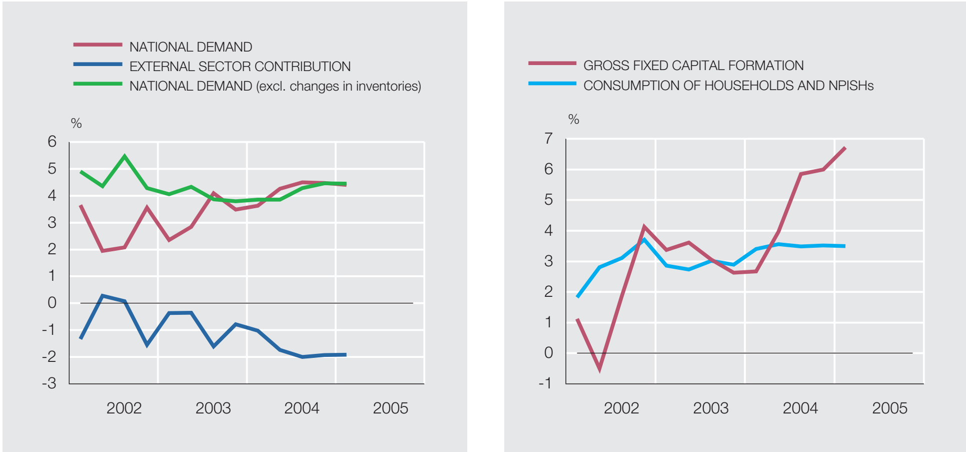
From the viewpoint of output, in the first few months of 2005 the growth of the value added of the market economy was based on the ongoing buoyancy of construction, while industrial activity and market services grew at moderate rates and agriculture fell back again. The conjunctural indicators for employment in Q1 (in particular, the EPA figures) were compatible with a strengthening of the rate of job creation. The rate of growth of productivity in Q1 remained on the path of low values that have become normal for this variable.

It is estimated that, against the background of low productivity gains just mentioned, unit labour costs accelerated somewhat at the beginning of 2005, owing to the impact of the wage indexation clauses on the growth of compensation per employee. These clauses have been activated owing to the deviation of actual inflation in 2004 from its 2% reference rate. Against this background of ULC rises of close to 4%, the rise in the oil price has had a further impact on price developments, taking the inflation rate, measured in terms of the CPI, to year-on-year rates of 3.4% in March.

4.1 Demand

At the end of 2004, Spanish household final consumption expenditure was growing, in real terms, at a year-on-year rate of 3.5%, in line with the profile of notable growth throughout the year (see Chart 15). According to the most up-to-date conjunctural information, this strength was maintained in 2005 Q1, against the background of a smooth slowdown in disposable

MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

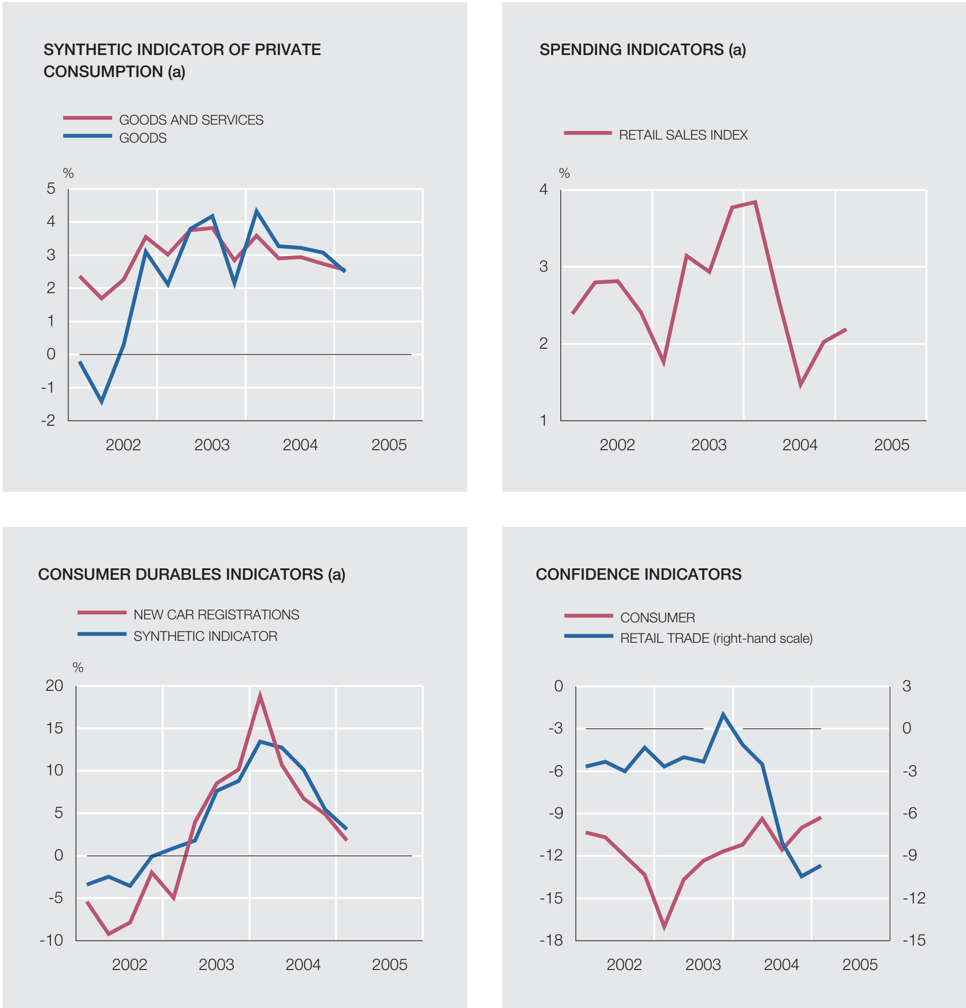
income, buoyed by the net real wealth gains in this sector and generous financing conditions, leading to a further fall in the household saving ratio.

The available indicators for 2005 Q1 point to a sustaining of the significant rate of growth of private consumption at end-2004 (see Chart 16). The composite indicator of private consumption of goods and services shows a profile of stable growth, with the slowdown in the component of durables consumption tending to be offset by an acceleration in the component of non-durables consumption and stable growth of consumption of services. Also, energy consumption is likely to have increased, given the low temperatures during this period. The slowdown in durables consumption was a result of the loss of buoyancy in new car registrations, although these are still at historical highs. Among the other indicators relating to household expenditure, in Q1 as a whole there was a rise in the general retail sales index, accompanied by a similar movement in the retail trade confidence indicator, which continued to rise in April. Likewise, the consumer confidence indicator improved slightly in Q1, although it fell in April.

Among the determinants of private consumption, the available estimates point to a slowdown in real disposal income, following the notable growth estimated for 2004. This would be explained, essentially, by a smaller contribution from the net transfers from general government to households, linked to the end of the impact of the fiscal reform introduced in 2003 and lower growth in social benefits, which were boosted in 2004 by a significant revision to pensions owing to the inflation deviation, and to a significant increase in the eligibility ratio. In any case, employment growth is expected to continue to be the main support for disposable income. Household wealth continued to increase as a result of the significant rise in property prices and the increase in household financial wealth, since stock markets remained high. Although the positive impact of wealth on consumption may decline in future, the effects associated with its notable increase in the latest period are still large.

According to the available QNA data, in 2004 Q4, general government final consumption increased by 5.4% year-on-year, in real terms, 0.6 percentage points more than in the previous quarter. The general government accounts for 2004, already available with the new base year of 2000, in nominal terms, indicate that the growth of government consumption in the year as a whole reflected the notable growth in purchases of goods and services, while compensation of employees grew at a similar rate to 2003, although it is true that the number of employees

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.

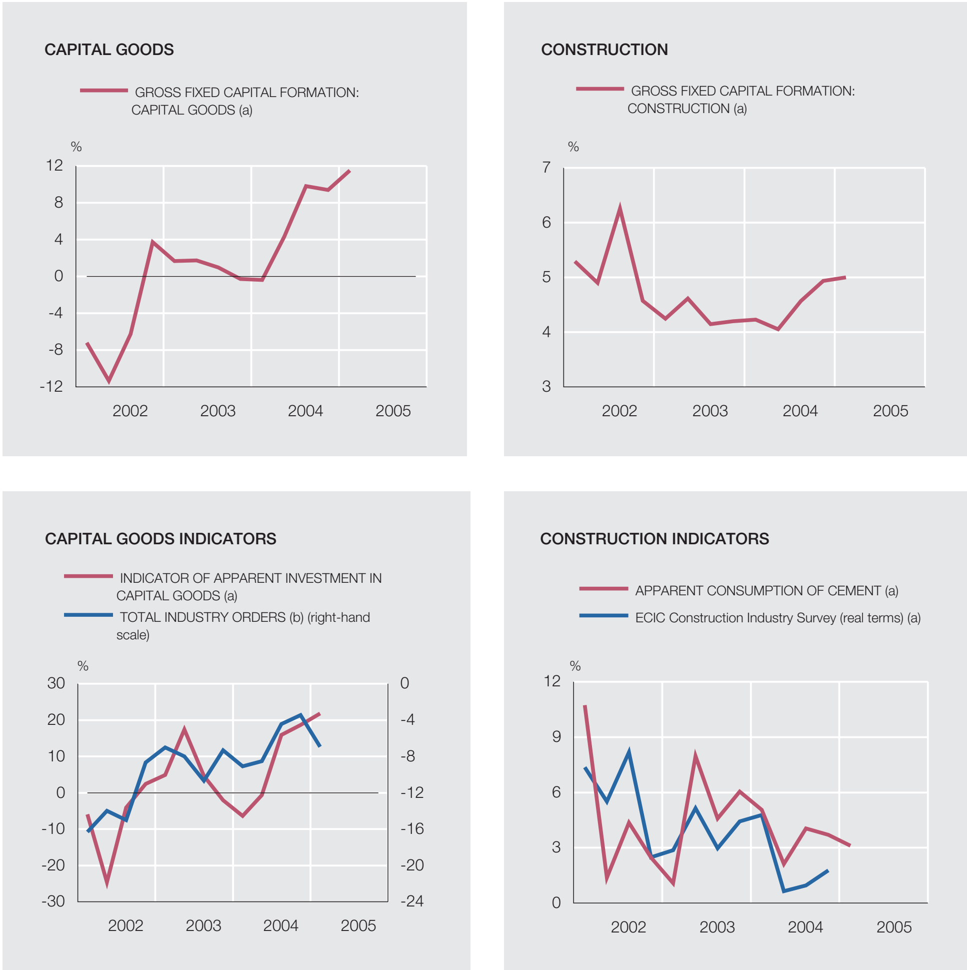
in the sector slowed. The information supplied by the State budget outturn data in 2005, still very incomplete, points to a slowdown in this aggregate.

Gross fixed capital formation grew by 6% in 2004 Q4, maintaining the notable strength of the previous quarter. This year-on-year growth of investment, which was 0.2 percentage points up from the previous quarter, reflected the greater buoyancy of investment in construction and in other products, which reached rates of 4.9% and 3.8%, respectively, while investment in equipment increased by 9.4%, somewhat less than the rate recorded in Q3. The conjunctural indicators available for 2005 Q1 point to a further acceleration in investment, as a result of a slight additional strengthening of construction and higher growth of investment in equipment.

On the information released for 2005 Q1, the indicator of apparent investment in capital goods appears to have accelerated smoothly during that period (see Chart 17), owing to a very positive contribution from the external trade in these goods. The deterioration in the industrial climate indicator of the capital goods sector and its order book in March suggest that domestic production has benefited to a lesser extent from investment demand. At the same time, capacity utilisation in industry as a whole increased in Q1 to 80%, the highest level since 2001, although the percentage of firms that consider their capacity excessive also rose.

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.

Even so, the recovery in investment in capital goods is in line with the buoyancy of final demand and very generous financing conditions for business. The information on non-financial corporations to 2004 Q4 collected by the Central Balance Sheet Office Quarterly Survey shows sustained growth of business activity, during 2004 as a whole, based on strong performances in wholesale and retail trade, transport and telecommunications, and on the recovery of the industrial sector. Among the firms of the CBQ, the moderation in personnel costs contributed to the positive behaviour of ordinary net profit, and this, along with the decline in financial expenses, meant that profit levels remained high. The indicators of financial pressure, which also incorporate developments in indebtedness, improved over the year. The good results in 2004 should sustain the buoyancy of investment in equipment in the coming quarters, although this positive scenario could be affected by the rise in oil prices and by slower growth in the nearest external markets.

In 2004 Q4, investment in construction grew by 4.9% year-on-year, with average growth of 4.4% in the year as a whole. According to the latest conjunctural information, this buoyancy was maintained in 2005 Q1, while the confidence indicator remained at the high level of the previous quarter. Apparent consumption of cement followed a gentle upward path in early 2005, and the registered unemployment and Social Security registrations of the sector were highly buoyant, although with a mildly decelerating profile. According to the Construction Industry Survey (ECIC), the real value of the work carried out by construction firms picked up smoothly in 2004 Q4, following the low growth in previous quarters.

Among the leading indicators, those relating to residential building, suitably lagged, indicate a turning point for this component around the turn of the year, with a deceleration forecast for the surface area to be built during 2005, based on building approvals. At the same time, the information on foreign investment in property showed a downturn in the final quarter of 2004, which continued in January 2005, according to the balance of payments statistics. In any case, the residential building component remained the most buoyant of construction, as indicated by the real value of the work carried out according to the ECIC, which grew by 5.2% in 2004 Q4. In the case of civil engineering works, the official procurement rose in 2004 Q4, ending the year with average growth of 24%. The effects of this expansion on construction activity would begin to be visible in 2005 and, mainly, in 2006. In this respect, the ECIC corresponding to civil engineering reflected a certain improvement in 2004 Q4, with a stabilisation of the work carried out, after the negative results of previous quarters. Finally, with respect to non-residential building, both the official procurement and approvals continued showing negative results in 2004 Q4.

According to the latest QNA data, in 2004 Q4, net external demand subtracted 1.9 pp from output growth, its negative contribution falling by 0.1 percentage points. Exports of real goods and services grew by 5.2% year-on-year, while the year-on-year growth rate of real imports rose to 10.2%. These developments took place against a background of notably vigorous world trade, although the increase in Spanish exports (for the third consecutive quarter) was less than the growth in export markets, pointing up the intense loss of competitiveness since the previous year vis-à-vis the developed countries, with the euro at very high levels. On the imports side, the greater buoyancy was based on the upward path of final demand, which resulted in a pick up in foreign purchases of equipment and, to a lesser extent, in consumer goods, driven also by the competitiveness gains by imports in the domestic market. According to the information on 2005 Q1, net external demand remained rather contractionary, while exports grew at a much lower rate than imports.

According to Customs data goods exports, deflated by the relevant UVIs, grew by 4.3% year-on-year in 2004 Q4, making for an increase in the year as a whole of 5.2% (see Chart 18). The data available for the first two months of 2005 indicate that the deceleration in goods exports intensified, with a decline of 1.5% in real terms. This result is consistent with the slowdown in activity in the euro area, the main Spanish export market, and with the fall in price competitiveness vis-à-vis this area and, to a greater extent, vis-à-vis the rest of the developed countries, despite the fact that this deterioration came to a halt in the initial months of 2005, against a background of moderation in relative prices and a less strong euro. By geographical area, sales to the whole of the expanded EU fell by 0.8% in January and February, in real terms, the estimated increase in their prices being 6.9%. Extra-Community exports, with a rise in prices of 2.5%, fell by more (-3.6%), in real terms, in contrast to their vigour in 2004. The negative performance of sales to Japan and Latin America was notable.

According to the QNA, in 2004 Q4 real tourism revenue declined by 2% year-on-year, making for a drop of 1.8% in the year as a whole. These figures do not reflect the profile of recovery recorded by the main real indicators of tourism in 2004 Q4, which is partly attributable to the progressive cut in spending per tourist (see Chart 18). In 2005 Q1, foreign travellers staying in hotels grew by 2.2%, while overnight stays in hotels grew by 0.8%. When it is taken into account that Easter was in March this year, while last year it was in April, these figures for hotel

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.

occupancy reflect a negative behaviour. The indicator of tourists entering Spain showed a more sustained trend, rising by 7.4% between January and March, the discrepancy with the hotel occupancy indicators being attributable to the progressive shift in tourist accommodation towards rented or private housing. In Q1, the British market, from where most tourists to Spain are drawn, grew moderately, while the German market showed positive increases and the French market, the third most important, saw a notable upturn. As for tourism from outside Europe, there was a sharp fall in US tourists, while numbers of tourists from the rest of the American continent grew notably.

According to QNA data, the downtrend that had been characterising exports of other services came to a halt in 2004 Q4, when they recorded a slightly positive growth rate (1.7%), in line with the upward trend in the balance of payments. Revenue from business activities and transport services also picked up in that quarter.

Goods imports, on Customs data, sustained their notable vigour in 2004 Q4, growing by 8.8% in real year-on-year terms, very close to the rate in the previous quarter. This buoyancy extended into the first two months of the current year, with real growth of 7.8% (see Chart 18).

By product group, purchases of capital goods sustained the notable vigour that had characterised them since the second half of 2004, growing by 20% year-on-year in January and February, while real imports of consumer goods, having recovered some vigour in February, increased by 7.8%; however, purchases of food fell by 6.4% in the two months analysed. The real growth rate of imports of intermediate goods, which had been moderating progressively since the beginning of 2004, fell to 3.7% in January and February. Finally, purchases of intermediate energy goods picked up notably in February, growing by 14.3% in 2005 to date.

Lastly, imports of services continued to accelerate in 2004 Q4, growing by 5.4% year-on-year, in QNA terms. The already moderate growth of purchases of non-tourist services slowed to 0.5%, while payments for tourist services increased by 25.7%, in real terms, a figure consistent with the vigour of the nominal tourism payments of the balance of payments in the same quarter; the January balance of payments data point to similar buoyancy at the beginning of the year. The recovery in consumer confidence and the strength of the euro are conducive to such expansionary behaviour for this item.

4.2 Output and employment

The value added of the market economy grew by 2.4% in 2004. There was a mild slowdown in the second half of the year, so that its year-on-year growth rate in Q4 was 2.2%. All sectors decelerated in Q4, except construction, which remained highly buoyant throughout the year (see Chart 19). In 2005 Q1, the value added of the market economy appears to have grown in line with the second half of 2004.

The fishing and agricultural sectors saw a substantial contraction in their activity in 2004, with a rate of change of –2.1%, according to the QNA. This fall in output was concentrated in crop production, especially olives and fruit, which recorded double digit negative rates, while animal production held steady. The negative trend in agricultural production continued at the beginning of 2005, given the scant rainfall recorded in the winter period, which was well below historical levels, and the low temperatures that substantially affected a significant proportion of crops.

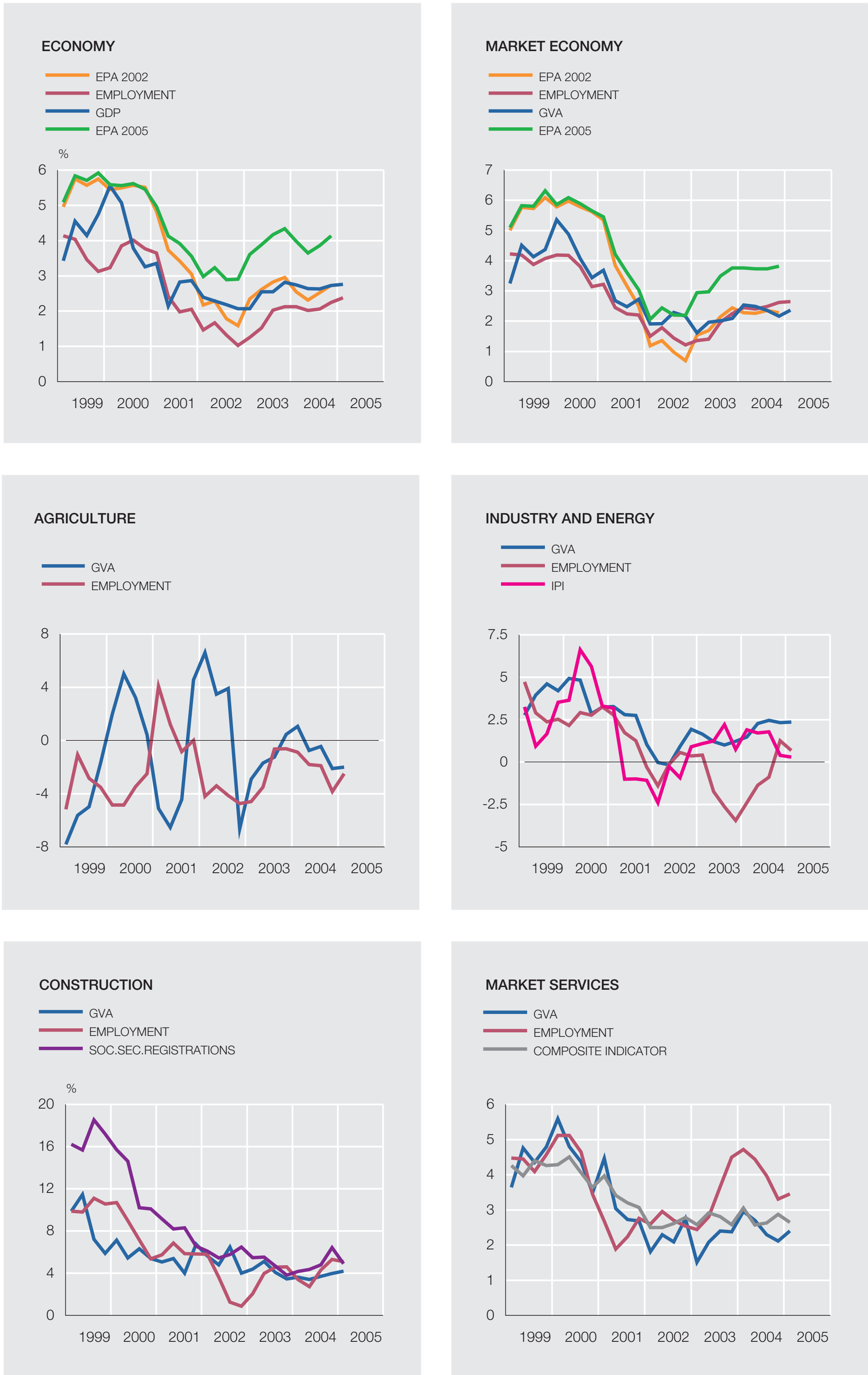
Growth in the industrial and energy sectors moderated in 2004 Q4, following the step-up in Q3. Gross value added increased by 2.3%, 0.2 percentage points less than in the previous quarter, despite the growth of 3% in energy production, which was 0.7 percentage points up from Q3. In 2005 Q1 energy production is estimated to have accelerated further, owing, among other factors, to the low temperatures last winter. The conjunctural information, however, generally shows less buoyancy in the industrial sectors. Among the most relevant indicators, in the two-month period January-February, the year-on-year growth rate of the non-energy component of the IPI fell by more than half a percentage point from 2004 Q4, turnover showed a substantial loss of momentum and imports of intermediate goods decelerated; the sector's confidence indicator fell in Q1 as a whole, basically as a result of the deterioration in the order book, while the number of Social Security registrations declined in the same period at a slightly higher rate than at the end of the year. Only the deflated index of orders received showed upward momentum in January and February.

As already mentioned, the buoyancy of construction continued to show signs of resilience, with another rise in the growth rate of this sector in 2004 Q4, up to 4%, from 3.7% in the previous quarter. The most dynamic segment continued to be housing construction. As commented when discussing expenditure, the conjunctural information available shows that this greater degree of dynamism extended into 2005 Q1.

Services activity, as at the end of 2004, had recovered some of the momentum it had lost in Q3, rising by 2.7% in Q4. However, this increased vigour was exclusively concentrated in non-

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.

market services, which reached a year-on-year growth rate of 4.6%. Market services, meanwhile, continued to decelerate, as they had been doing since 2004 Q1, with a loss of 0.2 percentage points in their year-on-year rate of growth, to 2.1%. The conjunctural information available on this sector, for 2005 Q1, which is still very incomplete, points to a certain braking in this deterioration. The sentiment indicators have been coincident, with a profile of slight growth in Q1 as a whole, both in the case of the European Commission confidence indicator (which reflects better demand expectations) and in that of the purchasing managers' index, although the latter saw a substantial downward correction in March; the growth rate of Social Security registrations also improved in this period. Other indicators, however, show less favourable developments, such as the composite market services indicator (ISIS), which slowed in Q1, and the deflated index of activity indicators for the services sector, which recorded a loss of momentum in January and February.

Among the various sectors included in market services, real estate, renting and business activities picked up in Q1, according to Social Security registrations. Transport, storage and communication activity tended to stabilise, and the wholesale and retail trade and repairs sector decelerated. Finally, the hotels and restaurants maintained the momentum of end-2004; in particular, the figure for overnight stays of residents in March was very positive, enabling the deceleration observed in previous months to be corrected.

On QNA estimates, with base year 1995, employment maintained in 2004 the sustained rate of growth it achieved in the second half of 2003, recording average growth of 2.1% (see Chart 19). In the final quarter of the year, employment rose by 2.2%, year-on-year, extending the path of smooth acceleration of the previous quarter. This trend in employment, against a background of relatively stable output, means that apparent labour productivity continues to display low rates of growth (0.6% on average in 2004). In the market economy, employment was more buoyant, with estimated average annual growth of 2.5% with a relatively stable profile over the year, so that apparent labour productivity fell by 0.4% year-on-year in the final quarter. The persistence of the low apparent labour productivity gains (or even losses) shows the need to implement policies to boost productivity. In this respect, Box 4 summarises the set of measures included in the plan to invigorate the economy and boost productivity, recently approved by the government.

As already mentioned at the beginning of the report and at the beginning of this section, according to the new employment figures supplied by the EPA, which incorporate the demographic changes that have occurred in recent years (in particular, the rapid increase in the immigrant population), employment growth rates in the period 2002-2004 were well above those estimated previously, both by this survey and by the QNA with base year 1995. Chart 19, which depicts the new series along with the previous ones, shows the magnitude of the revision, which is explained in greater detail in Box 1 in the Overview. As regards job creation in 2004, the new EPA figures indicate growth of 3.9% (2.5%, according to the figures published previously), similar to that recorded in 2003 (4%) with a quarterly profile of recovery in the second half, which ended with year-on-year growth of 4.1%. Obviously, the CNE employment series with the new base year of 2000, due to be published in May, will incorporate, to an extent that cannot be specified, this higher level of employment growth. It is therefore not possible to make even a rough estimate of what employment growth will have been in Q1, according to the National Accounts. Among the conjunctural information relating to the year to date, Social Security registrations showed stable growth in Q1, at a rate of 2.8%, similar to the average growth rate in the previous year, while a certain slackness is discerned in contracts registered in the period January-March, following the spurt in 2004. The new 2005 EPA data for Q1, however, point to greater dynamism in employment, which would have grown by 5.1%

On 1 March, the Government presented a Plan to invigorate the economy and boost productivity, which is designed to secure a balanced and lasting pattern of growth for the Spanish economy based on increases in productivity and employment. The government has promised to evaluate the Plan annually, to report on its results and, periodically, to make improvements to it.

The Plan's first package of measures consists of a set of actions aimed at a large number of sectors (telecommunications and the information society, energy, transport, wholesale and retail trade, postal services, the tobacco market, the rented housing market[1], financial markets and the public sector), and to impact the regulatory and tax framework. Although the objectives of this programme are ambitious, the first package of measures has a partial approach and is limited in scope. The package of measures is not accompanied by an economic report, although the tax cost of its implementation is expected to be low.

The measures of the first package are contained in a Royal Decree-Law, three draft bills and a large number of mandates to various ministries. Royal Decree-Law 5/2005 on urgent reforms to boost productivity and improve public procurement ("RDL"), came into force on 15 March. The implementation of the draft bills may take rather longer and their final content is less certain, since it depends on the outcome of the established parliamentary procedures. In the case of the mandates, their content is less specific, given that in most cases studies are to be conducted before reforms are introduced, and the latter will have to be designed and subsequently approved by one of the legal procedures in force. For these reasons, this box only makes a very general assessment of the first package, although there is a more detailed discussion of the measures contained in the RDL, which are grouped according to whether they affect energy markets, financial markets or general government.

Most of the measures in the first package seek to increase the level of competition in the sectors concerned and to introduce efficiency improvements in cost and price formation. In some cases, the proposed actions attempt to impact activities in which, after several years of deregulation, sufficient progress has not been made towards effective competition (electricity, liquid and gaseous hydrocarbons, postal service) and, in other cases, sectors in which deregulation has been more recent (such as rail transport), in order to facilitate their development in its initial stages. In the case of general government, the aim is to increase the transparency and efficiency of its activities. Certain measures have also been adopted in response to the obligation to implement a set of Community directives, which will probably help to increase competition in the markets concerned. The package also contains a number of minor tax reforms. Among these, only those which seek to promote the use of information technology and communication technology in small and medium-sized businesses may have a certain impact on productivity.

As regards the RDL, a significant proportion of the measures correspond to the energy sector and, within this, the electricity industry, and their main aim is to increase competition and efficiency in cost and price formation. Notable among them are, first, the exclusion of the system operators[2] from the list of main operators, which enables the number of firms subject to restrictions as regards their share in the capital of other firms of the sector to be increased. Second, a category of dominant operator is defined (those with more than a 10% share of the market), and firms having this status are subject to certain obligations conducive to competition, although the latter have only been specified for the dominant operators in the electricity sector, as indicated below.

Notable among the measures specifically affecting the electricity sector is the reduction of the limit on the stake that firms of the sector may hold in REE to 1% (the current limit is 3%), to strengthen the independence of the technical operator of the system from the other firms of the sector. Dominant operators are not permitted to import electricity from markets other than the Iberian Electricity Market (MIBEL), in order to reserve a segment of the market for smaller operators and thereby promote a reduction in the degree of concentration of the sector. The settlement date for the costs of transition to competition (CTC) for 2004 has been postponed, until the government establishes the objective criteria for their determination. This is an aspect of the RDL that may help to reduce distortions between the various companies in the sector. The costs relating to the dismantling of nuclear power stations, the management of spent fuel and radioactive waste are removed from the electricity tariff, which should stimulate better management of these costs by the electricity utilities. The obligation to provide information on facts that may affect price formation in the market is regulated, which may help increase transparency in the price formation process.

In short, the measures discussed are designed to facilitate the unbundling of activities and to promote the entry of new operators so as to reduce the high degree of concentration still present in the electricity sector, although there are doubts regarding their capacity to generate a significant effect immediately. The other measures aim to increase the transparency of price and tariff setting, in order to detect the possible existence of distortions and to achieve a more efficient allocation of resources, which may boost competition in the sector.

With regard to the other energy industries, a register of oil product supply points has been set up, thereby laying the foundations for an analysis of the degree of competition in the sector. In the gaseous hydrocarbon sector the main measures seek to promote rationality in the construction of gas distribution infrastructure and switching natural gas supplier is regulated, large consumers being required to remain at least three years in the deregulated market before requesting their return to the tariff market.

In relation to the financial markets (see the Financial Regulation article in this Economic Bulletin), the Securities Market Law has been

1. The government has recently announced the setting up of the Sociedad Pública del Alquiler.

2. REE in the electricity industry, CLH in the liquid hydrocarbons industry and ENAGAS in the gaseous hydrocarbons industry. The main operators are the five firms in the industry with the largest market share and their status means that they cannot have a holding of more than 3% in the capital or voting rights of another company that is also a main operator.

amended in relation to the approval of prospectuses for issues of marketable securities and to the rules on public offerings and their listing, in order to adapt Spanish law to the Prospectus Directive before the deadline of 1 July 2005. The delay in the implementation of this directive may lead to a loss of competitiveness by Spanish primary markets, since it addresses two crucial issues: a) securities offerings authorised in any EU Member State may be marketed in Spain without the need for further information or authorisation by the CNMV; b) in the case of offerings of certain categories of securities (securities other than shares with a nominal value of more than €1,000, i.e. the bulk of the fixed-income market), issuers shall be free to choose the competent authority. This means that Spanish fixed-income issues may be authorised in any EU Member State and subsequently marketed in Spain. Reform of the primary market, which has traditionally been relatively undeveloped in Spain and has recently seen a slowdown in its private fixed income segment, is important and, it might be added, opportune. In fact administrative deregulation could spur a relaunch of the fixed-income markets, against a background in which competition between the EU financial centres is going to intensify.

Also, the Directive on financial collateral arrangements has been transposed into Spanish law by means of an amendment to the Securities Market Law, to facilitate certain financial transactions that require the creation of collateral, substantially reducing the requirements for the creation and enforcement of such collateral.

Turning to other areas, the Law on general government contracts has been amended to improve public procurement, including certain aspects of the activity of foundations and agreements signed with other governments.

The Plan's measures will have a positive impact on productivity to the extent that the actions which aim for a more efficient allocation of resources and to boost competition generate a more competitive environment, that is conducive to innovation and further enhances efficiency in productive processes.

in that period, clearly above the level recorded at end-2004 (4.1%). However, it is worth stressing that the 2005 EPA incorporated in this first quarter a series of methodological changes that make it difficult to calculate homogeneous rates of change with respect to previous quarters. Accordingly, the INE conducted a parallel survey to enable employment growth to be estimated in Q1 according to the methodology prior to the changes introduced in the 2005 EPA, the result being a rate of 4.3%. In any case, this rate involves an acceleration in employment in Q1.

By activity, and according to the available QNA figures, agriculture shed employment in 2004, albeit at a lower rate than in the previous year, but this rate rose over the year (see Chart 19). The new EPA series also show a fall in 2004, albeit less intense, but becoming more pronounced in Q4. In industry, the recovery in employment in 2004 was progressive, an increase in employment being seen in Q4, after a year and a half of continuous losses. Again, this profile is reproduced by the EPA, which also shows a recovery in Q4, to 2.6% year-on-year (1.3%, according to the QNA). The QNA already showed very dynamic employment creation in construction, especially towards the end of 2004, when it accelerated to 5.3%. According to the EPA, the average growth of employment in construction, in 2004, was 7.2%. In the market services sector, employment slowed during 2004 to a rate of increase of 3.3% in Q4 (3.5%, according to the new EPA). Finally, job creation in non-market services was basically characterised by slackness last year, the rate moderating by more than one percentage point, to a modest 0.6%. With regard to 2005 Q1, the EPA data indicate that the greater dynamism of employment in the first few months was basically concentrated in the services sector, where total employment grew by 6.4% (5.1%, according to the homogeneous sample). In construction, there appears to have been a slowdown in Q1, following the strong increase in employment in late 2004 (9.8%), although the new EPA shows a notably sharper slowdown than the homogeneous sample (5.1%, as against 8.1%). Industry, for its part, seems to have maintained positive rates of job creation (2.6%), although with a notable deceleration according to the homogeneous estimates (0.9%). Finally, agriculture continued to shed employment, albeit at a lower rate.

According to the National Accounts, in 2004, the recovery in self-employment was the main factor behind the acceleration in employment. Self-employment increased by 2.3% on average, as against a fall of 1.4% in 2003, while dependent employment decelerated by 0.2 percentage points, to 2.1%. However, self-employment decelerated slightly in Q4, while dependent employment, which moderated in the first half, tended to recover in the final quarter. In the registration statistics, the greater dynamism displayed by self-employment was more than offset by the moderation in the creation of dependent employment, the year-on-year growth rates of these two groups converging to around 3% at the end of the year. The revised EPA data also reflect these developments, with significant growth in dependent employment of 2.6% in 2004 (0.3% in 2003) and a slowdown in self-employment of 0.7 pp to 4.2%.

As to the duration of contracts, it should be stressed, first, that the greater job creation in recent years estimated by the EPA, following the revision published by the INE for the 1996-2004 data, was especially strong in the case of temporary employment, so that the ratio of temporary to total employment rose slightly (32.5% in 2004, as against 30.6% on the old data). In Q1, temporary hiring appears to have maintained its vigour, although the rate of change has been notably affected by changes introduced in the EPA. Thus, according to the new survey, the number of temporary employees grew by 5% in Q1, a notable deceleration from the growth at end-2004 (7.4%), which results in a 1 pp reduction in the ratio of temporary to total employment, to 31.9%. However, the homogeneous sample shows year-on-year growth of 8.4% in temporary employment in the quarter and a practical stabilisation of the ratio of temporary to total employment (32.8%). In both cases, however, this growth is greater than that estimated for permanent employment (3.8% according to the new survey and 3% with the common methodology). From the standpoint of the length of the working day, the changes introduced in the EPA have had a very significant effect on the measurement of the number of part-time workers, so that the part-time ratio stood at 13.1%, as against the 8.7% previously estimated by the EPA for end-2004.

With respect to labour market participation, the revision of the base population of the EPA has involved a greater increase in recent years (3.3% in 2004, as against 2% on the old data), but with a similar profile. In Q1, the buoyancy of the labour force would appear to have increased, with growth of 3.5% according to the new 2005 EPA. This greater buoyancy is also seen if we consider the information provided by the INE on the homogeneous sample with the previous methodology, which shows somewhat lower labour force growth (3.3%), but also higher than at end-2004. As for unemployment a significant fall is seen in Q1 (–8.2%, year-on-year) and the rate of unemployment fell to 10.2%, 0.4 pp below its level at end-2004. However, this performance seems to have been significantly affected by the changes introduced by the INE in the sample, since, according to the information on the homogeneous sample, the fall in unemployment was smaller (–4.8%) and the rate of unemployment stabilised at 10.6%. The registered unemployment data show a similar trend, with a fall of 1.5% in 2004 Q4, which extended into 2005 Q1, when registered unemployment fell by 2.5%.

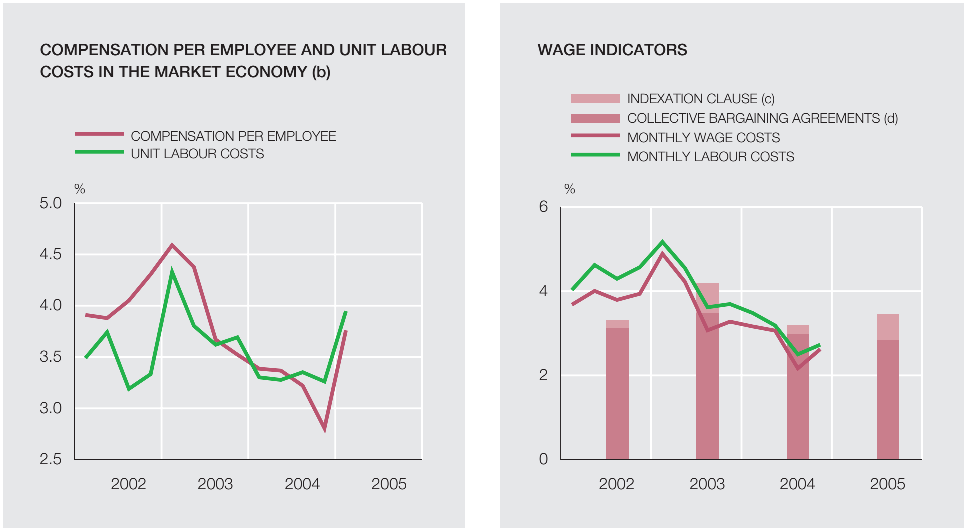
4.3 Costs and prices

Compensation per employee, on QNA estimates, rose by 4% in 2004, a smaller increase than in 2003 (4.3%). This slowdown was greater in the market economy, where compensation increased by 3.2%. All the branches of this aggregate contributed to the deceleration, especially services (2.7%) and industry (3.7%). Over the course of the year, compensation per employee in the market economy followed a smoothly moderating path, which steepened in Q4, when the increase was 2.8% year-on-year (see Chart 20).

The Quarterly Labour Cost Survey (ETCL) shows stronger wage moderation in 2004 as a whole than the Quarterly National Accounts. The increase in monthly labour costs was 3%, a

WAGES AND LABOUR COSTS (a)

CHART 20



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

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

slowdown of 1.2 pp from the preceding year. By branch of activity, the slowdown in labour costs was across the board, with cuts in their respective rates of increase of around one percentage point, to 2.6% in services, 3.4% in industry and 5.2% in construction. By component, there was a slowdown in wage costs, which grew by 2.8%, and a notable deceleration in other costs, which grew at a rate of 3.6% (5.4% in 2003). Within wage costs, the slower growth for the second year running in ordinary wages, which grew by 2.1% in 2004, was notable. Comparing this figure with settlements shows negative wage drift. This may be related to the incorporation of workers with lower wage levels and, also, to the significant growth in part-time employment in 2004, although it is difficult to explain it completely on the basis of these phenomena.

In 2005, wage settlements in the agreements recorded to 31 March were slightly lower than in the previous year, at 2.85%. These agreements affect almost 4.8 million workers, but practically all of them are revised, so that the settlements in newly signed agreements (3.6%) cannot be considered indicative of future collective bargaining developments. In March, social agents renewed the Interconfederal Collective Bargaining Agreement (AINC) without any changes from the previous year, so the results are not expected to differ significantly from those of the previous year. This fact, together with a greater indexation-clause effect in 2004 (which could reach 0.6 pp, as against 0.2 pp in 2003), would point to a rise in labour costs this year.

Moderation in the growth of compensation per employee in 2004 Q4, despite the slight reduction in the growth of productivity, was reflected in the labour cost per unit of value-added, which decelerated to 3.5%. By contrast, the rate of growth of the value-added deflator rose to 4.3%, so that, as in previous quarters, margins continued to widen. A similar widening of margins was seen in the market economy, given that prices were even more expansionary. Chart 21 shows the behaviour of the deflator and unit labour costs in the market economy and in its main branches. In Q4, as in previous periods, these variables behaved differently across the various branches of activity. While the acceleration in the deflator was seen in all the non-agricultural branches,

PRICES AND COSTS BY BRANCH OF ACTIVITY (a) CHART 21

SOURCES: INE and Banco de España.

a. Percentage change on a year ago based on QNA seasonally adjusted series.

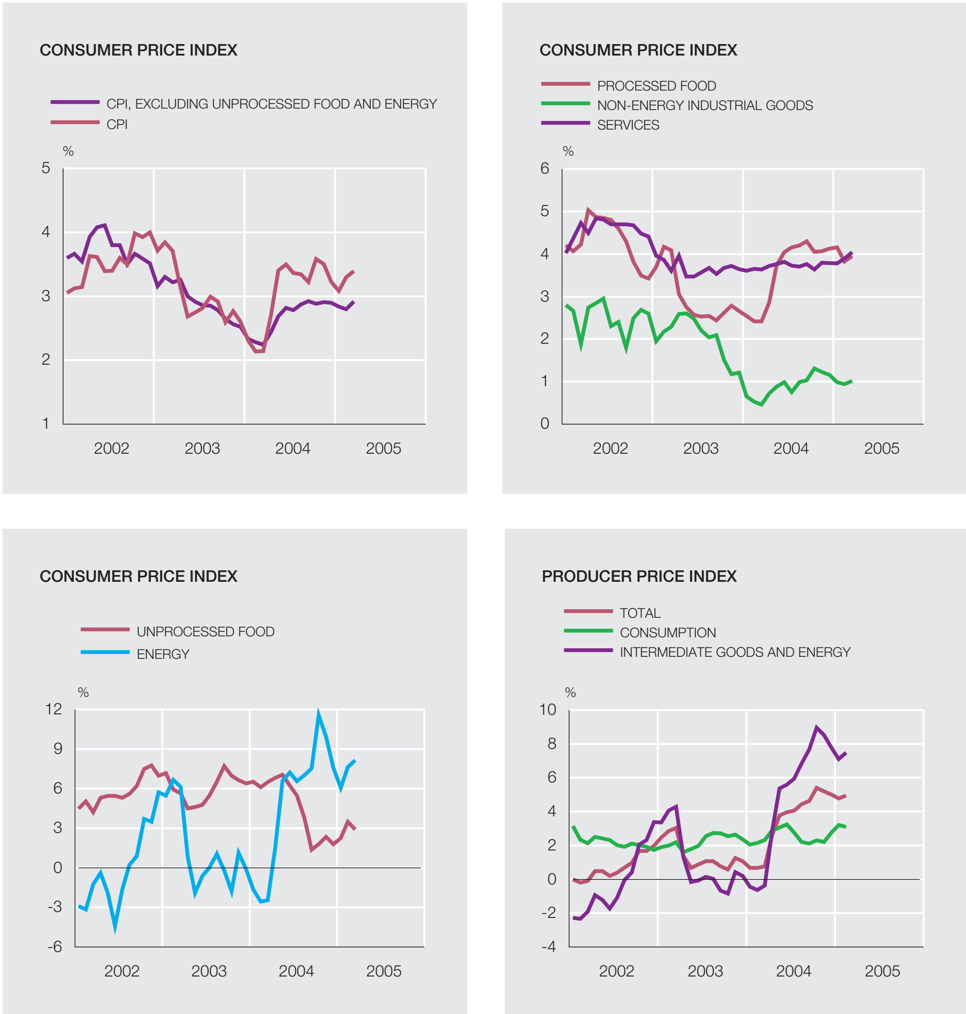
unit labour costs accelerated in industry and energy, although margins continued to widen. In construction, a similar process of widening of margins was observed, against a background of stable cost growth, while in services, after a number of consecutive quarters of contraction, margins widened, owing to the strong slowdown in labour costs per unit of value added.

In Q4, the year-on-year growth rate of the final demand deflator held steady at 4%, while the GDP deflator accelerated by 0.2 percentage points to 4.7%, and there was a slight slowdown in the imports deflator to 2.8%. All this took place against a background of a continuous rise in the weight of imports in final demand, to the detriment of domestic output. Although energy import prices accelerated in Q4, the rise in the euro against the dollar helped to moderate the behaviour of the import prices of non-energy goods.

From the standpoint of demand, the consumption deflator grew by 3.3% year-on year in 2004 Q4, having followed an upward path over the year. The CPI displayed a similar profile, increasing by 3.4% in 2004 Q4 (0.1 percentage point more than in the previous quarter). In Q1, average CPI growth fell to 3.3%, while the CPI excluding unprocessed food and energy held steady at 2.9% (see Chart 22). The most inflationary component was again energy prices, with average growth of 7.3%, boosted by the increase in electricity prices at beginning of the year and the upward path of heating and vehicle fuel prices since the late January, in line with the trend in the price of crude oil on international markets. For their part, the prices of non-energy industrial goods in-

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

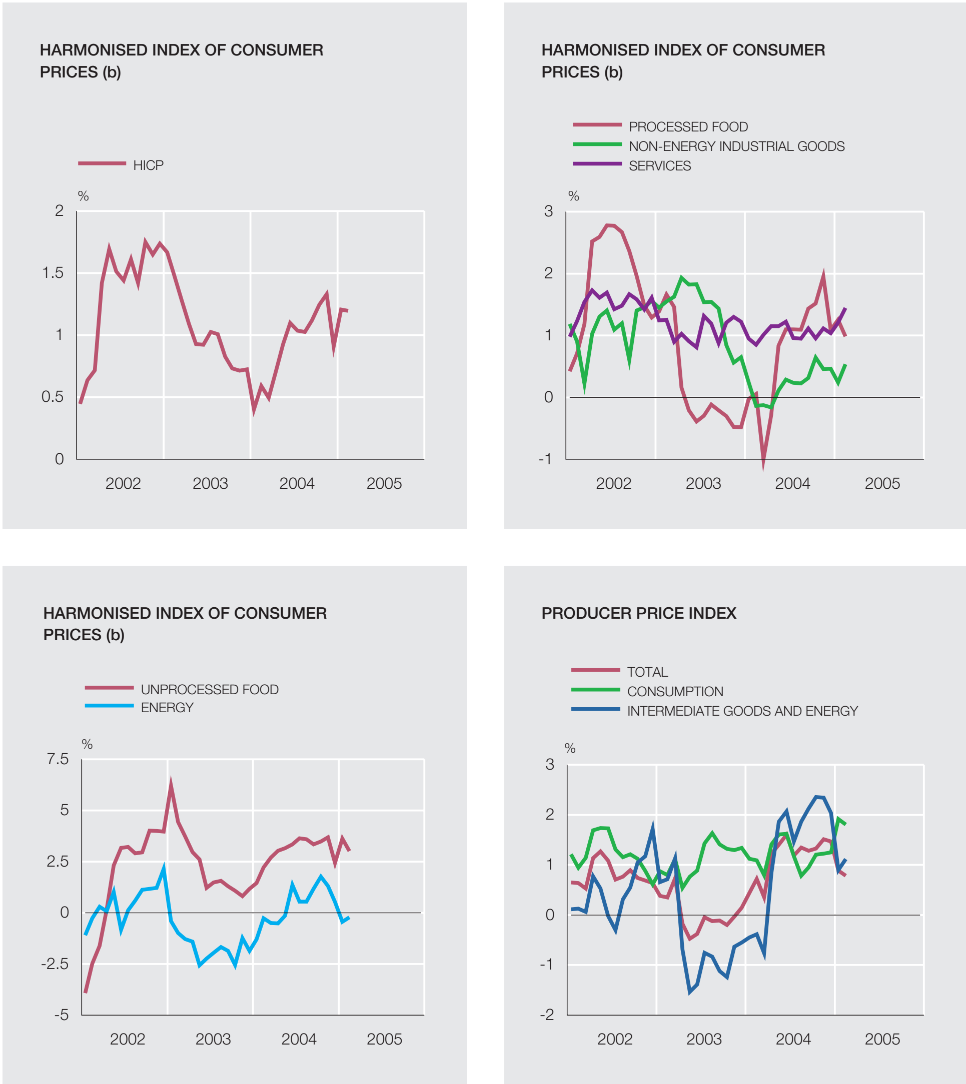
creased by 1% year-on-year in Q1, 0.2 percentage points less than in the previous period, partly as a result of the less generous winter sales and a reduction in drug prices in March.

In Q1, processed food prices decelerated by 0.1 percentage point from the previous quarter, which took their average twelve-month growth rate to 4%. The growth rate of bread, cereal and oil prices moderated, unlike the growth rates of the prices of meat products. Meanwhile, the growth rate of unprocessed food prices increased in Q1 to 2.9%, having reached a low in the same quarter; the prices of certain items such as poultry and fruit and vegetables increased, the latter as a result of the February frosts. Finally, services prices accelerated by 0.2 percentage points in Q1, to an average twelve-month rate of 3.7%, owing to higher increases in transport prices in Q1 than last year; also the fact that Easter fell in March and not April, like in 2004, contributed to the acceleration, although this effect is transitory.

In 2005 Q1, Spanish inflation as measured by the HICP fell by 0.2 pp to 3.3%. In the euro area as a whole, inflation fell by 0.3 pp to stand at 3.3% in Q1. Consequently the differential widened by 0.1 pp to 1.3 pp (see Chart 23). The widening of the inflation differential in services reflected the slowdown in these prices in the euro area. In the case of goods, the differential

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.

narrowed owing to the favourable behaviour of their prices across all components. The reduction was especially sharp in the case of energy industrial goods, since the slowdown in Spain was larger than in the euro area, with a negative differential since January last year. According to the leading indicator of the HICP, inflation rose by 0.1 pp in April to 3.5%, while it held steady in the euro area, with a further widening of the differential.

Finally, the producer price index accelerated again in March, resuming the upward path it followed during 2004, which it abandoned temporarily in early 2005. Its twelve-month growth rate stood at 5.1% that month, as against 4.9% in the previous month and 5.2% on average in 2004 Q4. The rise stemmed from energy producer prices, whose twelve-month rate reached 13.1% in March and, to a lesser extent, from a certain acceleration in the producer prices of capital goods. By contrast, the producer prices of consumer goods and intermediate goods slowed. The differential vis-à-vis the growth of producer prices in the euro area fell to 0.8 pp in February, the latest figure available, as against 1.5 pp at the end of last year (see Chart 23). Among the other price indicators, the index of prices for farm produce behaved moderately in

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2004	Percentage change 2004/2003	Initial Budget 2005	Percentage change 2005/2004	Outturn 2004 JAN-MAR	Outturn 2005 JAN-MAR	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	115,270	5.1	117,592	2.0	27,259	31,019	13.8
Direct taxes	58,668	3.8	63,689	8.6	10,138	12,466	23.0
Personal income tax	30,405	-7.4	33,703	10.8	9,513	11,091	16.6
Corporate income tax	26,019	18.7	27,901	7.2	115	854	--
Other (a)	2,244	26.5	2,085	-7.1	510	520	2.0
Indirect taxes	41,350	5.8	43,051	4.1	13,179	15,638	18.7
VAT	29,108	7.3	30,015	3.1	10,394	12,683	22.0
Excise duties	9,751	-0.4	10,413	6.8	2,203	2,289	3.9
Other (b)	2,491	14.9	2,623	5.3	582	666	14.5
Other net revenue	15,252	8.5	10,852	-28.9	3,942	2,915	-26.1
2 EXPENDITURE	114,743	0.8	124,527	8.5	29,556	34,030	15.1
Wages and salaries	19,488	5.6	20,447	4.9	4,371	4,507	3.1
Goods and services	3,510	17.2	2,905	-17.2	965	813	-15.8
Interest payments	16,760	-15.3	19,293	15.1	6,003	8,209	36.7
Current transfers	61,006	5.0	63,565	4.2	14,531	16,426	13.0
Contingency fund	…	…	…	…	…	…	…
Investment	7,104	-5.7	8,841	24.5	2,012	2,455	22.0
Capital transfers	6,875	-0.9	6,986	1.6	1,673	1,621	-3.1
3 CASH-BASIS BALANCE (3 = 1 – 2)	527	…	-6,935	…	-2,297	-3,011	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Resources	115,683	4.6	118,145	2.1	26,771	30,168	12.7
Uses	125,546	11.6	121,538	-3.2	25,690	27,028	5.2
NET LENDING (+) OR BORROWING (–)							
	-9,863	…	-3,392	…	1,081	3,140	…
(as a percentage of GDP)	-1.2		-0.4		0.1	0.4	

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.

recent months, while hotel prices decelerated in January and February, in a similar fashion to Q4 last year.

4.4 The State budget

The figures published for the State budget outturn in Q1, based on National Accounts methodology, show an improvement in the surplus, which rose from €1,081 million in 2004 Q1 to €3,140 million in 2005 Q1. This was a result of a 12.7% increase in resources and a 5.2% increase in uses.

These figures contrast with the outturn in cash-basis terms, according to which the State recorded a deficit of €3,011 million euro in 2005 Q1, as against the somewhat smaller deficit of €2,297 million in the same period a year earlier (see Table 3). The difference in the behaviour of the outturn according to these two methodologies was mainly a result of the adjustment arising from the different criteria for recording interest payments. It should be noted however that the figures for the first few months of the year are highly erratic and give little indication of the behaviour of the State budget in the coming months.

Under the cash-basis criterion revenue increased by 13.8% in Q1, owing to the strength of the main taxes, in sharp contrast to the budget projection of a 2% increase for the whole of 2005.

Direct tax receipts were boosted both by personal income tax, which rose by 16.6% (in particular, withholdings on earned income, which increased by 15.7%) in this period, and by corporate income tax[1] (in this case, partly due to the fall in rebates). VAT stepped up its growth rate with respect to Q4, to 22%. By contrast, excise duties, owing to the stagnation in hydrocarbon tax receipts as a result of a freeze in the rate of tax and moderation in consumption, posted weaker growth. The fall in the revenue items included under the heading other net revenue was a result of the sharp reductions in receipts from the Banco de España and autonomous agencies, as well as the decrease, of around 70%, in funds received from the European Union (although these transfers are highly erratic).

Meanwhile, cash-basis expenditure posted extraordinarily high growth compared with the budget projection, owing to interest payments and current transfers. In the first case, expenditure was determined by the public debt maturity calendar and by the effect of the assumption of RENFE debt by the State in 2004[2], although the latter was offset by lower expenditure on subsidies to the same corporation. As regards transfers, the sharp increase in GNP resource transfers to the European Union owing to their payment a month early should be noted. The growth rates of these two items can be expected to converge in the coming months on figures more in line with those budgeted. On the other hand, wages and salaries grew very moderately to March (3.1%), while goods and services declined notably. By contrast, investment increased by 22%, partly on account of expenditure associated with the conventional railway network, which the State has been responsible for managing since January 2005. However, this higher expenditure was offset by a decline in the capital transfers that were made to RENFE under the previous railway model.

The information on the Social Security budget outturn relates to January, being that available from the System which is released with a relatively long lag. Contributions increased by 7.1% with respect to January 2004, a rate of growth similar to that posted at the end of 2004, although below the 8.9% increase projected in the budget, with respect to the previous year's budget. The number of persons registered for Social Security increased by 2.8% in 2005 Q1, the same rate as in 2004 as a whole. On the expenditure side, pensions rose by 6.7% in January, somewhat less than budgeted for the year as a whole. The number of contributory pensions continued to grow at very moderate rates (0.8% in Q1). Spending on unemployment benefit increased by 5.9% to February, as against an increase of 9.6% in 2004 as a whole. This slowdown was determined by the fall in registered unemployment of 1.4% in 2005 Q1, as against the 1.8% increase in 2004 as a whole. Conversely, the eligibility ratio stood at 75.9% in January 2005, significantly above the level at end-2004. As a result of these two opposing factors, the number of beneficiaries grew by 2.7% in January, as against 5.6% on average in 2003.

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

In the first month of 2005, the overall balance on current and capital account was a deficit of €3,719 million, up €3,086 million from a year earlier. This result is explained by the notable deterioration in the current account balance, whose deficit widened by €3,346 million, since the capital-account surplus was €260 million higher than in the same month of 2004. The adverse trend in the current account was basically a consequence of the further widening of the merchandise deficit, the notable decline in the current transfers surplus and, to a lesser extent, the deterioration in the income deficit, while the positive services balance improved somewhat (see Table 4).

1. This tax will not post relevant rates of change until the prepayment in April. **2.** This operation is linked to the restructuring of the railway system and had no effects on the cash-basis balance for 2004.

BALANCE OF PAYMENTS: SUMMARY (a) TABLE 4

EUR m

		JANUARY	
		2004	2005
CREDITS	Current account	20,173	20,599
	Goods	10,814	10,932
	Services	4,583	4,942
	Tourism	2,214	2,379
	Other services	2,369	2,563
	Income	1,563	1,800
	Current transfers	3,213	2,925
	Capital account	270	568
	Current + capital accounts	20,443	21,166
DEBITS	Current account	20,982	24,753
	Goods	13,803	15,607
	Services	3,291	3,511
	Tourism	632	784
	Other services	2,659	2,727
	Income	2,203	3,024
	Current transfers	1,685	2,612
	Capital account	95	132
	Current + capital accounts	21,077	24,885
BALANCES	Current account	-809	-4,155
	Goods	-2,989	-4,675
	Services	1,292	1,431
	Tourism	1,582	1,595
	Other services	-290	-164
	Income	-640	-1,223
	Current transfers	1,528	313
	Capital account	176	436
	Current + capital accounts	-633	-3,719

SOURCE: Banco de España.

a. Provisional data.

In January 2005, the trade deficit posted a deterioration of €1,686 million with respect to the same month of the previous year; the negative balance increased by 54.6% in year-on-year terms, with an intensification of the notable deterioration that characterised it during the previous year. The strength of real import flows in January, set against the decline in real external sales, together with the ongoing strong rise in the energy bill, in line with the climb in oil prices on international markets, were responsible for this significant widening of the trade deficit.

Turning to services, the positive balance in January 2005 was €1,431 million, 139 million euro higher than in the same month of 2004, a year-on-year increase of 10.8%. This improvement is explained by the timid increase of 0.8% in the tourism surplus and, to a greater extent, by the 43.5% correction in the non-tourism services deficit. Tourism credits rose by 7.4% in January, a step-up in the recovery that began in 2004 Q4, in line with the positive developments that month in foreign tourist arrivals and, especially, overnight hotel stays, although they displayed some weakness in February. Meanwhile, the notable buoyancy that had characterised tourism debits the previous year was extended into January, with an increase of 24.1%, against a background of notable appreciation of the euro.

The negative balance on the income account deteriorated by €584 million in January 2005 relative to the same month of the previous year, to stand at €1,223 million. Revenues rose by 15.1%, reflecting the momentum acquired by those received by resident financial institutions, while revenues received by the non-financial private sector fell notably. Payments, for their part, posted a larger rise, of 37.2%, largely attributable to the strength also displayed by those made by the financial sector.

The current transfers surplus stood at €313 million, in January 2005, a significant decline, of €1,215 million, relative to January 2004. Revenues fell by 9%, as a result of the decline in January in flows from the EU, both to the private sector under EAGGF-guarantee and to the public sector under the European Social Fund, partly affected by delays in the receipt of funds usually received at the beginning of the year (although there was a certain increase over the first quarter as a whole). Payments, on the other hand, rose by 55%, basically reflecting the notable increase in those to the Community under GNP resource and, to a lesser extent, VAT resource, although those made by the private sector also rose.

Finally, the capital account surplus stood at €436 million in January 2005, up €260 million from the same month of the previous year, which is explained by the increase in structural funds from the EU, especially those to the ERDF.

5 Financial developments

5.1 Overview

In 2005 Q1 money market interest rates held steady and long-term public debt yields underwent a decline in January and the first half of February, which was subsequently corrected. As a result, in March the average one-year Euribor was 2.3%, similar to that in December, while the average ten-year Spanish bond yield has risen so far in the year by 10 basis points (bp) to 3.7%. On available information to February, interest rates applied by credit institutions to the private sector did not vary significantly in general, and thus remain near to the lows recorded in 2003. Financing costs for firms issuing fixed-income securities remained low as a result of the low yields on public debt markets and of the persistence of risk premiums at around the moderate end-2004 levels (Chart 24).

Spanish and European stock market prices held on the upward course of the closing months of 2004, accompanied by continuing low volatility, although March saw some corrections, which continued in April against a backdrop of renewed pressure on oil prices. Hence at the end of Q1 the Madrid Stock Market General Index was up by 3.7% this year, which was a similar gain to that shown by the broad EuroStoxx (4.3%) in the same period and contrasted with the falls in the S&P 500 on the US stock markets (–2.6%).

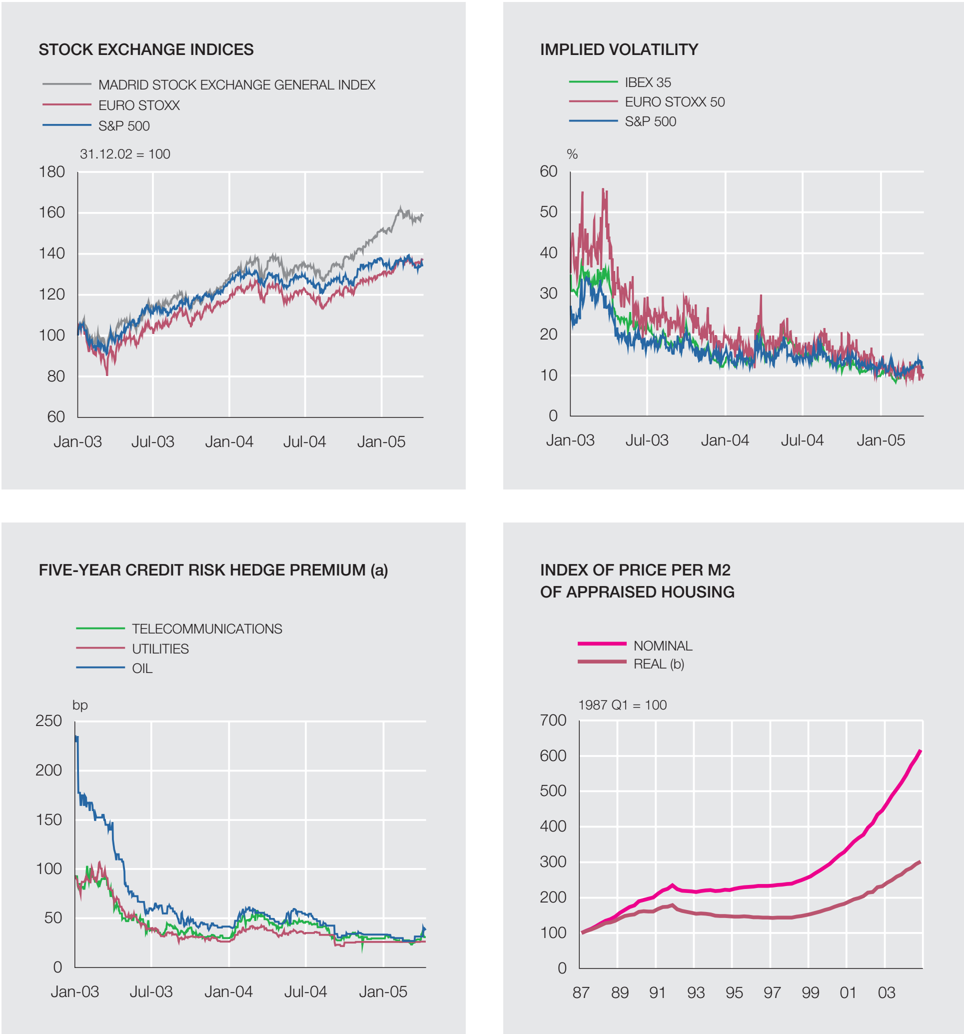
According to the latest data, house market prices have continued to rise quickly. Thus, on official housing ministry information for 2004 Q4, the year-on-year rate of expansion of house prices rose by 0.3 pp with respect to September and stood at 17.5%. This slight pick-up was seen in both small and medium-sized municipalities, while those of more than 500,000 inhabitants, which had been posting higher-than-average growth, showed a certain moderation.

Against this backdrop, in 2004 Q4 financing to the private sector continued to expand at brisk rates of around 16%. Analysis of the available information by component shows that the bulk of resources continued to be directed to the property sector, although the heightened buoyancy of credit to the industrial sector, in line with the recovery of productive investment, was significant. Provisional information on the early months of 2005 shows no sign of a slowdown in the funds borrowed by households and Spanish firms.

The indicators of financial pressure on households deteriorated further in 2004 Q4. According to the latest provisional information, this deterioration seems to have continued in the opening months of 2005. Thus the ratios of debt and financial burden to gross disposable income (GDI) again increased, while saving after debt service continued to decline and, according to the Financial Accounts, the sector's financial saving decreased in 2004 to a negative value equal to 0.1% of GDP (Table 5). By contrast, the rising path of household net wealth between October and December of that year continued, basically due to the rising prices of property, which is the main asset of most Spanish households (Box 5).

In the case of firms, the aggregate debt/profit ratio rose again between October and December 2004, while the interest burden held at the levels of the previous quarter. Provisional information on 2005 to date points to fresh increases in the first statistic and to a slight rise in the second, which, however, will still stand below the highs of recent periods. Meanwhile, the financing gap, which measures the net external funds needed to undertake gross capital formation and direct investment abroad, narrowed further in 2004 Q4. As to profits, the CBSO Quarterly Survey (CBQ) shows that in 2004 the favourable performance of ordinary net profit was fairly extensive to all sectors, though the recovery was more marked in the case of indus-

PRICE INDICATORS FOR VARIOUS ASSETS CHART 24



SOURCES: Bloomberg, Credit Trade and Banco de España.

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

try. This permitted the synthetic indicators of financial pressure on employment, and in particular on investment, to decrease despite the rise in debt.

The generous financing conditions and the increased household wealth have continued to underpin the buoyancy of consumption and residential investment and will foreseeably keep doing so in the coming months. Nevertheless, the degree of financial pressure on the sector is increasing and its performance is partly sustained by house price rises in excess of those indicated by their long-term determinants. The more time that passes before these trends start to be corrected, the more likely it is that the risks to the buoyancy of household expenditure noted in previous reports will end up manifesting themselves.

By contrast, although companies' debt is growing, their financial burden is lower than in recent periods. Moreover, the improvement in synthetic indicators of financial pressure, the healthier situation of large companies and the confirmation of the signs of recovery in industry suggest that the risks to investment spending and recruitment in this sector associated with its financial position are less significant.

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP	1999	2000	2001	2002	2003	2004			
					Q4	Q1	Q2	Q3	Q4
National economy	-1.0	-2.5	-2.2	-1.6	-2.1	-2.4	-3.0	-3.6	-4.2
Non-financial corporations and households and NPISHs	-0.3	-2.4	-3.4	-2.9	-4.0	-3.8	-4.7	-5.6	-4.8
Non-financial corporations	-2.3	-3.4	-4.5	-4.4	-4.5	-4.7	-5.4	-5.7	-4.7
Households and NPISHs	2.0	1.1	1.1	1.4	0.6	0.9	0.7	0.2	-0.1
Financial institutions	0.5	0.8	1.5	1.5	1.5	1.6	1.5	1.4	0.8
General government	-1.2	-0.9	-0.4	-0.1	0.4	-0.1	0.2	0.6	-0.3

SOURCE: Banco de España.

5.2 Households

Financing conditions for households were again generous in 2005 Q1. Thus in February the cost of credit for house purchase and for consumption and other purposes stood at 3.44% (5 bp more than in December 2004) and 5.84% (43 bp less), respectively. In the first case, the figure is somewhat above the 2004 low, while in the second it is the lowest rate in the series. Similarly, according to the latest Bank Lending Survey (EPB), institutions anticipated in this period a certain tightening of the terms on house purchase loans and a slight easing of those for consumer and other loans.

In 2004 Q4, household debt continued to increase at high rates of nearly 20% year-on-year. The bulk of lending continued to be for house finance, which expanded at rates above 23%, while consumer and other loans moderated and grew at around 11% with respect to the same period a year earlier, more than two percentage points below the September 2004 figure. Provisional information on the opening months of 2005 points to a certain pick-up in the funds received by households for property purchase, along with a moderate fall off in the growth of those for other purposes.

Financial investment by households (measured in cumulative terms over the last 12 months) continued to decelerate and at end-2004 represented 10.6% of GDP, down 0.6 pp on September 2004 (Table 6). The preference for more liquid and low-risk assets (cash, deposits, fixed-income securities and money market funds) was more marked, and their flow increased by 0.3 pp as a proportion of GDP, taking it to 5.7%. By contrast, both net subscriptions of capital market mutual fund shares and direct purchases of shares moderated to 1.9% and 0.4% of GDP, respectively. Finally, purchases of insurance (including pension funds) held at similar levels to those of the previous quarter.

Household liabilities continued to grow more quickly than the sector's income, so the debt/gross disposable income (GDI) ratio increased further and, at end-2004, exceeded 103%. This level is some distance from the euro area average (90%) and is approaching that of the United States (115%). Also, the associated financial burden held on a rising path and in the same period stood at nearly 14%, while saving after debt service saw further declines, dropping to values equal to just 0.5% of household GDI (Chart 25). Similarly, the Financial Accounts show that, in cumulative twelve-month terms, the balance of net financial transactions fell once again, posting a negative value equal to 0.1% of GDP. However, according to the Spanish Household Expenditure Survey, in the same period the percentage of households able to set aside money for saving rose to 40%. By contrast with this unfavourable trend in financial pres-

The analysis of the composition of household wealth is important because, among other things, it enables conclusions to be drawn on the wealth effects associated with changes in the prices of the various assets. Using the Spanish Survey of Household Finances[1], which takes 2002 as a reference, this Box analyses the structure of Spanish households' portfolio and how it varies with the level of wealth or income.

For this purpose, the table shows the percentage of households that own the different types of real estate and financial assets, distinguishing levels of income and of net wealth (top panel), and also the proportion of total gross wealth represented by each asset class (bottom panel). These data confirm Spanish households' strong preference for ownership over rental, since 82% of them own the home in which they live. Although this percentage grows with both income and wealth, it is very high even in the lower ranges of both variables.

As may be expected, in households with less resources in terms of income or net wealth, their main residence makes up the bulk of their real estate property wealth and, in turn, of their total wealth. As income and wealth rise, the value of the main residence accounts for a progressively smaller weight in net wealth, although largely at the expense of other real estate assets. Thus the relative importance of real estate property wealth remains at very high levels, in most cases

1. For more information on this survey, see Bover (2004), *The Spanish Survey of Household Finances (EFF)*: description and methods of the 2002 wave, Occasional Paper 0409, Banco de España.

THE COMPOSITION OF SPANISH HOUSEHOLD WEALTH. ANALYSIS BY INCOME AND WEALTH LEVEL

REAL AND FINANCIAL ASSETS HOLDINGS AND COMPOSITION OF THE GROSS WEALTH OF SPANISH HOUSEHOLDS BY INCOME AND WEALTH LEVEL

%

	Real assets			
	Main residence	Other real estate properties	Jewels, antiques and works of art	Businesses related to self-employment
A. Percentage of households owning the asset				
ALL HOUSEHOLDS	81.9	30.1	18.2	12.4
PERCENTILE OF INCOME				
Below 40	76.4	20.7	12.7	6.2
40 to 60	80.8	27.4	16.4	12.8
60 to 80	85.1	33.5	20.7	15.3
80 to 90	89.6	42.7	26.8	19.9
90 to 100	92.3	53.7	29.9	22.6
PERCENTILE OF NET WEALTH				
Below 50	66.6	12.7	14.6	5.0
50 to 75	97.6	31.9	17.4	12.1
75 to 90	97.3	53.0	21.2	20.6
90 to 100	96.4	78.4	33.6	37.8
B. Contribution of value of the various assets to gross wealth				
ALL HOUSEHOLDS	58.2	21.0	0.5	7.7
PERCENTILE OF INCOME				
Below 40	72.4	15.7	0.3	3.1
40 to 60	65.1	19.5	0.3	6.0
60 to 80	58.9	22.4	0.4	7.5
80 to 90	55.5	21.9	0.6	9.6
90 to 100	42.8	24.9	1.0	11.7
PERCENTILE OF NET WEALTH				
Below 50	80.3	7.5	0.5	1.7
50 to 75	77.3	11.4	0.3	2.7
75 to 90	63.3	20.8	0.5	4.9
90 to 100	36.2	31.7	0.7	14.3

SOURCE: Spanish Survey of Household Finances (EFF).

more than 75%. Only the wealthiest households exhibit lower figures, although they are still fairly high (near 70%).

The contribution of real estate assets other than the main residence is, in most population groups, higher than that of financial assets, reflecting Spanish households' marked preference for residential investment. This occurs even in households that have more resources and therefore greater possibilities of diversification.

Holdings of financial assets increase with both income and wealth (see top panel of the table), as occurs with real estate assets. Pension schemes are, after bank accounts, the most common assets. By contrast, the importance of fixed-income securities is fairly low (only 1.9% of households directly hold these assets and this percentage does not exceed 5% in any population group presented in the table). In any event, the small contribution of financial assets to household wealth is notable (12.6% for a representative household). Although the relative weight of financial assets tends to increase with both income and wealth, the rise is not large, and only for households in the extreme decile of the distribution does the weight exceed 15%. As might be expected, it is the latter who invest the highest proportion of their wealth in mutual funds and, above all, in shares and other equity, while the opposite occurs with bank accounts. Moreover, it can be seen that for a high percentage of households, the contribution of these latter instruments to the value of their financial portfolio exceeds 50%.

Taken as a whole, these results illustrate the high relative importance of real estate property assets (not just the main residence) in the portfolio of Spanish households. This is seen in all the population groups analysed. In addition, the percentage of total household assets represented by their real estate property wealth is one of the highest among the countries in the area and the weight of domestic residential investment in GDP is among the largest in the euro area.

Financial assets							
Bank accounts	Shares and other equity	Mutual funds	Fixed-income securities	Pension schemes	Other financial assets		
							A. Percentage of households owning the asset
98.2	12.5	7.2	1.9	24.1	4.5		ALL HOUSEHOLDS
							PERCENTILE OF INCOME
96.7	5.2	2.7	1.0	10.2	3.0		Below 40
98.7	8.9	5.4	2.2	22.0	4.6		40 to 60
99.3	14.9	9.5	2.3	30.5	4.3		60 to 80
99.4	19.3	11.9	2.6	39.1	5.3		80 to 90
99.8	37.1	19.9	3.4	55.6	9.9		90 to 100
							PERCENTILE OF NET WEALTH
97.3	4.1	2.1	0.7	12.6	3.6		Below 50
99.0	11.2	7.5	1.9	27.6	3.3		50 to 75
99.3	21.5	13.1	4.2	37.4	4.0		75 to 90
99.3	44.1	23.4	4.5	52.7	12.9		90 to 100
							B. Contribution of value of the various assets to gross wealth
5.0	3.3	1.2	0.3	2.2	0.6	100.0	ALL HOUSEHOLDS
							PERCENTILE OF INCOME
5.6	0.8	0.6	0.3	1.0	0.2	100.0	Below 40
5.2	1.1	0.7	0.3	1.2	0.6	100.0	40 to 60
5.2	1.7	1.2	0.4	1.9	0.4	100.0	60 to 80
5.0	2.3	1.4	0.3	2.9	0.6	100.0	80 to 90
4.3	8.4	2.0	0.2	3.7	1.0	100.0	90 to 100
							PERCENTILE OF NET WEALTH
7.1	0.5	0.4	0.1	1.3	0.5	100.0	Below 50
4.8	0.6	0.7	0.2	1.8	0.3	100.0	50 to 75
5.3	1.0	1.1	0.5	2.3	0.2	100.0	75 to 90
4.1	7.1	1.9	0.3	2.8	0.9	100.0	90 to 100

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

TABLE 6

% GDP

	2001	2002	2003	2004 Q2	2004 Q3	2004 Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	7.9	8.8	10.1	11.5	11.2	10.6
Cash and cash equivalents	1.2	3.7	4.4	4.6	4.2	4.1
Other deposits and fixed-income securities (a)	3.5	1.6	0.1	0.9	1.5	1.8
Shares and other equity (b)	-0.2	0.7	0.7	0.9	0.9	0.4
Mutual funds	0.8	0.2	2.3	2.2	1.6	1.4
FIAMM	1.3	0.7	0.6	0.0	-0.3	-0.2
FIM	-0.5	-0.5	1.8	2.2	2.0	1.7
Insurance technical reserves	2.7	2.6	1.9	1.9	2.0	1.9
Of which:						
Life assurance	1.5	1.5	0.7	0.7	0.8	0.6
Retirement	0.9	0.9	1.0	0.9	0.9	1.0
Other	0.0	-0.1	0.7	1.0	1.0	1.0
Financial transactions (liabilities)	6.8	7.3	9.5	10.8	11.0	10.7
Credit from resident financial institutions (c)	5.4	7.2	9.3	10.6	10.9	10.9
House purchase credit (c)	4.8	5.1	7.2	8.3	8.7	8.9
Consumer and other credit (c)	0.6	2.1	2.1	2.2	2.2	1.9
Other	1.4	0.1	0.1	0.2	0.1	-0.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	16.6	16.4	17.5	15.3	14.8	15.7
Cash and cash equivalents	1.7	1.7	0.9	1.3	1.2	1.0
Other deposits and fixed-income securities (a)	0.8	1.8	1.3	-0.3	-0.3	0.9
Shares and other equity	6.1	6.9	7.5	6.2	5.0	4.1
Of which:						
Vis-à-vis the rest of the world	4.6	5.2	4.6	3.6	3.0	2.6
Other	8.0	6.1	7.9	8.1	9.0	9.6
Financial transactions (liabilities)	21.1	20.8	22.1	20.7	20.6	20.4
Credit from resident financial institutions (c)	6.5	6.3	7.2	7.9	8.3	9.8
Foreign loans	4.0	3.0	2.8	2.3	1.5	0.3
Fixed-income securities (a)	0.0	-0.4	-0.2	0.0	0.0	0.0
Shares and other equity	5.2	5.9	4.9	3.5	3.5	2.6
Other	5.4	6.0	7.3	7.1	7.3	7.7
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (d)	15.4	14.3	15.9	16.7	16.5	16.0
Households and NPISHs	12.3	15.6	18.7	20.1	20.5	19.5
Non-financial corporations	17.8	13.3	13.9	14.1	13.5	13.4

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.

sure indicators, net wealth has increased again thanks to higher house prices and, to a lesser extent, rising stock market prices.

5.3 Non-financial corporations

Financing conditions for corporations remained generous in 2005 Q1, even more so than in late 2004. Thus the lending interest rates applied by financial institutions in February stood at 4.09% and 2.91% for transactions above and below €1 million, respectively, representing a decrease of 3 bp and 10 bp with respect to December 2004. At the same time, according to the latest EPB, the lending terms that institutions expect to offer in the same period will be less

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 25

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 use of disposable income account.
g. Gross saving less estimated debt repayments.

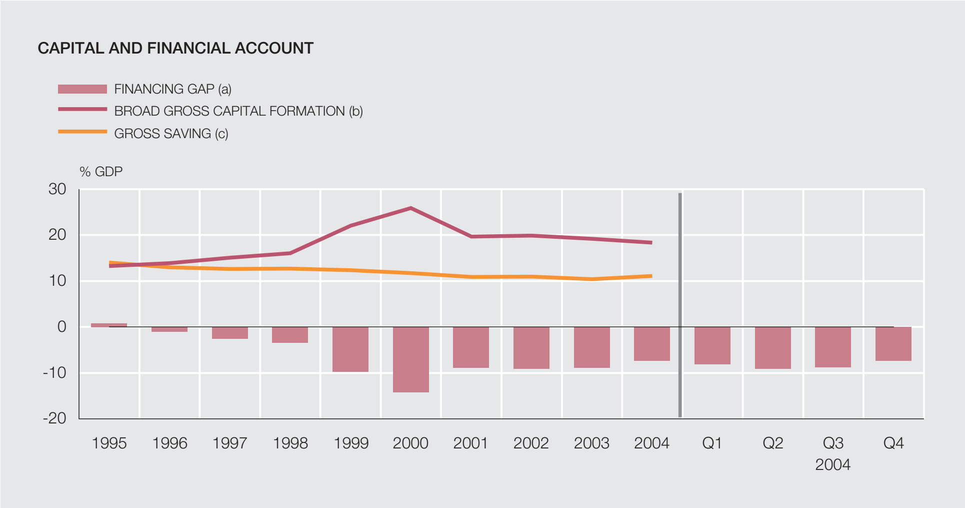
tight than in the previous quarter. Additionally, the cost of financing on the fixed-income markets held at low levels as a result of the low public-debt yields and the continued moderate values of credit risk premiums. Finally, the conditions for raising funds on equity markets improved somewhat as a result of the slight increase in market prices, against a background of low volatility.

On the latest Financial Accounts data, which relate to 2004 Q4, the volume of corporations' liabilities-side transactions moderated slightly (0.2 pp) to 20.4% of GDP in cumulative twelve-month terms (Table 6). As regards instruments, the relative importance of funds raised in the form of equity decreased, falling to just 2.6% of GDP, while the opposite was true of interest-bearing funds. As regards rates of change, the year-on-year growth of debt was somewhat higher than 13%, a similar level to that in September 2004, although provisional information on the opening months of 2005 points to a pick-up. The breakdown of this aggregate shows that in the fourth quarter of the year lending by resident institutions was the most dynamic

NON-FINANCIAL CORPORATIONS

Cumulative four-quarter data

CHART 26



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.

component, growing at 19% with respect the same period of 2003, a performance which contrasts with the sluggishness of foreign loans and of domestic fixed-income securities issuance.

In terms of production branches, funds for construction and property development continued to lead the expansion of lending by resident institutions in 2004 Q4, although the rates of change diminished by around 3 pp and 1 pp, respectively, with respect to those in September. In the other services, growth rates also moderated, standing below 11%. In line with the recovery in private productive investment, there was a notable pick-up in borrowing by the industrial sector, which grew by more than 5% in year-on-year terms.

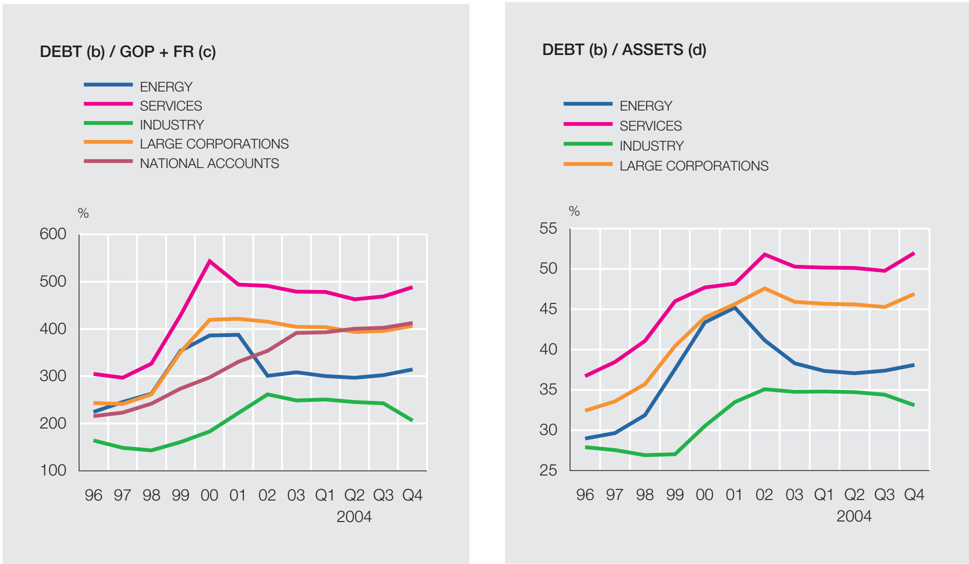
On the assets side, the volumes invested in financial products by corporations increased in cumulative twelve-month terms and in December 2004 stood at 15.7% of GDP, nearly 1 pp more than in September of the same year. Most notable as regards instruments was the increase in flows in the form of deposits and fixed-income securities and the decline in purchases of shares and other equity.

The movements in financial assets and liabilities in 2004 Q4 resulted in a decrease of 1 pp in the sector's net borrowing to 4.7% of GDP in cumulative twelve-month terms. The financing gap, which measures the net external funds needed to undertake gross capital formation and direct investment abroad, narrowed for the second quarter running, dropping to 7.2% of GDP (Chart 26). Nonetheless, it should be noted that these figures are affected by a one-off extraordinary restructuring of the railway sector in the final stretch of 2004, which reduced the sector's borrowing needs by approximately 0.7 pp of GDP.

The vigorous external borrowing by corporations in 2004 Q4 led to a fresh rise in the aggregate debt/profit ratio, although the declining trend in the cost of financing prevented the associated interest burden from increasing (Charts 27 and 28). On CBQ data, the behaviour of these

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a)

CHART 27

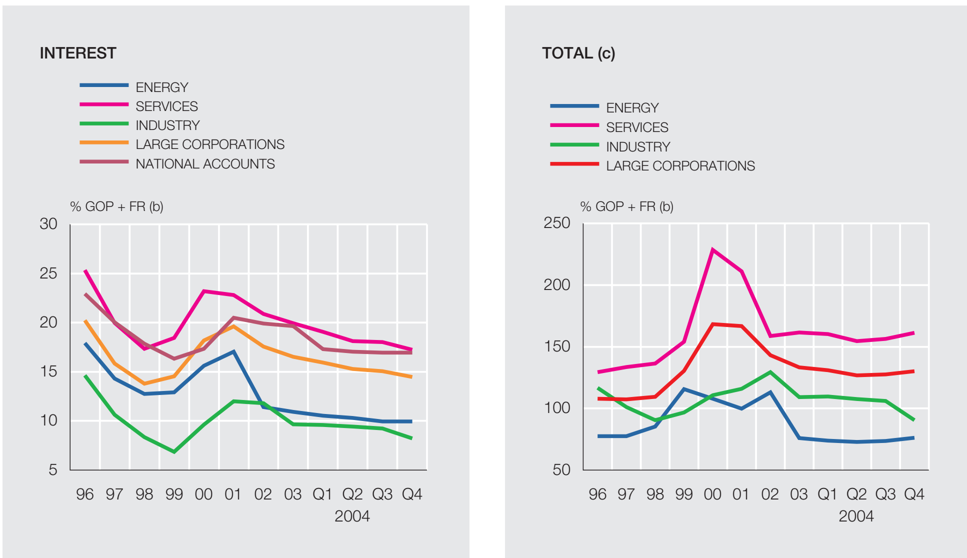


SOURCE: Banco de España.

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 28

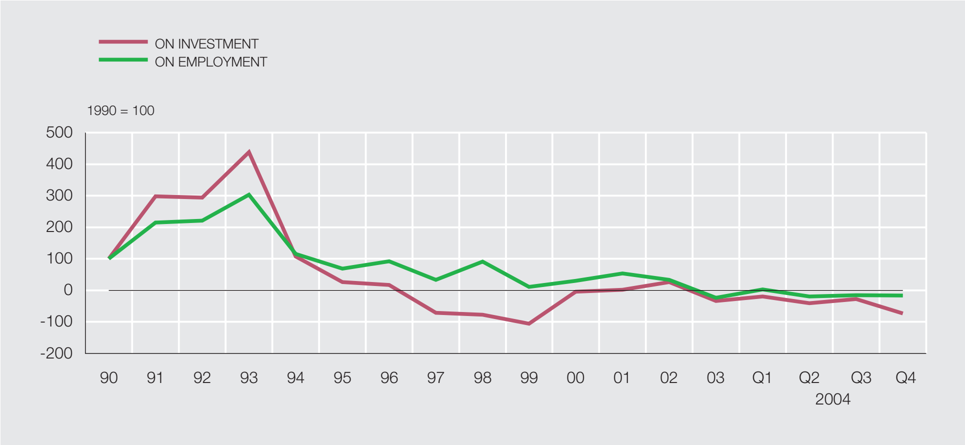


SOURCE: Banco de España.

a. All the series, except "National Accounts", are calculated with CBSO information. Up to 2003, 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 29

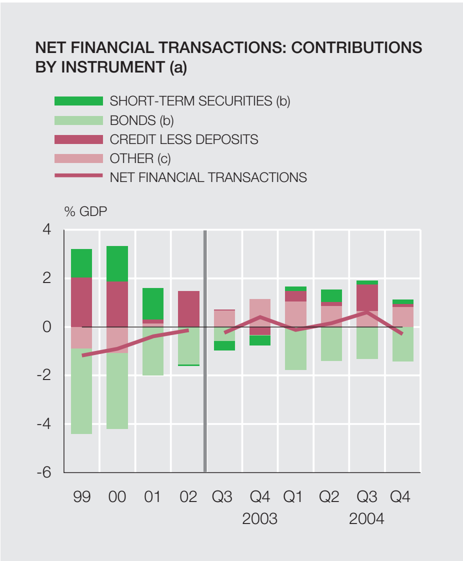


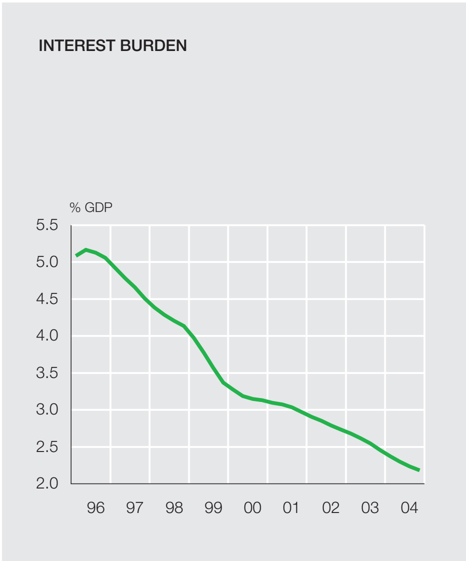
SOURCE: Banco de España.

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

GENERAL GOVERNMENT
Cumulative four-quarter data

CHART 30





SOURCE: Banco de España.

a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
b. Includes only liabilities transactions.
c. Includes unpaid accrued interest on bonds.

variables for reporting corporations, along with the improvement in profits, led to a decrease in the synthetic indicators of financial pressure on employment, and in particular on investment, to historically low levels, evidencing financial conditions conducive to hiring and capital spending decisions (Chart 29).

Finally, analysts' expectations about listed non-financial corporations' profits in the short and long term scarcely changed, and in 2005 Q1 they thus stood at relatively high levels in the first case and at above the low early-2004 figures in the second.

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP	2001	2002	2003	2004 Q2	2004 Q3	2004 Q4
NET FINANCIAL TRANSACTIONS	-2.2	-1.6	-2.1	-3.0	-3.6	-4.2
FINANCIAL TRANSACTIONS (ASSETS)	12.2	13.8	13.6	14.2	11.5	12.6
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-2.7	3.5	0.8	3.0	4.4	3.8
Securities other than shares	7.2	4.3	7.0	4.5	1.6	1.6
Of which:						
Credit institutions	2.0	0.5	3.7	3.3	0.7	1.0
Institutional investors (a)	5.4	3.3	3.3	1.3	0.8	0.4
Shares and other equity	5.1	5.4	4.8	5.5	4.1	5.8
Of which:						
Non-financial corporations	4.6	5.2	4.6	3.6	3.0	2.6
Institutional investors (a)	0.5	-0.1	1.2	1.7	1.3	1.1
Loans	2.5	0.6	1.0	1.1	1.4	1.4
FINANCIAL TRANSACTIONS (LIABILITIES)	14.4	15.4	15.7	17.1	15.1	16.9
Deposits	2.8	4.4	7.5	7.0	3.2	1.8
Securities other than shares	3.1	4.5	5.6	9.6	11.3	12.8
Financial institutions	1.5	3.2	6.7	8.2	9.0	10.0
Rest of resident sectors	1.6	1.2	-1.1	1.4	2.3	2.8
Shares and other equity	4.6	4.1	0.8	-1.6	-0.8	1.8
Of which:						
Non-financial corporations	4.1	3.5	0.9	-1.0	-0.2	0.6
Loans	4.3	3.4	3.2	2.8	2.2	1.4
Other, net (b)	-0.4	-1.1	-1.4	-0.7	-0.9	-0.9

SOURCE: Banco de España.

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

5.4 *General government*

The balance of the general government sector's net financial transactions in 2004 Q4 was negative, which, in cumulative twelve-month terms, contributed to reducing the sector's financial saving to –0.3% of GDP, nearly 1 pp below the figure three months earlier (Chart 30). However, as in the case of non-financial corporations, these changes were strongly influenced by the extraordinary restructuring of the railway sector. In the absence of this transaction, general government would have shown net lending (in cumulative four-quarter terms) of nearly 0.4% of GDP. The breakdown by instrument shows that in 2004 short-term securities were again redeemed, while the net issues of medium- and long-term debt were positive in an amount equal to 1.4% of GDP.

In 2004 Q4 the general government interest-burden indicator again decreased due to the lower cost of financing (Chart 30).

5.5 *The rest of the world*

The nation's net financial transactions in 2004 again showed a debit balance, this time amounting to 4.2% of GDP, up 0.6 pp on September of the same year (in cumulative four-quarter terms). This increase in the financial requirements of Spain's economy came about because the deterioration in the financial saving of households, financial institutions and general government could not be offset by the improvement in this item in the case of corporations (Table 5).

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

TABLE 8

% GDP	1999	2000	2001	2002	2003	2004
National economy	-29.6	-26.2	-27.0	-30.8	-38.2	-44.3
Non-financial corporations and households and NPISHs	-17.3	-9.4	-10.2	-11.6	-15.2	-13.8
Non-financial corporations	-24.1	-16.7	-17.6	-18.9	-23.0	-22.0
Households and NPISHs	6.8	7.3	7.4	7.3	7.8	8.2
Financial institutions	8.2	8.3	8.5	6.5	-0.7	-5.9
Credit institutions (b)	-7.5	-11.6	-13.9	-14.3	-22.2	-23.2
Institutional investors (c)	16.3	20.7	24.3	24.4	27.7	28.4
Other financial institutions	-0.6	-0.9	-1.8	-3.6	-6.3	-11.0
General government	-20.5	-25.1	-25.4	-25.7	-22.3	-24.6

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

The net acquisition of external assets by resident sectors in 2004 amounted to 12.6% of GDP, which represented an increase of more than 1 pp with respect to September 2004 in cumulative twelve-month terms (Table 7). However, this behaviour was uneven from one instrument to another. Specifically, flows in the form of cash and deposits decreased as a proportion of GDP, while the opposite occurred in the acquisition of equity securities. On provisional balance of payments information, direct investment abroad rose notably in 2004 (63%) with respect to 2003, while portfolio investment decreased by a similar percentage.

On the liabilities side of the Spanish economy vis-à-vis the rest of the world, net flows in 2004 amounted to 16.9% of GDP, up 1.8 pp on 2004 Q3, in cumulative twelve-month terms. This increase resulted from the heightened buoyancy of both fixed-income and equity securities and from the lower relative weight of the other items. On provisional balance of payments information, direct investment of non-residents in Spain in 2004 represented nearly one-third of that in 2003, while portfolio investment practically tripled.

Finally, on the available provisional information, the Spanish economy's debit position vis-à-vis the rest of the world increased in 2004 to 44.3% of GDP, up 6 pp on December 2003 (Table 8).

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