QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

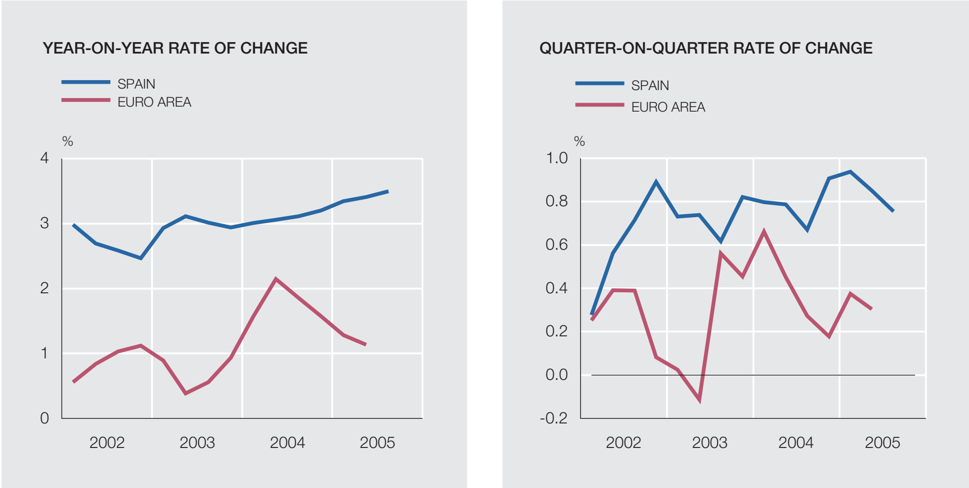
During the summer months developments in the Spanish economy unfolded against a very similar background to that marking the first half of the year. The external environment remained expansionary overall, accompanied by stability in the financial and foreign exchange markets, despite the substantial shocks continuing to affect the oil market. The euro area has remained far less buoyant than the other geographical regions. And this, combined with the relative containment of price increases, has allowed generous monetary and financial conditions to be maintained. From a domestic perspective, these conditions have continued to be conducive to the sustained growth of Spanish household and corporate spending, and it is estimated that domestic demand grew at a real rate of around 5% in Q3, compared with 5.6% the previous quarter. This slowdown will have been due, on one hand, to something of a downturn in the growth of consumption and, on the other, to the profile of investment in equipment. Despite having posted a high quarter-on-quarter increase, the year-on-year rate of this latter variable will have seen the base effect of its strong rise in 2004 Q3 stripped out. The behaviour of demand has given rise to a slowdown in imports, enabling the lower increase in domestic spending to be offset by a less negative contribution of net external demand.

There was thus something of a restructuring of growth in Q3, with a move towards a lower increase in domestic demand and a less negative contribution of the external sector, although the divergence between both magnitudes remains very marked and the underlying factors have scarcely altered. As a result of this adjustment, the year-on-year growth of GDP in real terms is estimated at 3.5%, somewhat higher than in Q2, although this signifies a slight easing of the quarter-on quarter rate of increase (see Chart 1). From the standpoint of value added, growth has continued to be based on construction and on services, a mix which explains, at least partly, the strong job-creation seen in this expansionary phase. Indeed, EPA (Labour Force Survey) data for Q3 confirm that the job-creation process has not lost momentum. There was a further rise in the inflation rate in Q3, reflecting the direct impact of dearer energy. As a result, the 12-month increase in the CPI stood at 3.7% in September, and the inflation differential with the euro area was 1.2 pp. The information available for October, relating to the HICP, points to a slight easing of the 12-month inflation rate to around 3.5%.

In August and September oil prices rose further, moving up to close to $70 per barrel. At the same time, a series of devastating storms hit the Gulf of Mexico head-on, jeopardising oil production and refining in the area. However, once the critical moments of these events were behind, the oil price resumed the – undoubtedly high – levels it had reached in July and speculative positions in this market diminished considerably. The impact of these increases on inflation rates continues to be confined, since it has scarcely passed through to underlying inflation and wage increases in the main economies remain moderate. Elsewhere, notwithstanding the effect on local activity in the areas affected, global activity and trade are sustaining very high rates of expansion, albeit lower than in 2004, without additional signs of deceleration being perceptible.

GDP growth in the United States fell off moderately in Q2 to an annualised rate of 3.3%, which would possibly have moved back up in Q3 were it not for the adverse impact of the hurricanes. The rate of inflation has risen, owing to dearer oil and refined product prices, but not that of underlying inflation. Despite that, the Federal Reserve is expected to further tighten its monetary policy stance with fresh rises in official rates. Nonetheless, long-term interest rates have scarcely increased. Among the Asian economies, the first half of the year was much better

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

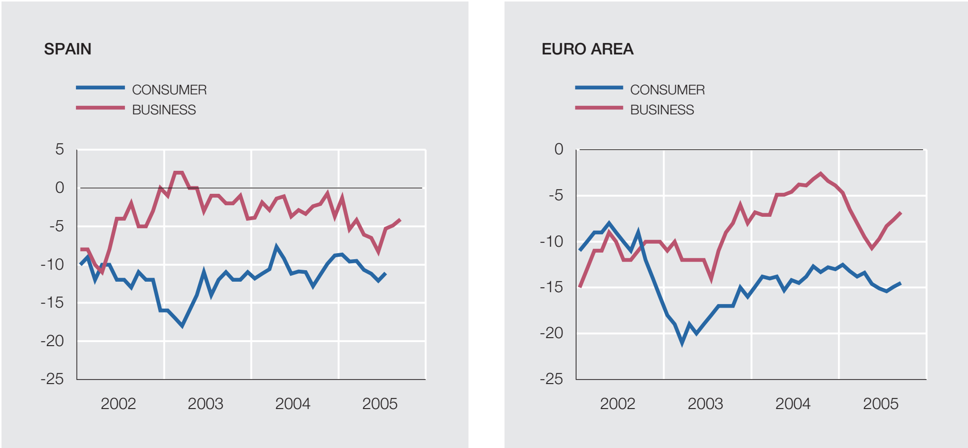
a. Seasonally adjusted series.

than expected in Japan, spurred on by the pick-up in private consumption and investment, while deflationary pressures appear to be beginning to wane. The main emerging economies in Asia, namely China and India, have maintained – and in India's case even built on – their high growth rates, as in the rest of the region. A recovery was also seen in Latin America as from 2005 Q1, with a sound performance by exports, as a result of which average year-on-year growth stands at 5%. Inflation is generally under control, which has provided for a fresh cut in interest rates in the main countries in the area. Lastly, among the European countries not belonging to the euro area, mention should be made of the United Kingdom. There, the signs of a slowdown in domestic demand and, in particular, in private consumption are clear and have been accompanied by a rapid moderation in house price increases. The Bank of England lowered interest rates in August and has held them constant since, in anticipation of potential inflationary pressures arising essentially from high oil prices.

Against this background, in which the world economy has continued to show a high capacity to absorb adverse shocks without these seriously affecting its course, the outlook for the coming quarters points to a mild slowdown in, or even to a maintenance of, the high tempo of global growth. Nonetheless, the downside risks to this scenario are similar to – or even sharper than – those identified before the summer. Oil prices remain at very high levels, while futures market prices scarcely incorporate a correction of these levels. The slow process of expanding extraction and refining capacity may prolong this period of high prices, thereby heightening the vulnerability of the world economy to new unforeseen events in this market or to adverse weather. Further, the current-account imbalances between the main economic areas and, in particular, the US deficit remain at similar levels, and a sharp adjustment entailing considerable exchange rate movements and substantial interest rate hikes cannot be ruled out.

In the euro area, the Eurostat figures released for Q2 showed GDP growth of 0.3% compared with the previous quarter, and of 1.1% in comparison with the same period in 2004. Both rates indicate a slowdown in activity, set against the greater buoyancy achieved at the start of the year, stemming from a more negative contribution of net external demand and, in particular, from the rise in imports. Under domestic demand, investment in construction performed better, while private consumption remained notably slack, as in the previous quarter. The activity and employment indicators for Q3, most of which are of a qualitative nature, have tended to

CONFIDENCE INDICATORS CHART 2



SOURCE: European Commission.

improve. That might presage something of a pick-up in GDP in this period, with a subsequent resumption of growth rates close to those at the start of the year (see Chart 2). From the expenditure standpoint, the recovery in Q3 was essentially centred on investment and on external demand, and only to a lesser extent on private consumption, the course of which is highly influenced by the scant growth in employment and the adverse impact of the energy price rises on household purchasing power. Other factors of uncertainty, relating mainly to consumer expectations about future income, have not abated either and have tended to restrict the increase in spending in recent years.

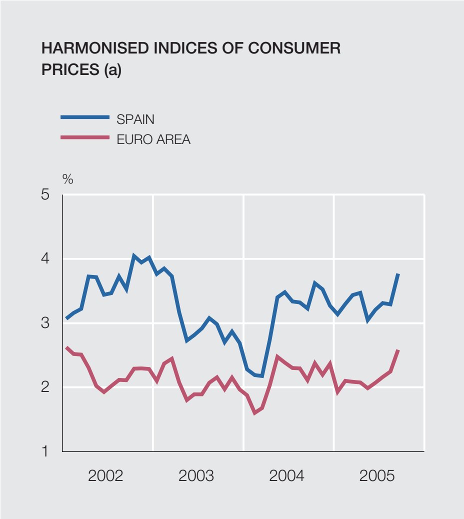
During Q3, the overall HICP for the euro area quickened, markedly so in September when it climbed to a 12-month rate of 2.6%, compared with an average increase of 2% in the first half of the year. This acceleration was the result of dearer energy, while underlying inflation – which excludes energy prices, among others – had evidenced a declining profile since the start of 2005, standing at around 1.4% in early summer, although it edged up to 1.5% in September (see Chart 3). The divergent course of both indices illustrates the fact that, despite the strong direct impact of higher oil prices on inflation, dearer oil is not yet significantly affecting either the general price formation process or the behaviour of wages, rises in which are moderate in most member countries.

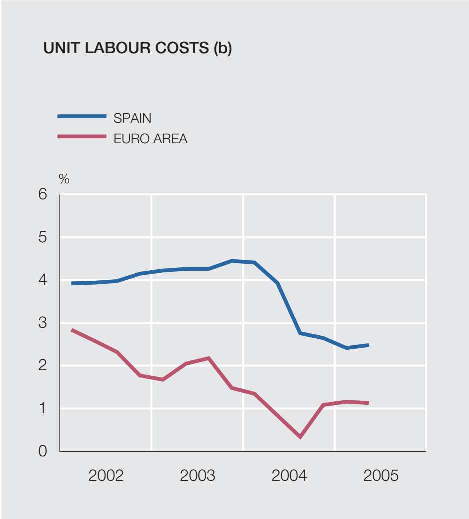
In these circumstances the ECB Governing Council has decided to hold its official interest rates unchanged, leaving the rate on its main refinancing operations at 2%. The Council believes that, for the moment, inflation developments are compatible with a gradual return to rates consistent with price stability. Nonetheless, it is acknowledged that the risk of the current price rises passing through to underlying inflation and to wage increases has heightened, whereby the Council will be extremely vigilant. Against this backdrop, the markets are discounting an increase in official interest rates in early 2006.

In any event, financial conditions in the euro area remain easy and uphold expectations that, in an expansionary external environment, the pace of growth will gradually pick up and move towards its potential rate. However, there is considerable uncertainty over this scenario. The risk of inflation and wage increases moving off paths compatible with price stability were already mentioned. And without a significant and lasting contribution of household spending, the sustainability of the recovery is not guaranteed. In this respect, economic policies should play an active role in promoting growth and dispelling the uncertainty that is denting household confidence.

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.

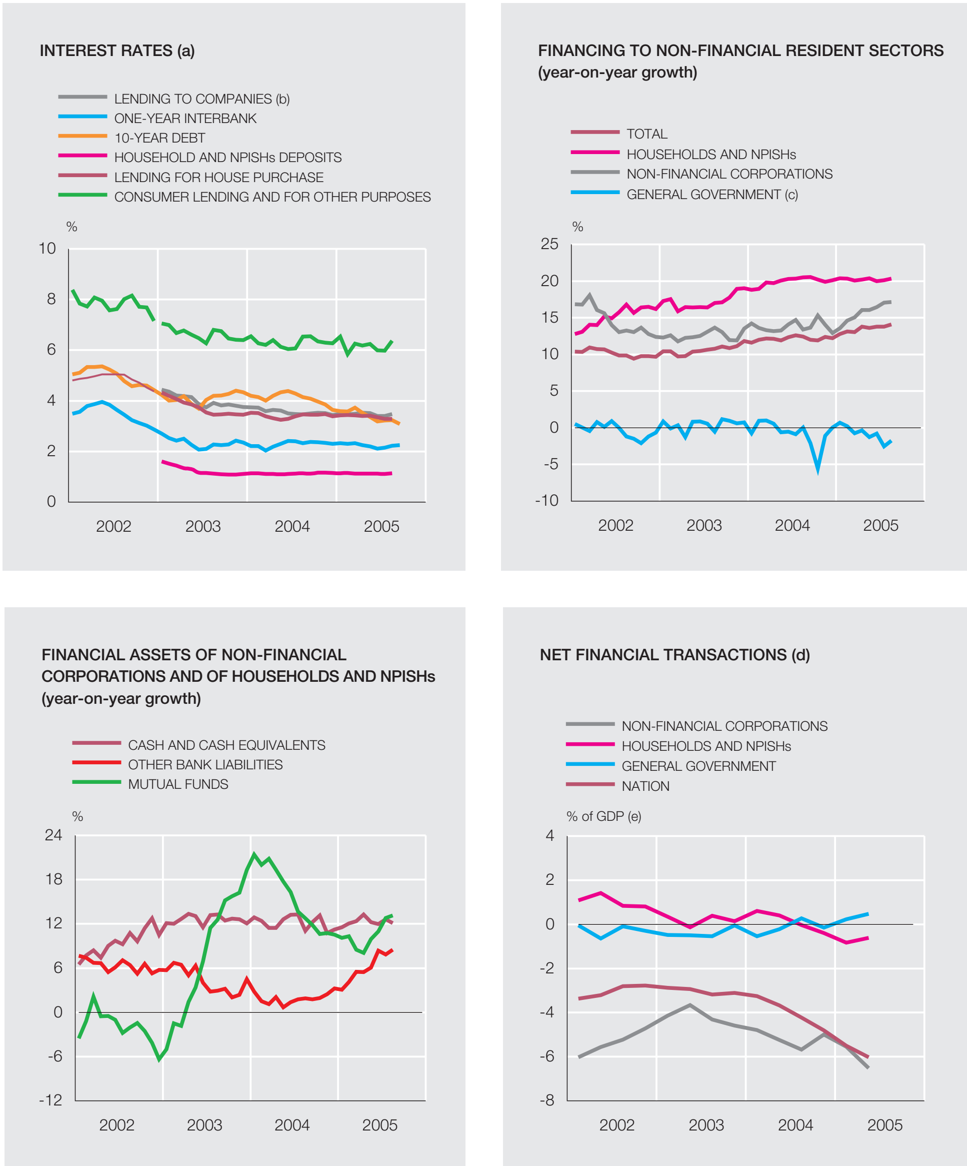
Sustaining sound public finances is an indispensable requirement for sustained growth, and the fiscal discipline framework in place in Europe should smooth the attainment of this objective, provided its credibility is retained. In this connection, the current public finances situation, with a significant number of EU countries running the risk of failing to comply with the rules set in the Stability and Growth Pact, is very delicate. Moreover, the application of structural reform programmes, which are being defined under the re-launching of the Lisbon agenda, is also pivotal for overcoming the obstacles to growth present in the European economies. This can only be addressed by means of a broad and well-defined programme of measures aimed at improving market workings, at promoting innovation and at increasing human and technological capital.

The Spanish economy continues to post very favourable results in terms of growth and employment creation, and the information received for Q3 has not altered this diagnosis. As indicated, real GDP is estimated to have grown by 3.5% year-on-year in this period, while employment, measured in terms of full-time equivalent jobs, continued to rise strongly at a rate of 3.2%. A certain turnaround in the trend of the main expenditure components was also discernible, since the buoyancy of domestic demand has begun to moderate, maintaining considerably high rates, while a strong deterioration in the contribution of the external sector points to a correction, although this has not sufficed to contain the increase in the nation's financing requirements.

Under domestic demand, the real rate of change of private consumption fell by several tenths of a point in Q3 after having grown at a rate of close to 5% since late 2004. Even so, it clearly continued to outpace the disposable income of households, whose purchasing power was adversely affected by dearer consumer prices during the summer; overall, the saving ratio has fallen again. The strength of consumption continues to be attributable to the effects on expenditure arising from the rise in wealth. These effects remain very substantial, since house price increases are holding at double-figure rates and stock market prices have risen significantly. The favourable financial conditions continue to underpin residential investment, which has scarcely slowed in relation to 2004 and which posted an increase of around 6% on the

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCE: Banco de España.

a. There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.
b. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
c. Consolidated financing: net of securities and loans that are general government assets.
d. Cumulative four-quarter data.
e. Spanish National Accounts, base year 2000.

latest QNA estimates (see Chart 4). In these circumstances, the growth rate of credit intended to finance house purchases continues to stand at around 24%, while the household debt ratio has reached a level close to 110% of disposable income. Households' lending capacity, moreover, remains in negative figures. That all makes for greater financial pressure on the sector, the main source of relief of which lies in the favourable trend of its total net wealth.

Turning to productive investment, its lower year-on-year growth in Q3, judging by the estimated trend for investment in equipment, does not so much reflect a contemporaneous weakening of expenditure as the stripping out of the strong increase it underwent a year earlier.

Among the determinants of investment, demand expectations are favourable, financial conditions very lax, as earlier mentioned, and corporate profitability high, according to data from the Banco de España CBQ survey. Nonetheless, the ongoing deterioration in the competitive position of companies in the most exposed sectors, in both their foreign and domestic markets, might also affect their investment plans. Moreover, the sector's indebtedness has continued to increase, further to expenditure picking up and the process of balance-sheet restructuring undertaken by the major business groups being concluded. As a result, the sector's borrowing requirements expressed as a percentage of GDP are high. The financial position of companies remains healthy, as confirmed by the main indicators available, although the ongoing increase in their liabilities raises their exposure to possible future rises in interest rates.

The contribution of net external demand to growth had turned very negative by late 2004. This remained the case throughout the first half of 2005, followed by an improvement in Q3. Goods exports left behind the declines recorded at the start of the year, although their subsequent recovery has not been as sharp as expected, given the buoyancy of world trade. Tourism, for its part, has recovered more clearly in 2005 to date, with tourist inflows posting a notable increase, especially in the summer months. Nonetheless, the increase in revenue continues to be held back by the progressive decline in spending per tourist. Compared with the moderate recovery in exports of goods and services, imports have grown sharply, largely as a result of the pick-up in investment in equipment, which is drawing mainly on imported products. As mentioned, the external imbalance continues to widen, in terms of the current account and of borrowing requirements. Undoubtedly, the higher growth rate of the Spanish economy compared with its euro area partners is contributing to the overall negative results of the external sector. But the losses in export share and growing import penetration show the additional influence of the deterioration in competitiveness, associated with the inflation and cost-growth differentials that have built up.

As earlier indicated, there have been no significant changes in the growth pattern of value added, which continues to be based on the expansion of activities high in employment generation but which are less capital-intensive. The EPA data for Q3 indicate that job creation remains very resilient, but continues to be concentrated in activities where productivity is relatively flat, such as construction and services, although a better performance in industry was also observed in the past quarter. Against this background of low productivity gains, labour costs per unit of output continued to post comparatively high increases. Wage settlements are anchored in the increases agreed upon in collective bargaining, which stand at around 3% (2.9% to August 2005), and here the effects of the wage indexation clauses must be taken into account, these having added more than 0.5 pp to this increase in 2005. Although these negotiated increases may subsequently be tempered by composition effects, arising from the fact that the new contracts have lower wage levels, the final result is an increase in unit labour costs that is excessive, compared with our competitors, and which restricts the expansion capacity of industries with export potential. In addition, the upturn in the inflation rate in the second half of this year will give rise to a new and significant effect in 2006, owing to the activation of the 2005 wage indexation clauses, hampering the desirable containment of cost increases.

In any event, cost differentials are only part of the factors underlying the persistent inflation differential maintained by the Spanish economy, whether vis-à-vis the euro area or a broader set of countries. In the past three months the Spanish inflation rate has increased by 0.6 pp, practically the same rise as that in the euro area, leaving the inflation differential at 1.2 pp in September. In Spain, too, the energy component has been chiefly responsible for the acceleration in prices, while underlying inflation has held relatively stable at around 2.5%. That said, this latter index shows widely differing behaviour between the prices of industrial products (excluding energy), which grew by 0.9% in September compared with the same month a year earlier, and services prices, which climbed by 3.7%. These differences are illustrative of the different degrees of competition in place in different markets and which also contribute to exacerbating the losses in competitiveness via the inflation differential.

In sum, the current economic situation highlights how important it is that the Spanish economy should tackle the factors underlying the ongoing build-up in losses in competitiveness. In this respect, the government has published and sent the National Reforms Programme (NRP) to the European Commission in compliance with the undertakings made by the European Council as part of the re-launching of the Lisbon agenda. The Programme provides a highly appropriate framework for structuring the responses needed in terms of medium and long-term policies that simultaneously promote employment and productivity growth, based on deeper market liberalisation and efficiency. The NRP sets objectives in terms of employment creation (the employment rate should stand at 66% in 2010) and of real convergence (per capita GDP should be the same as the EU-25 average level that same year), which should be attained with significant gains in efficiency. As the Banco de España has indicated on numerous occasions, the achievement of these objectives is crucial for shoring up the growth foundations of the Spanish economy.

Fiscal policy is the other pillar which should underpin not only the drive to sustain macroeconomic stability, but also those economic policy strands aimed at promoting growth and productivity. With respect to macroeconomic stability, it is important that fiscal policy should help bring the pace of demand towards more sustainable rates in the medium term. In this respect, the provisional close of public finances in 2005 contained in the draft State budget – which points to a surplus of at least 0.1% of GDP – might, if it finally stands around this figure, signify a slowdown in the fiscal drive made this year, given the continuing buoyancy of tax revenue.

Budgetary programming for 2006 estimates a surplus on the general government account of 0.2% of GDP and a substantial cut in the public debt ratio, which might fall to around 45%, comfortably meeting the requirements of the SGP. Nonetheless, the limited improvement in the public finances balance would not provide for an additional improvement in the primary structural surplus, whereby it would not correct the expansionary stance of 2005 or contribute to regulating the behaviour of domestic demand. In this setting, any increase in revenue above the forecasts included in the budget should be harnessed firmly to bringing about a higher surplus and to achieving a fiscal policy stance more in step with the requirements arising from the Spanish economy's current situation.

2 External environment of the euro area

The price of oil and other fuels continued to be the focus of international markets' attention during 2005 Q3. Oil, refined products and natural gas prices all reached new highs (an all-time high in the case of crude oil) in September and early October. Conducive to this rise in prices was the increase in outbreaks of geopolitical and labour turbulence in major oil producing areas during July and August, but key triggers were the Katrina and Rita hurricanes in late August and mid-September ($67 per barrel of Brent). The oil price progressively resumed pre-Katrina levels in mid-October, although the grinding to a halt of part of US gas production and oil refining meant that the price of these products held strongly above those seen at the start of Q3. The prices of futures contracts at over six years stabilised from early August in a range of between $55-60 per barrel of WTI crude.

On the financial markets, developments in Q3 were very favourable. That said, in recent weeks market expectations about further rises in US official interest rates have heightened, owing to the increase in inflationary risks. Judging by what the markets have discounted, the federal funds target rate might be standing at 4.25% at the end of the year and there would be further rises in 2006. Long-term interest rates rose moderately in October to a level at over 4.45%, compared with 4.25% the previous month. That did not change the slope of the yield curve, which remains very flat. At the same time, low-grade corporate bond spreads have increased and there have been declines on the main stock markets. The dollar retained a proportion of the gains it posted the previous month against the euro and it appreciated further against the Japanese yen. The sound behaviour of the emerging financial markets continued and even heightened during the quarter, against a background of extensive global liquidity and sound economic fundamentals. Nonetheless, in the first half of October, and as on the developed markets, there was a generalised correction on stock exchanges and in sovereign spreads.

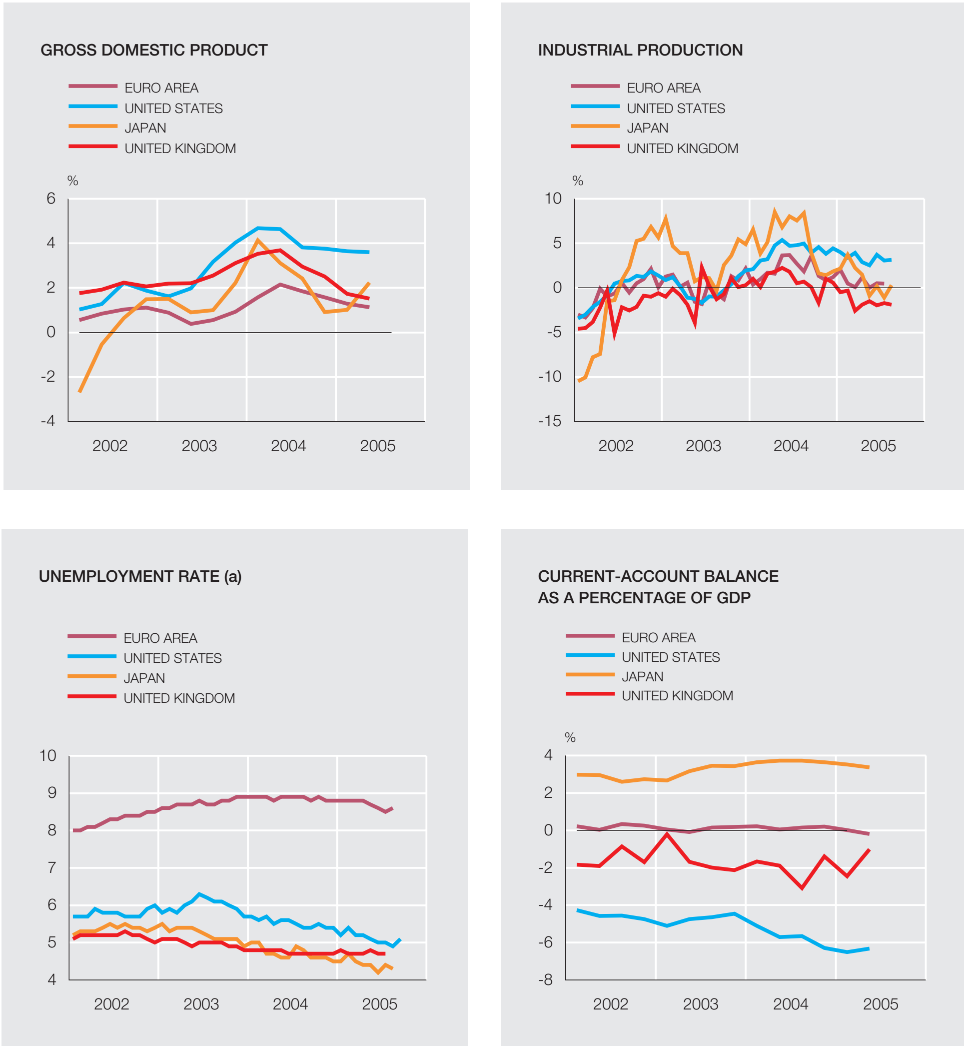
US GDP quickened in Q3 in relation to Q2 (to an annualised quarterly rate of 3.8%, from 3.3%). Domestic demand quickened once more (from 2.1% to 3.5% in annualised quarterly terms) and the contribution of the external sector turned positive again, albeit considerably down on Q2.

Exports slowed sharply in relation to Q2 and the growth of business investment also eased. Although the initial indicators for Q3 (retail sales, orders for durables, employment) point to robust growth, the hurricanes considerably upset the outlook. Consumer confidence and the services ISM index fell, as did employment in September, interrupting its rising path. Even so, the positive ISM manufacturing index and retail sales figures, and the favourable opinion reflected by the *Beige Book*, suggest the impact of the hurricanes will be short-lived. Set against this, supply frictions and the strong rise in energy prices necessarily increase inflationary risks, as can be perceived in the September CPI, which posted a year-on-year rate of 4.7%, the highest since June 1991. Notwithstanding, underlying inflation dipped from 2.1% to 2%. Turning to the external sector, the trade deficit edged up again in August from $58 billion to $59 billion, owing largely to increased exports in volume terms and energy product prices.

In Japan, real GDP was more buoyant than expected in Q2, growing at a year-on-year rate of 2.1%, against 1.3% in Q1, which is equivalent to 3.3% in annualised quarterly terms. At the root of this robustness was the favourable trend of investment and private consumption, which offset the slightly negative contribution of external demand. The partial indicators for Q3 confirm this favourable pattern, albeit suggesting slightly less momentum. On the supply side, in-

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

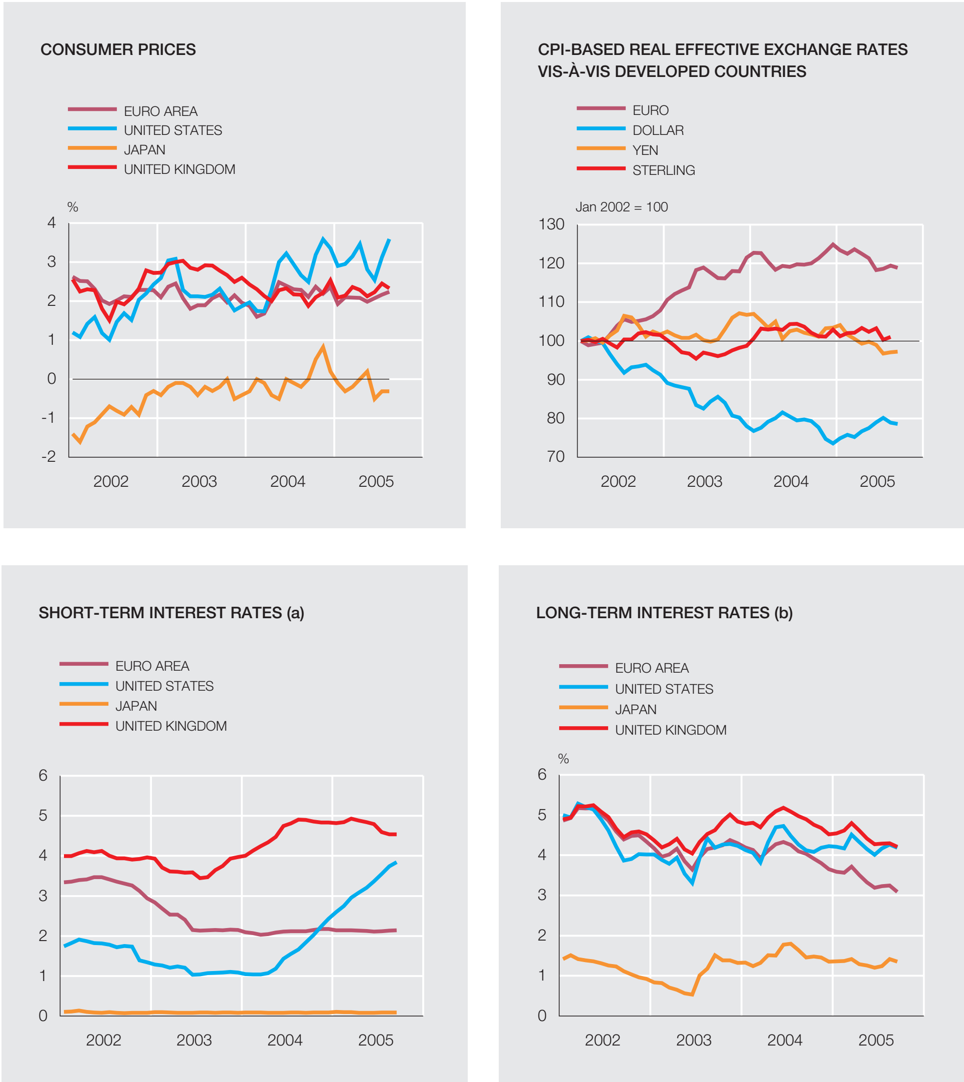
a. Percentage of the labour force.

dustrial production, the synthetic indices of activity and orders for machinery advanced significantly during the quarter, despite the slip in the first two variables in July. Moreover, confidence at the major manufacturing firms (according to the Tankan survey) improved. As regards the labour market, there was a notable increase in employment despite it flattening in September. The unemployment rate dipped slightly (24.3%), while employee compensation fell. On the demand side, retail sales slowed in the final months, while the external sector picked up in August, as exports showed renewed momentum. Finally, the deflationary pressures on consumer prices declined slightly in Q3, making for a slight increase in the underlying rate from –0.2% year-on-year in June to –0.1% in September. The prospect of deflation disappearing during 2006 is the backdrop to the current debate within the bank of Japan on a possible change in monetary policy, towards a lesser expansion and different policy implementation.

In the United Kingdom, year-on-year GDP slowed in Q2 from 1.7% to 1.5%, holding at 2% in annualised quarterly terms. Domestic demand decelerated from 2.5% to 1.3% compared with the same period a year earlier, with an even sharper slowdown in private consumption from

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

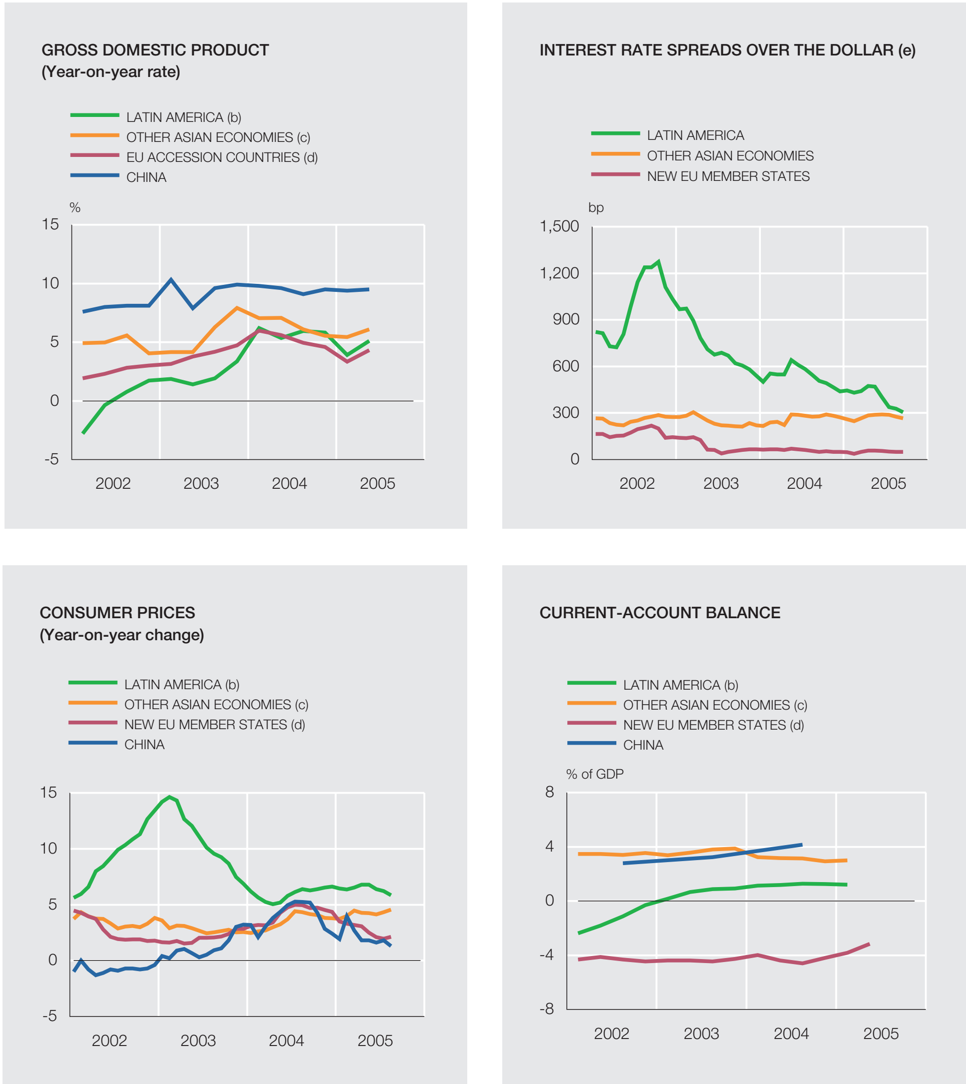
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

2.7% to 1.5%. The improvement in net external demand, based on an increase in exports, partly countered the slowdown in domestic demand. The year-on-year increase in GDP in Q3 was 1.6% (as it also was in annualised quarterly terms). The latest indicators point to a relative weakening compared with Q2, albeit with signs of a slight pick-up in manufacturing. The 12–month growth rate of consumer prices, measured by the harmonised index, rose from 2.4% in August to 2.5%, despite which the Bank of England decided to keep its intervention rate unchanged, following the cut in August.

In the new EU member states, GDP growth rebounded in 2005 Q2 thanks to the improved external balance and, in most cases, to the fresh momentum of domestic demand. The indicators for Q3 show signs that activity in the region is holding up well. Further, inflation has continued to ease in recent months, thanks to the favourable trend of food prices and, in most of the countries with flexible exchange rates, to the appreciation of their currencies. That said, inflation has risen slightly recently owing to the increase in energy prices. The sound behaviour of prices has enabled official interest rates to continue being cut in some countries, such as

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy. Based on IMF information.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines 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.

Hungary or Poland. The public finances situation in the year to date allows for optimism regarding compliance with the fiscal targets for 2005, with the notable exception of Hungary, which has recently revised its deficit targets for this and next year substantially upwards. Finally, negotiations for the accession of Turkey and Croatia to the EU formally began on 3 October.

In China the economy remains very buoyant, and Chinese real GDP grew by 9.4% in Q3 compared with the same period a year earlier, 0.1 pp down on Q2. Regarding the indicators of activity for the quarter, industrial production and retail sales eased slightly in August, but investment in fixed assets remained very strong. Following the rise in oil prices, imports picked up forcefully in August and in September to the year-on-year rate of 23.5%, while exports slowed in September from their high growth rate in August to 25.9% year-on-year. Turning to inflation, the fall in food prices was conducive to CPI-based inflation dipping to a 12-month rate of 0.9 % in September, 0.5 pp down on July. Further to the reform announced on 21 July, the central bank widened the daily fluctuation bands of the currencies other than the dollar to which the renminbi is pegged to 3%. Despite the reform, the exchange rate has held virtually stable and the central bank's foreign reserves grew at a year-on-year rate of over 50% in August, rising to $753 billion, 46% of GDP.

Following a hesitant start to the year, activity in Latin America firmed in Q2, and year-on-year growth of 5% was posted for the region as a whole. The indicators for Q3 tend to support the pick-up in activity. Although the negative contribution of external demand to growth is increasing, the behaviour of exports remains very sound, with growth rates of over 20% in the area as a whole. Against this background, the inflation figures in most countries, and particularly in Brazil and Mexico, were favourable, which was conducive to the onset of interest-rate cuts in both countries, and also in Colombia. Conversely, Chile continued to gradually tighten its monetary policy, while the annual rate of inflation exceeded 10% in Argentina in September, highlighting the difficulties the authorities face in controlling inflationary pressures.

3 The euro area and the monetary policy of the European Central Bank

The euro area does not appear to have been capable of benefiting fully from the relatively favourable situation of the world economy in 2005. Over the last three quarters growth in the area has remained modest, holding at a similar rate to that recorded in 2004 Q4, and the growth outlook for the year as a whole has been progressively scaled back as the months have transpired. The latest forecasts point to modest average growth in GDP of around 1.3% in 2005, reflecting the notable sluggishness of internal demand. The information available for 2005 Q3 suggests a slightly more optimistic short-term outlook than before the summer, which would be compatible with a central scenario in which economic activity – supported by the favourable monetary and financial conditions in place and the relatively sharp growth of world trade – would pick up sustainedly and promptly to a rate of around 2%, in line with growth potential. Nonetheless, the hesitant trajectory of some economic indicators, particularly those relating to private consumption, coupled with continuing very high oil prices, add uncertainty to the foreseeable course of activity and mean that this scenario is still subject to fundamentally downside risks.

As regards inflation, the euro area HICP has felt the impact of the strong increase in the prices of crude oil, which rose to an all-time high in nominal terms in the summer, and in petrol. These prices were particularly affected by the refining capacity constraints in the wake of the two hurricanes in the United States. As a result, the 12-month inflation rate stood at 2.6% in September, driven essentially by the energy component. While there are clearly temporary factors at play in this acceleration, inflation in the area is unlikely to fall below 2% until well into 2006. Looking further ahead, in the medium run, there is still no clear evidence that underlying inflationary pressures are looming, as evidenced by the moderate course of the most stable component of consumer prices and of wages (see Box 1). The foreseeable holding at high levels of energy prices (where there is still no sign of a reduction in the short term), the possible pass-through to other components of the overall index to a greater extent than hitherto observed and the possible second-round effects on wages look to be the main – and this time upside – risks for inflation in the euro area.

Against this background, the ECB governing Council decided that official interest rates, which have held unchanged at 2% since June 2003, still remain appropriate. However, and in step with the markets' interpretation of the latest data, the ECB indicated that the risks for inflation in the area have been increasing, which requires a reinforcement of monetary policy vigilance. Turning to fiscal policies, it cannot be ruled out that certain Member States will not meet this year the budgetary commitments established under the excessive deficit procedure and the Stability and Growth Pact. That would entail a fresh challenge to upholding the credibility of the fiscal discipline framework in force in the euro area. Finally, it is to be expected that national reform plans, which should be unveiled by the member countries under the new Lisbon strategy this autumn, will contain, at core, labour market policies enabling headway in rates of employment to be made (see Box 2).

3.1 Economic developments

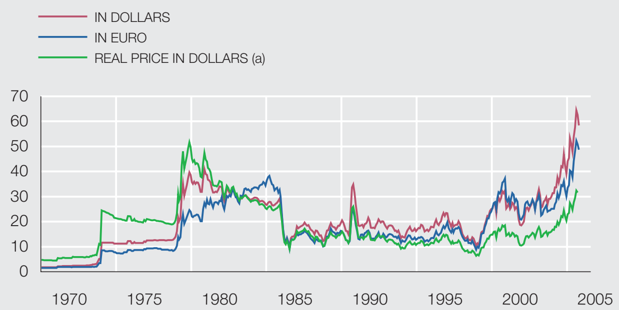
On euro area National Accounts figures for 2005 Q2, GDP grew by 0.3% in quarter-on-quarter terms, 0.1 pp down on Q1 (see Table 1). Compared with the same period a year earlier, GDP has slowed to 1.1%. As regards the composition of growth, the contribution of internal demand, excluding inventories, to the increase in GDP rose to 0.3 pp thanks to the pick-up in gross fixed capital formation, insofar as the improvement in investment in construction offset the loss of momentum of equipment. The sluggishness of private consumption continued, with

EFFECTS OF THE RISE IN OIL PRICES ON THE EURO AREA

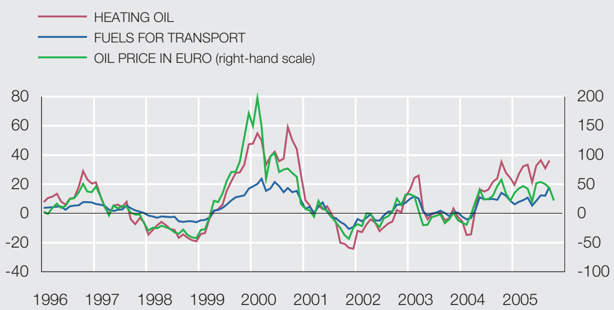
Since May 2003 oil prices have moved on a sharply rising path, up to an all-time high of close to $67 dollars in the case of a barrel of Brent (see panel 1). In real terms, however, the prices observed in the recent period have been some way off those reached in the early eighties, although they have shown a marked growing profile throughout 2005. Behind this climb are widely differing factors, including the vigour of the demand for energy in the emerging countries, such as China and India, political tension in the Middle East and, more recently, the effects of hurricanes Katrina and Rita in the Gulf of Mexico, which have damaged oil refining and production capacity in the United States. Against this background, this Box analyses the extent to which the increase in the energy bill is passing through to prices and wages in the euro area.

As can be seen in panel 2, the oil price rises have had a direct effect on the energy component of the HICP. In 2005 to date, heating oil prices have been growing at an average year-on-year rate of 30%, and fuels for transport have done so at an average rate of 10.1%. Moreover, the rise in crude oil prices has not only affected the items most closely linked to oil. Energy substitutes, such as gas and, to a lesser extent, electricity, have also experienced higher growth rates (see panel 3). This acceleration in energy prices accounts for 1.2 pp of the increase in the HICP recorded between May 2003 and September 2005 (which amounted to 0.8 pp). The growth of energy prices also contributes 1.2 pp to the current inflation rate, which stood at 2.6% in September.

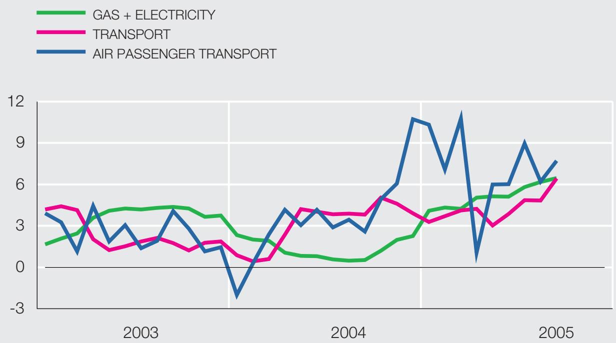
1. OIL PRICE



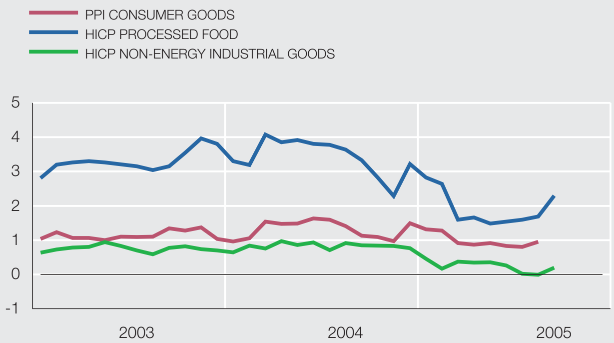
2. ENERGY COMPONENT (b)



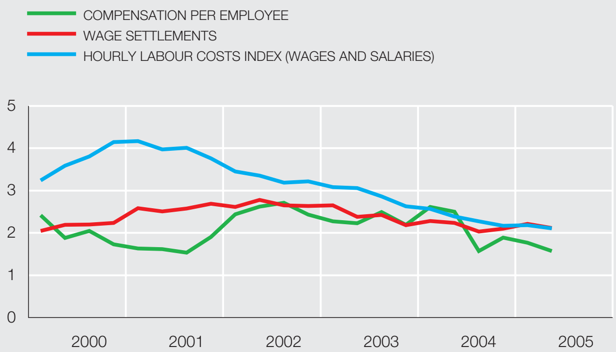
3. INDIRECT EFFECTS (b)



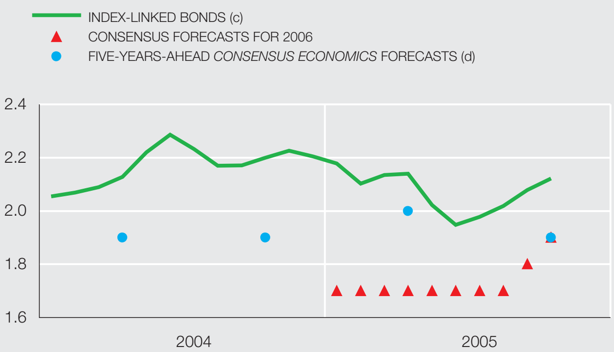
4. INDIRECT EFFECTS (cont'd) (b)



5. WAGES (b)



6. INFLATION EXPECTATIONS



SOURCES: EUROSTAT, OECD and *Consensus Economics Forecasts.*

a. Deflated by the US CPI.
b. Year-on-year rate of change.
c. Expected inflation is derived from French index-linked bonds maturing in 2012.
d. The long-term *Consensus* forecasts are only published in April and October.

However, despite the undeniable direct effects on the above-mentioned items, the impact of the rising oil prices is not so perceptible in other HICP components which, given the indirect effects stemming from the rise in the price of an important factor of production such as oil (and its derivatives), might also be expected to reflect the hike in the price of crude oil. Only the items related to transport within the services component have reflected these inflationary pressures, as can be seen in panel 3. The remaining components have behaved moderately. The annual average growth rate of the prices of processed food and of non-energy industrial goods is down in 2005 on that recorded in 2004 (see panel 4). This moderation, in any event, corresponds to the course shown by the producer prices of consumer goods, whose average growth in the year to date has been only 1%, 0.3 pp down on 2004.

Finally, it is particularly worth studying the appearance of so-called second-round effects, i.e. the possibility that the rise in oil prices may have been incorporated into inflation expectations, and hence into wage negotiations, which might generate a price-wage spiral. So far, the evidence available does not appear to corroborate this hypothesis. The growth of the negotiated wages indicator has been notably stable since early 2004 (see panel 5), as has the labour costs index. Moreover, compensation per employee continues to grow at a very moderate pace, which has not exceeded a year-on-year rate of 2% over the past four quarters (1.6% in 2005 Q2).

It would be worth enquiring into the factors that may have contributed to this limited response by inflation rates to the climb in crude oil prices. In the case of the euro area, one of the salient factors has been the sluggishness of economic activity in the reference period. The slackness of internal demand may have obliged producers to restrict the growth of their prices, despite higher production costs. Moreover, the stagnation of the labour market in recent years has made for an absence of second-round effects. Conceivably, the credibility obtained by the European monetary authority in combating inflation has been conducive to containing inflation expectations and, therefore, wage growth.

Nonetheless, oil prices remain at very high levels, with much uncertainty surrounding future oil production capacity, given the insufficient investment in this industry in recent years. Accordingly, further rises cannot be ruled out, adding to which will be the additional pressure imposed by refining capacity constraints on the prices of derivative products. Since June a slight rising trend has been observed in some inflation expectations indicators (see panel 6). This means close monitoring of inflation developments in the short-term and of their possible impact on the forthcoming wage negotiation rounds is necessary, since the risk of second-round effects ultimately emerging persists. To date, the weakness of the euro area economy has moderated the transmission of energy price increases, but if the crude oil price holds at its current high level for any length of time, there is a risk that the likely pick-up in activity in the area will fan inflationary pressures.

a meagre figure of 0.1%, and the rate of expansion of government consumption also held at 0.4%. The contribution of net external demand was negative (of the order of 0.1 pp) as a result of the greater recovery in imports than in exports. Finally, stockbuilding contributed 0.1 pp to GDP growth (see Chart 8).

The National Accounts country-by-country breakdown shows that the growth of the two economies with most weight in the area was virtually zero, while in Italy and Spain the expansion of GDP was relatively high. In Germany, the stagnation of GDP was due to the persistent weakness of private consumption, which fell off once again, and to the deterioration of net external demand, as a result of the lesser momentum of exports and import buoyancy. By contrast, gross fixed capital formation posted a positive rate of change after two consecutive quarters of contraction. In France, GDP slowed to 0.1%, owing to the negative growth of private consumption and of gross fixed capital formation, which fell in relation to Q1. Both imports and, above all, exports quickened notably, meaning that the negative contribution of the external balance declined. Italy, by contrast, which grew 0.7%, recovered from its technical recession thanks to the rise in all domestic demand components and in exports. Only stockbuilding detracted from output. Finally, GDP in Spain increased by 0.9%, the same as in the two previous quarters. The buoyancy of output was attributable to dynamic consumption and investment, while the net external balance subtracted almost 1 pp from growth.

Across the different branches of production, value added in the euro area economy grew in Q2 by 0.4%, unchanged on Q1. As regards sectors, construction posted a positive growth rate

The recent publication of the European Labour Force Survey, which includes the data for 2004, offers the opportunity for an updated evaluation of labour market developments in the area from a medium- and long-term perspective and, in particular, an assessment of the progress made in meeting the Lisbon Agenda targets.

The March 2000 European Summit in Lisbon defined a strategic objective consisting of turning the EU into “the world’s most competitive and dynamic knowledge-based economy”. For this to happen, stepping up the degree of utilisation of the labour factor is an essential ingredient. Acknowledging this, the Lisbon Summit and that held a year later in Stockholm chose to set a series of targets in terms of the rates of employment of various population groups. One such target was for the employment rate for individuals of working age in the EU to stand at 67% in 2005 and at 70% in 2010. In the case of the female population, the aim is for this variable to rise to 57% and 60%, respectively, by each of these dates, while for the over-55s a target of 50% has been set for the end of the decade.

In the specific case of the euro area countries, progress towards these targets has been modest and uneven. In the case of the female population, a simple extrapolation to the future of the headway made to date reveals that the target for the end of the decade appears feasible. Conversely, the pace of increase of the employment rate in the case of older workers and of the population of working age as a whole does not appear to be consistent with the attainment of the targets set for 2010.

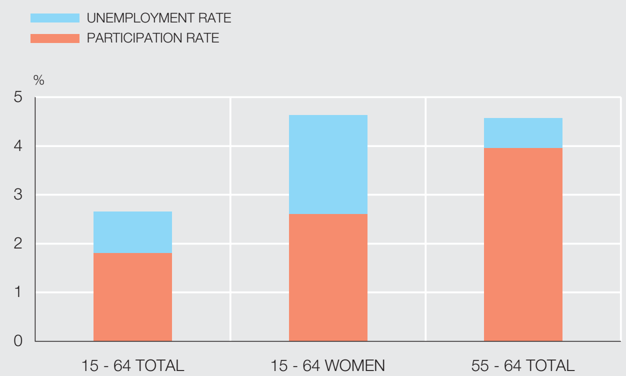
The rate of employment of a population group reaches a figure that is all the greater the higher the proportion of the population in this group that participates actively in the labour market (i.e. the participation rate) and the lower the proportion of those who participate in the market but cannot find a job (unemployment rate). As can be seen, the contribution of the increase in the participation rate to the rise in employment rates in each of the three groups for which targets have been set has been substantial. However, although the fall in the unemployment rate has also helped in all cases in progress towards these targets, only in the case of women has the contribution made by this component been on a substantial scale.

Furthermore, the survey data reveal that employment rates are all the greater the higher the level of education attained. In particular, this is

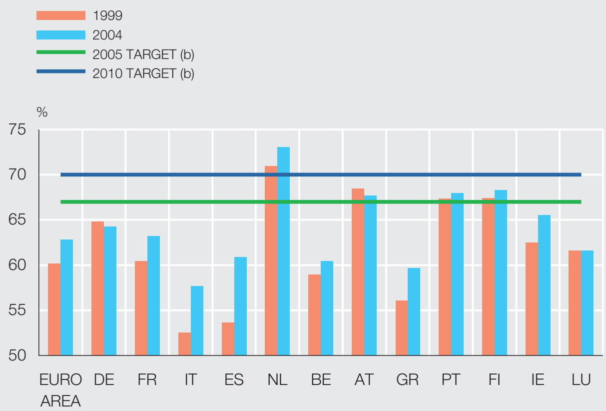
1. RATES OF EMPLOYMENT, PARTICIPATION AND UNEMPLOYMENT IN THE EURO AREA (a)

	1999	2000	2001	2002	2003	2004	2005 (b)	2010 (b)
TOTAL: 15-64-YEAR-OLDS								
Rate of employment	60.2	61.3	62.1	62.4	62.6	62.8	67.0	70.0
Participation rate	67.1	67.5	67.5	68.1	68.6	69.1		
Unemployment rate	10.4	9.2	8.1	8.4	8.8	9.1		
WOMEN: 15-64-YEAR OLDS								
Rate of employment	49.8	51.2	52.2	52.9	53.6	54.3	57.0	60.0
Participation rate	57.1	57.7	57.9	58.7	59.7	60.5		
Unemployment rate	24.3	21.4	18.8	19.5	20.3	20.8		
TOTAL: 15-64-YEAR-OLDS								
Rate of employment	33.7	34.2	34.7	36.1	37.8	38.4		50.0
Participation rate	37.3	37.3	37.5	38.8	40.8	41.6		
Unemployment rate	9.4	8.4	7.4	7.0	7.3	7.8		

CONTRIBUTIONS TO CHANGES IN THE EMPLOYMENT RATE: 1999-2004



3. TOTAL EMPLOYMENT RATE: 15-64-YEAR-OLDS



SOURCE: European Commision.

a. The equation linking the three variables is the following: employment rate = participation rates * (1–unemployment rate).
b. Lisbon Agenda targets for the EU 15.

associated with more intense participation in the labour market and with a lower unemployment rate. That shows the importance of improved training, both in the stage prior to the start of a working life and during it, in raising employment rates in the area.

Country by country, and since the implementation of the agenda, the employment rate of the whole of the population of working age has increased across the board. The only exceptions are Germany and Austria, where the negative contribution arising from the increase in unemployment rates could not be countered by the rise in participation rates. At the other end of the spectrum, the proportion of people employed has increased most substantially (by more than 5 pp) over the past five years in Spain and Italy, this being due in similar proportions to the contributions of the participation and unemployment rates.

The population pockets in which the room for an increase in employment rates is greater have been correctly identified in the so-called Integrated Guidelines package approved last July by ECOFIN for the period 2005-2008. Along with other economic policy recommendations, the package contains a series of employment policy guidelines aimed at removing the obstacles hampering swifter progress towards the Lisbon and Stockholm targets. For instance, in the case of older workers, the text urges Member States to adopt the necessary measures to encourage the prolongation of working life and to lessen the incentives offered by tax and welfare benefit arrangements for premature access to early retirement. As regards the female labour force, the provision of services for childminding and the care of dependent persons is promoted so as to help reconcile family and working life. Finally, the pursuit of initiatives enabling youth unemployment rates to be reduced is advocated.

The guidelines also emphasise the need to introduce measures that increase the adaptability of labour market participants to the constant changes in the economic environment. The growing pace of change requires the implementation of mechanisms that make for the readier occupational adaptability and regional mobility of workers, along with the adaptation of workplaces to the new technologies. In particular, wide-ranging measures to reform the legislation on employment protection, to provide continuing training and to promote new businesses are required. More generally, in terms of educational policies, the guidelines advocate better identification of the skills required at each point in time by the labour market and the establishment of extensive continuing training strategies.

Finally, the Member States are advised to implement policies aimed at supporting the incorporation into the labour market of the underprivileged, through mechanisms such as improved job-search assistance or the provision of specific training.

after contracting in Q1. By contrast, industry and services slowed, albeit moderately. Turning to the labour market, employment increased by 0.2%, a similar rate to that seen in the previous quarters, meaning an unchanged rate of increase of 0.7% in year-on-year terms. Against a background of slightly slowing GDP, this entailed lower growth in apparent labour productivity. Nonetheless, the quarter saw the continuing moderate growth of unit labour costs, which proved lower than the increase in the GDP deflator, meaning that business margins widened further (see Chart 11).

The latest information on the course of indicators in Q3 signals a slight improvement in the rate of increase of GDP compared with that witnessed in Q2. As regards the supply-side indicators, the industrial production index (excluding construction) grew by 0.8% in the July-August period compared with Q2, and all the qualitative indicators of activity increased on the previous quarter. The European Commission's business confidence and construction indices, together with the Reuters Manufacturing PMI (Purchasing Managers' Index), improved significantly, placing the latter at a level of over 50, consistent with an expansion of activity (see Chart 9). The indicators of activity in the services branch – that of the European Commission and the PMI – posted an appreciable increase in the same period (see Table 1). As to employment, the survey-based indicators also showed something of an improvement in Q3 in industry, and to a greater extent in construction and services (see Chart 10). Finally, the unemployment rate stood at 8.6% in August, somewhat down on that posted at the beginning of the year.

On the demand side, the indicators available do not yet reflect a resolute rebound in consumption in Q3, although they are consistent with a moderate increase in investment. While retail sales in July and August were on average above the level for Q2 and new car registrations

EURO AREA ECONOMIC INDICATORS TABLE 1

	2004				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP								
Year-on-year growth	1.6	2.1	1.9	1.6	1.3	1.1		
Quarter-on-quarter growth	0.7	0.5	0.3	0.2	0.4	0.3		
European Commission forecasts (c)							(0.2 ; 0.6)	(0.4 ; 0.8)
IPI (d)	1.1	2.9	2.5	1.1	0.9	0.7	*1.5*	
Economic sentiment	98.6	99.8	100.6	100.9	99.0	96.3	98.0	
Industrial confidence	-7.0	-5.0	-3.7	-3.7	-6.7	-10.3	-7.7	
Manufacturing PMI	52.8	54.4	53.9	51.4	51.4	49.3	51.0	
Services confidence	11.3	11.7	12.0	11.0	10.7	9.0	10.7	
Services PMI	56.0	55.2	54.4	52.9	53.1	53.1	53.8	
Unemployment rate	8.9	8.9	8.9	8.8	8.8	8.7	*8.6*	
Consumer confidence	-14.3	-14.3	-14.0	-13.0	-13.3	-14.3	-15.0	
HICP (d) (e)	1.7	2.4	2.1	2.4	2.1	2.1	2.6	
PPI (d) (e)	0.4	2.4	3.3	3.6	4.2	4.0	*4.0*	
Oil price in USD (e)	33.8	35.3	43.3	39.7	53.3	54.0	62.6	58.4
Loans to the private sector (d) (e)	5.4	6.1	6.5	7.2	7.5	8.0	8.6	
Euro area ten-year bond yield	4.2	4.4	4.2	3.8	3.7	3.4	3.3	3.3
US-euro area ten-year bond spread	-0.11	0.28	0.14	0.36	0.67	0.80	0.98	1.18
Dollar/euro exchange rate (e)	1.222	1.216	1.241	1.362	1.296	1.209	1.204	1.195
Appreciation/Depreciation of the euro (e)	-3.2	-3.8	-1.7	7.8	-4.8	-11.2	-11.6	-12.3
Dow Jones EURO STOXX Broad index (e)	1.9	3.7	1.5	9.9	4.3	8.9	17.7	12.3

SOURCES: Eurostat, ECB and Banco de España.

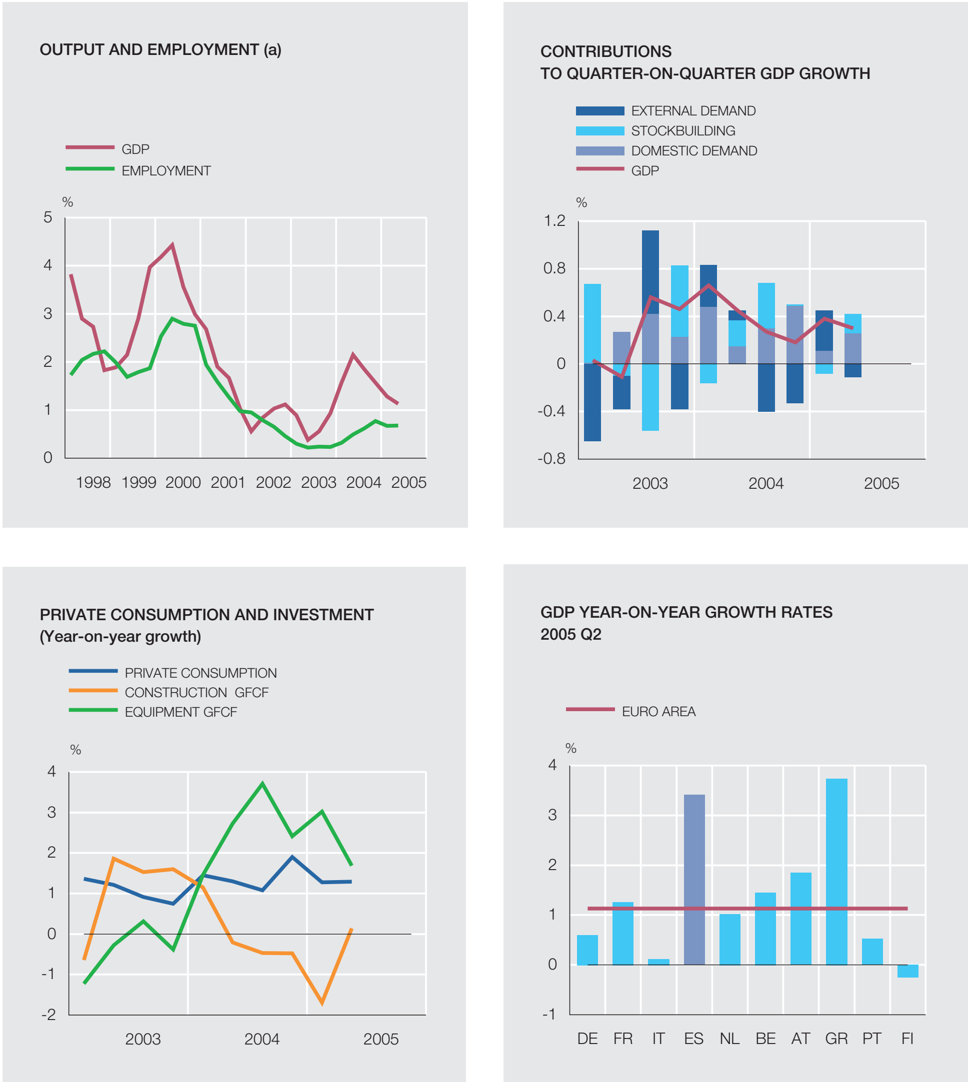
a. The information in italics does not cover a full quarter.
b. Information available up to 19 October 2005.
c. Quarter-on-quarter growth forecasts.
d. Year-on-year growth.
e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

increased, the confidence indicators relating to consumption trended negatively in this period. In particular, consumer confidence has held stable since May at a level below its historical average. With regard to the investment indicators, employers improved their assessment of industrial orders and the degree of capacity utilisation rose slightly. Export data from the balance of payments in July and August point to the continuing buoyancy of this variable. The quarterly indicator of export expectations compiled by the EC held stable in the summer months and the monthly indicator of the assessment of foreign orders increased. Finally, drawing on the business confidence survey, the assessment of stock levels coincided in the quarter with the related historical average, which would suggest a virtually zero contribution of inventories to output.

In sum, the information available on activity in the euro area in Q3 appears to suggest a maintenance or slight improvement in the growth rate of GDP. That would be in line with the European Commission's estimate, which places the increase in output in Q3 in a range of 0.2% to 0.6% (see Table 1). Nonetheless, uncertainty remains about the future course of consumption, in which the momentum of external demand and improved business confidence have yet to translate into greater employment creation and where the strong rise in energy product prices is eroding households' spending capacity.

The inflation indicators reflected the effects of dearer energy over the summer. The HICP showed a 12-month growth rate of 2.6% in September, 0.5 pp up on June and due essentially to the greater contribution of the energy component. Food prices also quickened during

EURO AREA NATIONAL ACCOUNTS CHART 8



SOURCES: Eurostat and national statistics.

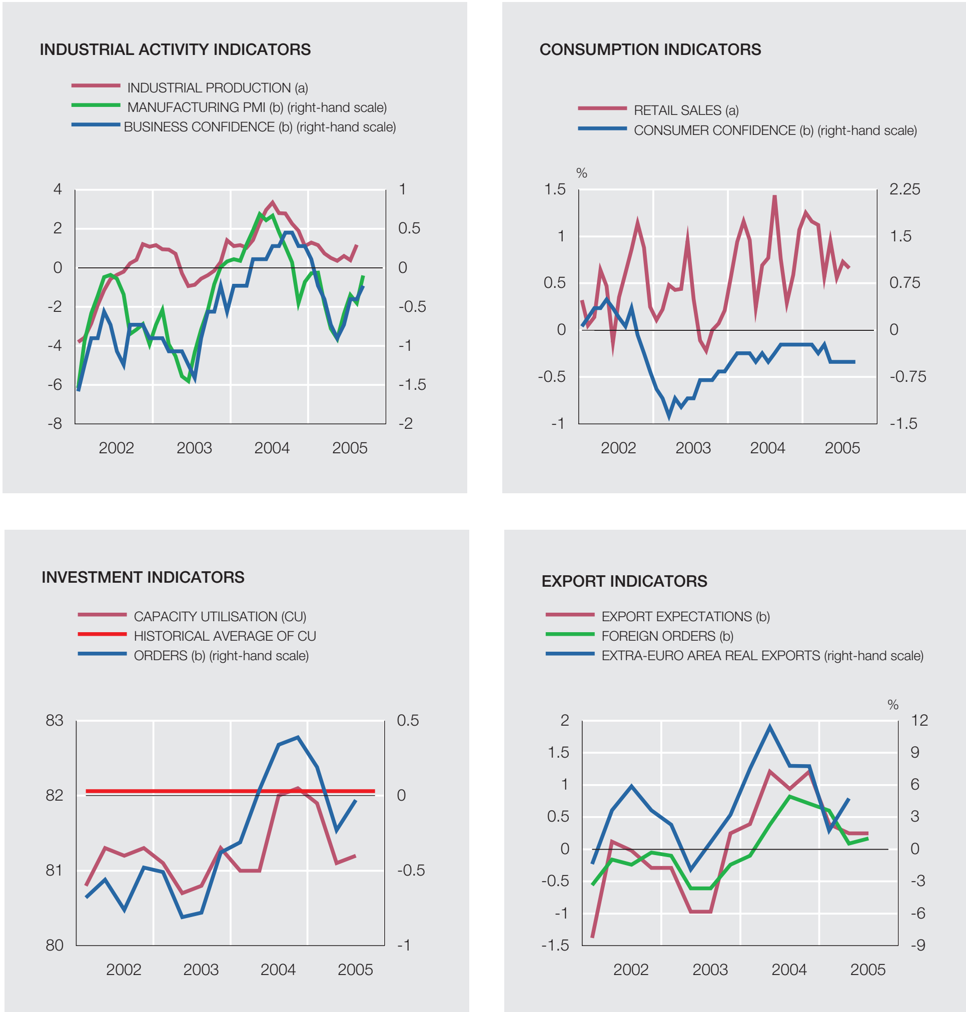
a. Year-on-year rates of change.

Q3, largely as a result of the rise in the price of tobacco in Germany (see Chart 10). The stability of the remaining components meant that underlying inflation, which excludes unprocessed foods and energy from the overall index, rose by only 0.1 pp between June and September to 1.5%. Country by country there was a strong acceleration in prices in Germany, Ireland, Luxembourg and Portugal in the summer months. The year-on-year increase in producer prices was 4% in August, unchanged on June. Behind this stability is the acceleration in the energy component, which is countered by the lower growth of intermediate goods prices, in line with the moderation of commodity prices.

As Box 1 shows, there are upside risks concerning the future course of prices stemming from the trend of oil prices and their pass-through to price and wage formation in the economy. So far, the economic sluggishness in the euro area, the slackness of the labour market, stiff foreign competition and the credibility of monetary policy objectives have meant that the effects of the increase in oil prices on wage growth have been limited. Any attempt by workers to make up for their purchasing power losses through increasing their wage demands would automatically reinforce inflationary pressures.

EURO AREA. REAL INDICATORS

CHART 9



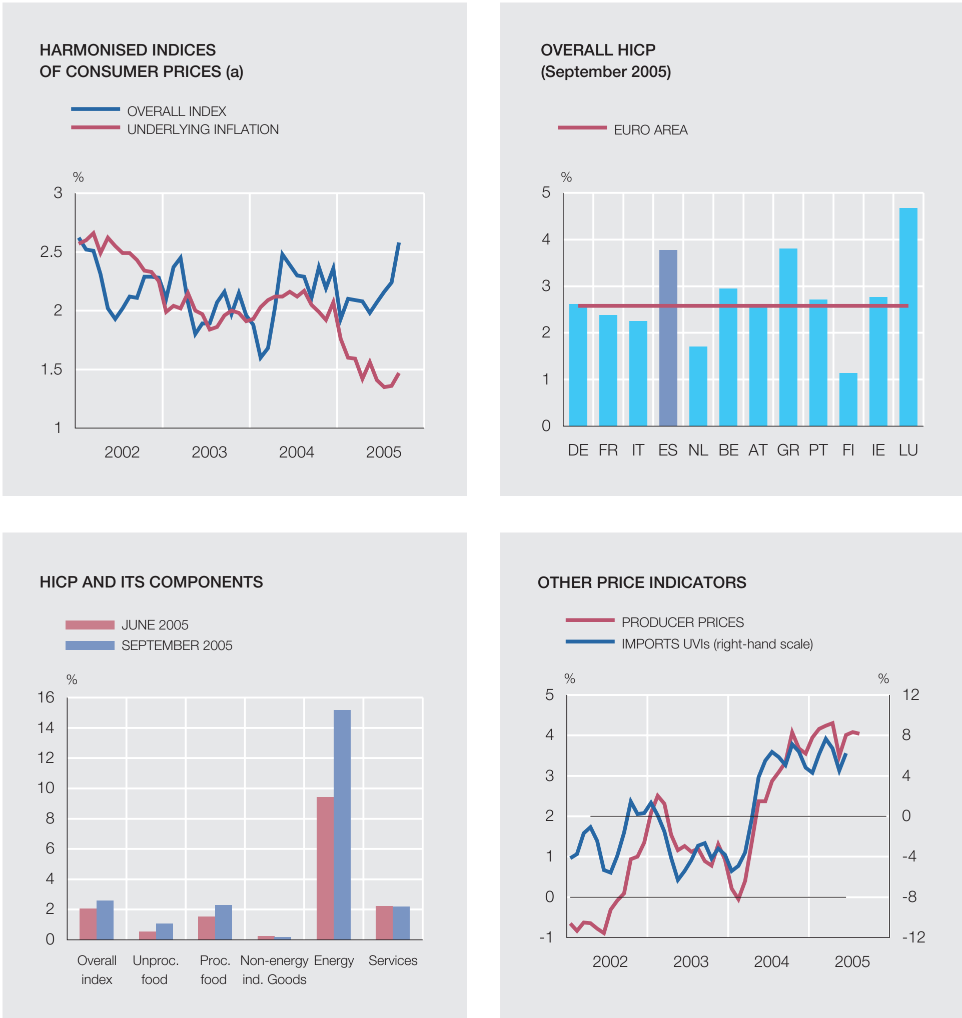
SOURCES: Eurostat and European Commission.

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

According to estimates published by the ECB, the current-account deficit on the balance of payments in the seven months to July 2005 amounted to €12.6 billion, compared with a surplus of €27.8 billion in the same period in 2004. This reduction was chiefly the outcome of a lower surplus on the goods balance, as a result of the higher increase in imports than in exports. By contrast, net capital inflows in the form of portfolio investment were witnessed in the same period for an amount higher than net outflows in respect of direct investment; consequently, the basic balance posted a surplus of €62.3 billion in 2005 to July, compared with a deficit of €16.8 billion observed in the same period in 2004.

Turning to fiscal policy, the budget deficit will exceed in 2005 in several euro area countries the ceiling of 3% of GDP established in the Treaty on European Union, according to the information available (see Table 2). Specifically, it is very likely that the German deficit will exceed this level, while it cannot be ruled out that the French deficit will do likewise. Judging by the conclusions of the November 2003 ECOFIN Council and the Commission's communiqué of December 2004, the deadline for the correction of the excessive deficit expires in both countries this year. Accordingly, if the European Commission's autumn forecasts confirm that this breach will take place, it will be necessary to reactivate the procedure. In this respect, there is evidently a

EURO AREA. PRICE INDICATORS CHART 10
Year-on-year percentage changes



SOURCES: Eurostat and European Central Bank.

a. There is a break in January 2002 when the series was re-based to 2001.

need for the decisions adopted to be consistent with the revised version of the Stability and Growth Pact, so as to ensure the credibility of its disciplining capacity. In July and September, the Council adopted decisions on the existence of an excessive deficit in Italy and Portugal, a situation which will have to be corrected, by the latest, in 2007 and 2008, respectively. Under the new formulation of the Pact, the period for bringing the deficit below the ceiling of 3% of GDP has been extended beyond the year following that in which the excessive deficit is identified, owing to the significant size of the adjustment needed and to the poor economic situation of both these economies.

As regards budgetary plans for 2006, the French deficit is forecast to stand at 2.9% of GDP, based on the assumption of somewhat more favourable economic growth than that indicated in the forecasts available. Notably, the State budget for the coming year does not include the adoption of temporary measures (which are estimated to have contributed in 2005 to improving the overall general government balance by almost 0.5 pp). Further, to ease the social security deficit, the budget for this sub-sector envisages increases in payments by patients for drugs, medical certificates and hospital admittances. Moreover, the tax cuts foreseen for household income have been postponed until 2007, so as to avoid the impact of the resulting

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

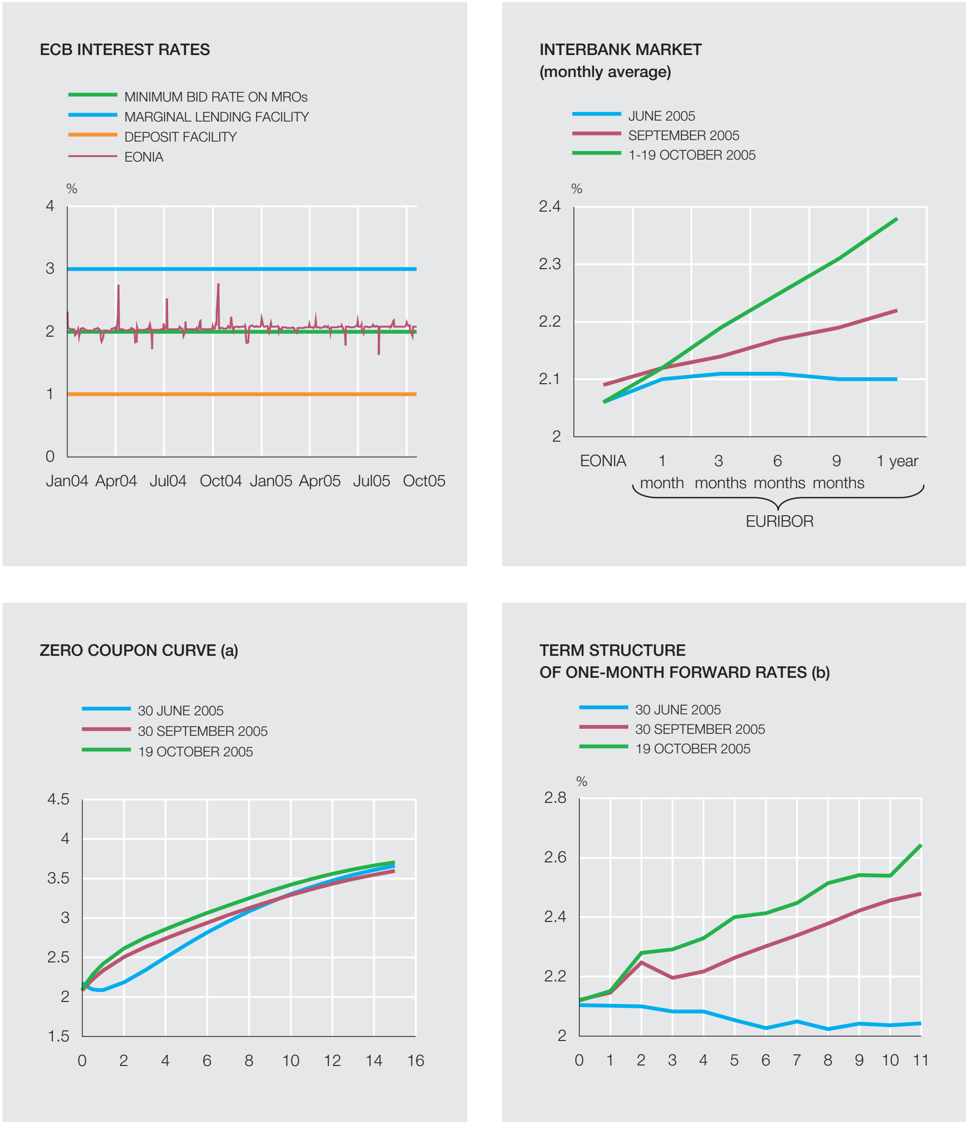
% of GDP

	2002	2003	2004 (b)	2005 (c)	2005 (d)
Belgium	0.1	0.3	0.0	-0.2	0.0
Germany	-3.7	-3.8	-3.7	-3.3	-3.0
Greece	-4.2	-5.2	-6.6	-4.5	-3.7
Spain	-0.3	0.3	-0.1	0.0	0.1
France	-3.2	-4.2	-3.6	-3.0	-2.9
Ireland	-0.5	0.2	1.4	-0.6	-0.8
Italy	-2.7	-3.0	-3.2	-3.6	-2.7
Luxembourg	2.3	0.5	-0.6	-1.5	-1.0
Netherlands	-1.9	-3.3	-2.1	-2.0	-2.6
Austria	-0.4	-1.3	-1.0	-2.0	-1.9
Portugal	-2.7	-3.0	-3.0	-4.9	-6.2
Finland	4.3	2.3	2.1	1.7	1.8
MEMORANDUM ITEM: EURO AREA					
Primary balance	1.2	0.6	0.5	0.6	
Total balance	-2.5	-2.9	-2.7	-2.7	-2.3
Public debt	69.5	70.8	70.8	71.7	70.6

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

a. As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+). The deficits that exceed 0.03 of GDP have been shaded.
b. Forecasts in accordance with notifications of the excessive deficit procedure.
c. European Commission forecasts (spring 2005).
d. Targets of the stability programmes presented between November 2004 and June 2005.

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.

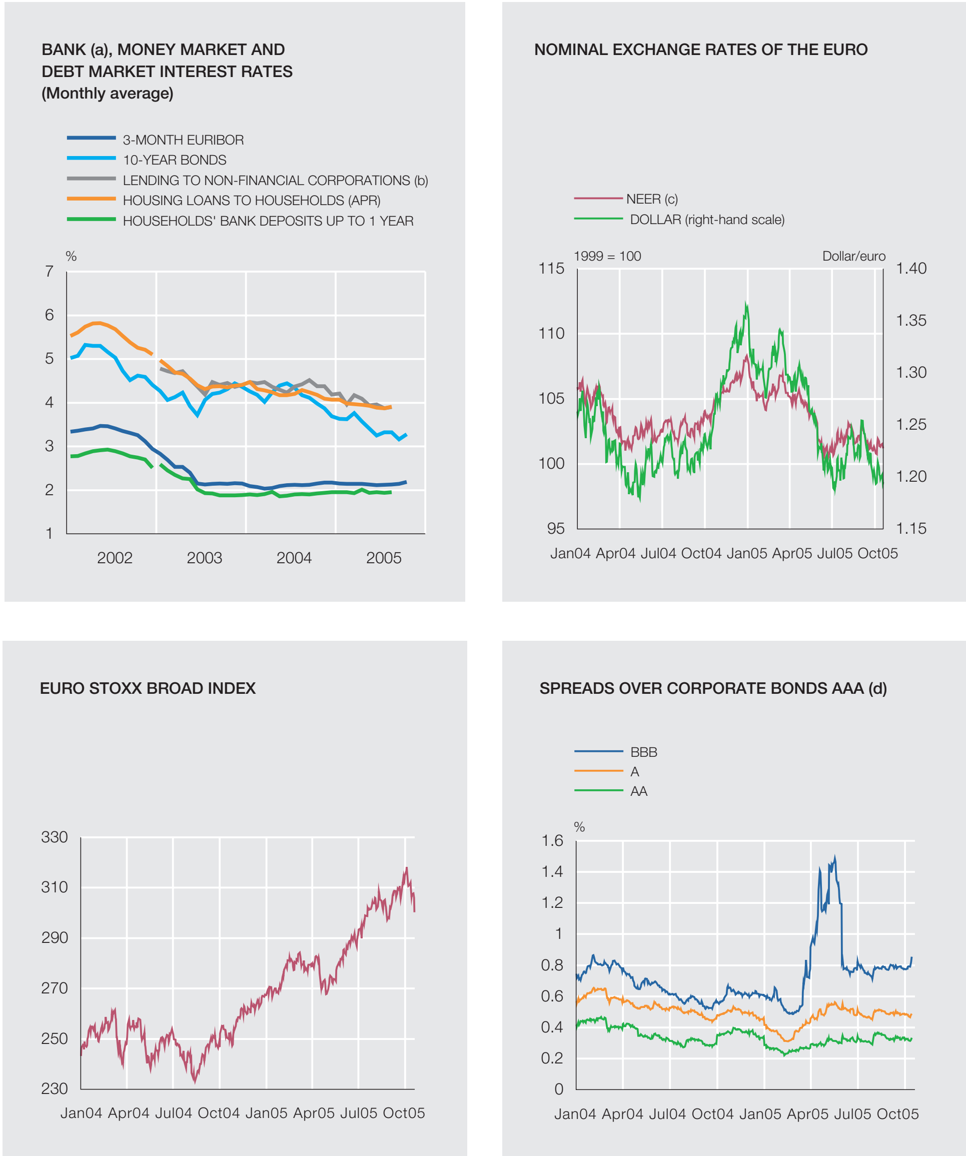
loss of tax revenue on the budget balance. In Italy, the budget for 2006, which envisages a deficit of 3.8% of GDP, combines certain measures aimed at stimulating the economy (such as an increase in deductions in the income tax base, cuts in social security contributions and an increase in public investment) with measures geared to fiscal consolidation (specifically, to containing public-sector employee compensation). Finally, there is still considerable uncertainty in Germany about the future course of budgetary policy, since the parties comprising the recently established coalition government have not yet reached agreement on this matter.

3.2 Monetary and financial developments

At its meetings during Q3, the ECB Governing Council considered that the monetary policy stance continued to be consistent with the maintenance of price stability in the medium term. In parallel, it believed that the level of interest rates was providing an appreciable stimulus to activity. Consequently, the interest rates on the main refinancing operations, the deposit facility and the marginal lending facility held at 2%, 1% and 3%, respectively (see Chart 12). Nonetheless, the ECB has indicated that the upside risks for price stability have increased, and it will

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX

CHART 13



SOURCES: Banco de España and European Central Bank.

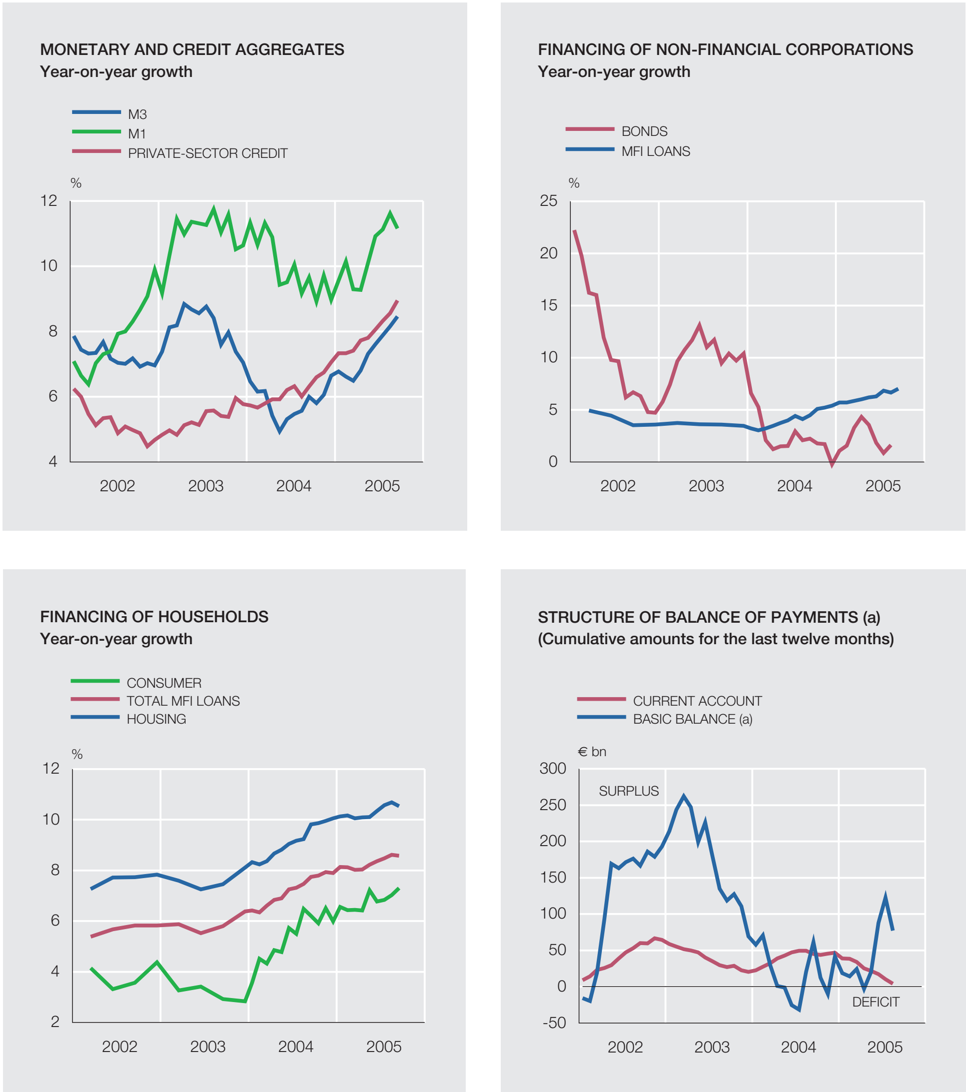
a. Data drawn from new statistics on interest rates compiled by the ECB for new business.
b. Interest rates at over five years depicted.
c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

remain extremely vigilant about the potential pass-through of oil prices to production prices and wages, which may threaten the goal of price stability.

The poor inflation data published for September prompted an increase in money market interest rates at the longer-dated terms. As a result, in mid-October the profile of the one-month forward rate curve was discounting a quarter-point rise in official interest rates for early 2006 (see Chart 12). On the debt markets, 10-year yields reached a level in mid-October of close to 3.3%, somewhat higher than that observed at the end of Q2. The sharp increase in US 10-year bond yields in the period considered gave rise to a widening of the positive spread of US long-term interest rates over their European counterparts to 1.2 pp. On the information available to August, the interest rates set by credit institutions on their lending and borrowing

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.

transactions held stable, generally, although the interest rate on loans extended to households for house purchase continued to move on a slightly declining trend, standing at 3.9% in August (see Chart 13).

On the currency markets, the euro ceased to move in the July-October period on the depreciating trend against the dollar seen since the beginning of the year, with the bilateral exchange rate stabilising at around $1.20 per euro. With regard to the yen and sterling, the euro also showed great stability over the past three months; as a result, in nominal effective terms the euro scarcely varied during the period considered (see Chart 13).

On the euro area equity markets, the rising trend of stock market prices continued in Q3, fuelled by good corporate results and by improved earnings expectations in the business sector. In October, prices underwent a slight correction, meaning that gains for the year 2005 stood at around 12%. The sub-indices relating to the different sectors trended unevenly in Q3. The increase in prices was greater in the energy sector and in consumer goods and commodities, but was meagre in the technology and telecommunications sectors. Accompanying these movements in equity market prices was a moderate increase in volatility compared with that in Q2.

In the summer months, the M3 monetary aggregate quickened once more, rising to 8.5% in September, 0.9 pp above the rate recorded in June (see Chart 14). In parallel, the growth of credit to the private sector gathered steam, whereby its year-on-year rate of change rose to 8.9% in August, 0.8 pp up on June. In terms of the demand-side agents, both loans extended to non-financial corporations and those to households gained in force. Among the latter, loans for the purchase of consumer goods quickened from June, rising to a rate of increase of 7.3% in September, while loans for house purchase held at a stable rate of increase of around 10.5%. Among the biggest countries, lending increased on June in Germany and Italy, and it quickened, albeit to a lesser extent, in France. In Spain, the growth of both loans to non-financial corporations and to households was very high, far higher than recorded in the euro area on average.

4 The Spanish economy

Coinciding with the release of the QNA for 2005 Q2, INE has published the new base-year 2000 National Accounts series as from 1995, thereby extending the revision initially made for the period 2000-2004. Compared with the base-year 1995 accounts, and as occurred for the period of 2001-2004, the new data entail an upward revision of the growth of the Spanish economy, markedly so in 1999 and 2000, when the rate of increase of GDP rose by 0.5 pp and 0.6 pp, respectively.

On QNA estimates, GDP growth rose by 0.1 pp in 2005 Q2 to a real year-on-year rate of 3.4%, in line with the mildly accelerating profile seen in the preceding quarters. In quarter-on-quarter terms, the increase was 0.9%, unchanged on the two previous quarters. In terms of components, national demand remained considerably buoyant, and its contribution to output growth was 6 pp, while the negative contribution of external demand to GDP growth declined slightly.

The short-term economic information available indicates that the rate of expansion of GDP may have risen once again in 2005 Q3 to 3.5%, underpinned, as in recent quarters, by the buoyancy of domestic demand, while net external demand has continued to contribute very negatively to the increase in output. Nonetheless, it is estimated that the expansion of domestic demand will ease and that the external sector will subtract less from growth (see Chart 15). The domestic demand components that slowed were private consumption and investment in capital goods. Also, both exports and imports lost momentum in relation to Q2.

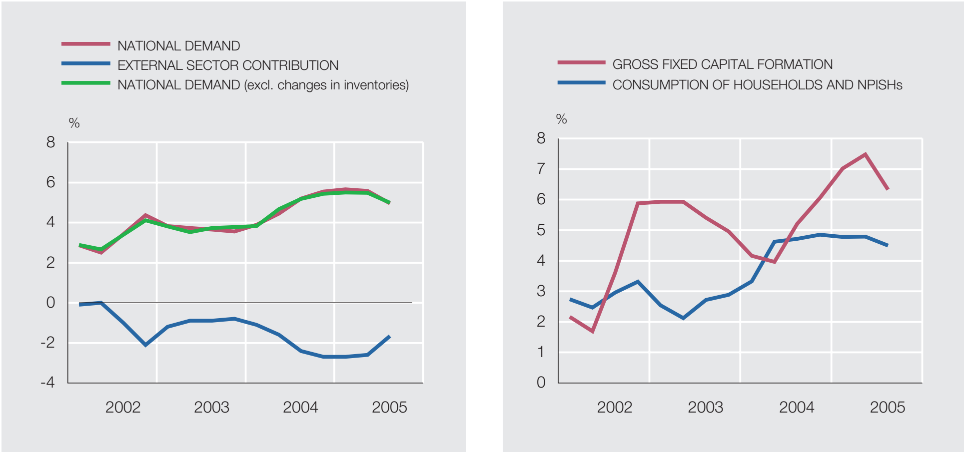
In terms of activity across the different branches, estimates point to the continuing strong buoyancy of services and construction in Q3, while value added in manufacturing industry appears to have continued posting a very moderate growth rate of scarcely 1%, and activity in the agriculture and fisheries branches has been adversely affected by the drought. The main employment indicators suggest this variable is stabilising at a high rate of expansion. Indeed, the EPA (Labour Force Survey) for Q3 reveals a 5.1% increase in numbers employed, somewhat higher than in Q2. Against this background, the growth rate of apparent labour productivity in the economy as a whole has tended to stabilise, while in the market economy it held at a very low rate (0.4%).

Compensation per employee grew at a very moderate rate in the first half of 2005, and it is estimated that in the second half of the year it will draw closer to a rate nearer to that shown by the wage indicators, giving rise, in conjunction with low productivity growth, to an acceleration in unit labour costs. Lastly, the inflation rate, measured by the CPI, increased to 3.4% in Q3, peaking at 3.7% in September. This was due essentially to dearer energy. The leading indicator of the HICP for October points to a 12-month increase of 3.5%.

4.1 Demand

The growth of household final consumption in real terms held at 4.8% in 2005 Q2, a similar rate to the previous quarter. The indicators available for Q3, with as yet incomplete information, appear to signal an easing of the marked robustness of private consumption (see Chart 16). However, private consumption spending appears to be holding at a significant rate of increase, far above that of disposable income, to which the rise in the real wealth of households – both financial and property-related – and the maintenance of favourable financing conditions are apparently still contributing.

MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

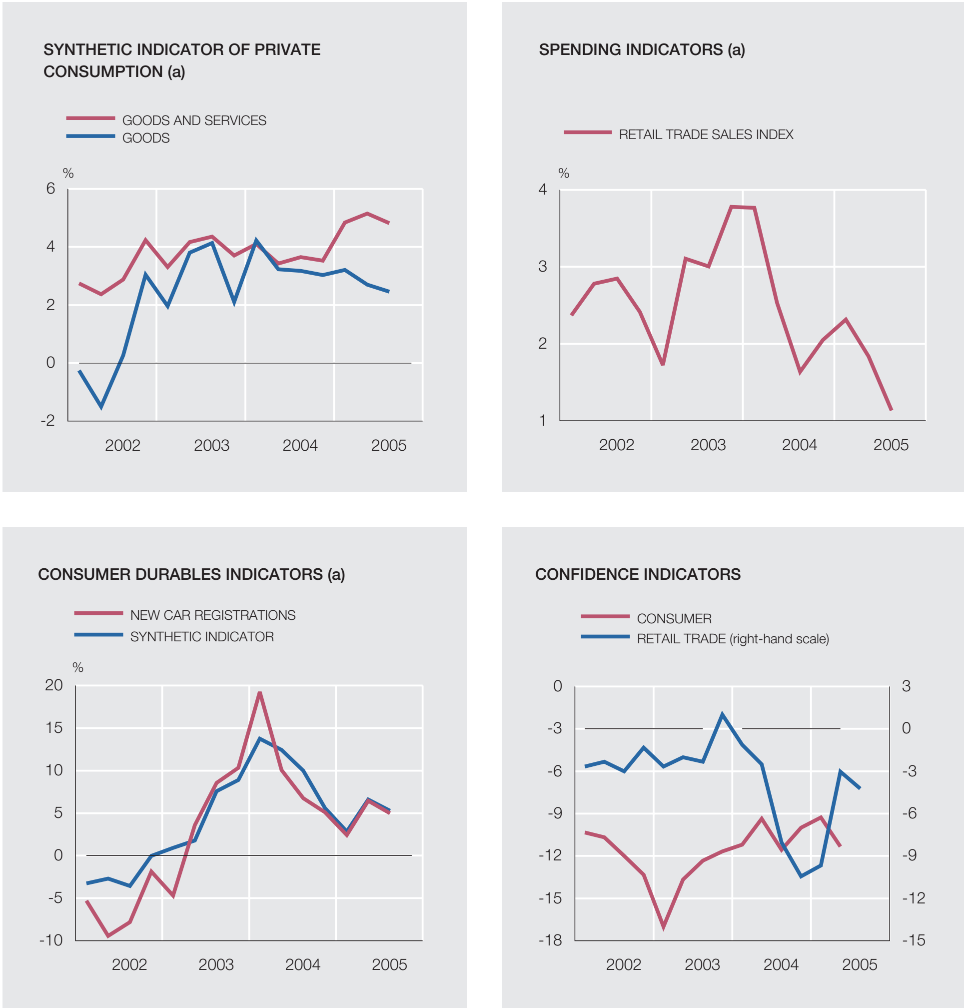
As Chart 16 shows, the synthetic indicator of private consumption of goods and services reveals a mildly slowing profile in Q3, which is more marked in the case of consumption of services and of durable goods. Notable among the indicators more directly related to household spending is the overall retail sales index, which slowed in July and August, while the retail trade confidence indicator fell off slightly in the summer months. New car registrations continue to grow at a significant pace, albeit down on Q2.

As regards the main determinants of private consumption, estimates point to a slowdown in real disposable income following its notable momentum in 2004. The slight acceleration in compensation per employee and in the gross surplus is being countered by the more contractionary contribution of general government to income growth, mainly as a result of higher tax revenue, now the effects stemming from the personal income tax reform in 2003 have been overcome. Conversely, household wealth has continued to increase at a high rate, underpinned both by the increase in stock market prices during the year (16% in the case of the IBEX 35 index) and by the rise in property values. Against a background marked, moreover, by low financing costs, this has led the saving ratio to fall further.

In 2005 Q2, general government final consumption posted a year-on-year increase of 4.6%, 0.9 pp down on the previous quarter. The as yet very incomplete short-term economic information available, drawn from State budget outturn figures, points to stability in the rate of increase of this aggregate.

Gross fixed capital formation continued to quicken in 2005 Q2, growing at a rate of 7.5% compared with the same period a year earlier, 0.5 pp up on Q1. This performance was the outcome of the greater buoyancy of all its components: investment in capital goods retained its considerable strength and increased by 10.4%, in real terms, construction grew by 5.8% and investment in other products by 8.7%. Judging by the latest available information, lower year-on-year growth in investment in equipment is expected in 2005 Q3. This estimate chiefly reflects the trend of the indicator of apparent investment in capital goods, and is due, in part, to a mere base effect, since in 2004 Q3 investment in equipment grew exceptionally sharply (see Chart 17). Other indicators offer positive signals: specifically, the orders of producers of capital goods and the indicator of business confidence have improved in the July-September period. Likewise, capacity utilisation in industry as a whole

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.

has increased, while the proportion of firms that consider their plant capacity to be excessive has fallen.

The information on non-financial corporations compiled by the Central Balance Sheet Office, encompassing 2005 Q2, has reflected a slight slowdown in activity. That said, some favourable factors remain, such as the growth of turnover, employment developments, the moderation of average compensation, the contained growth of financial costs and the rise in financial revenue (essentially due to the inflow of dividends from subsidiaries abroad). These circumstances explain why returns remain high and account for the sound behaviour of total net profit, which is in step with the momentum of investment.

Investment in construction rose by 5.8% in 2005 Q2, 0.1 pp up on the previous quarter. On the latest information, this buoyancy has continued into Q3. The indicators of intermediate supplies for construction, such as the apparent consumption of cement and the production of construction materials, were less intense on average in July and August than in Q2. However, the confidence indicator, which had fallen off in Q2, picked up in Q3, holding somewhat below the levels reached at end-2004, while the employment indicators trended somewhat more favourably in Q3.

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.

Distinguishing between the different types of works, the high growth rate of residential building eased and non-residential building picked up somewhat, after having exhibited considerable slackness until 2005 Q1. Indeed, according to building permits and approvals, the increase in the surface area of residential building to be built in the first seven months of the year is below the related increase in 2004, whereby it augurs a decelerating profile for work performed during 2005. In the case of building intended for other uses, the surface area to be built is, on the contrary, proving much more dynamic in the January-July period than in 2004 as a whole. Regarding civil engineering works, both the Construction Industry Survey (ECIC) and the indicators estimated drawing on the official procurement budgets indicate that the real value of works executed is holding at a similar level to that of last year. Despite the fact that the volume of general government civil engineering works executed in 2005 as a whole might be higher than that of the previous year, the estimated growth profile over the course of the year is a clearly declining one.

On QNA estimates, the contribution of net external demand to growth in 2005 Q2 continued to be markedly negative, although it picked up slightly on the previous quarter. Q2 saw a halt in the slowing trend of real exports of goods and services, which posted real growth of 1.9% (compared with –1.9% the previous quarter), while real import flows regained greater buoyancy, with a rate of increase of 8% (5.6% in Q1). In any event, the recovery in exports did not

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.

prevent them from continuing to lose ground on international markets. The as yet incomplete information for Q3 indicates that the contribution of net external demand in this period may have been less contractionary, against a background of lower growth in both exports and, to a greater extent, in imports.

Goods exports gained momentum during 2005 Q2, posting real growth of 2.6% year-on-year, following the contraction of 2% seen the previous quarter (see Chart 18). However, the latest foreign trade figures published by the Customs Department for July and August show a year-on-year slide in real terms of 1.4%, suggesting a loss of buoyancy of sales abroad in Q3. By geographical area, the slowdown in exports was across the board in July and August, although it affected those targeted on the EU to a greater extent, with a fall of 3.8% in real terms against the backdrop of quickening export prices. The performance of sales to the rest of the world, where demand had been showing greater robustness, was more favourable (4.3%), despite the marginal appreciation of the euro in this period.

Real exports of tourist services remained very sluggish in 2005 Q2, falling by 1.5% on QNA estimates, in line with the still-adverse course of the nominal Balance of Payments indicator.

However, the main real indicators of tourism, such as overnight stays in hotels by foreigners and real spending by tourists, drawn from the EGATUR figures, signalled the moderately favourable behaviour of tourism in this period. In fact, the Banco de España Balance of Payments Department, INE and the Instituto de Estudios Turísticos recently acknowledged that the data on tourism revenue in the first half of the year are underestimated, and will be revised upwards in the coming months. The recovery firmed in Q3, where most foreign tourist arrivals are concentrated. In July and August, total real spending by tourists increased by 6.3%, while the rate of increase of overnight stays in hotels and tourist numbers rose to 4.6% and 7%, respectively, in the quarter as a whole, heralding a recovery in tourism revenue. Exports of non-tourist services, according to QNA figures, showed something of an acceleration in 2005 Q2 (1.4%), though one less sharp than that shown by the nominal Balance of Payments indicator. Notable under this item was the favourable course of revenue relating to financial and IT services.

As can be seen in the QNA figures, real goods imports quickened by 1.5 pp to a growth rate of 8.5% in 2005 Q2 as a result of the bigger increase in final demand. Customs figures for July and August show, however, a slowdown in imports, with growth of 4.3% in real terms. These figures augur a loss of buoyancy of real goods imports in Q3, behind which is the low increase in final demand and, in particular, in the components with a greater import content, such as exports and gross fixed capital formation.

Lastly, in QNA terms, real imports of services in 2005 Q2 picked up notably: foreign purchases of non-tourist services ceased to exhibit the negative rates of the previous quarter, posting a rate of virtually zero, while the strong buoyancy of expenditure on tourist services (26.9%) continued, which is consistent with the strength of household consumption and the appreciation of the euro.

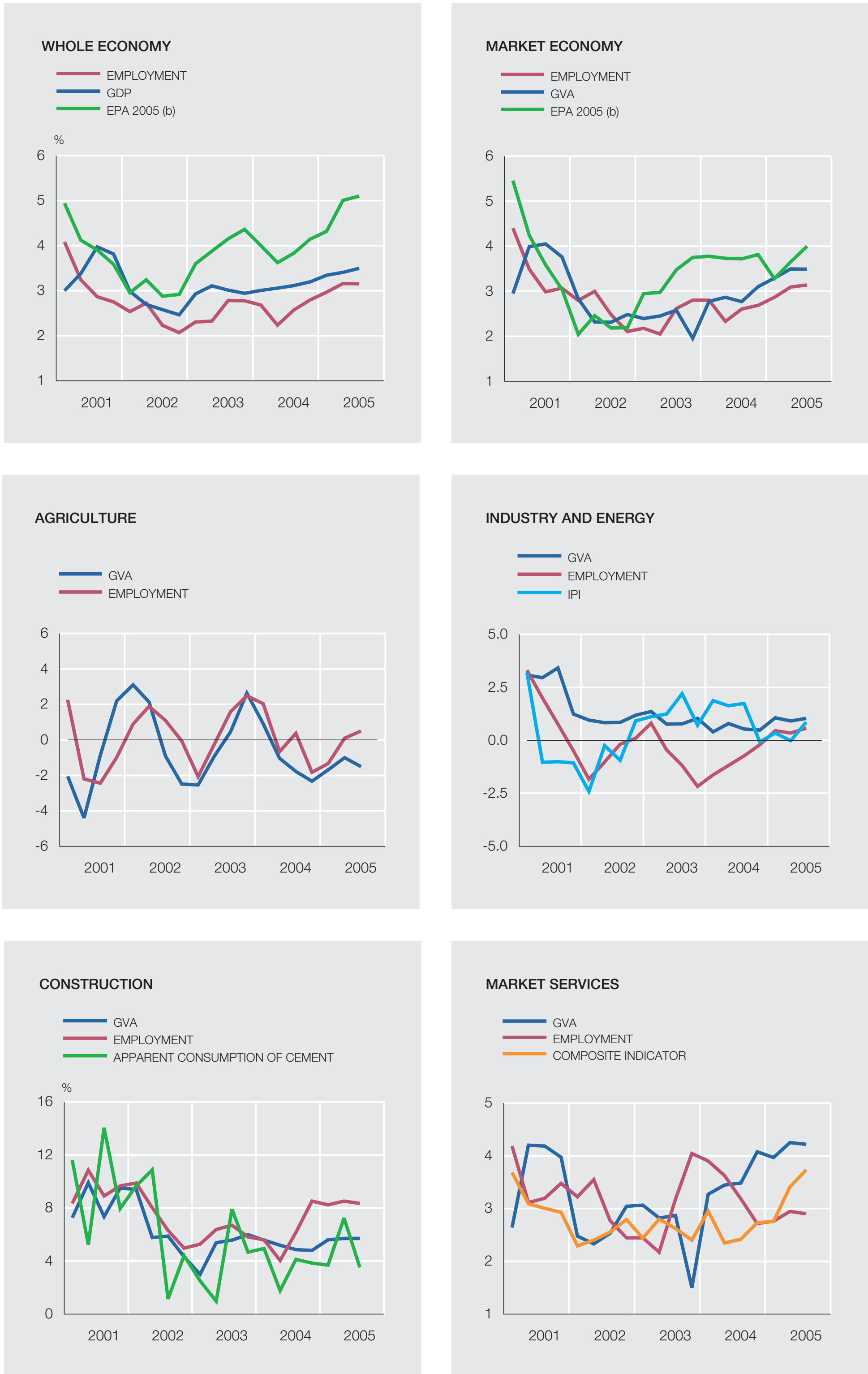
4.2 Output and employment

From the standpoint of supply, activity in the market economy was estimated in 2005 Q2 to have gathered fresh momentum, on a similar scale to that shown in the opening months of the year, attaining a growth rate of 3.5%, slightly up on that of the economy as a whole. This acceleration is mainly attributable to the behaviour of the services branch, although construction also improved. The information available indicates that the growth rate of activity in the market economy in Q3 might have stabilised.

Activity in the agricultural and fisheries branches continues to be influenced by the rainfall in the past hydrological year, in which only 63% of the average historical volume of rainfall was recorded. As a result, yields in the case of the main agricultural crops declined, markedly so in the case of cereals. The exception was fruit, which had already undergone a severe cut in 2004. Partially tempering this adverse behaviour of vegetable produce was that of livestock production, which showed signs of reviving. In QNA terms, the value added of these branches shrank by 1% in Q2 and forecasts point to an intensifying decline during Q3 (see Chart 19).

The industrial and energy branches as a whole lost momentum in Q2 owing to the scant buoyancy of industry, which partly felt the impact of the sluggishness of Spanish goods exports. The slackness of industrial activity in Q2 was manifest in the manufacture of capital and intermediate goods; consumer goods, for their part, performed favourably overall owing to the behaviour of non-food products, including cars. The information available points to these features continuing into Q3, although the industrial production index data are subject to a degree of uncertainty: after posting a negative rate of increase in July, this index performed very favourably in August, when it usually exhibits high erraticism. The indicators of turnover and incoming orders behaved similarly to the industrial production index, while employment acceler-

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



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

a. Year-on-year percentage rates based on seasonally adjusted series, except gross series in the EPA. Employment in terms of full-time equivalent jobs. EPA in persons.For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b. Series linked by the Directorate General Economics, Statistics and Research of the Banco de España based on the control survey carried out using the methodology applied until 2004 Q4.

ated during this quarter, according to the EPA (Labour Force Survey), showing growth of 1.1% compared with 0.3% the previous quarter. The opinion-based indicators trended favourably, since both the business confidence index and the PMI reflected an improved situation in relation to Q2.

According to QNA data, value added in construction remained very buoyant in 2005 Q2, and its rate of increase rose by several tenths of a point to 5.7%, the highest figure for the last 18 months. Housebuilding and other construction both gathered steam, more markedly so in the latter case. In keeping with the inertial behaviour characterising activity in this branch, growth is estimated to have held at a high rate in Q3. Despite the fact that signs of a slowdown in certain indicators of intermediate supplies (such as cement consumption) have been observed, the information from the EPA denotes a slight quickening in employment in the sector in Q3.

Activity in services in 2005 Q2 retained the momentum seen in the first quarter of the year, with a rate of increase of 4% on QNA figures. However, this figure masks the very different behaviour of the various components. While GVA in non-market services slowed by 0.8 pp to 3.2%, market services gained in force in Q2 after having paused in the first three months of the year, posting a growth rate of 4.3% year-on-year, 0.3 pp up on Q1. On the information available, the greater robustness of activity and market services did not continue into Q3. According to the EPA, numbers employed in services grew by 4.3%, slightly below growth in Q2, and Social Security registrations eased in this period (once the effect of the recent regularisation of immigrants was stripped out); the indicators of activity in the services sector (IASS) slowed in July and August, once deflated and adjusted for calendar effects; and the opinion-based indicators – the confidence indicator for the sector compiled by the European commission, and the PMI – declined over the quarter as a whole. Under the various branches making up market services, the profile of the hotels and restaurants trade was, according to the overnight hotel stays statistic, more dynamic in Q3, after having lost momentum the previous quarter. The real estate and business activities sector quickened in the summer months, though much more moderately. Conversely, trade and transport, and, above all, trade and repairs weakened, due in the latter case to both the diminished activity in vehicle sales and the loss of steam in retail trade.

Employment[1] in the economy as a whole continued to quicken in 2005 Q2 on QNA estimates, posting a year-on-year increase of 3.2%, 0.2 pp up on the previous quarter. As the growth profile of GDP was less marked, there was a slight deterioration in apparent labour productivity, which fell between April and June to 0.2%, thereby holding on the modestly expanding path seen in the past three years. As regards the latest short-term economic information, one of the main employment indicators[2], the EPA, showed growth in numbers employed of 5.1% in Q3, slightly up on the Q2 figure.

According to QNA data, employment trended relatively steadily in the different branches, except in agriculture, where the minimal increase recorded meant a break in the ongoing process of job destruction. In industry, the year-on-year growth of numbers employed eased by 0.1 pp to 0.2%; in market services, employment continued to increase at a sustained rate (2.9%, after quickening by 0.1 pp); in non-market services employment held stable at 3.4%; and finally, in construction, which remains the most dynamic branch in terms of job creation, there was a rise of 0.2 pp, which placed growth for the quarter at 8.5%. Employment in the market economy rose by 3.1%, from 2.9% at the start of the year. Nonetheless, as the increase in GVA was somewhat greater, the gain in apparent labour productivity remained relatively stable, in con-

1. In terms of full-time equivalent jobs. **2.** The rates of the indicators discussed in the text are based on gross data.

trast to the deterioration seen in the economy as a whole. The EPA data indicate, as earlier mentioned, that in Q3 employment quickened in construction and continued to advance at a higher rates in services, while it picked up somewhat in agriculture and industry

In National Accounts terms, the increase in total employment in Q2 continued to be more sharply perceptible among wage-earners, whose numbers grew by 3.4% in year-on-year terms, 0.3 pp up on the previous quarter, while the self-employed component slowed by 0.5 pp to 1.4%. The EPA figures also showed a sharper acceleration in dependent employment than National Accounts. This variable held firm in Q3, in contrast to the moderate slide in self-employment. Reflecting this was an increase in dependent employees as a proportion of total numbers employed, to 82.1%. Conversely, in the figures on registrations, the creation of self-employment has been exhibiting greater momentum than that of dependent employment since Q2, a development tied to the ongoing regularisation of immigrants, since 34% of those regularised to September come under the special household employees regime and, therefore, were not counted as dependent-employment registrations.

In terms of contract duration, the EPA figures (adjusted for the methodological changes introduced in early 2005) indicate that the behaviour of temporary employees in Q3 was once again very dynamic, while the pace of permanent employment growth held stable. Specifically, temporary employment increased at a rate of 13.1% during the quarter, in line with the rise in the previous quarter and far greater than that of permanent employees (3.1% in the same quarter). This prompted an increase in the contribution of temporary employment to the growth of dependent employment and an increase in the ratio of temporary to permanent employees, which climbed to 34.4%, more than two points above its level a year earlier.

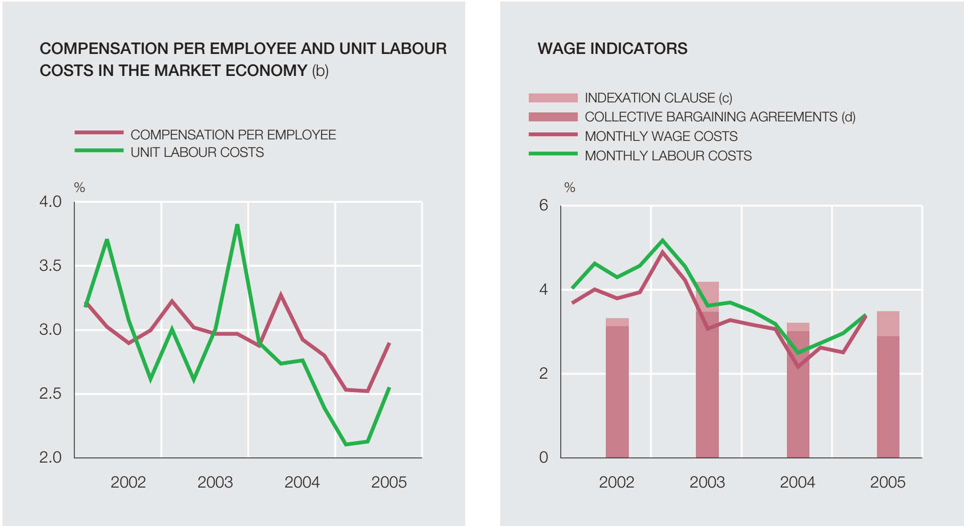
Concerning the length of the working day, EPA estimates show very high year-on-year changes in part-time hiring which are difficult to interpret even when adjusted for the above-mentioned methodological changes. The year-on-year growth rate of part-time employees adjusted for these changes was 17% in Q3, a figure nevertheless down on that recorded in the first half of the year. The increase in the number of full-time employees rose considerably in this quarter, although it held at a notably lower growth rate (of 4%, from 2.7% in Q2). As a result of these developments, the percentage of part-time employees rose to 11.6%, 1.3 pp above the level a year earlier, though 1.2 pp down in relation to the previous quarter.

On uniform information drawn from the EPA, the working population grew by 2.9% in Q3, entailing a significant slowdown on the previous quarter (when it grew by 3.4%). Behind this lies a lower increase in the participation rate, which stood at 57.4% in Q3, 0.7 pp higher than in the same period in 2004. The number of unemployed fell by 15.5% in relation to 2004 Q3, entailing a marked intensification of this variable's rate of decline. Consequently, the unemployment rate stood at 8.4%, 0.9 pp down on its level in the previous quarter and almost 2 pp below that of a year ago. Unemployment per the EPA figures is more favourable than registered unemployment, whose rate of decline eased in Q3 to –1.5%, after posting a figure of –3.6% the previous quarter.

4.3 Costs and prices

On QNA estimates, compensation per employee in the economy as a whole in 2004 Q2 increased at a rate of 2.7%, thereby extending the slightly slowing trend initiated in the preceding quarters (see Chart 20). In a market economy, the growth of compensation per employee stabilised at 2.5%, the lowest rate since 2000, as a result of a lower rate of expansion in agriculture and in industry combining with a slight rise in construction and market services. In contrast to the QNA figures, the quarterly labour costs survey (ETCL) revealed a 0.4 pp acceleration in monthly labour costs per employee in Q2, with growth standing at 3.4% year-on-

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.

year. On this occasion, the wage component was responsible for the upward trend of the aggregate, since its year-on-year rate increased notably from 2.5% in Q1 to 3.4%, while the rate of increase of non-wage costs dipped to 3.5%.

The information on increases in wage rates agreed under collective bargaining in the first eight months of 2005 reflects a wage increase of 2.93%, similar to that agreed the previous year, before considering the effect of the indexation clause. These agreements cover more than 6 million employees, a somewhat higher number than that observed in the same period in 2004. Revised agreements, which affect 87.5% of employees, show a wage increase of 2.85% to July, while under newly signed agreements wage settlements are almost half a point higher, although they only affect 740,000 employees. Regarding the effect of the indexation clause, the current estimate for the clause for the year 2004 is 0.6 pp, up from 0.2 pp the previous year, since the inflation deviation from the official government target was also higher (see Box 3). These clauses are present in 77% of the agreements signed between January and July 2005.

Despite the slowdown in compensation per employee, the increase in labour costs per unit of value added remained stable in 2005 Q2, since value added per employee slowed slightly. As a result, the unit surplus increased by 7%, thereby maintaining the ongoing widening of margins seen in previous quarters. Developments in the market economy were similar, against a background of stable costs and slightly accelerating prices.

The brisker pace of the value added deflator in Q2 was attributable to services and agriculture, since prices in construction and in industry and energy held stable or slowed in relation to Q1 (see Chart 21). By contrast, unit labour costs slowed in industry and energy, and in agriculture, while they posted higher increases in construction and in market services. Despite these differences, the widening of margins was extensive to all branches of activity, except agriculture. The indicators available for Q3 show these patterns of behaviour to be holding, with the growth of the deflators continuing to be above that of unit labour costs, although this differential is expected to narrow progressively in the coming quarters.

As is known, the collective bargaining system in Spain is characterised by the generalised use of indexation clauses as a safeguard against inflation. In episodes where actual inflation shows an upward deviation from the official forecast or from the reference adopted in the agreement, these clauses induce a lagged adjustment of wages to actual inflation. The inclusion of this type of clause is one of the key elements of the AINC (Inter-Confederal Agreements for Collective Bargaining) to which the social partners have subscribed since 2002.

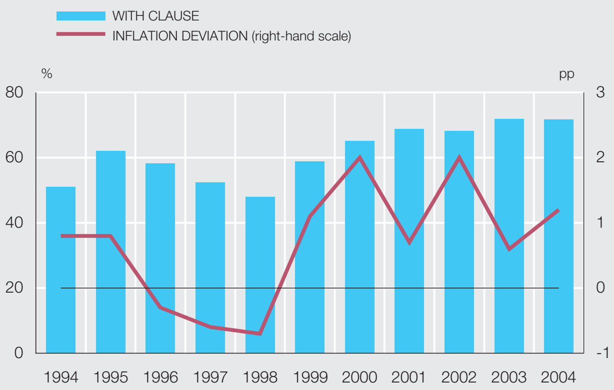
The first panel below shows how indexation clauses are used in the majority of collective bargaining agreements (72% of total agreements in 2004), and evidences the existence of a positive relationship between the number of employees affected by these clauses and the differential between the actual rate of inflation and the official forecast. The AINC entered into by the social partners since 2002 have also contributed to the increase witnessed in these clauses in recent years.

Two effects of the presence of counter-inflationary indexation clauses on the wage increases agreed under collective bargaining can be distinguished. First, the clauses have an indirect effect on the wage increase agreed ex-ante, insofar as their presence allows a wage increase to be agreed which is different from (normally lower than) that which would be agreed without them. Second, once the rate of inflation is known, the indexation clauses are activated on the basis of the actual inflation deviation and the different inflation thresholds set in each agreement, giving rise to an upward adjustment of wage increases.

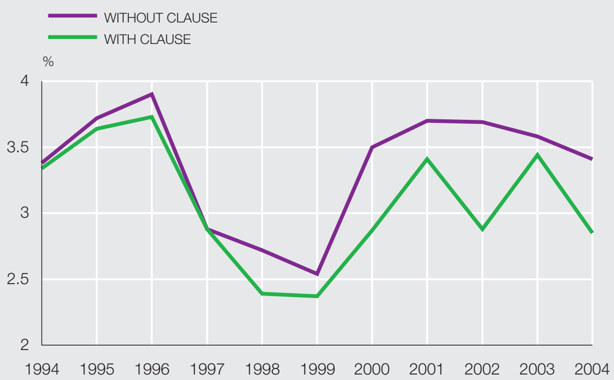
Panels 2 and 3 seek to isolate the impact of each of these effects on the ex-post wage increases (i.e. those finally observed). As can be seen in the panel, agreements with a clause usually entail initial wage increases that are lower than those agreed in agreements without a clause. In 2004, the last year for which full information is available, agreements with a clause resulted in an average wage increase of 2.85%, compared with 3.41% in agreements in which there was no such clause. Over time, this differential has hovered between 0.1 pp and 0.6 pp, although its sign has always been positive on the side of agreements without a clause. This result indicates that the presence of indexation clauses in agreements acts as a safeguard for employees against inflation deviations and therefore allows more moderate initial wage increases to be agreed.

Panel 3 below shows that, since 1999, a growing percentage of indexation clauses have been activated, once the inflation rate was

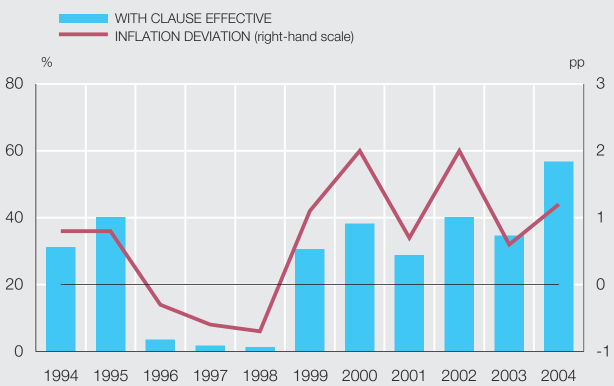
1. PERCENTAGE OF EMPLOYEES WITH CLAUSE



2. INITIAL WAGE INCREASES AGREED. ALL AGREEMENTS



3, ACTIVATION OF CLAUSES



4. WAGE INCREASES AGREED. ALL AGREEMENTS

SOURCE: INE, Ministerio de Economía y Hacienda and Ministerio de Trabajo y Asuntos Sociales.

known, owing to the sizeable deviations by actual inflation from forecast inflation of close to or more than 1 pp. Moreover, the thresholds above which the clauses become effective appear to have fallen in recent years. As can be seen in the panel, only 59% of clauses in 2002, with a deviation of 2 pp between forecast and actual inflation, were activated, while two years later, with a deviation of 1.2 pp, 79% of the clauses became operative.

The fourth accompanying panel shows that, once the activation of the indexation clauses is taken into account, agreements with a clause gives rise to higher wage increases than agreements without such a clause. In 2004, the final wage increase under agreements with a clause was 3.7%. That is to say, the 1.2 pp deviation by inflation from the official target of 2% brought about an upward adjustment of 0.85 pp in agreements containing an indexation clause, which placed the final increase 0.3 pp above that agreed in agreements without a clause. The sign of this differential has historically been positive — between 0.1 pp and 0.4 pp — with the exception of the 1996-1998 period, when the fact that the official inflation target was met meant that the indexation clauses were not activated.

Overall, the wage increases agreed under collective bargaining in 2004 have been raised by 0.6 pp owing to the impact of indexation clauses and, given the foreseeable course of the inflation rate in the final months of 2005, the effect this year is estimated to be at least 0.8 pp. Accordingly, although the presence of indexation clauses in collective bargaining agreements generally enables initial wage increases to be tempered, it subsequently entails an automatic adjustment of wages based on past inflation. This wage indexing mechanism may, in a setting such as the current one in which it is essential to limit to the utmost the pass-through of oil price increases to prices and wages, hamper the necessary adjustment of wages — and of the economy in general — to this shock.

The rate of increase of the final demand deflator fell by 0.5 pp to 3.7% in 2005 Q2, due in part to the lower growth of the imports deflator, while the GDP deflator held stable at 4.2%. On the expenditure side, the private consumption deflator slowed by 0.2 pp to 3.2% in Q2, a similar increase to that of the CPI over the same period. However, the rate of CPI-based inflation gathered fresh momentum in Q3, and stood at a 12-month rate of 3.7% in September. Underlying inflation posted growth of 2.5% (see Chart 22). As has habitually been the case in the past 12 months, energy prices were once again the most inflationary component, showing average growth of 12.7%, to which the price rises in natural gas and in the distribution of butane gas in July and August contributed. Further, the rising trajectory of fuel prices evident since the start of the year steepened. The average price of oil increased by $10 per barrel in Q3 compared with the previous quarter. Finally, the average year-on-year rate of increase of unprocessed food prices slowed by 0.7 pp to 2.7% in Q3.

In terms of the components of underlying inflation, the growth of processed food prices fell by 0.8 pp in 2005 Q3, taking the average year-on-year increase to 2.8%, due largely to the moderation of the growth of oil and tobacco prices. The increase in services prices held at 3.7%, against the backdrop of very moderate rises in hotel and package tour prices, while the prices of certain transport services, essentially air travel, quickened as dearer crude oil prices began to make themselves felt. Lastly, non-energy industrial goods prices slowed by 0.1 pp to an average year-on-year increase of 0.8% in Q3, partly as a result of the reduction in clothing and footwear prices, which was perhaps associated with the growing imports of Asian products.

Spanish inflation measured by the HICP rose by 0.2 pp in Q3 to an average rate of 3.5%, standing at 3.8% in September. As indicated, inflation in the euro area as a whole increased to 2.6% in the same month, marginally widening the inflation differential to 1.2 pp (see Chart 23). Component by component, price rises were higher in Spain in the case of services, where the differential with the euro area widened to 1.6 pp over the course of Q3, undergoing a more moderate increase in the case of non-energy industrial goods and food. The leading indicator of the October HICP points to a slowdown in consumer prices to a 12-month rate of 3.5%.

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

SOURCES: INE and Banco de España.

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

The producer price index quickened in September to a year-on-year growth rate of 5.4%. Its upward course since May has been caused by energy prices, which climbed at a year-on-year rate of 17.9%. Moreover, the overall index excluding energy also quickened slightly to 2.8%, owing to the behaviour of the prices of intermediate goods and of non-durable consumer goods. Capital goods and durable consumer goods prices moved on a more moderate course. As regards the other price indicators, prices received by farmers were more volatile in recent months, moving on a clearly increasing trend, as reflected by the rises in the prices in source markets in the face of the prospect of worse crop yields. Finally, hotel prices quickened slightly in July.

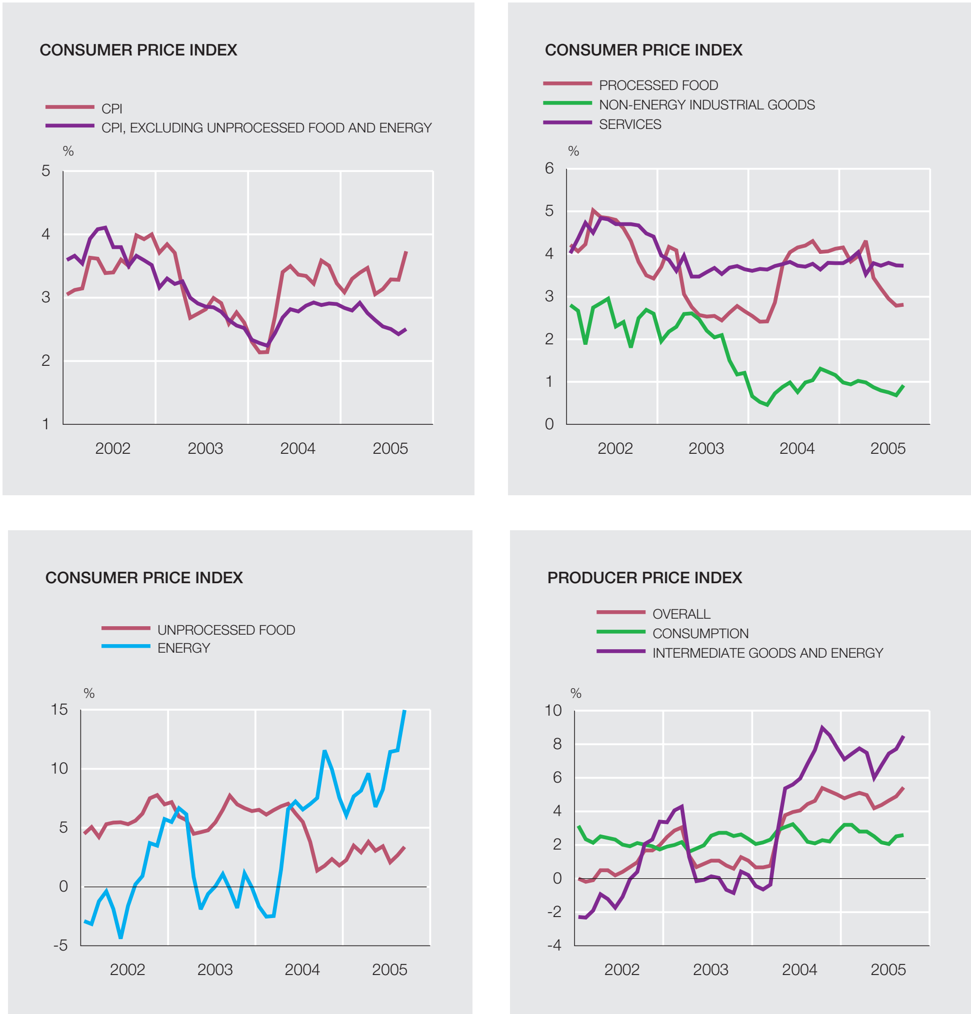
4.4 The State budget

On 27 September the government submitted the draft State budget for 2006 to Parliament. The aim of the budget is to achieve a surplus of 0.2% in 2006, as established in the Pluriannual Budgetary Stability Programme for the period 2006-2008. It is envisaged that the National Accounts balance for the general government sector will end the current year with a surplus of at least 0.1% of GDP, compared with the minor deficit (0.1% of GDP) for the year 2004[3]. In terms of the sub-sectors, central government will, according to this forecast, post a

3. Note, however, that 2004 saw the assumption by the State of the debt of RENFE, as part of the restructuring of the railway system, accounting for 0.7% of GDP. This operation was recorded as capital transfers paid by the State and, therefore, had a bearing on the National Accounts deficit, though not on the cash-basis figures.

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

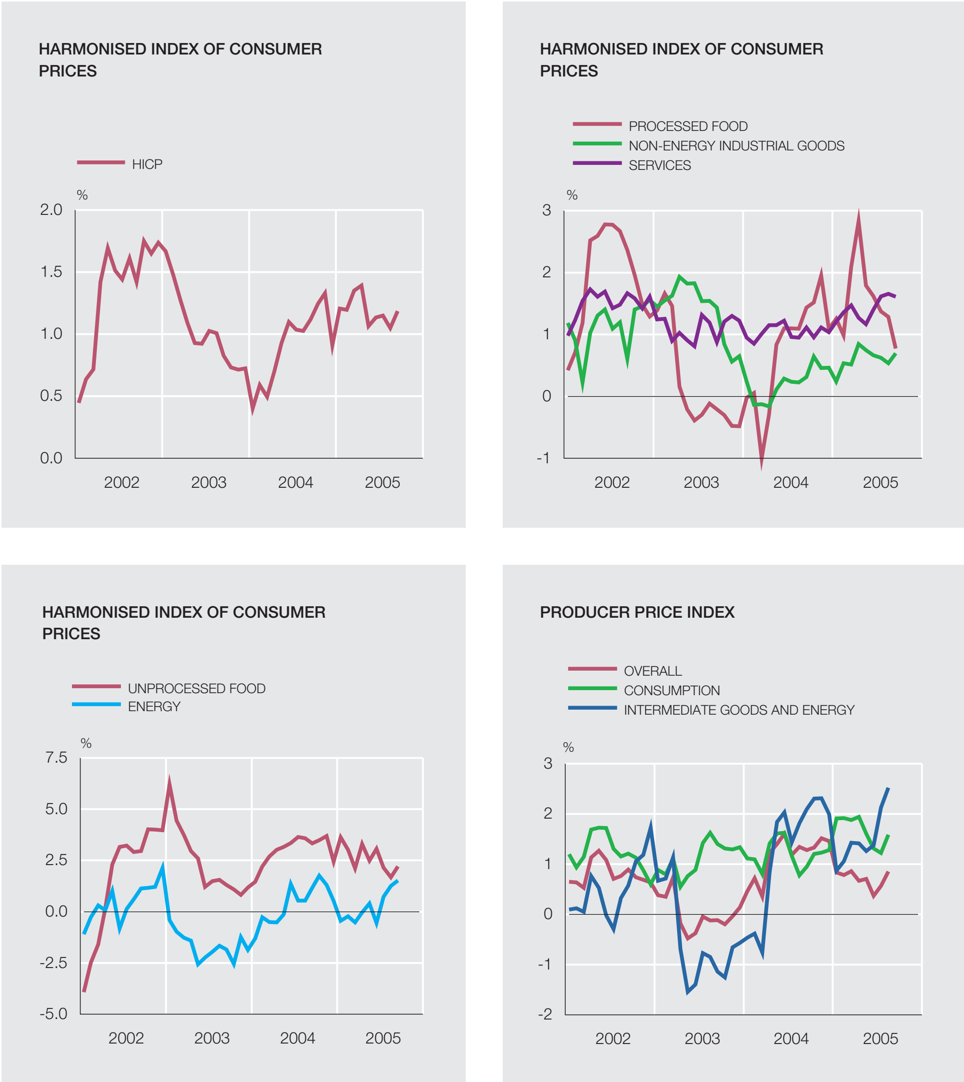
deficit of 0.5% of GDP in 2005, while the regional (autonomous) governments will end the year with a deficit of 0.1% of GDP and the local government accounts will remain in balance. As regards the Social Security system accounts, these are expected to be in surplus to the tune of 0.7% of GDP (see Box 4).

According to National Accounts methodology, the State accounts posted a surplus in the nine months to end-September of €8,108 million (0.9% of GDP) notably up on the surplus of €585 million (0.1% of GDP) in the same period a year earlier (see Table 3). This is due to the strong growth of revenue (14.2%), while expenditure has been contained somewhat, and will increase by 4.6%. In both cases, but especially in that of revenue, the growth rates observed to September exceed the forecast for the whole year provided by the 2005 outturn projection, included in the draft State budget for 2006. The projection augurs a State deficit of €3,073 million (0.3% of GDP).

In cash-basis terms, the State will record a slight deficit in 2005 (€220 million) according to the outturn projection, a substantial improvement on the deficit foreseen in the initial budgetary documentation, which set the deficit at €6,935 million. This difference arises as a result of

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.

higher tax revenue (especially indirect tax) and other net revenue, and of lower-than-budgeted expenditure (owing to the effect of lower interest payments and, probably, the only partial use of the Contingency Fund).

The State budget outturn to September resulted in a surplus of €3,599 million, compared with the deficit of €2,513 million recorded in the same period a year earlier (see Table 3). This performance is along the lines of that recorded to June, with a similar slowdown both in revenue and expenditure during Q3. Revenue increased by 15.7% to September, compared with 17% to June, while expenditure rose by 7.8%, against 9% in the first half of the year.

For the analysis of revenue, there is information on total takings under the main tax headings, both the portion assigned to the State, which is the only one reflected in Table 3, and the portion corresponding to the Regional (Autonomous) Governments. This aggregate information is more illustrative for evaluating tax revenue. The figures for total takings indicate that both direct taxes and other revenue quickened slightly during Q3, while indirect taxes slowed (due to VAT).

The Social Security system posted a surplus of €7,405 million in the period to July 2005, €463 million (6.7%) up on the same period the previous year, signifying a slightly less favourable outturn than that to April. However, the result to July contrasts vividly with the strong reduction in the surplus that is obtained on comparing the initially budgeted figure for 2005 with the previous year's outturn[1] (see accompanying table). Revenue quickened slightly in the recent period, growing at a rate of 7.2%, while the acceleration in expenditure was greater, posting an increase of 7.3% as a result of the course of sickness benefits and of non-contributory pensions.

Receipts from social security contributions quickened slightly and increased by 7.3% in the seven months to July, somewhat above the rate for 2004 as a whole (6.9%). The number of Social Security registrations rose by 4% in the period to September 2005, partly as a result of the ongoing regularisation of foreign workers. If the 468,633 additions to 30 September further to this regularisation process are discounted, the growth of the number of registrations in the first nine months of 2005 would have retained its momentum, since it would be standing at 2.9%, in line with the rate recorded the previous year.

1. This reduction is due to the fact that, as in previous years, takings relating to contributions are greatly underestimated in budgetary projections.

As to expenditure, that earmarked for contributory pensions slowed very slightly and posted an increase of 6.7% to July, marginally down on the budgeted figure and substantially below the rate of 7.2% for 2004 as a whole. However, the number of contributory pensions increased by 1%, somewhat up on that observed in the previous months and above what was expected. Spending on sickness benefits accelerated to 13.5% in July, in line with the previous year.

With regard to the SPEE (the State Employment Public Service), the information on which is not included in the accompanying table, contributions received increased by 8% to June, above the initially budgeted figure. Rebates on contributions in respect of employment-promoting contracts, meanwhile, climbed by 15.1% in the first half of 2005, running counter to the freeze set in the budgetary forecast.

SPEE expenditure on unemployment benefits rose by 6.9% to September, compared with the 9.6% increase in 2004 as a whole. Behind this slowdown was the change in the number of beneficiaries, which grew by 2.8% to July, compared with average growth of 5.6% in 2004. This development came about, in turn, as a result of the decline in registered unemployment, which dipped by 1.2% to September 2005, in contrast to the growth of 1.6% in 2004 as a whole. The effect of this reduction in unemployment on the number of beneficiaries was greater than that of the increase in the eligibility ratio, which stood at 59.8% in the period to July 2005.

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

EUR m and %

	Outturn	Budget		Outturn JAN-APR	Outturn JAN-JUL		
	2004	2005	% change	% change	2004	2005	% change
	1	2	3=2/1	4	5	6	7=6/5
1 REVENUE	88,571	90,040	1.7	7.0	50,762	54,433	7.2
1.1 Social security contributions (c)	82,675	83,915	1.5	7.1	47,489	50,973	7.3
1.2 Current transfers	4,618	4,874	5.5	-2.5	2,899	2,906	0.2
Other (d)	1,278	1,251	-2.1	56.6	374	554	48.2
2 EXPENDITURE	79,105	84,100	6.3	6.4	43,820	47,029	7.3
2.1 Wages and salaries	1,909	1,998	4.7	11.8	1,072	1,186	10.6
2.2 Goods and services	1,556	1,566	0.6	12.9	784	857	9.2
2.3 Current transfers	75,226	80,060	6.4	6.2	41,816	44,884	7.3
Benefits	75,225	80,059	6.4	6.2	41,816	44,883	7.3
Contributory pensions	64,453	68,905	6.9	6.9	36,140	38,569	6.7
Sickness	5,830	5,925	1.6	8.3	2,883	3,271	13.5
Other	4,942	5,229	5.8	-4.2	2,793	3,042	8.9
Other current transfers	1	1	-3.1	—	0	1	—
2.4 Other (e)	414	476	15.0	-26.5	148	102	-31.1
3 BALANCE	9,466	5,940	-37.2	9.0	6,942	7,405	6.7

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

a. Only data relating to the system, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security funds are not available to July 2005.
b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.
c. Including surcharges and fines.
d. Excluding surcharges and fines.
e. Reduced by the disposal of investments.

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2004	Percentage change 2004/2003	Outturn projection 2005	Percentage change 2005/2004	Outturn JAN-JUN Percentage change 2005/2004	Outturn 2004 JAN-SEP	2005 JAN-SEP	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	114,950	4.8	122,166	6.3	17.0	79,592	92,093	15.7
Direct taxes	58,692	3.9	65,933	12.3	22.0	39,189	47,896	22.2
Personal income tax	30,412	-7.3	34,951	14.9	21.8	22,591	27,372	21.2
Corporate income tax	26,025	18.8	28,793	10.6	31.0	14,907	18,888	26.7
Other (a)	2,255	27.1	2,189	-2.9	-11.7	1,691	1,636	-3.3
Indirect taxes	41,368	5.8	43,100	4.2	18.9	30,959	34,672	12.0
VAT	29,124	7.3	30,158	3.6	27.0	21,715	25,116	15.7
Excise duties	9,751	-0.4	10,175	4.3	-4.6	7,388	7,456	0.9
Other (b)	2,493	15.0	2,767	11.0	12.9	1,855	2,100	13.2
Other net revenue	14,890	5.9	13,133	-11.8	-2.7	9,445	9,526	0.9
2 EXPENDITURE	114,891	1.0	122,386	6.5	9.0	82,105	88,494	7.8
Wages and salaries	19,488	5.6	20,677	6.1	7.4	13,919	14,861	6.8
Goods and services	3,510	17.1	3,419	-2.6	-11.6	2,383	2,223	-6.7
Interest payments	16,751	-15.3	18,291	9.2	21.2	13,689	15,421	12.7
Current transfers	61,136	5.3	64,002	4.7	7.6	43,049	46,002	6.9
Contingency fund	…	…	…	…	…	…	…	…
Investment	7,104	-5.7	8,776	23.5	12.0	4,712	5,446	15.6
Capital transfers	6,901	-0.6	7,221	4.6	4.4	4,352	4,541	4.3
3 CASH-BASIS BALANCE (3 = 1 – 2)	59	…	-220	…	…	-2,513	3,599	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	113,330	2.5	120,856	6.6	13.8	78,082	89,193	14.2
Uses	122,652	9.0	123,929	1.0	4.4	77,497	81,085	4.6
NET LENDING (+) OR BORROWING (–)	-9,322	…	-3,073	…	…	585	8,108	…
(as a percentage of GDP)	-1.1		-0.3			0.1	0.9	

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.

Revenue from both personal income tax and corporate income tax maintained high growth rates. In the case of the former, revenue was underpinned by the withholdings on income from work and by the withholdings on gains on mutual funds (with growth of over 30% to September) and, in the latter case, by corporate profits. In both cases, revenue should moderate notably in the final quarter to enable the outturn projection, which points to growth for 2005 as a whole of 12% in personal income tax and 10.6% in corporate income tax, to be met. As regards indirect tax, VAT slowed notably and posted growth of 14%, as the cumulative delay in paying out refunds was partially corrected. This correction should continue in the coming months, with revenue approaching a growth rate of 7.3%, as forecast in the outturn projection. Excise duties remained sluggish throughout the year, influenced above all by the freeze on the tax on hydrocarbons and the moderation in the consumption of this type of product. Following the recent rises in the duties on alcohol and spirits, and on tobacco, the outturn projection foresees higher takings for excise duties, seeing them rise to growth of 4.3% over the year as a whole. Finally, other revenue quickened slightly, with a rate of change of 0.9% to September, owing to the fact that the increase in charges and current transfers offset the decline in interest received and capital transfers. The outturn projection foresees a further slowdown in the sec-

BALANCE OF PAYMENTS: SUMMARY TABLE (a) TABLE 4

EUR m

		JANUARY-JULY	
		2004	2005
CREDITS	Current account	150,327	153,494
	Goods	87,310	89,284
	Services	38,050	39,619
	— Tourism	19,771	20,028
	— Other services	18,279	19,591
	Income	14,888	14,281
	Current transfers	10,080	10,310
	Capital account	5,127	4,737
	Current + capital accounts	155,454	158,231
DEBITS	Current account	172,855	191,166
	Goods	114,566	127,447
	Services	26,413	28,569
	— Tourism	5,182	6,495
	— Other services	21,231	22,074
	Income	22,882	25,028
	Current transfers	8,993	10,122
	Capital account	507	348
	Current + capital accounts	173,361	191,514
BALANCES	Current account	-22,527	-37,672
	Goods	-27,257	-38,163
	Services	11,637	11,050
	— Tourism	14,589	13,532
	— Other services	-2,952	-2,482
	Income	-7,994	-10,746
	Current transfers	1,087	187
	Capital account	4,620	4,388
	Current + capital accounts	-17,907	-33,283

SOURCE: Banco de España.

a. Provisional data.

ond half of the year, due above all to charges (for which a decline of 0.3% over the year as a whole is foreseen, compared with growth of 38.1% to September).

As regards expenditure, the slowdown in Q3 was marked by the deceleration in current expenditure. The growth rates of both wages and salaries and interest and current transfers eased, while the rate of increase of goods and services (the only item posting a negative rate) increased over the course of these months. In all cases, the same trends should continue in the second half of the year, judging by the figures furnished by the outturn projection for the close of the year. Specifically, the additional slowdown in current transfers will be influenced by the exceptional payment of €2,500 million to the Andalusia regional government, for the cancellation of outstanding debt, made in the closing months of 2004. Lastly, there were bigger increases in capital expenditure in this quarter as a result of the strong growth of investment (15.6%), the buoyancy of which is partly due to the fact that the State has included in its accounts investment relating to the conventional railway network since January 2005, as part of the restructuring of the railway system. Unlike with current expenditure, the outturn projection foresees an acceleration in such expenditure in the final months of the year.

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

In the first seven months of 2005, the overall balance on the current and capital account resulted in a deficit of €33,283 million, 86% up on a year earlier. This was due essentially to the notable widening of the current-account deficit (67.2%) and, to a lesser extent, to the slight decline in the surplus on capital transactions (–5%), which stood at €4,388 million. The main items of the current account worsened, especially the trade deficit, although the negative balance on income also widened and the surpluses on tourism and on current transfers declined; conversely, the deficit on non-tourist services showed something of an improvement.

In the January-July period, the deficit on the trade balance increased by €10,906 million in relation to the level attained in the same period a year earlier, rising to a figure of €38,163 million. In year-on-year terms, the deficit widened by 40%, thereby sharpening the notable deterioration already seen the previous year. Behind the significant increase in the trade deficit lay the sluggishness of real export flows in this period — as opposed to the robustness of imports, against the background of a widening economic growth differential with our main trading partners and the prolongation of the recent years' losses in competitiveness — combined with the strong rise in the energy bill. Nonetheless, the pace at which the trade deficit is widening has slowed somewhat from Q2, as a result of the slight pick-up in exports in this period and the greater moderation of imports.

Turning to the services balance, there was a surplus of €11,050 million in the first seven months of 2005, €587 million down on that recorded in the same period the previous year. This deterioration is due to the €1,057 million decline (–7.2%) in the tourism surplus, since the non-tourist services deficit improved by €470 million. Tourist revenue, following a negative performance at the start of the year, posted a slightly positive rate (1.3%) in the period to July, thanks to the recovering path on which it has been moving since May. It should be clarified, however, as acknowledged by the Balance of Payments Department of the Banco de España, INE and the Instituto de Estudios Turísticos (part of the Spanish Ministry of Industry, Trade and Tourism), that tourist revenue in the first half of the year is underestimated and will be revised upwards, meaning that its growth rate in this period could be close to 3%, compared with the initial estimate of -0.5%. Tourist expenditure, for its part, increased by 25.4% in the seven months to July.

The deficit on the income balance worsened notably in the January-July period, climbing to €10,746 million, an increase of €2,752 million on the same period a year earlier. The rate of growth of revenue was negative (–4.1%) as a result of the fall in revenue relating to the private non-financial sector, contrasting with the 9.4% increase in expenditure, owing essentially to the notable momentum of payments made by monetary financial institutions. Foreign direct investment flows into Spain continued to decline in this period, partly as a result of the fall in non-resident investment in real estate, which accounted for more than 40% of direct inflows in this period. However, portfolio investment and other investment from abroad grew notably. As to Spanish investment flows abroad, direct investment increased slightly while portfolio investment gathered considerable steam.

The surplus on the balance of current transfers stood at €187 million in the January-July period, a decline of €900 million in relation to the level seen in the same period in 2004. Revenue increased by scarcely 2.3%, despite the favourable trend of flows from the EU under the EAGGF-Guarantee heading; however, flows directed to the public sector under the European Social Fund fell off. Expenditure, for its part, increased at a much higher rate (12.6%), due above all to the notable increase in expenditure earmarked for Community coffers under the additional resource (GNP) and VAT resource headings. Likewise, emigrants' remittance payments maintained momentum (7.3%), although the strong increase seen the previous year slowed.

Finally, the surplus on capital account was €4,388 million in the first seven months of 2005, €232 million down on the same period a year earlier. This deterioration is due to the notable fall-off in Community transfers under the Cohesion Fund and ERDF flows, while structural funds relating to the EAGGF-Guidance Fund trended favourably.

5 Financial developments

5.1 Overview

In 2005 Q3 the financial conditions of Spanish households and corporations were largely determined by the low interest rate environment. In September, the twelve-month EURIBOR stood on average at 2.22%, up 12 basis points from June, while at the shortest maturities rates remained unchanged, so that the yield curve regained a positive slope between the one-month and twelve-month maturities. During the same period, the ten-year Spanish bond yield fell by 11 bp to the historically low level of 3.09%. These developments, together with the fact that Spanish corporate risk premia remained at moderate levels, led to a further reduction in the cost of bond financing (see Chart 24). Meanwhile, the cost of bank financing for firms and households remained practically unchanged at low values in July and August.

Spanish stock markets, between July and September, remained on an upward trend. The Madrid Stock Exchange General Index rose by 9.3% over the period (by 20.9% since the beginning of the year), thereby outstripping the EURO STOXX broad index of euro area markets (6.2%) and especially the US market S&P 500 (0.1%). These developments, led by the oil and energy sector, were accompanied by continued low levels of volatility and notable growth in the earnings of listed companies.

On the property market, according to Ministry of Housing statistics with base year 2005, the price of appraised unsubsidised housing rose in Q3 by 13.4% year-on-year. The new rate is 0.5 pp down from June and more than 4 pp down from the average rate last year, although it is still at very high levels.

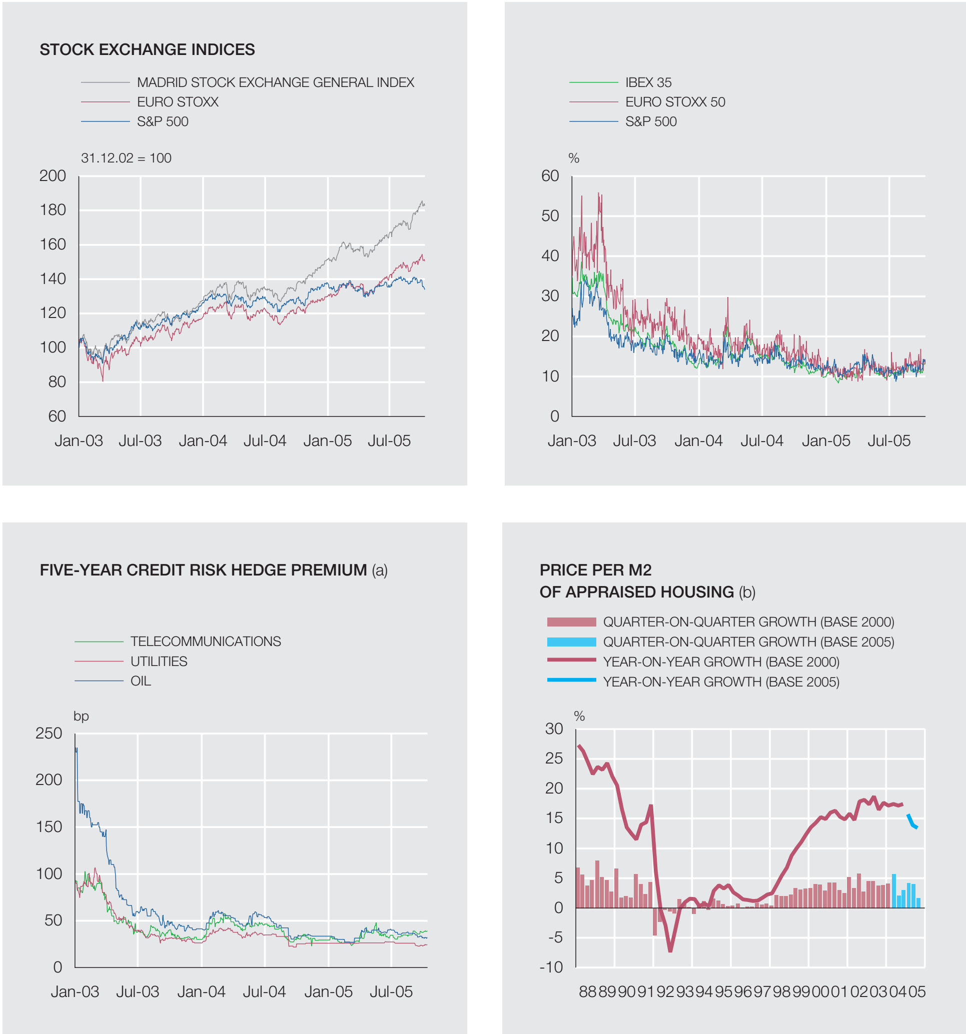
Against this background, between April and June the volume of financing to households and corporations remained on a path of rapid expansion, with growth rates of around 20% and above 16%, respectively. The provisional information available for Q3 points to continuation of the same patterns. This growth in the liabilities of corporations and households is at the root of the fresh increase in the nation's net borrowing which, in cumulative four-quarter terms, rose to 6% of GDP. The intermediation of Spanish credit institutions is channelling the resources needed to finance the economy's current pattern of growth, putting further pressure on their risk management and control systems.

In the case of households, the buoyancy of debt continued to be driven by credit for house purchase, which grew at a rate of close to 24%. This high growth led to a further deterioration in the indicators of financial pressure on the sector in 2005 Q2. Thus, the debt and debt burden of households continued to rise relative to their gross disposable income (GDI), while their saving after debt service fell. Meanwhile, household net lending remained negative, at -0.6% of GDP, in cumulative twelve-month terms (see Table 5). However, the upward trend in house prices and rising stock markets enabled the net worth of households to continue to increase.

The aggregate debt and debt-interest burden of non-financial corporations also rose, relative to their earnings. The debit balance of their financial transactions grew, in cumulative twelve-month terms, to 6.5% of GDP in Q2, as against 5.6% in March, while the financing gap, which approximates the funds necessary to undertake gross capital formation and direct investment abroad, rose by 0.7 pp to 9.6% of GDP. However, according to quarterly Central Balance Sheet Data Office data, these developments were mitigated by the favourable trend in corporate returns, which led the synthetic indicators of financial pressure on investment and employment to remain at moderate levels.

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



SOURCES: Bloomberg, Credit Trade and Banco de España.

a. Average asset-weighted premia. On 22.6.03 a change in the contractual conditions of European firms came into force. The new contract carries lower premia (around 10%).
b. New statistic from 2004.

Financial conditions continued, therefore, to contribute to boosting household and corporate spending. That said, there was a further deterioration in some indicators of financial pressure. In the case of households this has tended to increase the risks to the medium-term growth of consumption and residential investment described in previous reports.

The risks to private productive investment arising from the financial situation of companies are, in contrast, more balanced, since the increase in debt has been accompanied by an improvement in firms' profitability and signs of a possible end to large companies' rebuilding of their balance sheets. That said, it should not be forgotten that the continued rise in corporate liabilities increases the sector's exposure to adverse developments in the macroeconomic environment and in the cost of financing.

5.2 Households

The financing conditions for households remained highly favourable during Q3. In August, the interest rates applied to new housing loans stood at 3.3%, the same level as in June, while the cost of bank finance for consumption and other purposes reached 6.4% (up 40 bp from the middle of the year). According to data from the latest available Bank Lending Survey, institu-

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP (a)	2000	2001	2002	2003	2004			2005	
					Q2	Q3	Q4	Q1	Q2
National economy	-2.9	-3.7	-2.8	-3.1	-3.7	-4.2	-4.8	-5.5	-6.0
Non-financial corporations and households and NPISHs	-2.8	-4.6	-3.9	-4.5	-4.8	-5.7	-5.4	-6.4	-7.1
Non-financial corporations	-4.4	-6.0	-4.7	-4.6	-5.2	-5.7	-5.0	-5.6	-6.5
Households and NPISHs	1.6	1.4	0.8	0.1	0.4	0.0	-0.4	-0.8	-0.6
Financial institutions	0.8	1.5	1.4	1.4	1.4	1.2	0.7	0.6	0.6
General government	-0.9	-0.5	-0.3	0.0	-0.2	0.3	-0.2	0.2	0.5
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (b)	-14.4	-9.5	-9.7	-9.5	-9.2	-9.0	-7.6	-8.9	-9.6

SOURCE: Banco de España.

a. Spanish National Accounts, base 2000.
b. Financial resources that cover the gap between expanded gross capital formation (real and permanent financial investment) and gross saving.

tions planned to offer similar lending terms between July and September to those existing in the three previous months, while expecting the demand for funds to be relatively stable.

The generous financial conditions continued to help sustain the growth of household debt, which carried on growing at a high year-on-year rate in Q2, of around 20%, as has been the case since mid-2004. This growth was again driven by credit for house purchase, which grew by around 24%, representing a flow equivalent to 9.5% of GDP, in cumulative twelve-month terms, 0.3 pp more than in March. The funds assigned to consumption and other purposes grew more moderately, at around 11%. The provisional information to August on the financing of the sector shows the same patterns as in the preceding months.

Household financial investments between April and June amounted to 9.8% of GDP in cumulative twelve-month terms (see Table 6). The weight of liquid, low risk assets (cash and deposits) rose, to 6.7% of GDP, as against 6% in March. Meanwhile, investments in the form of insurance technical reserves and in mutual funds held relatively stable, at 2% and 1.4% of GDP, respectively. Finally, there was a net divestment of shares equivalent to 0.5% of GDP, despite the favourable performance of stock markets.

As a result of the developments in the flows of financial assets and liabilities, household net lending, according to the June Financial Accounts, was negative, being equivalent to -0.6% of GDP in cumulative twelve-month terms. This negative sign contrasts with the credit position traditionally shown by the household sector, but the figure was 0.2 pp lower than in March.

The expansionary trend in financing led to a further rise in household debt, as a percentage of GDI, to 106% in Q2 (see Chart 25). Likewise, the associated debt burden, despite the stability of the interest rate, rose to practically 14% of GDI. This, along with the decline in gross saving, led to a further decline in the sector's saving after debt service. That said, the information from the Spanish family expenditure survey shows that the percentage of households that can save and the percentage that report some degree of difficulty making ends meet (around 39% and 55%, respectively) held steady.

A MEASUREMENT OF THE TAX INCENTIVE TO THE DEMAND FOR HOUSING IN SPAIN

BOX 5

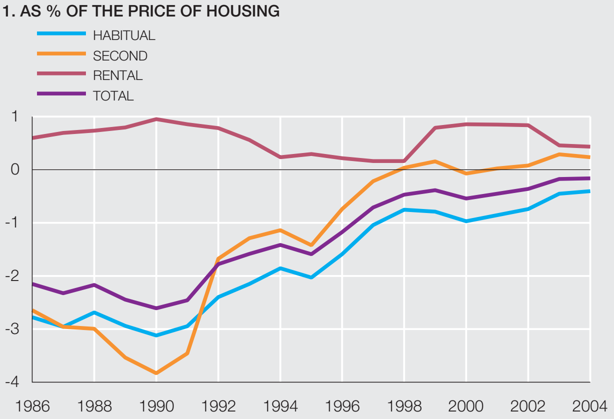
In western societies, the availability of a home is considered a basic objective (if not a right). This, together with the positive externalities associated with house ownership, has meant that, in many countries, including Spain, there have traditionally been tax incentives for house purchases.

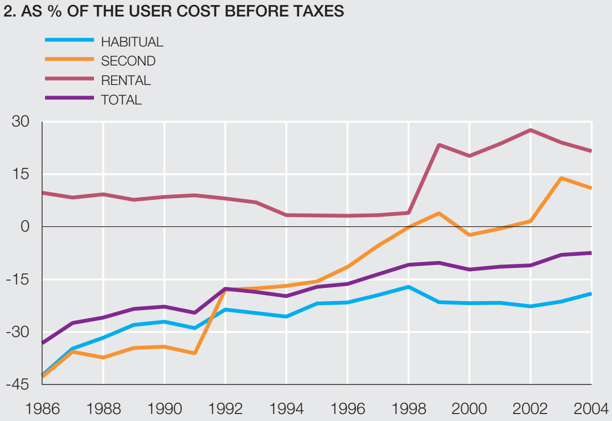
This box presents an estimate of the net incentive arising from the tax system for the demand for housing in Spain during the period 1986-2004, taking into account the structure (income, number of persons submitting tax returns, recourse to external financing) of households demanding housing in Spain. Also, not only are purchases of habitual dwellings considered, but also those of second dwellings for own use and to rent out, along with their specific tax treatment in each case. In this way it is possible to obtain an aggregate measure that takes into account the characteristics of the housing market in Spain and its evolution. The necessary information is obtained from various sources (in particular, the Spanish Survey of Household Finances (EFF), recently established by the Banco de España, and housing censuses) and the measure used is the tax wedge, or difference between the user cost of property calculated before and after taxes and deductions.

The adjoining chart shows the tax wedge over the last 19 years, both as a percentage of the price of housing and of its user cost before taxes. When interpreting this measure, it should be taken into account that the exercise performed did not consider the possible pass-through of tax incentives into house prices. Also, the taxes associated with property construction and development and the direct government assistance to the purchase of subsidised housing were not considered either.

In any case, the chart shows that the total tax wedge remained negative throughout the period considered, indicating that the overall effect of taxes and subsidies on purchasers was a net subsidy and, therefore, an incentive to the demand for housing vis-à-vis other alternative assets. As might be expected, this is particularly true in the case of housing acquired as a habitual residence. On the other hand, the positive value of the tax wedge for housing acquired for rental shows that the existence of taxes associated with its purchase is not offset, in this case, by significant deductions in personal income tax (IRPF). As regards the tax regime for purchases of second dwellings for own use, there was a fundamental change in 1992, when the deductions for investment and the payment of interest on external financing associated with such purchases disappeared. However, the treatment of this type of purchase was still relatively favourable, insofar as the imputed income taxed under the IRPF was generally below the actual income that could be obtained by renting out the property on the market.

During the period considered, the total tax wedge displayed a downward trend in terms of the price of housing. This is basically, but not exclusively, a result of the decline in nominal interest rates. Thus, lower rates involve a smaller implicit return on housing, so that the advantages arising from the favourable tax treatment of this return are also smaller. In addition, in the case of habitual dwellings, there was a decline in the effect of the deduction for interest in the IRPF. Thus, the tax system continues to favour housing over other alternative assets, although its effect on the house price upswing that the Spanish economy is still experiencing does not seem to have been significant.





SOURCE: Banco de España.

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

TABLE 6

% GDP (a)

	2001	2002	2003	2004	2005	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	7.5	8.3	9.3	10.0	9.7	9.8
Cash and cash equivalents	1.1	3.6	4.2	3.9	4.2	4.2
Other deposits and fixed-income securities (b)	3.4	1.7	-0.1	2.0	1.8	2.5
Shares and other equity (c)	-0.2	0.6	0.6	0.1	-0.2	-0.5
Mutual funds	0.8	0.2	2.3	1.5	1.3	1.4
FIAMM	1.2	0.7	0.6	-0.2	-0.1	0.0
FIM	-0.5	-0.5	1.7	1.6	1.2	1.3
Insurance technical reserves	2.6	2.5	1.8	1.8	1.9	2.0
Of which:						
Life assurance	1.4	1.4	0.7	0.7	0.7	0.8
Retirement	0.9	0.9	0.9	0.9	0.9	1.0
Other	-0.1	-0.3	0.5	0.7	0.6	0.1
Financial transactions (liabilities)	6.1	7.5	9.1	10.4	10.5	10.4
Credit from resident financial institutions (d)	5.4	7.2	9.2	10.8	11.0	11.4
House purchase credit (d)	4.7	5.1	7.0	8.7	9.2	9.5
Consumer and other credit (d)	0.6	2.1	2.2	2.0	1.8	1.9
Other	0.7	0.3	0.0	-0.4	-0.5	-1.0
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.6	14.5	16.2	14.0	16.2	17.5
Cash and cash equivalents	1.6	1.6	0.8	1.0	1.2	1.2
Other deposits and fixed-income securities (b)	0.9	1.6	1.4	0.8	0.7	1.0
Shares and other equity	5.4	6.6	7.5	4.2	4.9	4.6
Of which:						
Vis-à-vis the rest of the world	3.9	4.8	4.5	2.6	3.4	3.1
Other	6.8	4.7	6.5	8.0	9.4	10.7
Financial transactions (liabilities)	20.7	19.2	20.8	19.0	21.8	24.1
Credit from resident financial institutions (d)	5.8	5.4	6.4	8.5	9.6	10.8
Foreign loans	3.8	2.7	2.7	0.5	0.9	0.8
Fixed-income securities (b)	0.0	-0.4	-0.2	0.0	0.0	0.0
Shares and other equity	4.9	5.9	5.2	2.7	2.7	2.4
Other	6.2	5.5	6.7	7.3	8.6	10.1
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.3	14.0	15.9	16.1	17.3	18.0
Households and NPISHs	12.6	16.2	19.0	20.1	20.1	20.0
Non-financial corporations	17.4	12.4	13.5	12.9	15.0	16.5

SOURCE: Banco de España.

a. CNE with base 2000.
b. Not including unpaid accrued interest, which is included under "other".
c. Excluding mutual funds.
d. Including off-balance-sheet securitised credit.
e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 25

SOURCE: Banco de España.

a. Until 2000, the sectoral National Accounts data correspond to the CNE with base 1995. From 2000, a provisional estimate consistent with the CNE with base 2000 is used.
b. Includes bank credit and off-balance-sheet securitised credit.
c. Assets 1 = total financial assets - "other".
d. Assets 2 = assets 1 - (shares including shares in FIM).
e. 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. New house price statistics from 2004.
f. CNE with base 2000.
g. Estimated interest payments plus debt repayments.
h. Balance of households' use of disposable income account.
i. Gross saving less estimated debt repayments.

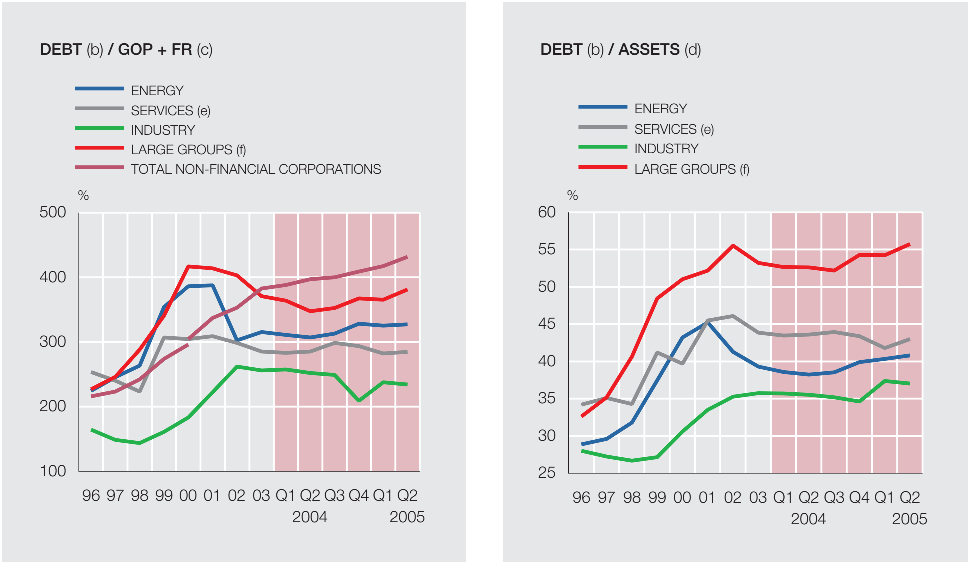
Meanwhile, the net wealth of the sector continued to grow in Q2, driven by stock market developments and, above all, by the price of property. As a result of the increase in the value of property, the affordability of housing continued to deteriorate.

5.3 Non-financial corporations

The financing conditions of companies were also highly favourable in Q3. Thus, in August, the interest rates charged by credit institutions on new loans to companies remained at low levels (2.9%-4%, depending on the size of the transaction), similar to those in June. Likewise, according to the latest Bank Lending Survey, the institutions planned to offer lending terms between July and September similar to those existing between April and June, while expecting companies’ demand for funds to continue to accelerate. At the same time, the reduction in the public debt yield and moderate risk premia enabled the costs of financing to fall further, albeit only slightly, while the rise in stock market indices tended to facilitate the raising of funds on equity markets.

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a)

CHART 26



SOURCE: Banco de España.

a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series «total non-financial corporations», which was obtained from the National Accounts (CNE and FASE). Until 2000, the income of the sector corresponds to the CNE with base 1995. From 2000, a provisional estimate consistent with the CNE with base 2000 was used.
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
e. Excluding holding companies.
f. Aggregate of all the firms belonging to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.

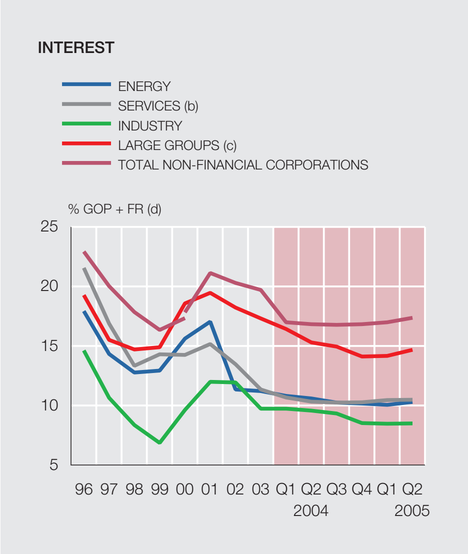
Against this background, the volume of the liabilities-side transactions of corporations between April and June was large, exceeding 24.1% of GDP in cumulative twelve-month terms, up 2.3 pp from March (see Table 6). By instrument, the main source of financing continued to be external funds. Within the latter, credit from resident financial institutions accounted for the bulk of the funds, with a flow equivalent to 10.8% of GDP, while loans from non-residents remained at similar levels to Q1 (0.8%) and the net issuance of fixed-income securities was practically zero. Meanwhile, those in the form of shares and other equity fell by 0.3 pp to 2.4% of GDP, despite the improvement in financing conditions on stock markets. In terms of rates of change, the year-on-year growth of debt reached more than 16% in June, an increase of 1.5 pp from March. The latest provisional information shows no significant changes in this accelerating profile.

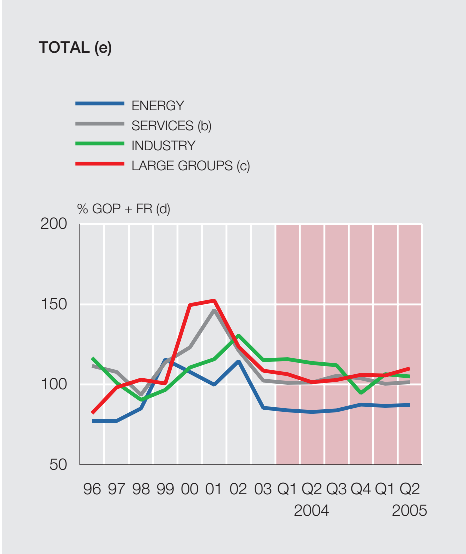
The amount of the financial investments of non-financial corporations also grew, although more moderately, to 17.5% of GDP in cumulative twelve-month terms, up 1.3 pp from March. The breakdown by instrument shows that the largest change was in the heading that includes trade credit (included in the item “other” of Table 6), the volume of which stood at 10.7% of GDP (1.3 pp above the previous figure). Meanwhile, share purchases fell by 0.3 pp, to 4.6% of GDP, this being fully explained by the behaviour of securities issued by non-residents, while funds in other deposits and fixed-income securities increased by a similar amount to reach 1% of GDP.

As a result of these developments in assets and liabilities-side transactions, there was a notable rise in the net borrowing of corporations to 6.5% of GDP in June, in cumulative twelve-month terms, a figure that was 0.9 pp higher than in March (see Table 5). Meanwhile, the fi-

DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a)

CHART 27



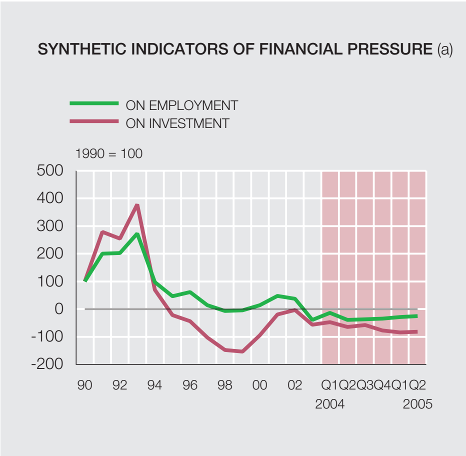


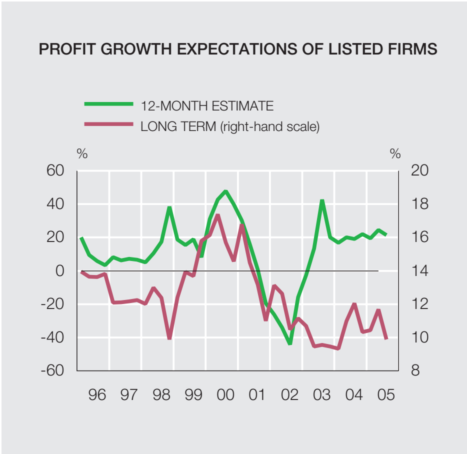
SOURCE: Banco de España.

a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series "total non-financial corporations" which was obtained from the National Accounts (CNE and FASE). Until 2000, the income of the sector corresponds to the CNE with base 1995. From 2000, a provisional estimate consistent with the CNE with base 2000 was used.
b. Excluding holding companies.
c. Aggregate of all the firms belonging to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.
d. Gross operating profit plus financial revenue
e. Includes interest plus interest-bearing short-term debt.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 28



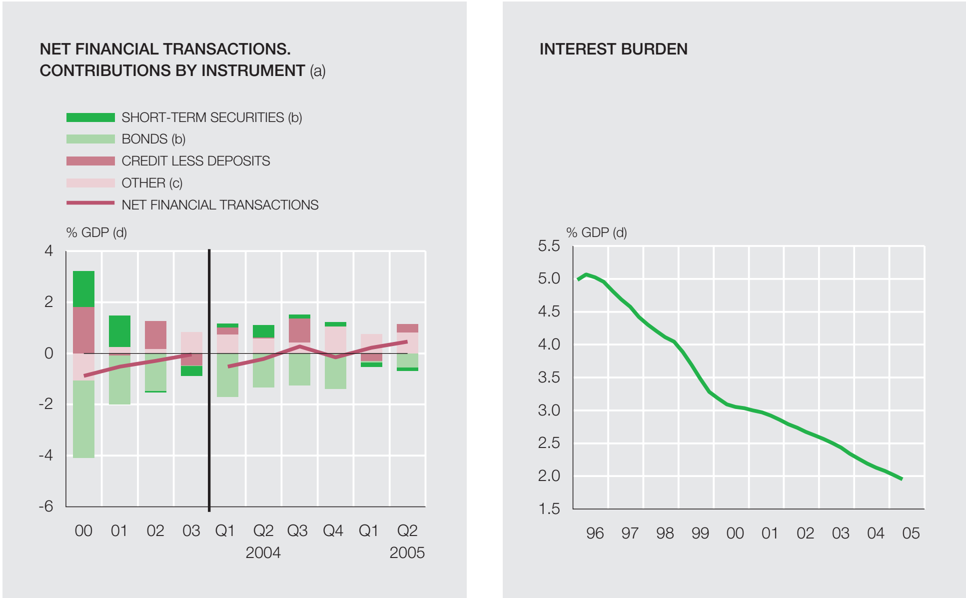


SOURCES: I/B/E/S and Banco de España.

a. Indicators estimated drawing on the CBSO annual and quarterly surveys. A value above (below) 100 indicates more (less) financial pressure than the reference level.

GENERAL GOVERNMENT
Cumulative four-quarter data

CHART 29



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.
d. CNE with base 2000.

nancing gap, which approximates the funds necessary to undertake gross capital formation and foreign direct investment rose to 9.6%.

The rapid expansion of the external funds of the companies caused the aggregate debt of the sector to continue to grow, to 430% of gross operating profit plus financial revenue (see Chart 26). Also, interest payments rose relative to profits, although they remained at moderate levels thanks to the stability of the costs of financing (see Chart 27). Similar developments were seen in the case of companies belonging to large industrial groups. Meanwhile, the ordinary net profit of firms reporting to the quarterly survey of the Central Balance Sheet Data Office grew by 10.7% during the first half. Although this figure was below the 21.2% rate recorded in the same period of the previous year, it was sufficient to raise the returns on investment (8.2%) and on equity (12%) and to keep the synthetic indicators of financial pressure on investment and on employment at historically low levels (see Chart 28).

Finally, analysts' expectations as to the earnings growth of listed non-financial corporations were revised slightly downwards in Q3, although in the case of short-run expectations they remained high.

5.4 General government

In 2005 Q2, the balance of the general government sector's net financial transactions was again positive, making for a further improvement in the sector's financial saving in cumulative twelve-month terms, which stood at 0.5% of GDP, as against 0.2% in March (see Chart 29).

In terms of instruments, there was a positive net issuance of short and long-term securities by general government, in cumulative twelve-month terms, while the balance of its deposits rose relative to the same period of the previous year. For their part, interest payments continued to

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP (a)

	2001	2002	2003	2004	2005	
				Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-3.7	-2.8	-3.1	-4.8	-5.5	-6.0
FINANCIAL TRANSACTIONS (ASSETS)	11.0	13.0	12.9	12.0	13.2	12.9
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-2.6	3.3	0.7	3.4	3.3	2.6
Securities other than shares	6.9	4.1	6.5	1.7	2.4	3.4
Of which:						
Credit institutions	1.9	0.5	3.5	1.0	0.6	1.9
Institutional investors (b)	5.2	3.1	3.1	0.0	1.2	1.0
Shares and other equity	4.4	5.0	4.7	5.7	5.8	5.1
Of which:						
Non-financial corporations	3.9	4.8	4.5	2.6	3.4	3.1
Institutional investors (b)	0.4	-0.1	1.1	1.0	1.0	0.6
Loans	2.3	0.6	0.9	1.3	1.6	1.8
FINANCIAL TRANSACTIONS (LIABILITIES)	14.6	15.8	16.0	16.8	18.7	18.9
Deposits	2.5	4.0	6.9	1.7	2.2	0.5
Securities other than shares	2.9	4.3	5.3	12.2	12.6	15.1
Financial institutions	1.4	3.1	6.4	9.6	11.3	14.1
Other national sectors	1.5	1.2	-1.1	2.6	1.4	1.0
Shares and other equity	4.4	4.0	1.1	1.9	2.1	1.8
Of which:						
Non-financial corporations	3.8	3.3	1.3	0.9	1.3	0.9
Loans	4.2	3.3	3.2	1.5	2.1	2.0
Other, net (c)	0.7	0.2	-0.5	-0.5	-0.5	-0.5

SOURCE: Banco de España.

a. CNE, base 2000.
b. Insurance corporations and portfolio investment institutions.
c. Includes the asset-side caption reflecting insurance technical reserves.

fall relative to GDP, as a result of both the fall in financing costs and the downward path of the debt-to-GDP ratio.

5.5 *The rest of the world*

In 2005 Q2, the debit balance of the nation's financial transactions continued to deteriorate, to 6% of GDP, in cumulative twelve month terms, as against 5.5% in March (see Table 5). By sector, this behaviour was the result of higher net borrowing by non-financial corporations and households, which was not fully offset by general government saving.

In Q2, investment in external assets by resident sectors amounted to 12.9% of GDP, in cumulative twelve-month terms, down 0.3 pp from March (see Table 7). By instrument, purchases of shares and other equity abroad continued to account for a high percentage of flows, representing 5.1% of GDP. Meanwhile, funds in the form of cash and deposits fell by 0.7 pp, to 2.6% of GDP while securities other than shares rose by 1 pp, to 3.4% of GDP.

For their part, the new liabilities assumed vis-à-vis the rest of the world amounted to 18.9% of GDP, in cumulative twelve-month terms, 0.2 pp above the figure recorded in March. By instrument, the bulk of the capital inflows were channelled through the issuance of securities other than shares by financial institutions, which totalled 14.1% of GDP, up 2.8 pp from 2005 Q1.

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

TABLE 8

% GDP (b)

	2000	2001	2002	2003	2004	2005 (c)
National economy	-26.1	-27.1	-30.0	-36.0	-42.1	-43.8
Non-financial corporations and households and NPISHs	-9.6	-10.6	-11.2	-13.6	-12.5	-9.3
Non-financial corporations	-16.6	-17.7	-18.0	-21.1	-20.7	-17.9
Households and NPISHs	6.9	7.0	6.8	7.5	8.3	8.6
Financial institutions	7.3	7.4	5.6	-1.3	-6.6	-11.4
Credit institutions (d)	-11.9	-14.1	-14.3	-21.7	-22.9	-23.2
Institutional investors (e)	20.1	23.3	23.4	26.4	26.6	27.2
Other financial institutions	-0.9	-1.8	-3.4	-6.0	-10.4	-15.5
General government	-23.7	-23.9	-24.4	-21.1	-23.0	-23.1

SOURCE: Banco de España.

a. Calculated as the difference between the stocks of financial assets and liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.
b. CNE, base 2000.
c. Q2 data.
d. Defined in accordance with the First Banking Directive.
e. Insurance corporations and portfolio investment institutions.

This shows the central role played by these institutions in raising abroad the funds necessary to finance the economy's growing external deficit.

Finally, the developments in flows with the rest of the world, along with the changes in the price of financial assets and the exchange rate, led to a further increase in the debit position of the Spanish economy vis-à-vis the rest of the world, which stood in June at 43.8% of GDP (see Table 8). By sector, there was a deterioration in the position of financial institutions, which was not fully offset by the improvement in that of non-financial corporations and households.

18.1.2006.