QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

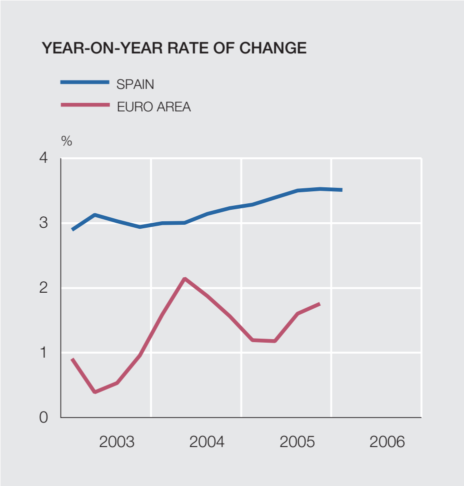
The Spanish economy ended the year 2005 in a highly robust mode stabilising at a real year-on-year rate of 3.5%, although the hitherto mildly rising trend of its growth rate was checked. This performance continued to be clearly more expansionary than that in the euro area as a whole (see Chart 1). The QNA estimates for 2005 Q4 showed a fresh improvement in the negative contribution of net external demand to growth, underpinned by the slowdown in imports and, in a more muted fashion, an easing of the brisk pace of national demand, which stood below 5%. In the opening months of 2006, and drawing on as yet incomplete conjunctural data, real GDP is estimated to have again posted a high year-on-year increase (of 3.5%), similar to that of the previous quarter. Quarter-on-quarter growth, for its part, would have been 0.8%, compared with 0.9% in 2005 Q4.

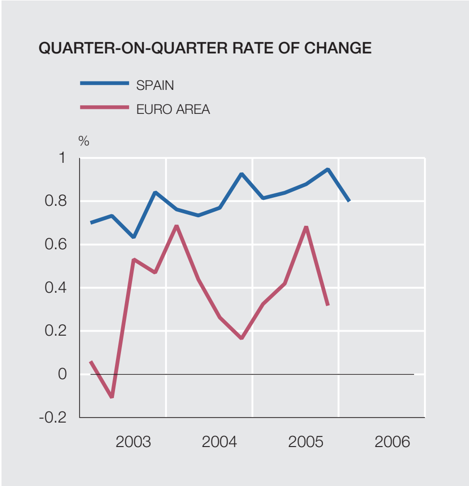
National demand continued its slow deceleration in early 2006 (its growth rate fell by 0.1 pp to 4.7%), underpinned by the course of private consumption and of investment in fixed capital. The momentum of both investment in equipment and construction eased, although the growth of gross capital formation held at around 6%. The improvement in the contribution of net external demand was less sharp than during 2005, standing at –1.4 pp, 0.1 pp less than in the previous quarter. Significantly, however, goods exports picked up substantially in these opening months, while imports also increased at a higher rate. Employment trended in line with output, maintaining its growth rate, with no changes discernible in the pattern of low productivity gains. Finally inflation, measured by the HICP, rose notably at the start of 2006 and stood at 3.9% in March, fuelled by dearer oil and by the rise in underlying inflation to over 3%.

Turning to the external environment, the world economy began the year with high growth rates, the year 2005 having closed with an expansion that the IMF has recently estimated at 4.8%. Indeed, the available forecasts point to an increase of this order in 2006. Mention may be made of the greater geographical diversification of world growth, based on the recovery in Japan and in the euro area, while a somewhat lesser increase is expected in the United States. Among the emerging economies, dynamism remains very forceful, especially in Asia, although there has been some easing in Latin America. Generally, the behaviour of the financial and foreign exchange markets, characterised by stability, the moderation of risk premiums and low volatility, has been supportive of growth. Against this background, the gradual withdrawal of the monetary impulse in the main economies (the process is furthest ahead in the United States, just starting in the euro area and foreseeably due to start in Japan during the second half of this year) is finally translating into a rise in long-term interest rates, although these remain at low levels.

The cloud on this favourable horizon has been the oil market, with the oil price exceeding its all-time high in April. The fresh rise in oil has been prompted by the emergence of geopolitical tensions in certain producer zones. And this, against the backdrop of the strong increase in demand and scant production and refining capacity, has rapidly fed through to prices. Along with oil, other commodities have also seen their prices rise. So far, the influence of these increases on inflation and growth rates remains limited; but a delayed emergence of these effects should not be ruled out. Further, the risk of tensions in the oil market being exacerbated is high and, given that the source would, in this case, be a possible cut in supply, the impact on global growth could be greater. Moreover, dearer oil tends to heighten the uncertainty surrounding the world economy, particularly that stemming from the persistence of global imbalances and from the high US external deficit, which has tended to widen in 2005. Although the

GROSS DOMESTIC PRODUCT (a) CHART 1





SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

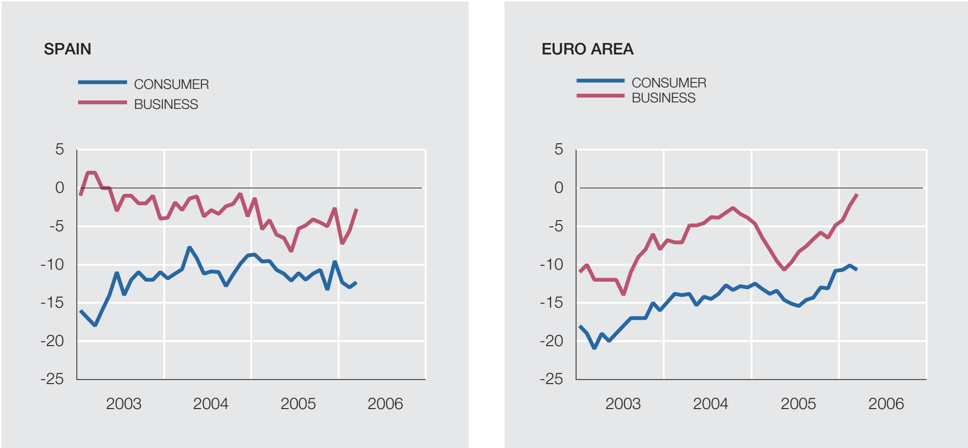
financing of this deficit poses no problems for the moment, its dynamics do not seem to be sustainable, and its direction in the medium term will require certain adjustments and some type of economic policy co-ordination to lessen the risk of sharp swings on markets.

Although average growth was low (1.4%) in the euro area in 2005, economic activity in the zone improved clearly in the second half of the year, when a rate close to potential growth was attained. Set against this recovery, the figures for Q4 reflected a temporary slowdown, largely as a result of technical factors associated with the National Accounts estimates, which appears to have been overcome in 2006 Q1. Indeed, the indicators for the opening months of 2006, which are in the main still qualitative in nature, and the initial estimates, in terms of intervals, made by the European Commission point to a quarter-on-quarter growth rate of around 0.5%.

As in the second half of 2005, growth remains underpinned by the increase in private investment, favoured by the generous financing conditions and the healthy position of European companies, and by sound export results. However, household consumption remains at a low rate, due principally to the scant dynamism of disposable income, where both limited job creation and the moderate trend of wages have a bearing. The low levels of consumer confidence, linked possibly to the uncertainty surrounding their income expectations, have likewise been a factor containing expenditure, although the latest figures indicate an improvement here (see Chart 2). In any event, the pick-up in employment and consumption is the factor posing the biggest risks, from a domestic perspective, to higher growth taking root in the area.

The moderate course of unit labour costs in the euro area, anchored in inflation expectations consistent with area-wide price stability, is a key factor for explaining the behaviour of inflation. Despite the upward impact of energy prices, inflation has held at a level only slightly above 2%. The year-on-year increase in the HICP thus stood at 2.2% in March, while underlying inflation, which excludes the energy component among others, held at below 1.5%, revealing the absence of relevant pressures on core prices. Nonetheless, the risk remains that dearer oil may extend over time and ultimately affect the inflationary core, especially against a background of more buoyant activity as is expected. This has led the ECB governing Council to continue to reduce the expansionary character of its monetary policy stance, raising official interest rates by

CONFIDENCE INDICATORS CHART 2



SOURCE: European Commission.

25 bp in March. This increase, which adds to that of the same amount made last December, leaves the interest rate on the main refinancing operations at 2.5%, a level which is still low.

Following the presentation of the newly updated Stability Programmes in late 2005, there have been no substantial changes regarding the design of the euro area countries' fiscal policies. These programmes comply with the new criteria applicable under the Stability and Growth Pact, following the reform agreed last year (albeit with only a small margin in the case of some countries running an excessive deficit). It is estimated that the fiscal results for 2005 as a whole were better than foreseen in autumn by the European Commission and that they have drawn closer to the budgetary targets initially set. This result is largely attributable to the economic recovery in the area. In this respect, it is important to reiterate the need for the European countries to step up their budgetary consolidation drive so as to make growth more sustainable, now that a phase of higher growth has begun. Along the same lines, it is important to implement the commitments made in the National Reform Programmes, approved as part of the re-launch of the Lisbon strategy.

The recovery in the main euro area economies is an important add-in to the environment in which the Spanish economy is operating since it may help see through the changes which, very incipiently, are taking place in the composition of demand, making it somewhat less unbalanced. As earlier mentioned, in recent quarters and with differing degrees of intensity and persistence, there has been a pattern of slow moderation in national demand (which retains a very high rate), along with a reduction in the negative contribution of external demand to growth, although this contribution remains highly contractionary. The estimates for 2006 Q1 are generally in line with these trends, consolidating an increase in domestic demand of slightly below 5% and a negative contribution of net external demand of somewhat below 1.5 pp in absolute terms. In this setting, the lesser degree of looseness of monetary and financial conditions, and the moderate slowdown seen in house prices, consistent with the gap between their current and long-term equilibrium levels gradually being reabsorbed, would provide for the gradual adjustment of expenditure. Nonetheless, set against these factors, the build-up of losses in price and cost competitiveness has continued, with the continuing risk of a fresh widening of the external imbalance.

Household consumption increased by 4% in 2005 Q4, 0.5 pp down on the growth in the first six months of last year, and it is estimated to have slowed further in the opening months of

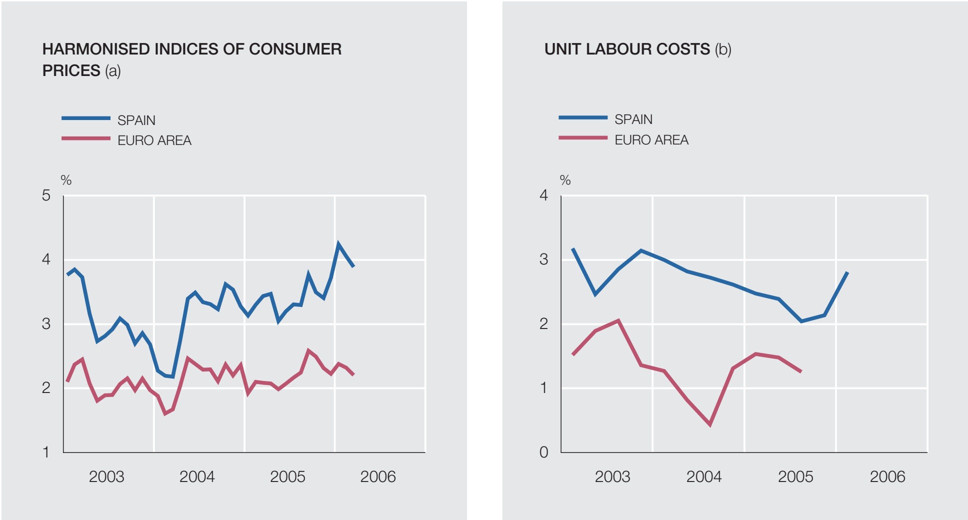
2006. Even so, it continues clearly to outgrow disposable income, the increase in which is firmly underpinned by employment growth, at a rate of close to 3%. The rise in interest rates provides for an easing in consumption, essentially via the effect on income, from which it is subtracting several tenths of a point of growth. Also, the lesser rise in household wealth, linked to the lower growth in house prices, contributes to slowing expenditure, although this lower growth is not sufficient to halt the reduction in the saving ratio. In the case of residential investment, where the impact of higher financing costs is in principle more forceful, the moderation in expenditure is currently also proving gradual. As a result, in the opening months of 2006 the rise in financing extended to households has continued to be very high, at a rate of over 20%, giving rise to a fresh increase in the debt ratio and in the financial burden, which raises the vulnerability of expenditure to any further tightening of monetary conditions.

Corporate expenditure on gross capital formation has retained significant momentum, against a background of expectations of high demand, although it has tended to slow in relation to the first half of 2005 (as illustrated by spending on capital goods), having possibly been affected by the increases in financing costs that are beginning to materialise. In any event, the data available on credit extended to non-financial corporations do not yet reflect this slowdown; rather, they have reached a highly significant rate of change of around 20%. Although the financial pressure indicators have shown some deterioration recently, they do not reveal significant levels of pressure on spending on investment. It should be clarified, however, that these indicators are above all representative of the position of large companies (included in the CBQ sample), while smaller companies may be subject to greater pressure owing to the tightening of financing conditions. As regards general government investment, its growth in 2005 was substantially higher than initially foreseen, and the procurement figures point to a fresh and significant increase in 2006.

As indicated, the information available to date indicates that the negative contribution of net external demand to growth improved slightly in 2006 Q1, following its progressive correction throughout 2005, against the background of lacklustre exports and slowing imports. There appears to have been a turnaround in these trends in 2006 towards more buoyant exports and imports of goods. That would point, in the case of sales abroad, to the presence of certain extraordinary factors behind the poor results last year. However, the scant information available to substantiate the improvement in exports and the accumulation of additional losses in price competitiveness mean these signs must be viewed with caution. Moreover, the pick-up in imports might be illustrative of the resumption of a pattern whereunder competitiveness has a greater impact on the pace of import penetration in the domestic market. The data relating to the performance of tourism since end-2005 have generally been adverse and, although the initial figures for March this year show a significant improvement, this change must once again be viewed with caution. Overall, the recovery in exports indicated by the trade results in the opening months of 2006 is undoubtedly a positive development; but it has been accompanied by other movements which tend to offset it, and which are conducive to the continuing deterioration in the external deficit.

From the standpoint of activity and the labour market, developments in the opening months of 2006 have seen few changes to the previously witnessed patterns of surging value added in construction and services, and low actual labour productivity growth, especially in these same branches. Of note is the fact that industry has held on a line of modest recovery in recent quarters, which has continued into early 2006. The Labour Force Survey (EPA) indicates that employment generation in the economy as a whole remained very high at the start of 2006, against the background of sharp growth in the labour force and the ongoing incorporation of immigrants into the labour market. Consequently, it is estimated that the pace of labour pro-

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.

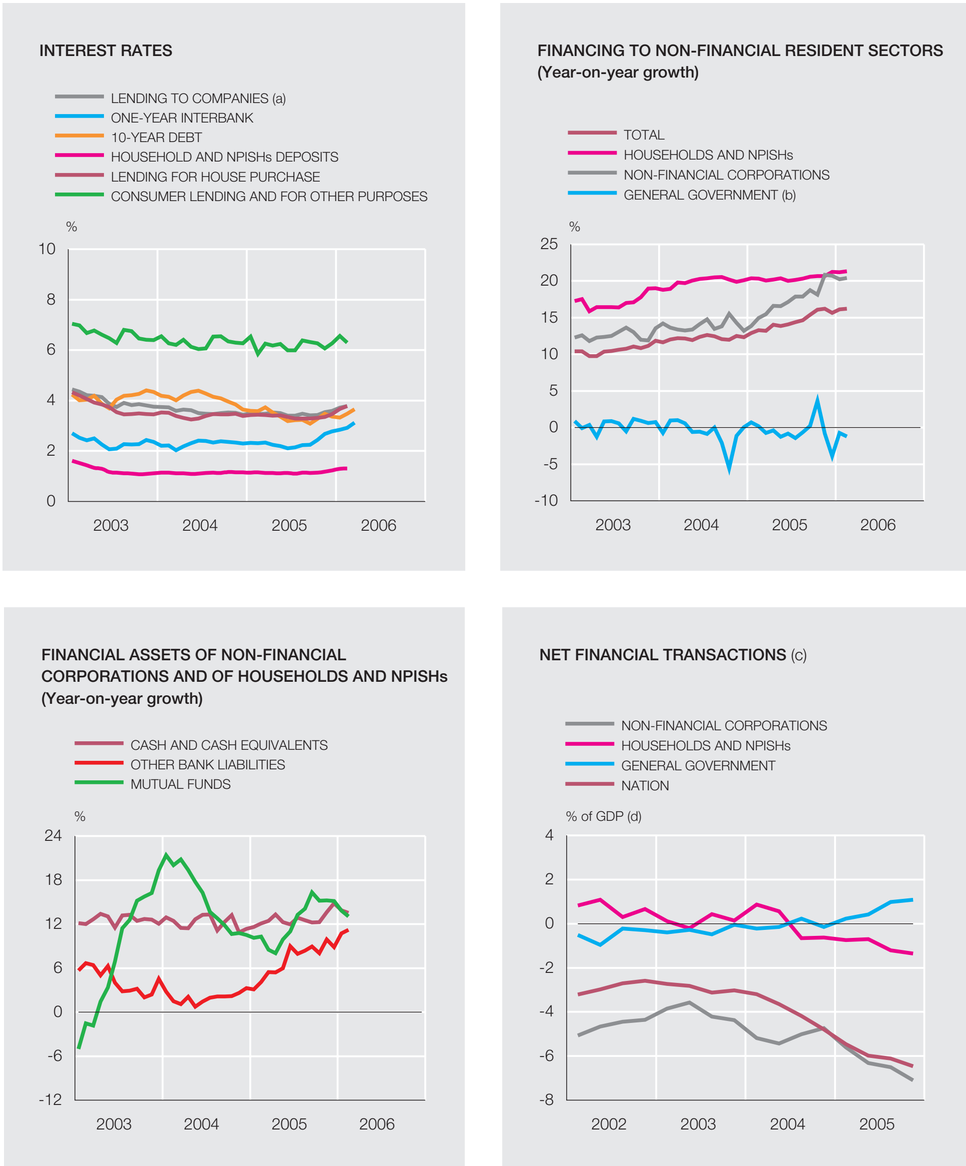
ductivity – which continues to reflect, in part, high job creation, many in sectors with lower-than-average productivity – held at a very low rate.

Labour costs per employee tended to slow last year, growing by 2.3% in the market economy, despite the fact that wage settlements in collective bargaining agreements held at around 3%. Indeed, if the impact of the previous year's indexation clauses is taken into account, the increase in wage rates amounts to 3.6%. The lower growth of compensation, relative to the increases agreed under collective bargaining (a result that has been arising to differing degrees for several years), reveals that the new jobs created are paid lower wages, partly because less experienced and, on average, less productive workers are involved. The outcome of collective bargaining for 2006 points again to wage increases of around 3%, although the impact of the activation of the 2005 indexation clauses will be sharper than last year. Accordingly, it is estimated that compensation per employee will have quickened in the opening months of this year.

Following the trend of compensation, unit labour costs slowed significantly in 2005. However, it is estimated they will have risen in the opening months of 2006 (see Chart 3), maintaining in any event a positive growth differential with the unit labour costs of the euro area countries. Nevertheless, in the current situation of buoyant demand, the lower growth of unit labour costs is not feeding through to final prices, on the whole, but is rather allowing margins to be widened further. The CPI, the main inflation indicator, ended 2005 at a year-on-year rate of 3.7% and had risen to 3.9% in March. Some of this high inflation is the outcome of dearer consumer prices for energy. But these rates also reflect the fact that underlying inflation is holding at a high level, one which has exceeded 3% in recent months. In turn, these developments have made for a widening of the inflation differential with the euro area.

Although in recent quarters the Spanish economy has been able to generate changes in its patterns of behaviour, in step with the necessary correction of the imbalances characterising it, these changes are still uncertain and incipient and may, in general, prove too slow and gradual to bring about the required correction. Further, in other areas such as price formation,

FINANCIAL INDICATORS OF THE SPANISH ECONOMY CHART 4



SOURCE: Banco de España.

a. 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 NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
b. Consolidated financing: net of securities and loans that are general government assets.
c. Cumulative four-quarter data.
d. Base 2000 Spanish National Accounts.

inertial behaviour continues to prevail. This not only fails to contribute to correcting losses in competitiveness, but may even exacerbate them. In these circumstances it is important that domestic economic policies should be geared to correcting these imbalances, moderating demand pressures, particularly as far as fiscal policy is concerned, and increasing the flexibility and efficiency of the workings of the economy, as regards structural reform policies, the only means of improving productivity and competitiveness in the medium term. In this respect, mention should be made of the publication of the second package of measures under the *Plan de Dinamización Económica* (a plan designed to bring about a more dynamic economy and improve productivity performance) and the assessment of the implementation of the first package, unveiled a year ago.

The external environment of the euro area

Between January and April this year, the key features in respect of economic and financial developments in the external environment of the euro area were the increase in oil prices, the favourable performance of financial markets (despite dearer oil and the moderate increase in long-term interest rates), the continuing withdrawal of monetary stimulus in the United States and the foreseeable start of a trend of the same sign in Japan.

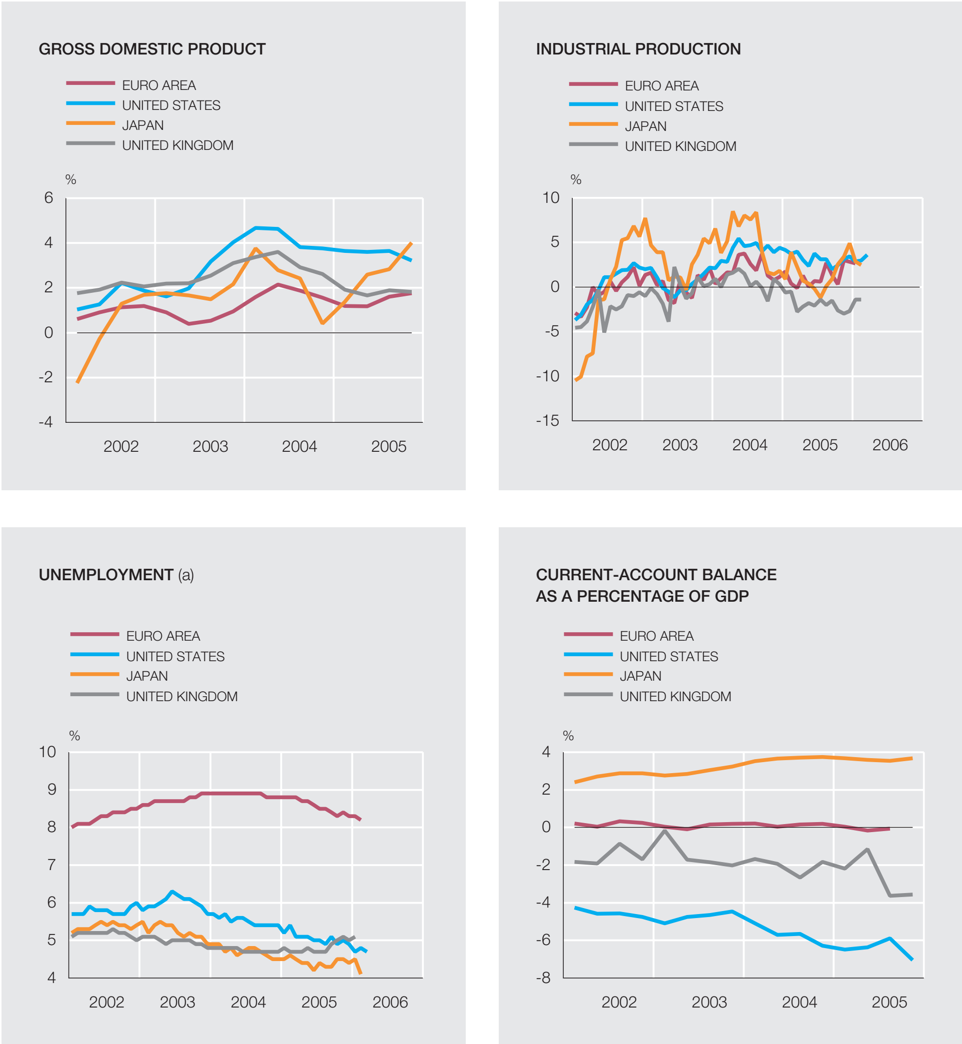
The rise of around 28% in oil since the beginning of the year led its price to new all-time highs in April, with the price of a barrel of Brent crude exceeding $73. In recent months these upward movements have been influenced by supply-side problems and by the geopolitical instability in the Middle East and in Nigeria, against the background of continuing production and oil refining capacity constraints. Long-term futures followed this movement in spot prices closely, meaning that the futures curve continued to show similar or higher prices to the spot price for a horizon of up to two years. The hike in oil prices was accompanied by strong rises in prices of other commodities, especially industrial and precious metals, which in many cases stood at levels not seen for 20 or 25 years.

The higher oil price did not, however, appear to have a significant effect on financial markets. The rising path of US official rates thus continued, with a 25 bp increase at each of the two Federal Reserve meetings in the first four months of the year, which took the federal funds target rate to 4.75%. In the second half of April the markets discounted a further 25 bp rise, which would raise the federal funds target rate to 5% in May. Against this backdrop, there were also increases in US short and long-term interest rates. As a result, 10-year bond yields exceeded 5% in April and the slope of the yield curve resumed positive levels. Long-term interest rates in Japan also followed an upward course, standing at 2%, their highest level since 2000. On the foreign exchange markets the dollar fluctuated against the yen and the euro in a relatively narrow range, although it tended to depreciate against both in April, despite the increase in the short-term interest rate spread vis-à-vis the euro area. Corporate bond yields scarcely moved and the main stock exchanges posted minor gains, with the Nikkei index reacting positively to the change in Japan's monetary policy implementation arrangements. The emerging financial markets once again performed favourably, excepting a slight bout of volatility in the first fortnight of March. The stock markets in these areas posted rises and sovereign risk premiums generally continued to fall moderately, while exchange rates showed mixed signals.

Activity in the *United States* regained greater momentum in 2006 Q1 following the slowdown the previous quarter, when the economy grew at an annualised quarterly rate of 1.7% according to the final National Accounts revision. The Institute for Supply Management (ISM) index for the manufacturing and services sectors pointed to a dynamic expansion, despite some sluggishness in orders for durable goods and other manufactures in February. The indicators of disposable income, personal consumption and retail sales were firm in January and February, and the confidence surveys in March confirmed the continuing notable momentum of consumption throughout Q1. Also conducive to this expansion in consumption was the behaviour of the labour market, since the unemployment rate fell by 0.1 pp to 4.7% in March, and the number of unemployment benefit claimants held at a low level. Consumer prices grew moderately during the quarter and, although they rose somewhat more than was expected in March, the related year-on-year rates continue to be contained (3.4% and 2.1% for the overall index and for the underlying rate, respectively). Turning to the external sector, the trade deficit posted a new all-time high in January and only a slight correction in February, although exports have been more buoyant since the beginning of the year.

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5

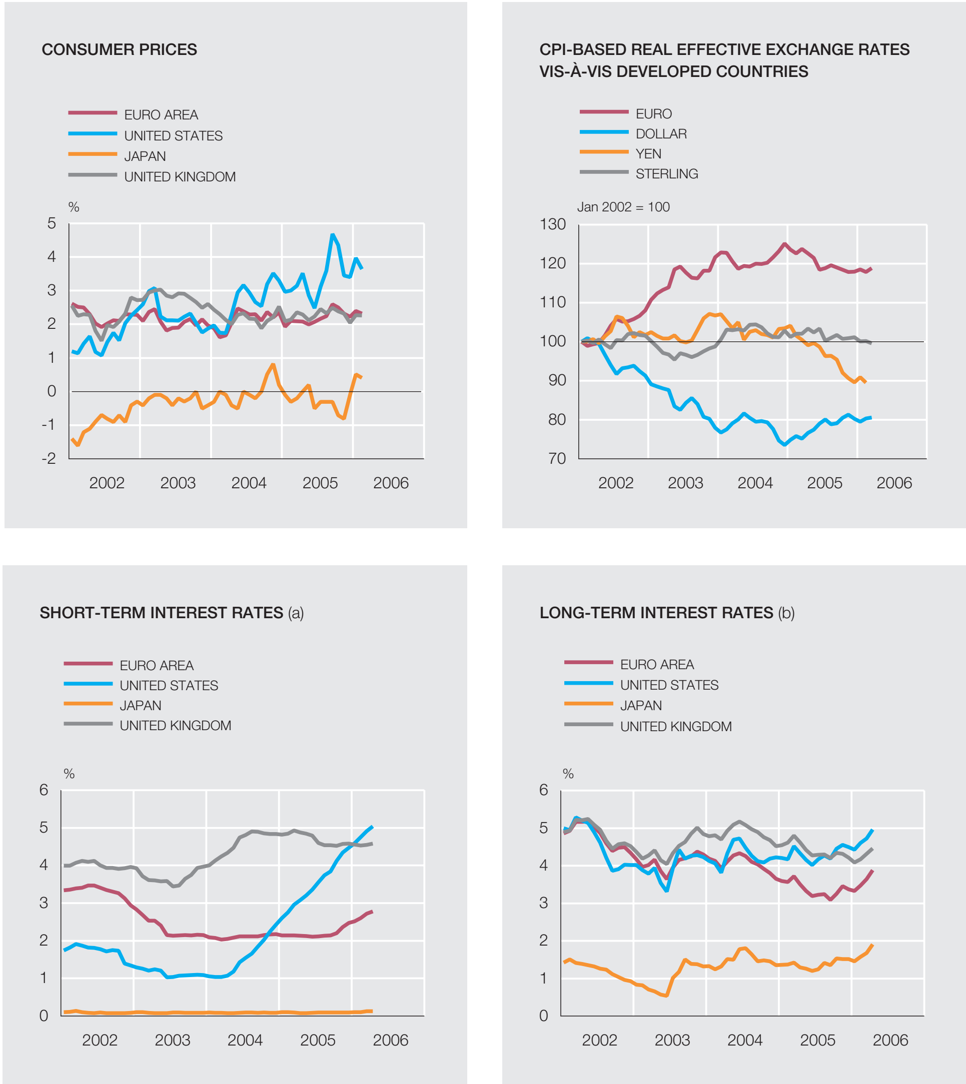


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

The economic performance in *Japan* in 2006 Q1 remained favourable. The dynamism of the industrial sector was confirmed both by the favourable performance of production in February and by the Tankan confidence survey for Q1, while the orders for machinery augured a robust rate of expansion of investment. Conversely, retail sales increased but slightly, despite the fact that consumer confidence was at its highest level for the past 15 years. The labour market remained notably resilient and the expansion of employment in February saw the unemployment rate cut by 0.4 pp to 4.1% of the labour force, while the nominal compensation of employees rose on January. The current account surplus also widened in February, as exports regained the momentum lost in January. Imports remained notably buoyant, led by the strength of domestic demand. As regards prices, the prospect of a permanent exit from deflation appears to be taking root as consumer prices grew for the second month running in February (at a year-on-year rate of 0.4%) and underlying inflation held at a positive rate for the fourth consecutive month (0.5% year-on-year in February). The Bank of Japan began gradually to reduce liquidity in March, in keeping with the announced change in the implementation of its monetary policy.

PRICES, REAL EXCHANGE RATE AND INTEREST RATES CHART 6



SOURCE: Banco de España.

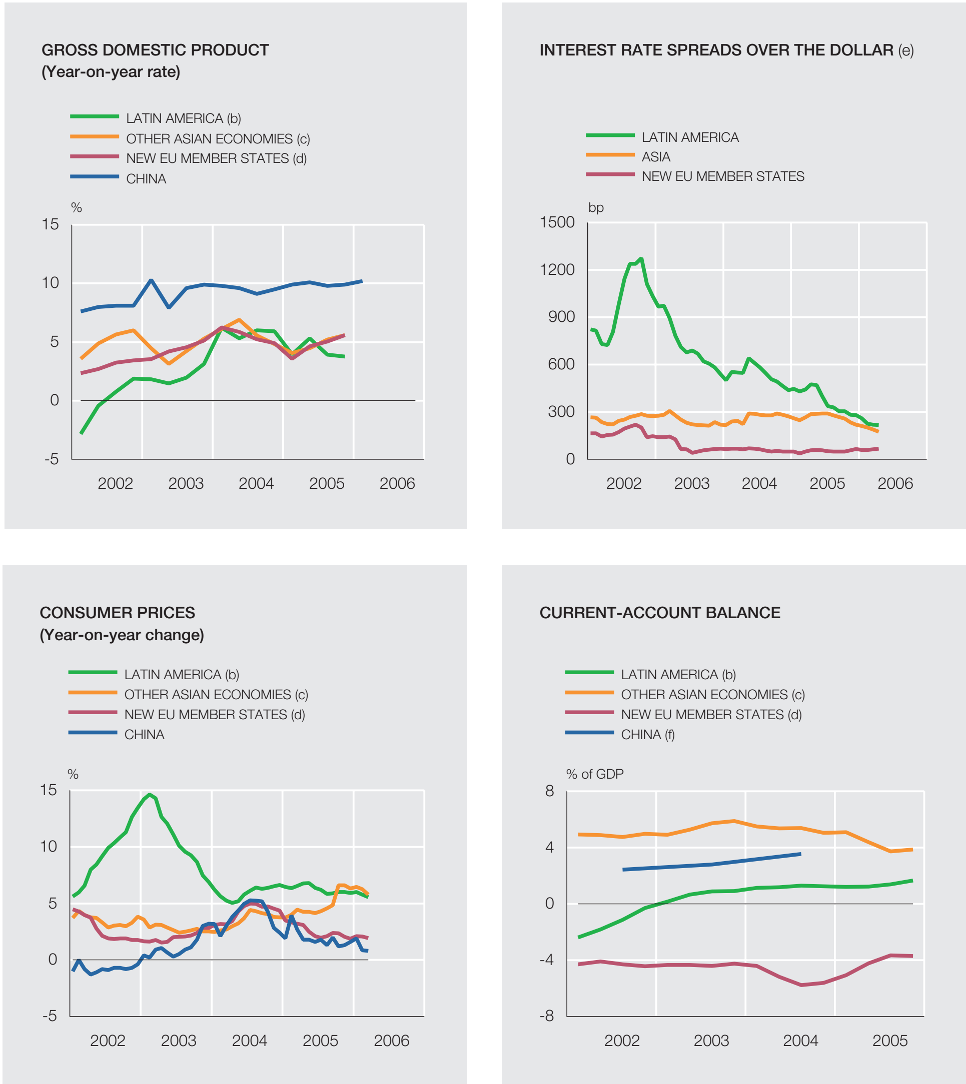
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

In the *United Kingdom*, final GDP in 2005 Q4 grew at a year-on-year rate of 1.8% owing to the slackness of private consumption, confirming the strong economic slowdown in the year as a whole. Although the contribution of external demand improved in 2005, the current account deficit in Q4 was higher than foreseen, rising to 3.6% of GDP. Most of the recent indicators show signs of sluggishness in consumption, compounded by the contraction in industrial output and manufactures in February, and the slide in the Purchasing Mangers Index (PMI) for March. Despite these developments, house prices remained on a moderately rising path. Consumer prices slowed in March, declining from a year-on-year increase of 2% to 1.8% (0.2 pp below the Bank of England’s central target). Turning to the labour market, employment rose in February, although the unemployment rate was up 0.1 pp to 5.1%. Also in February, the external deficit on trade in goods and services widened again to £4.8 billion, compared with £3.8 billion in January.

In the *new EU Member States*, GDP quickened in 2005 Q4 practically across the board, posting a year-on-year rate of 5.4% on average, up from 4.9% the previous quarter. The in-

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. Three-month interbank market interest rates.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
d. Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
e. JP Morgan EMBI spreads. The data on the new EU Members States relate to Hungary and Poland.
f. Annual data.

crease was due to the greater buoyancy of domestic demand, which offset the lesser contribution of the external sector. A notable average growth rate (4.5%) was maintained in 2005 as a whole. This was somewhat down on the 2004 figure of 5.3% owing to the deceleration of the Polish economy, the biggest in the region. The indicators for 2006 Q1 remain favourable. Inflation has continued to trend unevenly in recent months, standing in March in a range from 0.4% year-on-year in Poland to 6.5% in Latvia. Official interest rates declined in Poland to 4%, while they rose in Slovakia and held stable in the other countries. Fiscal targets for 2005 were met in almost all the countries, with the exception of Hungary, where the budget deficit exceeded 6% of GDP. Current account deficits also differed across these countries in 2005. Although the average deficit for the region fell from 5.3% to 3.5% in 2005, owing to Poland's favourable performance, deficits exceeded 5% of GDP in seven of the ten new members.

In *Asia*, the highlight was the marked buoyancy of the Chinese economy in 2006 Q1, where GDP grew at a year-on-year rate of 10.2%, 0.3 pp up on the previous quarter. The Chinese central bank amassed a volume of foreign reserves whose outstanding balance ($875.1 billion in March) exceeded that of Japan. That places China in first position worldwide in terms of accumulated reserves. In the opening months of 2006 there was also a slight acceleration in the appreciation of the renminbi against the dollar (a total of 0.7% from January to April). The export sector regained its dynamism in March, as reflected in the high trade surplus of $23.2 billion in 2006 Q1. Foreign direct investment inflows grew once more in the first three months of the year, after having stagnated from mid-2005. CPI inflation eased in March to 0.8% compared with a year earlier, a trend which was accompanied by producer prices. The remaining indicators of activity (industrial production, investment in fixed assets and retail sales) held at a slightly more robust growth rate than in 2005 Q4. Economic activity in India eased slightly in 2005 Q4 (from 8% to 7.6% year-on-year) following several quarters of strong growth, although it ended the year with an expansion of 8%, up on the 2004 figure of 7.4%. Economic activity continued to expand strongly in most of the other South-East Asian countries during 2006 Q1.

In *Latin America*, 2005 ended with year-on-year growth of 4.3%. This was a notable figure, but substantially down on the exceptional previous year (5.8%) owing to some easing in activity in the second half of the year. The favourable behaviour of the financial markets made it easier to take measures aimed at reducing exposure to external debt. Brazil and Chile thus announced new legislation to promote the entry of foreign investors on the local debt markets, while Uruguay repaid its IMF loan instalment for 2006 ahead of schedule, and Venezuela and Brazil bought back their remaining Brady bonds. On the prices front, the moderation of inflation rates in Mexico and Brazil allowed the process of interest-rate cuts to continue, although in Mexico's case the scope for further reductions is already limited. By contrast, upward price pressures in Argentina remained considerable, although the 12-month inflation rate stabilised somewhat in 2006 Q1 (at around 12%), a development assisted in part by the government measures to restrict price rises.

The information available on economic developments in the euro area in the first few months of 2006 points to consolidation of a recovery scenario, underpinned by vigorous world trade and the progressive strengthening of domestic demand, especially private investment. However, there remain downside risks arising from the uncertain path of consumption and employment and, in particular, the persistence of high oil prices. The relevance of this latter risk factor has been highlighted by the substantial rise in the price of crude oil in April, to more than $70 a barrel.

Price developments in 2006 Q1 provided little new to the assessment of underlying inflationary pressures, which were relatively contained. The growth rate of the HICP, which has held at levels slightly above the medium-term price stability target, continued to reflect, through its energy component, the fluctuations of oil prices, while the prices of the less volatile components of the index increased at a moderately stable rate. That said, the growing perception (which recent events do no more than confirm) that the rise in the price of oil is not a temporary phenomenon tends to increase the risks that rises in production costs will eventually feed through to prices in all sectors and that wage moderation will come to an end, especially if the labour market recovers. Overall, the Q1 conjunctural information tends to confirm a central scenario, in which moderate upside risks to price stability persist against a background of progressively strengthening economic activity in the area.

Against this backdrop, the ECB Governing Council decided to take a further step in reducing the expansionary stance of its monetary policy to ensure that medium and long-term inflation expectations are kept anchored, and at the beginning of March it raised its official rates by 25 basis points to 2.5%. This increase ended a prolonged period of negative short-term real interest rates, although the monetary policy stance remains clearly accommodative and conducive to an expansion of domestic demand, which has yet to become fully entrenched.

As regards fiscal policy, the aggregate budget deficit of the area stood, on provisional data, at 2.4% of GDP. This figure is 0.1 pp less favourable than that obtained by aggregating the targets set by the Member States in their Stability Programmes at the beginning of the year. However, the actual deficit was half a percentage point lower than that projected by the European Commission in the autumn, this being partly attributable to the improvement in the economic situation. As regards future budget plans, those countries in an excessive deficit situation have projected in their most recent stability programmes (the first to be submitted following the reform of the Stability and Growth Pact) adjustment paths that are generally consistent with the requirement for an annual improvement in the structural balance of 0.5% of GDP or more and with the deadlines established in the respective excessive deficit procedures. However, on occasions, the objectives set may suffer from a certain arbitrariness, as reflected in the scant definition of the measures that would permit them to be achieved.

3.1 Economic developments

According to the national accounts of the euro area for 2005 Q4, the area's GDP grew by 0.3% in quarter-on-quarter terms, 0.4 pp less than in the previous quarter (see Table 1). This weak growth rate largely reflects technical factors such as incomplete adjustment for calendar effects and seasonal adjustment complications in certain countries. The year-on-year rate, a more accurate reflection of the trend in economic growth, was 0.2 pp up from Q3, at 1.8%.

EURO AREA ECONOMIC INDICATORS TABLE 1

	2004		2005				2006	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP								
Year-on-year growth	1.9	1.6	1.2	1.2	1.6	1.8		
Quarter-on-quarter growth	0.3	0.2	0.3	0.4	0.7	0.3		
European Commission forecasts (c)							(0.4; 0.8)	(0.3; 0.8)
IPI (d)	2.5	1.1	0.8	0.7	1.5	2.1	*2.6*	
Economic sentiment	100.2	100.5	98.7	96.1	97.7	100.1	102.6	
Industrial confidence	-3.7	-3.7	-6.7	-10.3	-7.7	-6.0	-2.3	
Manufacturing PMI	53.9	51.4	51.4	49.3	51.0	53.0	54.7	
Services confidence	11.3	11.3	10.7	9.0	11.0	13.7	14.7	
Services PMI	54.4	52.9	53.1	53.1	53.8	55.6	57.8	
Unemployment rate	8.9	8.8	8.8	8.7	8.5	8.4	*8.2*	
Consumer confidence	-14.0	-13.0	-13.3	-14.3	-14.7	-12.3	-10.7	
HICP (d) (e)	2.1	2.4	2.1	2.1	2.6	2.2	2.2	
PPI (d) (e)	3.3	3.6	4.2	4.0	4.4	4.7	*5.4*	
Oil price in USD (e)	43.3	39.7	53.3	54.0	62.6	56.5	61.6	*69.5*
Loans to the private sector (d) (e)	6.5	7.2	7.6	9.2	9.7	10.4	10.8	
Euro area ten-year bond yield	4.2	3.8	3.7	3.4	3.3	3.4	3.6	*4.0*
US-euro area ten-year bond spread	0.14	0.36	0.67	0.80	0.98	1.12	1.06	*1.02*
Dollar/euro exchange rate (e)	1.241	1.362	1.296	1.209	1.204	1.180	1.210	*1.232*
Appreciation/Depreciation of the euro (e)	-1.7	7.8	-4.8	-11.2	-11.6	-13.4	2.6	*4.4*
Dow Jones EURO STOXX Broad index (e)	1.5	9.9	4.3	8.9	17.7	23.0	10.3	*11.6*

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available up to 21 April 2006.
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.

The slowdown in output with respect to the previous quarter was mainly attributable to the reduced buoyancy of every component of domestic demand, except inventories. Thus, private consumption grew by 0.1%, government consumption was unchanged and the contraction in equipment investment was only partly offset by the greater momentum in construction, so that the growth rate of gross fixed capital formation declined (see Box 1). External demand deducted 0.2 pp from the increase in output, having made a zero contribution in the preceding quarter, as a consequence of the sharp slowdown in exports, which was only partly offset by that in imports. Finally, the change in inventories contributed 0.4 pp to GDP growth, following a zero contribution in Q3 (see Chart 8).

The country breakdown of the national accounts shows that the slowdown in output in Q4 was concentrated in the three largest countries of the area. In Germany and Italy, where quarter-on-quarter GDP growth was zero, domestic demand excluding inventories declined notably, while in France, where 0.4% growth was recorded, its strength was sustained. As regards net exports, their contribution to output was considerably smaller in Germany and France, while it improved slightly in Italy. In Spain, Belgium and Austria, however, GDP grew at a higher rate than in Q3, while in the Netherlands its growth rate held unchanged.

In terms of branches of production, the loss of momentum was, albeit unevenly, shared by all of them except construction, whose value added accelerated by 0.7 pp to 1%. In the labour

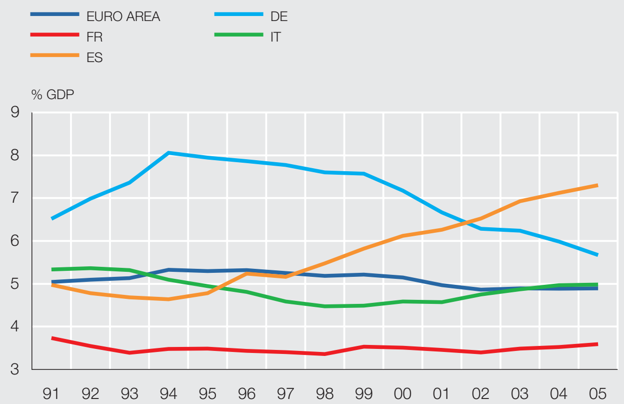
RESIDENTIAL INVESTMENT IN THE EURO AREA COUNTRIES

Residential investment is the macroeconomic aggregate that comprises households' acquisition of housing (both for own use and for investment). This, along with the purchase of property by firms and public infrastructure investment, makes up construction investment, a fundamental part of gross fixed capital formation. As seen in Chart 1, the relative weight of this demand component has declined, since peaking as a percentage of the area's GDP in 1994-1996, especially since the start of Economic and Monetary Union.

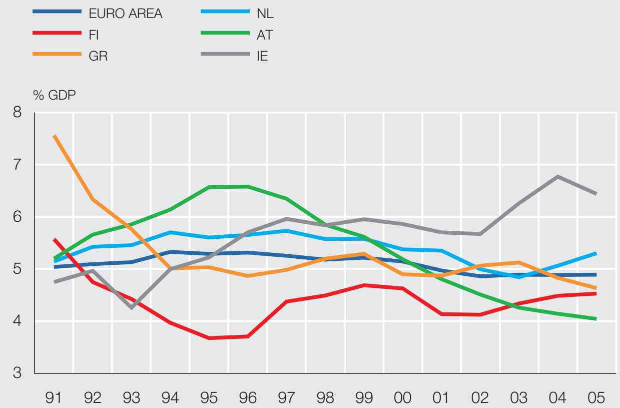
Charts 1 and 2 show how, in 2005, the weight of residential investment in GDP in the euro area as a whole was slightly below its value at the beginning of the 1990s (5%). However, the relative importance of residential investment varies greatly across the euro area countries, its weight in GDP ranging from a minimum of less than 4% in France to a maximum of more than 7% in Spain. Moreover, there have been large differences in its path over the last 15 years: in a first group, made up of France, Italy, the Netherlands, Finland and Greece, the percentage of GDP has held steady at around its long-term average, with fluctuations of varying magnitude. Meanwhile, in Germany and Austria the importance of residential investment has been gradually declining, following the boom at the beginning of the 1990s, while the opposite situation has been seen in Spain and Ireland, where it has progressively gained importance.

Focusing the analysis on the most recent period (from the start of Monetary Union until 2005), Charts 3 and 4 show the changes in the main determinants of residential investment for most euro area countries, i.e. household real disposable income, population growth and the user cost of housing (a variable that, in turn, depends positively on interest rates and negatively on changes in house prices). As regards disposable income, which would be a measure of household purchasing power, and population, the growth of which, in specific age groups, usually entails greater demand for housing, associated with household formation, there seems to be a positive relationship between the changes therein and residential investment. Also, since 1999, there has been a close relationship in most countries between residential investment and the user cost of housing. This latter variable has behaved very differently across countries, basically on ac-

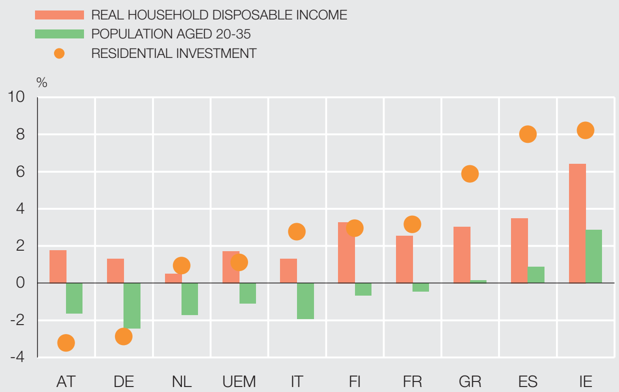
1. RESIDENTIAL INVESTMENT



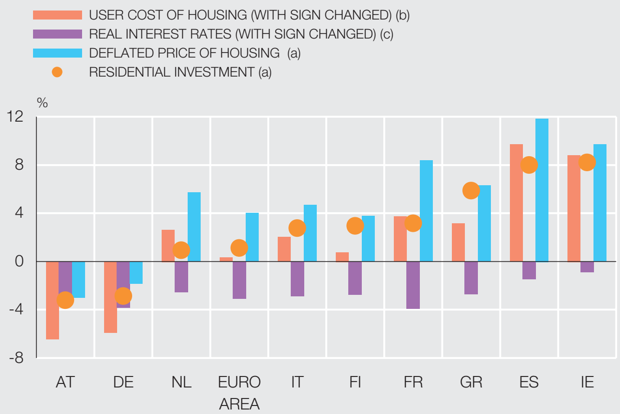
2. RESIDENTIAL INVESTMENT



3. DETERMINANTS OF RESIDENTIAL INVESTMENT (a)



4. DETERMINANTS OF RESIDENTIAL INVESTMENT



SOURCES: ECB and Eurostat.

a. Average annual change between 1999 and 2005, except for the price of housing (1999-2004)
b. Average 1999-2004.
c. Average 1999-2005.

count of the different behaviour of house prices, since real interest rates on mortgage loans have held at relatively similar levels in the various countries, with the exception of Spain and Ireland, where they have been lower. This has primarily been a consequence of the existence in these countries of higher inflation rates, but also of the higher relative weight of loans with variable rates based on interbank market yields which, in the period considered, have held below those on long-term debt.

The case of Germany merits special mention. The average rate of change of residential investment in this country during the period 1999 to 2005 was -2.7%, owing to the unfavourable trends in its determinants and, also, to the correction of the excessive investment in that country in the first half of the 1990s which has been holding back the growth of that variable (and, in general, that of construction investment) since the middle of that decade. In fact, in the period analysed, the average rate of growth of residential investment in the euro area, excluding Germany, was 3.7%, well above the rate of 1.3% for the area as a whole.

As for the outlook, the latest indicators seem to show that the decline in residential investment in Germany has bottomed out. This can be expected to give rise to a more favourable trend in that variable in the area as a whole, which would be reinforced by the improvement in household disposable income, against a background of higher growth in activity and employment. At the same time, however, a moderation in the growth rate of residential investment can be expected in those countries that have recorded very large increases in house prices in recent years, to the extent that these increases begin to subside.

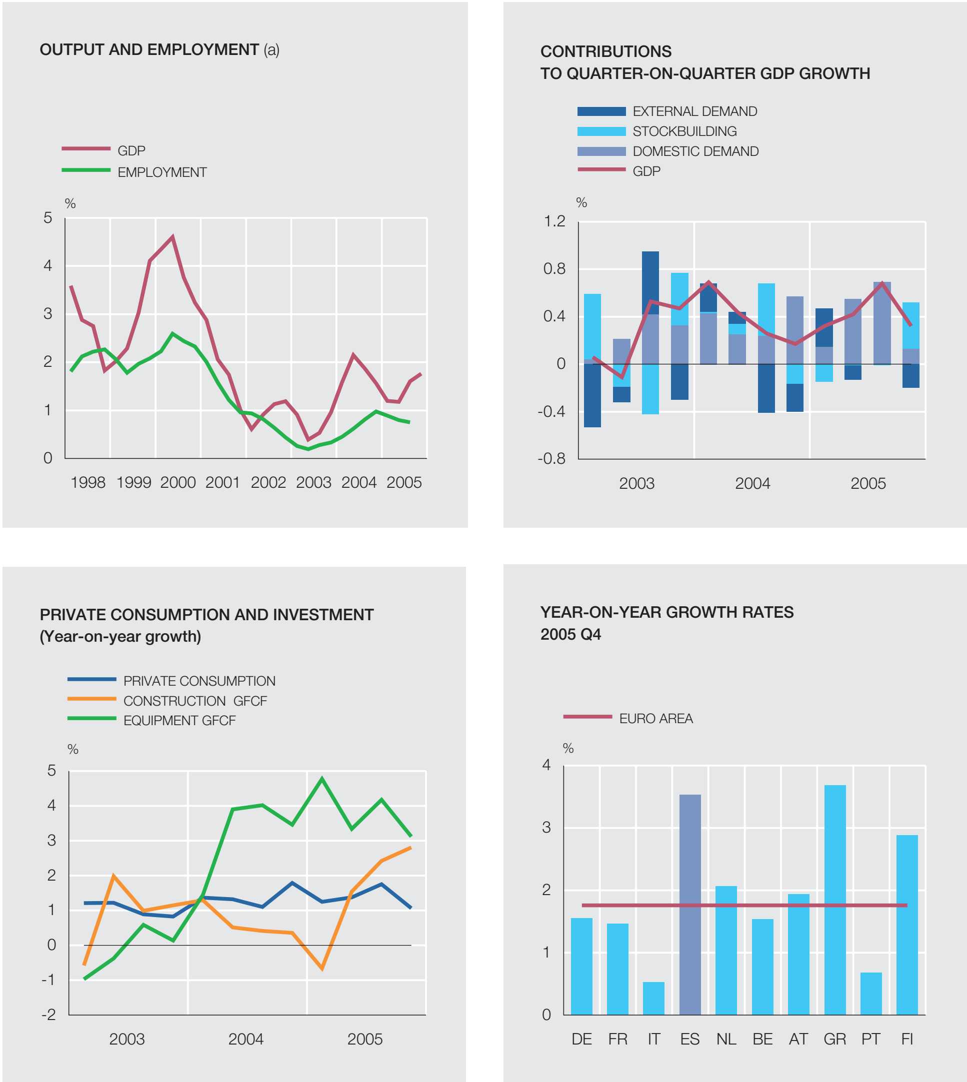
market job creation was weak, running at a year-on-year rate of 0.8%, so that growth in apparent labour productivity remained relatively steady, at slightly below 1%. From the viewpoint of domestic price formation, unit labour costs grew in 2005 Q4 by less than the GDP deflator, so that profit margins widened further (see Chart 10).

In 2005 as a whole, GDP grew by 1.4%, down 0.4 pp from 2004. The lower buoyancy of output was attributable to the decline in the contributions of net exports and changes in inventories, while the contribution of domestic demand rose slightly. This was the result of an increase in the growth rate of gross fixed capital formation and government consumption, while household consumption expenditure expanded at the same rate as in the previous year (1.4%). Foreign trade subtracted 0.2 pp from GDP growth, as exports slowed by more than imports.

Developments in the latest indicators show, overall, a rise in the rate of GDP expansion in 2006 Q1. As regards supply-side indicators, the industrial production index (excluding construction), on provisional data, increased by around 1% in January and February, with respect to the 2005 Q4 average, which made a year-on-year rate of change of slightly more than 3%. Meanwhile, survey-based qualitative indicators displayed very positive trends in Q1. In particular, the European Commission's industrial and construction confidence indicators showed net improvements and the manufacturing purchasing managers' index compiled by Reuters stood clearly above 50, consistent with an expansion in activity (see Chart 9). The services sector surveys also showed favourable signs, although these were more modest in the case of the European Commission survey than in that of purchasing managers' opinion (see Table 1). Finally, survey-based employment indicators increased in Q1. The increase was larger in industry and construction than in services (see Chart 10). The rate of unemployment, for its part, fell to 8.2% in February, down 0.2 pp from December 2005.

On the demand side, the available indicators offer patent signs of strengthening of investment and exports, but not such clear ones in relation to private consumption. Thus, retail sales, the monthly indicator most closely correlated with private consumption, grew at a low rate on

EURO AREA NATIONAL ACCOUNTS CHART 8



Sources: Eurostat and national statistics.

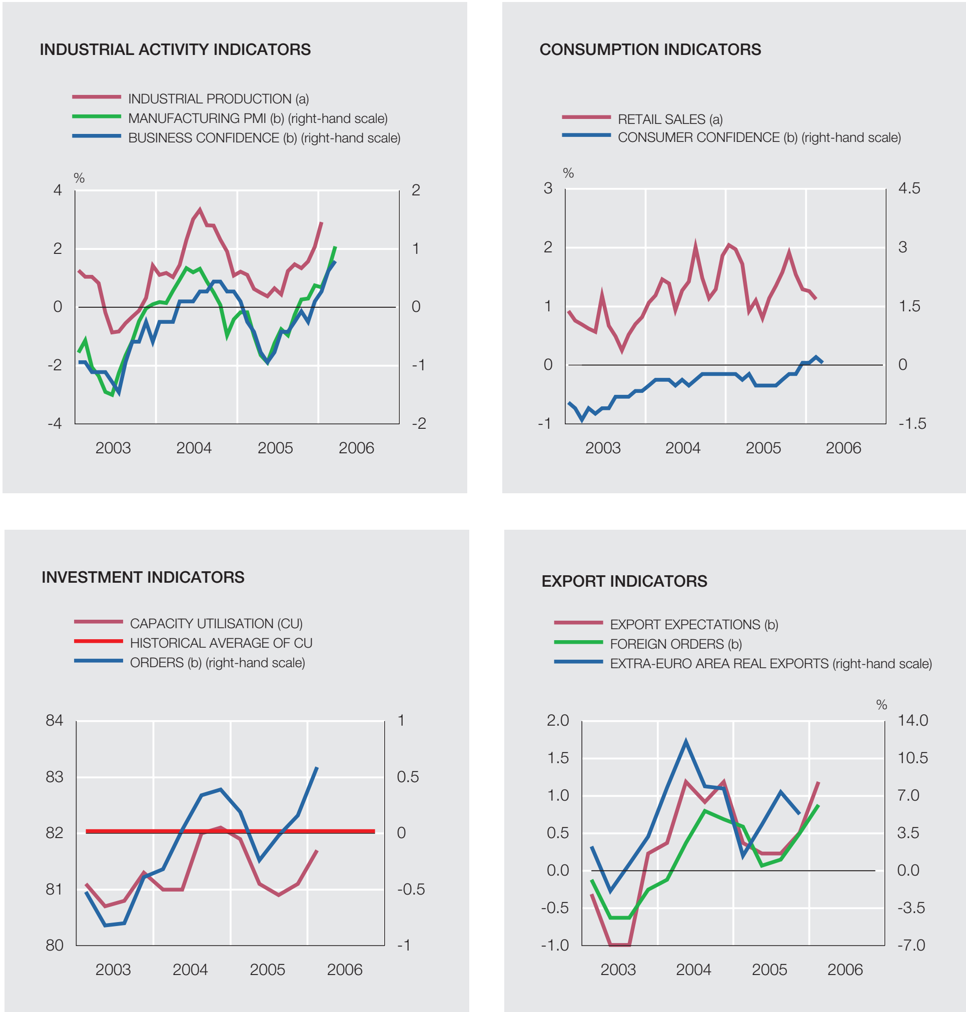
a. Year-on-year rates of change.

average in January and February, down slightly from the previous quarter. In contrast, car registrations and consumption-related surveys displayed a more favourable trend. In fact, in Q1 the consumer confidence indicator stood, for the first time since mid-2002, in line with its long-term average. As for investment indicators, businesses' assessment of order books and capacity utilisation improved, although the latter is still below its average level in recent years. For their part, the exports data from the January trade balance reflected greater dynamism in sales to the rest of the world, and both the European Commission's quarterly indicator of industrial export expectations and the survey of the monthly trend in foreign order books increased notably in Q1.

Overall, the available indicators of developments in activity in the euro area in Q1 would be consistent with an increase in the quarter-on-quarter GDP growth rate that could be in the range 0.4%-0.8% estimated by the European Commission (see Table 1) and several private analysts. Output would be driven by the strengthening of exports and gross fixed capital formation, against a background of favourable monetary and financial conditions, while consumption would continue to grow at a slower rate than investment. The faltering path still

EURO AREA. REAL INDICATORS

CHART 9



SOURCES: Eurostat and European Commission.

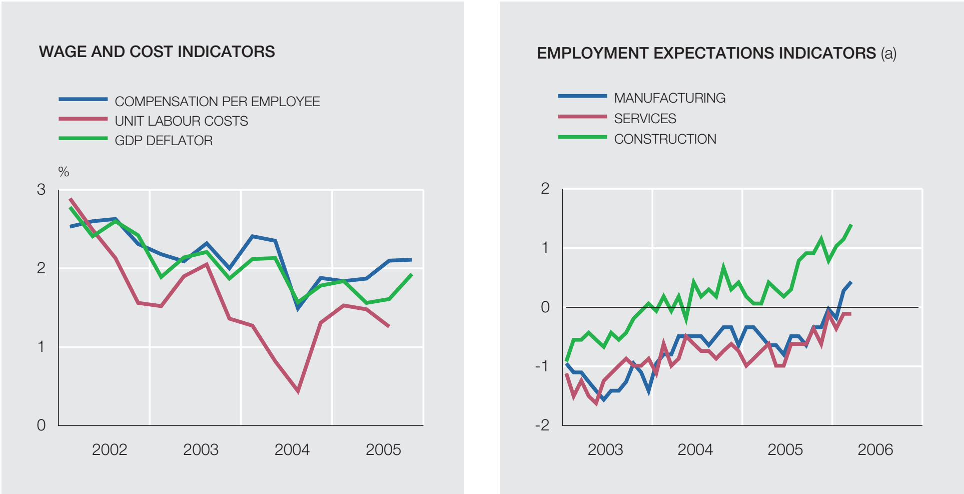
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.

displayed by consumption and employment in some Member States represents the main internal source of uncertainty surrounding the degree of strength of the economic expansion in the coming months. Also, the downside risks indicated in previous quarters, arising from the persistence of high oil prices and, more in the medium term, from a potentially disorderly correction of the global macroeconomic imbalances, still exist. The rise in oil prices in April to over $70 a barrel accentuates these risks.

Price indicators in Q1 continued to reflect the impact of energy price movements. Thus, following a rise in January, inflation tended to moderate, dipping to its end-2005 levels. The Harmonised Index of Consumer Prices (HICP) rose by 2.2% year-on-year in March, the same rate as in December, as a result of a slowdown in energy, unprocessed food and, to a lesser extent, services prices (see Chart 10), which offset the rise in processed food prices. Underlying inflation, measured in terms of the HICP excluding unprocessed food and energy, remained steady, and stood in March at 1.4%. By country, with respect to the end of the previous quarter inflation fell slightly in Germany and France, and, to a greater extent in the Netherlands and Belgium, while there were mild increases in the rate of change of prices in Spain and Italy.

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

CHART 10



SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators. Normalised data.

Producer prices, for their part, increased in February at a year-on-year rate of 5.4%, up 0.7 pp from December. The main reason for this rise was the acceleration in the energy component, although there were also mild increases in the growth rates of intermediate and consumer goods prices.

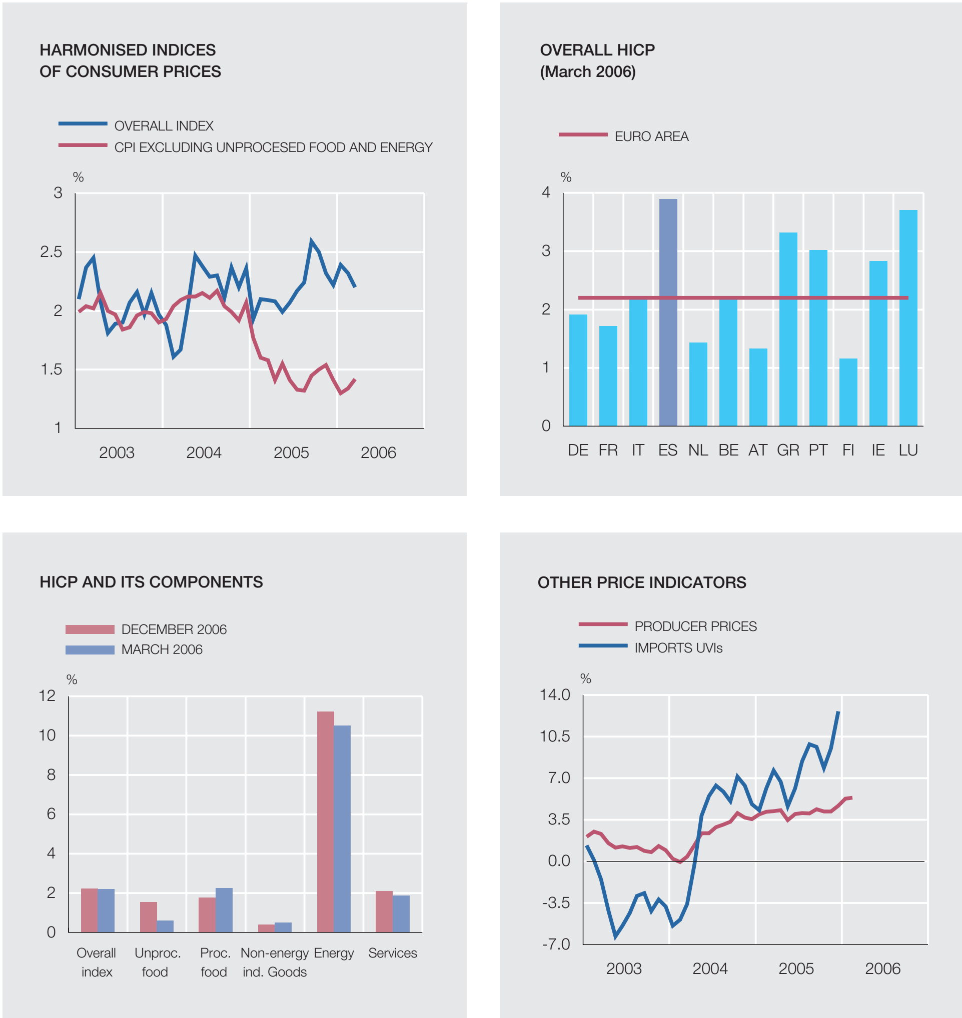
Inflation expectations remained at levels in line with price stability and no second-round wage effects were apparent. However, tensions in the markets for oil and non-energy commodities have increased the upside risks surrounding future price developments. In addition, the strengthening of activity may accentuate inflationary pressures, to the extent that it stimulates wage demands and a greater pass-through from production costs to final prices.

According to data published by the ECB, the current-account deficit in January 2006 was €11.3 billion, as against €5.8 billion in the same period of the previous year. This increase was basically attributable to the deterioration in the goods balance, which moved into deficit in January as imports had grown faster than exports over the previous 12 months. Net capital outflows in the form of portfolio investment that were much higher than net inflows under the heading of direct investment were also observed in January, and there was a decline from the previous year in net inflows of “other investment”, so that there was a negative basic balance of €44.4 billion, up from the negative balance of €33.6 billion in January 2005.

As regards budgetary developments in the euro area in 2005, the area deficit is estimated to have been 2.4% of GDP, while the debt ratio increased by 1 pp to around 71% of GDP. Just two months before the end of the year, in its autumn forecasts, the European Commission estimated that the deficit would be 0.5 pp higher than it actually was. The improvement seems to have been primarily a result of the increase in tax receipts owing to the more favourable cyclical conditions, although a rigorous budget outturn in some countries may also have contributed. These developments are a good starting point for a step-up in budgetary consolidation in 2006 (see Table 2).

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

CHART 11



SOURCES: Eurostat and European Central Bank.

By country, Germany, Greece, Italy and Portugal recorded budget deficits equal to 3% of GDP or more, while in France the budget deficit was reduced by 0.8 pp to 2.9%. Among the countries in breach of the limit laid down in the SGP, the deficit was reduced in the first two, while in the latter two it rose by 0.7 pp and 2.8 pp, to 4.1% and 6% of GDP, respectively. However, in Portugal, about two-thirds of the deterioration corresponded to the decline in the recourse to temporary measures, while in Italy this factor explains almost the entire deterioration. In fact, as the impact of macroeconomic conditions was unfavourable in Italy, the cyclically adjusted primary balance net of such measures improved.

Regarding the application of the excessive deficit procedures, in Germany the European Commission's December 2004 notification required correction of the excessive deficit by 2005 at the latest. Since the deficit for that period exceeded 3% of GDP, in March 2006 the Council adopted a decision pursuant to Article 104 (9) of the Treaty (for the second time, following the Greek precedent) in which it framed a warning to the German authorities to take measures to correct the excessive deficit. The Council has determined that the period within which the deficit must be reduced to below 3% of GDP ends in 2007. In the case of Italy, meanwhile, the Commission has assessed the measures taken by the authorities in response to the recommendation made pursuant to Article 104 (7) positively, albeit with some reservations.

GENERAL GOVERNMENT BUDGET BALANCES
OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2003	2004	2005 (b)	2005 (c)	2006 (d)
Belgium	0.1	0.0	0.0	0.1	0.0
Germany	-4.0	-3.7	-3.9	-3.3	-3.3
Greece	-5.8	-6.9	-3.7	-4.5	-2.6
Spain	0.0	-0.1	0.2	1.1	0.9
France	-4.2	-3.7	-3.2	-2.9	-2.9
Ireland	0.2	1.5	-0.4	1.0	-0.6
Italy	-3.4	-3.4	-4.3	-4.1	-3.5
Luxembourg	0.2	-1.1	-2.3	-1.9	-1.8
Netherlands	-3.1	-1.9	-1.8	-0.3	-1.5
Austria	-1.5	-1.1	-1.9	-1.5	-1.7
Portugal	-2.9	-3.2	-6.0	-6.0	-4.6
Finland	2.5	2.3	1.9	2.6	1.6
MEMORANDUM ITEM: Euro area					
Primary balance	0.4	0.5	0.3		0.7
Total balance	-3.0	-2.8	-2.9	-2.4	-2.3
Public debt	69.3	69.8	71.7	70.8	70.8

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

a. As a percentage of GDP. Deficit (–) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. European Commission forecasts (autumn 2005).
c. Spring 2006 notifications of Excesive Deficit Procedure.
d. Stability programme targets

Achievement of the targets contained in the budget plans for 2006 and the new Stability Programmes would entail an aggregate euro area deficit of 2.3% of GDP in 2006 and 1.8% in 2007. Among the countries in an excessive deficit situation, the balance in Germany is projected to remain unchanged in 2006 and to improve to –2.5% of GDP only in 2007. The German authorities have adopted a neutral fiscal policy for 2006 so as not to hinder the recovery in activity, postponing the correction of the excessive deficit to 2007. According to the plans presented, the correction of 0.5% per annum in the cyclically adjusted balance net of temporary measures required by the Stability and Growth Pact will only be achieved in 2006 and 2007 on average. Most of the budgetary consolidation is to fall on the revenue side, in the form of a 3 pp increase in the standard VAT rate and a widening of the tax bases, partly offset by lower unemployment contributions. On the spending side, the adjustment will be supported by continuation of strict implementation of the budget. In France, the Stability Programme seeks to keep the deficit below 3% of GDP, basically through containment of public expenditure. The European Commission, in its assessment of the programme, has stated the need to secure strict compliance with the spending limits established to ensure that the deficit targets are met. In Italy, the Stability Programme projects a decline in the deficit to 3.5% of GDP in 2006, accompanied by a further reduction in the use of temporary measures. In a similar vein, the Commission has indicated that there is a notable risk that the projected spending containment will not take place. Also, beyond the present year, the measures to achieve the targets are not described in sufficient detail. The deficits in Greece and Portugal are projected to be below 3% of GDP within the periods laid down in the excessive deficit procedures, i.e. in 2006 and 2008, respectively. In general, the programmes of these five countries do not aspire to meet their medium-term targets (close to budget balance) until the end of the decade.

STABILITY PROGRAMMES: DEGREE OF PAST COMPLIANCE AND OUTLOOK FOLLOWING THE REFORM OF THE STABILITY AND GROWTH PACT

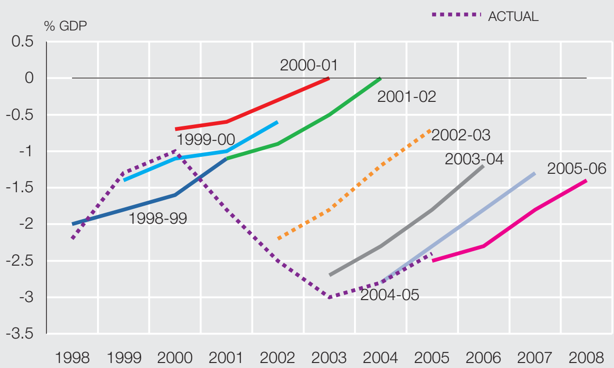
BOX 2

The Stability and Growth Pact (SGP) was conceived as a cornerstone of the edifice of Monetary Union with the aim of committing euro area Member States to budgetary discipline. At the same time, the Pact sought to allow fiscal policy to respond flexibly and within certain limits to the business cycle. In practice, however, the application of the SGP has not always been in step with these objectives. Ultimately, the difficulties that arose in 2003 and 2004 in the course of the Excessive Deficit Procedures initiated against Germany and France prompted the revision of the Pact, which the European Council finally ratified in March last year. Among other changes, the reform defines medium-term objectives for the structural balance (i.e. the cyclically adjusted balance adjusted net of temporary measures), which have to be more demanding for the countries with lower potential growth and with more indebted general government sectors. Further, it outlines the path to approach these goals for those countries that have not yet attained them. Specifically, the structural balance should improve annually, as a general rule, by at least 0.5% of GDP.

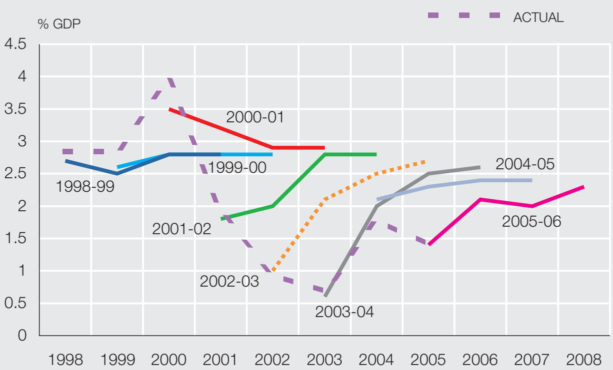
In both its original and reformulated versions, the SGP requires euro area members to submit, around the end of each year, the so-called Stability Programmes. These describe the future budgetary targets, conditional upon a specific underlying macroeconomic scenario. Since the first programmes were submitted in autumn 1998-1999, eight generations of these documents have followed.

In general, the sequence of programmes has left a trail of successive failures to comply. Only at the start of Monetary Union were the goals set achieved, although this was due exclusively to the unexpectedly favourable contribution of the cycle (see Charts 1 and 2). Thus, in 2000, the budget deficit for the area stood at the levels projected in the programmes drawn up a year earlier, despite the fact that economic growth had more than outpaced the forecasts. From 2001, moreover, these documents systematically erred, as it was predicted that the slowdown in activity would be less persistent and profound than was actually the case, meaning that budgetary targets were revised successively downwards. Hence, in 2003, with output growth of 0.7%, the area's budget deficit rose to 3% of GDP. That was in strong contrast to the balanced budget projected for that year in the programmes submitted at the end of 2000 when economic growth was running at 2.9%. Nonetheless, in almost all the years, the up-

1. BUDGET BALANCE PROJECTED IN THE STABILITY PROGRAMMES GENERATED (a)



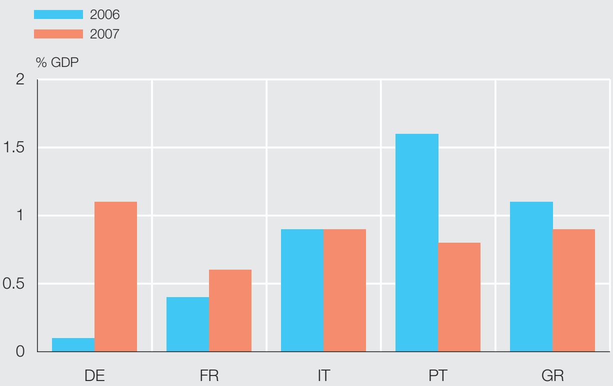
2. REAL GDP PROJECTED IN THE STABILITY PROGRAMMES GENERATED (a)



3. ONE-YEAR-AHEAD FORECASTING ERRORS

	1999	2000	2001	2002	2003	2004	2005 (b)
Budget blance (c)	0.5	0.1	-1.2	-1.6	-1.2	-0.2	-0.1
GDP growth (c)	0.3	1.2	-1.3	-1.1	-1.4	-0.2	-0.9
Estimation of the impact of the GDP forecasting error on the balance (d)	0.2	0.6	-0.6	-0.5	-0.7	-0.1	-0.5

4. STRUCTURAL BALANCE ADJUSTMENTS ENVISAGED IN THE LATEST STABILITY PROGRAMMES OF THE COUNTRIES IN AN EXCESSIVE DEFICIT SITUATION



SOURCES: Stability Programmes and European Commission.

a. The continuous lines plot the Stability Programme targets submitted between the end of the year first mentioned and the sta rt of the following year.
b. Provisional.
c. Difference between the budget balance (or GDP growth) observed in each year and that projected a year earlier in the Stabiliy Programmes.
d. Proxied by the product of the sensitivity of the budget balance to the cycle (estimated as 0.5 for the area as a whole) and the GDP forecasting error.

STABILITY PROGRAMMES: DEGREE OF PAST COMPLIANCE AND OUTLOOK FOLLOWING THE REFORM OF THE STABILITY AND GROWTH PACT (cont'd)

BOX 2

ward deviation in the deficit from the targets set in the programmes prepared at the end of the previous year can only be explained partly by the error committed in the GDP growth forecast (see Table 3). That indicates that the expansionary discretionary policies also contributed to the deficit targets being surpassed.

Between late 2005 and early 2006, the first programmes following the SGP reform were submitted. Among the five countries in an excessive deficit situation, Greece, Italy and Portugal set as their target an adjustment to the structural balance of more than 0.5% of GDP in each of the two coming years, in step with the new requirements (see Chart 4). Conversely, Germany and France would only meet the prescribed target over the two-year period as a whole.

The prospect, on this occasion, that the goal of moving towards correcting the area's fiscal imbalances will be met is somewhat more favourable than in recent years. In particular, along with the institutional changes in the wake of the reform of the Pact, the budgetary targets are based on more realistic GDP growth projections, precisely against the background of the growing firmness of the recovery. As a result, the setting is more conducive to the announced structural-deficit-correction drive being pursued in practice. It is also significant that in 2005 the actual deficit should have worsened to a lesser extent than would have been accounted for by the cycle.

However, the limited resolve shown in the past by numerous governments to move towards fiscal consolidation is an inauspicious precedent that advises caution when judging ex-ante to what extent the plans will be met. In addition, in its evaluation of the programmes of the Member States in an excessive deficit situation, the European Commission considered that the degree of detail of the measures enabling the goals to be met was insufficient, or that the margin by which it was intended to meet the requirement to correct the structural deficit by half a percentage point per year was very tight, meaning that any setback might require the application of additional measures. Lastly, in several of these cases, the medium-term objectives would be met only at very distant time horizons.

In short, although there was a modest improvement in public finances in 2005, the situation in many countries remains worrying. Moreover, the degree of ambition in the latest stability programmes contrasts with the persistence of high deficits. On past experience, delaying fiscal consolidation during a period of strengthening economic activity gives rise to imbalances that are very persistent in the medium term. Thus, the excessive deficit countries should take advantage of the current more favourable economic conditions to comply with their obligations (see Box 2). Finally, in the area of structural reforms, the March 2006 European Council reiterated its commitment to relaunching the Lisbon agenda, insisting on the importance of application by national authorities of the measures contained in their national reform programmes, in order to strengthen medium-term growth and employment generation.

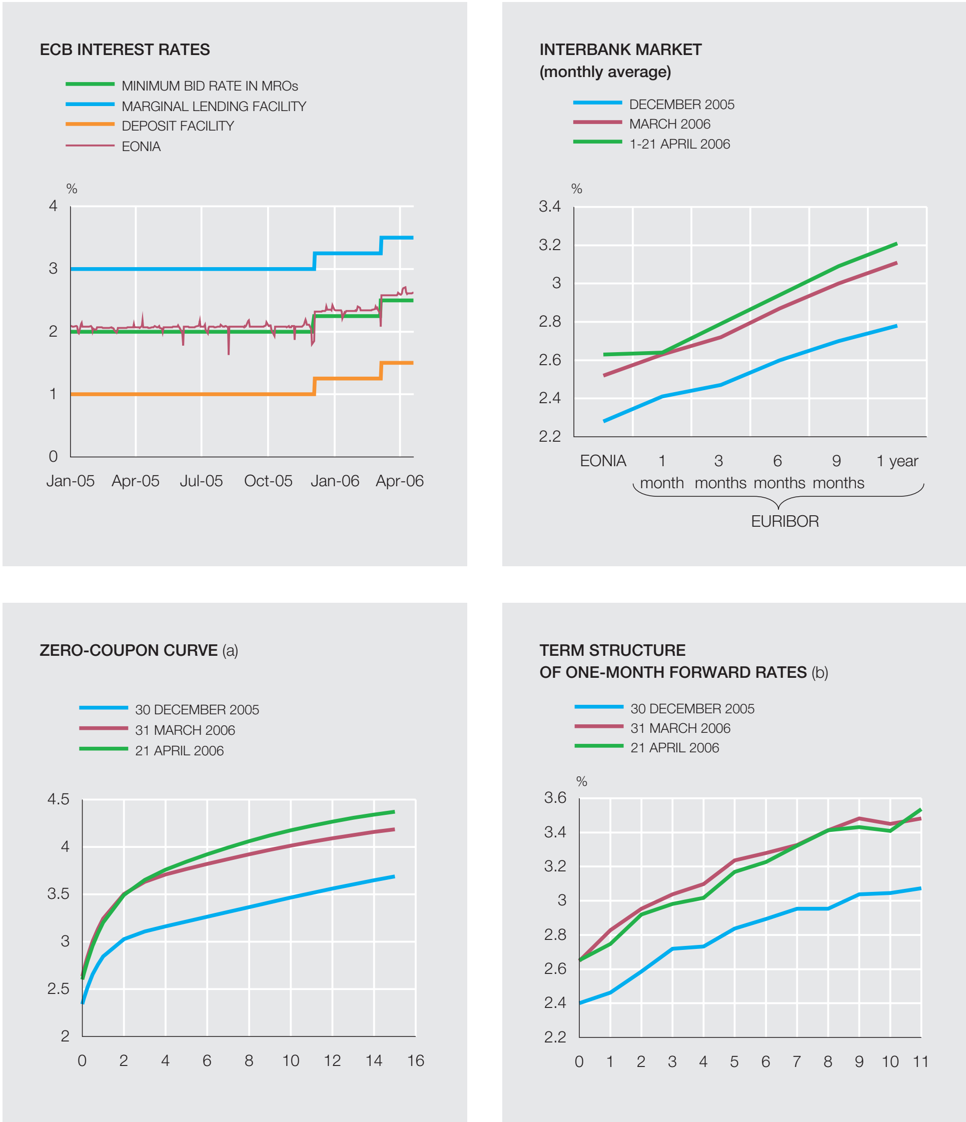
3.2 Monetary and financial developments

In the first quarter of the year, the ECB Governing Council considered that the risks to medium-term price stability had increased significantly, as a result of the rise in oil prices, against an economic background in which the prospects for a strengthening of activity had clearly improved. Consequently, at its meeting of 2 March, it raised its official interest rates by 25 basis points. Thus, the interest rates on its main refinancing operations, the deposit facility and the marginal lending facility stood at 2.5%, 1.5% and 3.5% respectively (see Chart 12). Subsequently, at its April meeting, the ECB announced that it would continue to monitor economic developments very closely to ensure that risks to price stability over the medium term did not materialise.

In the opening months of the year, money market interest rates reflected the change in monetary policy stance by rising at all maturities. Thus, the one-month forward rate curve had shifted upwards and steepened by mid-April (see Chart 12). On the debt markets, yields negotiated at the 10-year maturity also rose, not only as a result of the signals from short-term rates but also because of the strengthening of activity. By mid-April they had reached 4.2%, up 0.7 pp from end-2005. An increase of the same size in the yield on 10-year debt

EURO AREA INTEREST RATES

CHART 12



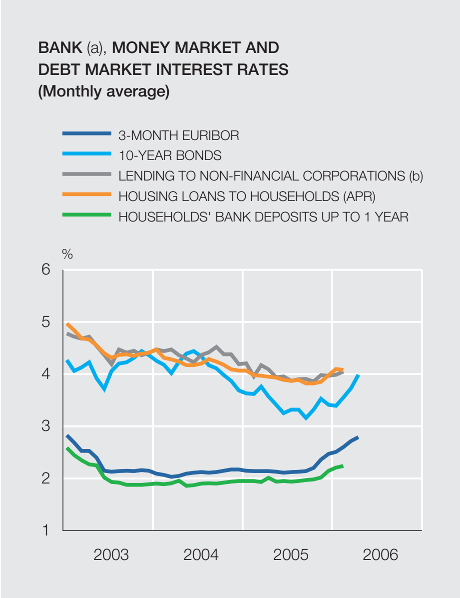
SOURCES:European Central Bank and Banco de España.

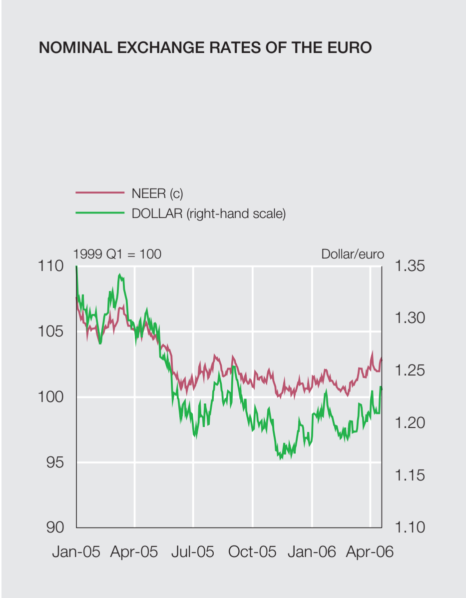
a. Estimated using swap market data.
b. Estimated using Euribor data.

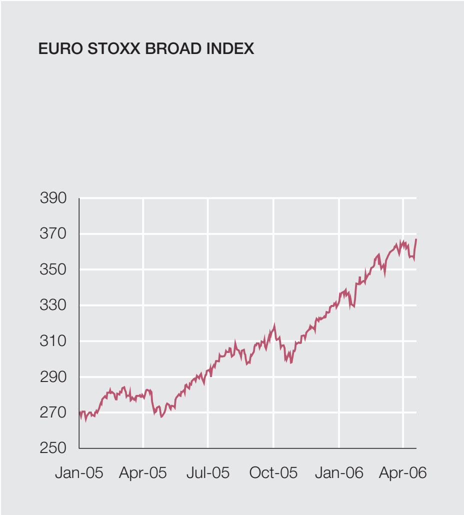
in the United States means that the spread over the European bond held relatively steady at somewhat more than 100 bp. According to the data available to February, the interest rates set by credit institutions in their lending and borrowing transactions generally reflected the upward movements in rates on the financial markets, although the rate charged on loans granted to non-financial corporations at a maturity of more than five years held unchanged at around 4% (see Chart 13).

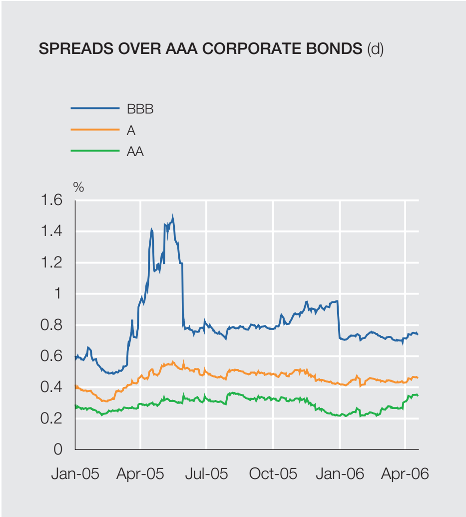
On the currency markets, the euro fluctuated against the dollar during the first four months of the year within a range of 1.18 to 1.23 dollars to the euro, showing no clear trend over the period as a whole. The euro also held very steady against the yen and sterling, so that in nominal effective terms it hardly moved (see Chart 13). The rising trend in euro area equity markets continued during Q1 against a background of moderate volatility. However, oil and commodity price increases led to temporary corrections in April, given the fear of an outbreak of inflationary pressures in future.

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







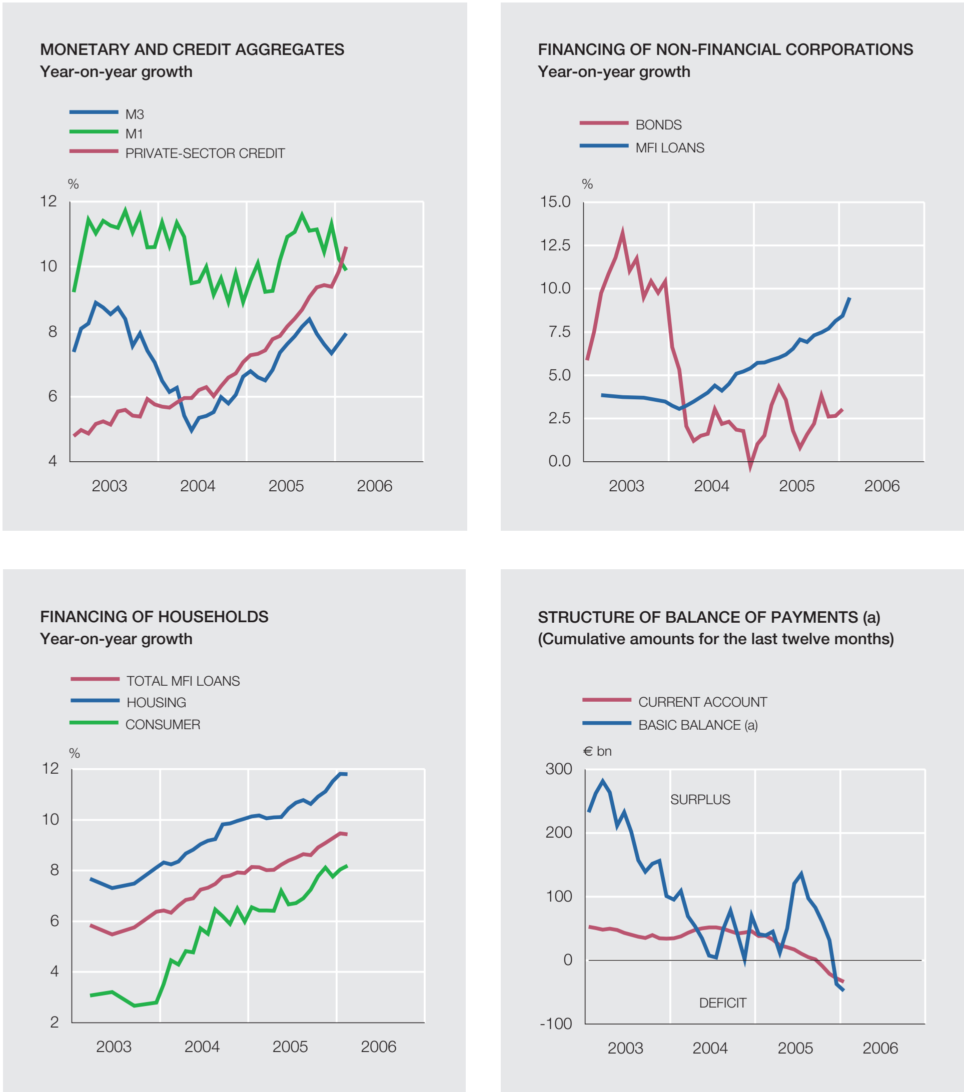


SOURCES: Banco de España and European Central Bank.

a. Data drawn from new statistics on interest rates compiled by the ECB for new business.
b. Interest rates on loans at over five years.
c. Nominal effective exchange rate index (EER-23). Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

The year-on-year growth rate of M3 accelerated in 2006 Q1, to reach 8.6% in March, up 1.2 pp from December (see Chart 14). The growth of credit to the private sector also gained momentum, its year-on-year rate rising to 11.5% in March, up 2.1 pp from December. As for the agents demanding credit, the greater strength of loans to non-financial corporations was notable, stimulated both by new investment projects and increased mergers and acquisitions activity. Loans to households grew at a slightly higher rate, consistent with an acceleration in those for house purchase, which was partly offset by the slowdown in other loans granted for other purposes. The increase in the rate of growth of credit was common to most member countries. In Germany, the recovery in the growth of total credit to the non-financial private sector was notable, although there was no comparable increase in the buoyancy of loans. In Spain, loans to both non-financial corporations

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.

and households continued to expand at a very high rate, considerably above the euro area average.

4 The Spanish economy

On published QNA figures, the growth of GDP in the Spanish economy in 2005 Q4 stabilised at a year-on-year growth rate of 3.5%. In this period, domestic demand increased by 4.8%, having moderated slightly, and net external demand subtracted 1.5 pp from growth, marking an improvement in relation to the previous quarter (see Chart 15). The information available points to these patterns continuing at the start of the current year, with an additional easing in domestic demand as a result of the diminished buoyancy of private consumption and, to a greater extent, of gross fixed capital formation. Set against this, government consumption should show renewed strength. It is estimated that foreign trade flows increased substantially in the opening months of the year, giving rise to a somewhat smaller negative contribution of the external sector, in absolute terms, to that recorded in 2005 Q4. Overall, GDP would have held at a year-on-year growth rate of 3.5% in 2006 Q1.

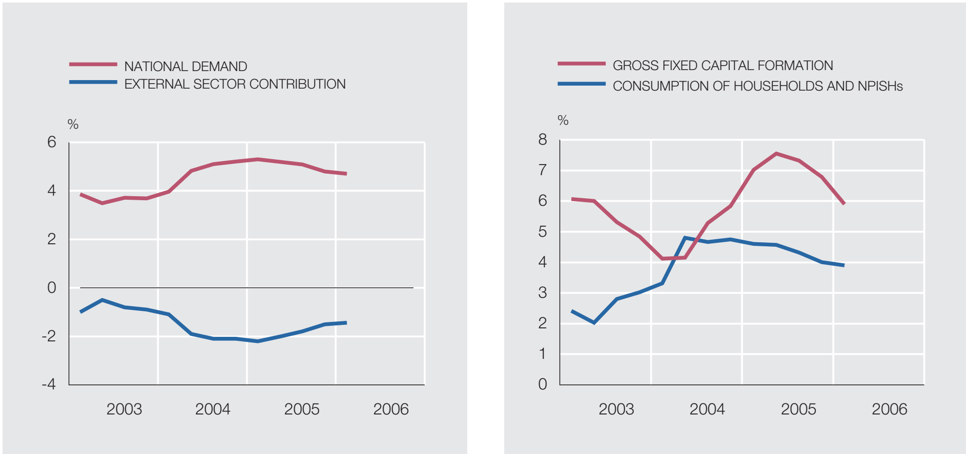
From the standpoint of value added, the activities most contributing to the increase in GDP at the start of 2006 are construction and market services, which remain the most buoyant market economy industries. Industrial activity tended to firm and further the improvement recorded in the second half of 2005. As regards employment, the number of jobs is estimated to have increased by 3.2% in Q1, with its rate of change stabilising, as is the case with GDP. Despite the stability in the growth of apparent labour productivity, unit labour costs tended to quicken in the opening months of the year owing to the upward behaviour of compensation. The expected acceleration chiefly reflects the activation of the indexation clauses under the 2005 agreements, with an estimated impact of close to 1 pp on the negotiated increase in wage rates for 2006. The rise in labour costs and the upward impact of dearer energy have been behind the increase in inflation in the early months of 2006, against the background, moreover, of the continuing widening of operating margins. The 12-month growth rate of the CPI stood at 3.9% in March, after having reached 4.2% in January, and the CPI excluding unprocessed food and energy quickened to 3.1%.

4.1 Demand

On QNA estimates, the rate of increase of household final consumption expenditure eased by 0.3 pp in 2005 Q4 to 4% year-on-year. The latest information indicates that the path of deceleration extended, albeit with less intensity, into 2006 Q1 (see Chart 16). Consumer confidence worsened somewhat over the first three months, reflecting a downward revision of sentiment in relation to the economic situation. The more volatile retail trade confidence indicator underwent a sharper deterioration, reaching its lowest level since 1996. At least in qualitative terms, this matches the behaviour of the retail trade sales index, in real terms, which moderated further on information to February, with zero growth in its non-food component. Car sales improved in Q1 following the decline in the closing months of 2005, though this recovery should be viewed with caution since it might be influenced by the Easter holidays calendar in 2005 and 2006. Finally, the synthetic indicator of private consumption of goods and services quickened in early 2006, in terms of seasonally adjusted rates. It was influenced by the anomalous imports figure for January, though its underlying trend points to a mild slowdown.

The course of the main determinants of private consumption helps explain the tendency towards lower growth of this expenditure component. Real household disposable income is expected to slow somewhat, mainly as a result of a bigger negative contribution of net interest payments, against the background of the rise in interest rates, while employee compensation would grow more sharply than in 2005 as a result of higher wage increases. The diminished degree of looseness of monetary conditions would further have a direct – albeit minor – effect on containing

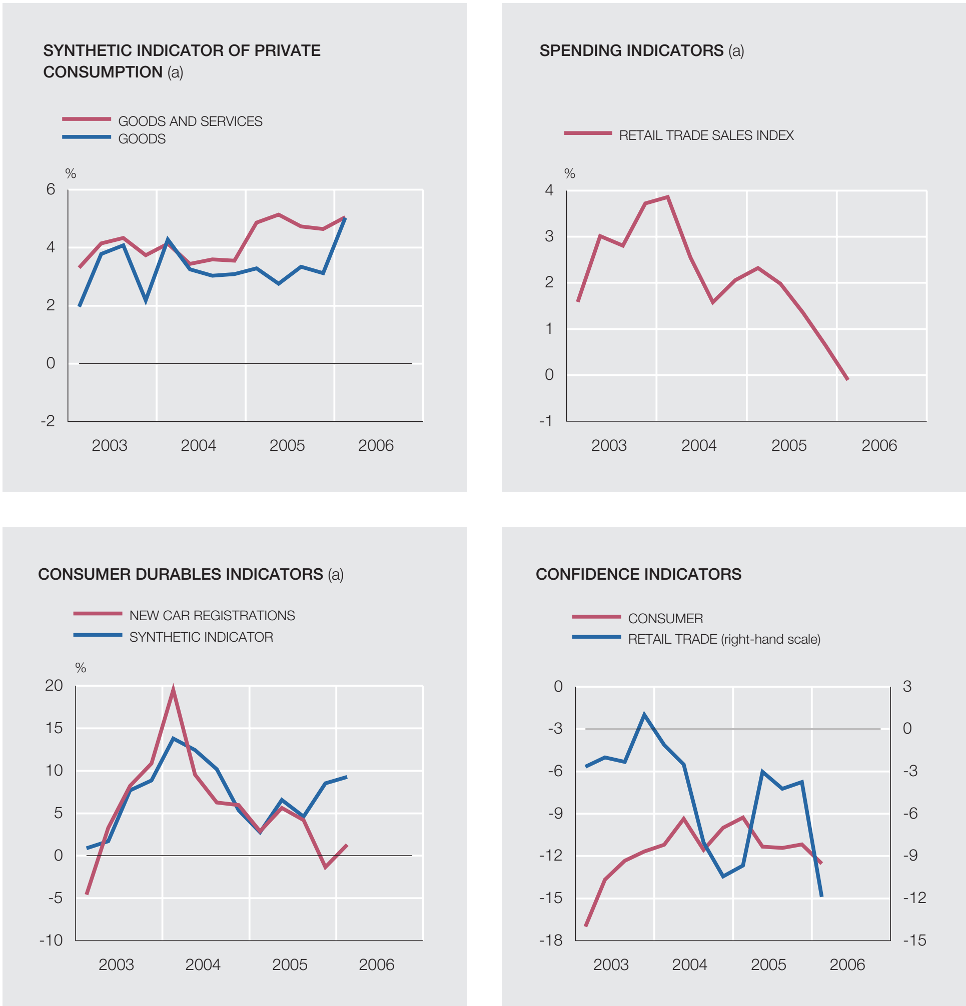
MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

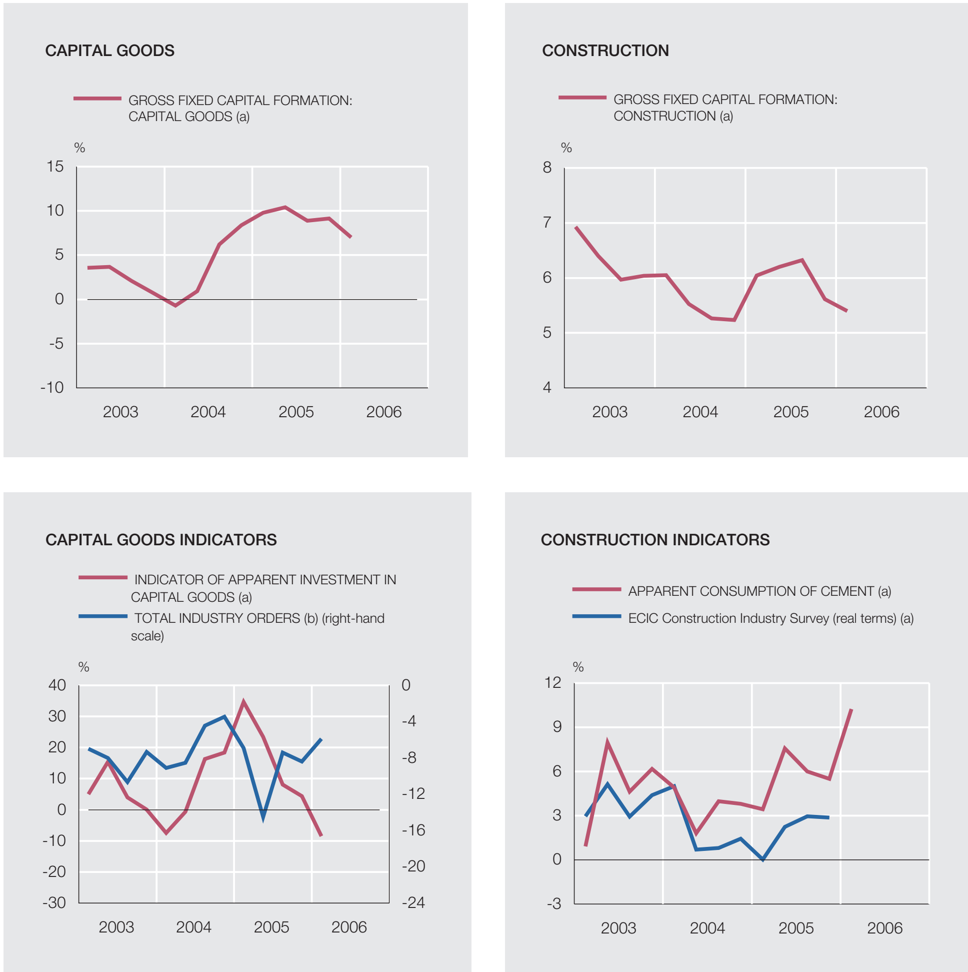
PRIVATE CONSUMPTION INDICATORS CHART 16



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

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

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.

consumption. Household wealth continues on an expansionary path, although it is estimated to rise less for the current year than in previous years, owing to the slowdown in house prices over the course of 2005, which has run into 2006 Q1. Financial wealth is being driven by the appreciable rise in stock market prices, which have grown by around 11% to March.

General government final consumption is estimated to have accelerated in 2006 Q1 to around 5.5%, compared with the growth of 4.6% posted in 2005 Q4, although this increase in the year-on-year rate is due above all to a base effect. The acceleration in general government consumption would be associated more with the behaviour of personnel costs and, specifically, the increase in public-sector employment, than with purchases of goods and services.

The growth rate of gross fixed capital formation moderated slightly in the final months of 2005; in Q4 as a whole, its rate compared with the same quarter a year earlier stood at 6.8%, 0.5 pp down on the growth posted in Q3. This was the result of the smaller increase in construction, the rate of change in which declined by 0.7 pp, and in investment in other products, a component very closely linked to investment in construction, the growth rate of which eased by 1 pp. Conversely, the pace of growth of investment in capital goods stabilised at a rate close to that of the preceding quarter (see Chart 17). The conjunctural indicators available for Q1 point to a fresh slowdown in fixed-capital investment, which would have spread to all its components: both to investment in equipment, which would nevertheless remain the most dynamic component of domestic demand, and to investment in construction and in other products.

Turning to capital goods expenditure, the indicator of apparent investment in capital goods, calculated with incomplete data for Q1, posted a notable slowdown in this period, which may have been partly influenced by exceptional increases in exports. The domestic production of capital goods increased by 6.5% in 2006 to February, compared with 2.5% in 2005 Q4, while imports of these goods eased somewhat over the same period, albeit posting a high growth rate. The related business confidence indicator increased appreciably in the first two months of 2006, reflecting a tendency to recovery of orders, and capacity utilisation in industry held far above its historical average, supporting the continuity of the investment process. Conversely, however, the number of companies assessing their plant capacity as excessive has increased considerably in the first three months of the year.

According to Central Balance Sheet Data Office (CBSO) figures, with information to 2005 Q4, non-financial corporations' productive activity held on a moderate growth path last year, lower than that observed the previous year. It should be recalled that some of the most buoyant sectors, such as construction and services, are not properly represented in this source. In any event, the smaller increase in activity was compatible with an appreciable acceleration in companies' net profit, thanks to the strong increase in extraordinary income, and with an increase in the ordinary return on equity higher than that in the cost of debt. The indicators of financial pressure on investment and employment, likewise calculated using CBSO data, are holding at very favourable levels, despite having worsened slightly. All these factors would have driven the observed momentum in corporate investment in 2005.

The year-on-year rate of investment in construction stood at 5.6% in the closing months of 2005. The diminished buoyancy of this variable compared with Q3 was due to the more modest trend of residential investment (5.1%), while other construction, an aggregate encompassing civil engineering works and non-residential building, rose to 6.1%, 0.5 pp up on the rate the previous quarter. Almost all the coincident indicators of activity in construction remained notably robust in 2006 Q1, limiting the scale of any possible slowdown compared with end-2005. There was an acceleration in the indicators of inputs (cement and the industrial production index of construction materials), the information for which is still incomplete. This was in line with the indicators of employment since the rate of decline of registered unemployment stepped up to February while Social Security registrations (adjusted for the effect of the regularisation of immigrants) increased by more than 7% (6.2% in 2005). The confidence of construction companies, however, was highly volatile over recent months and worsened in Q1 as a whole, owing to something of a slide in contracting orders.

The buoyancy of investment in housing is manifest in the burgeoning figures for housing starts (estimated on the basis of project-approval statistics released by the Spanish Ministry of Development), which continue on a rising trend. In 2004 around 690,000 houses were started, and there were 700,000 new houses in 2005 (without including refurbishments), while in 2006 Q1 the number of housing starts would have been 10% above the starts recorded in the same quarter in 2005. Drawing on this information and under different assumptions about work execution schedules, it is estimated that investment in housing has slowed slightly in 2006 Q1. Nonetheless, the rise in approvals in the opening months of this year projects robust residential investment for the whole of 2006.

FOREIGN TRADE
Percentage change on year ago

CHART 18

SOURCES: INE, Ministerio de Economía y Hacienda and Banco de España.

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

On the latest QNA data, net external demand subtracted 1.5 pp from output growth in 2005 Q4, reducing its negative contribution to GDP growth by 0.3 pp in relation to the previous quarter. The moderate pick-up in net external demand showed a loss of momentum in imports, to 6.6% year-on-year, against the background of a further easing in exports of goods and services, the year-on-year rate of which stood at 1.9% (see Chart 18). In 2005 as a whole, the net external balance made a negative contribution of 1.9 pp to growth, which was in response to the notable increase in imports of goods and services (7.1%), compared with the slackness shown by exports, in an international setting only slightly less expansionary than in 2004. The as yet very incomplete information for 2006 Q1 nevertheless points to a recovering profile for goods exports (along with some worsening in exports of tourist services), while imports would also be picking up, in line with the strength of domestic demand and the improvement in industrial activity. Overall, the net contribution of external demand would have improved slightly.

During 2005 Q4, real goods exports continued to weaken, posting a decline of 0.6% on QNA figures. The latest data from Customs records relate to January and February, and entail an interruption in this downward path, with a real increase of close to 12% (the biggest rise recorded since end-2004). Nonetheless, given the characteristic volatility of customs data, they should be viewed with some caution. Yet the trend of this indicator projects something of a recovering profile for this variable, consistent with its main determinants, in particular the pick-up on European markets (Spain's main trading partners) and fewer losses in competitiveness, underpinned by the stability of the euro. In the first two months of the year sales to the EU regained momentum, rising by 6.3% in real terms, following their poor performance in 2005.

According to QNA figures, the rate of increase of real exports of tourist services fell in 2005 Q4 to 4.1% year-on-year, in line with the slowdown in the nominal Balance of Payments indicator. Specifically, the main real-terms indicators of tourism embarked on a slide last December, which steepened in the first two months of the current year. Over the January-February period, both real total expenditure by tourists and overnight stays in hotels (one of the indicators best approximating tourist spending) posted declines of 2.3% and 1.5%, respectively. However, in March the number of overnight stays grew by over 6% year-on-year, a particularly favourable figure given that in 2005 the Easter holiday period was in March, unlike this year. As to the number of tourists, this moderated to March, with a growth rate of below 1% following a figure of 6.2% in 2005 as a whole, although the March figure also proved more favourable if adjusted for the above-mentioned Easter holiday week effect. That said, the decline in average expenditure per tourist appears to be continuing, owing to shorter average stays and the reduction in average daily expenditure.

Real exports of non-tourist services grew by 11.1% in 2005 Q4, according to QNA figures, intensifying the upward tone of recent quarters. Sales of transport services and exports of corporate services trended very favourably, while insurance, construction, financial and IT services posted big increases.

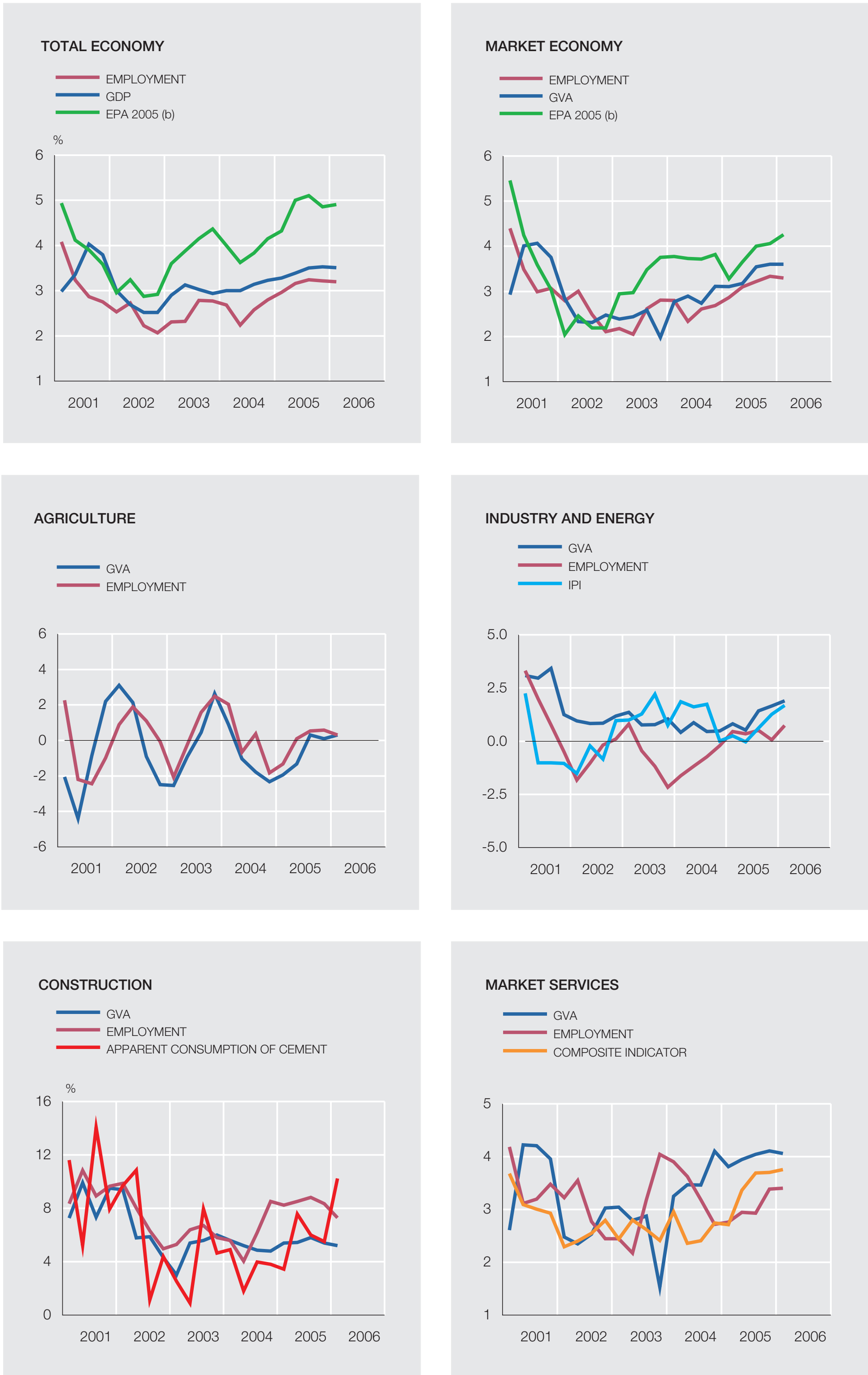
Real goods imports continued to slow in 2005 Q4, and their year-on-year growth rate stood at 5.3% on QNA estimates, affected by the great moderation of certain domestic demand components, such as final consumption expenditure or exports. However, according to customs data, imports rebounded significantly in January and February to 14.5% year-on-year. Purchases of consumer goods and of energy showed the most buoyancy, although it is possible that the January figure for consumer goods imports is biased upwards owing to the atypical entry of a large amount of textile products, which were not acquired in 2005 so as not to exceed the annual quotas with certain countries. By geographical area, there was a clear pick-up in purchases from the EU in the first two months of 2006, with an increase of over 11% compared with 2.5% growth in 2005 as a whole, while the strong demand from the rest of the world continued, with an expansion of 19%. The trend of customs figures also projects some momentum in imports, in line with the recovery in exports and the take-off of industrial activity.

Finally, real imports of services continued to quicken in 2005 Q4 to a rate of 12.4% on QNA figures. This was the consequence of the continued buoyancy of imports of tourist services (20.1%), which was consistent with the robustness of nominal tourism expenditure on the balance of payments during this period, and of the momentum of real non-tourist services imports (10.7%), in particular those relating to financial, IT and construction services. As to 2006, the information for January suggests tourism expenditure has continued to expand at a high rate.

4.2 Output and employment

The growing trend of value added in the market economy initiated in late 2004 continued in the closing months of 2005. Its year-on-year rate stood at 3.6% in Q4, reflecting the recovery in industry and energy, and the growing dynamism of market services. The high growth rate of value added in the construction industry eased to 5.4%, although it remains the most buoyant activity in the Spanish economy (see Chart 19).

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



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

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

The agricultural and fisheries branches ended 2005 with growth in value added of practically zero (0.1% year-on-year in Q4), following the cuts in the first half of the year. This trend largely responds to the reduction in vegetable produce in a year marked by scant rainfall. The outlook for 2006 is more favourable, with a start to the hydrological year marked by more abundant rainfall, which has already been reflected in the initial estimates of output. In any event, employment developments in the opening months of 2006 point to the continuation of the scant dynamism shown by these branches in the second half of 2005.

The recovery initiated in 2005 Q3 in the energy and industry branches continued in Q4, with a growth rate of 1.7%. The greater dynamism of this group of activities was largely due to the growing resilience of energy activities, the year-on-year rate in which rose by 0.5 pp to 5%. The industrial branches as a whole showed an acceleration of only 0.2 pp, with their year-on-year rate standing at 1.1%; but despite its scant magnitude, this is the highest growth rate recorded since 2003 Q1. On the latest available conjunctural information, the expansionary path of industrial activities as a whole ran into the opening months of 2006, boosted by the greater buoyancy of exports. The industrial production index increased by 1.8% in January and February, compared with 1.3% in 2005 Q4; the PMI reached a five-year high in March, while the growth rate of large industrial corporations' sales increased in the early months of the year, according to the information provided by the State Tax Agency. Social Security registrations in this branch increased marginally in Q1. Other conjunctural indicators show less favourable developments; such is the case of the confidence indicator compiled by the European Commission and of the turnover and incoming orders indicators, though the latter have been rather erratic in recent months.

Despite its growth being cut by 0.4 pp, the construction branch ended 2005 with a high growth rate (5.4%). As discussed in the previous section, the resilience of this sector was underpinned by the substantial dynamism of residential building and of civil engineering works executed by general government. Overall, the leading indicators project a mild slowdown in construction activity during the year.

Services activity was slightly more expansionary in 2005 Q4, growing at a rate of 4%, 0.1 pp up on the previous quarter. The two components of this branch contributed to the expansion: non-market services quickened by 0.3 pp to 3.8%, while the rate of increase of market services climbed by 0.1 pp to 4.1%. It is estimated that the moderately quickening path of value added in market services during 2005 has been interrupted in the opening months of 2006. Both the decline in the services and retail trade confidence indicators compiled by the European Commission, and the slight slowdown in the number of Social Security registrations point to the lesser momentum of tertiary activities. Nonetheless, other indicators suggest that services activity remains quite robust: such is the case of the synthetic services indicator, of the sales by major corporations according to the State Tax Agency or of the PMI. Among tertiary activities, developments in trade and repairs were notably adverse; their results were particularly poor in the opening months of the year, as shown by the employment and activity indicators, and, especially, by the related business surveys. In the hotel and catering trade, by contrast, the performance was positive in the early months of 2006, and a high pace of job creation was maintained according to the figures on Social Security registrations. Transport, storage and communications activities also performed favourably, while real estate and business services maintained the firmness shown in the closing months of 2005.

On QNA estimates, employment held at a growth rate of 3.2% in 2005 Q4, a similar rate to that seen in the two previous quarters. The same stability was seen in GDP, whereby the growth of apparent labour productivity remained at a minimal rate (0.3% in Q4 and on average for 2005).

For the market economy, the increase in apparent labour productivity was likewise scant, as a result of rises of the same order (of scarcely 0.1 pp) in the rates of increase of employment and value added to 3.3% and 3.6%, respectively. The main conjunctural indicators point to an ongoing expansion in employment in the opening months of 2006. The year-on-year growth of Social Security registrations, once the impact of the regularisation of immigrants was stripped out, stood at 2.7%, only 0.1 pp below the rate observed in 2005 Q4. Registered unemployment, meanwhile, held at a similar level in February and March to that recorded in the same months in 2005, confirming the end of the path of continuous declines seen since late 2004. To date in 2006, the rate of increase in the number of contracts has risen substantially, to a figure of close to 20%; however, this information should be viewed with great caution, since it includes a significant volume of contracts of a very short duration. Finally, according to the EPA (Labour Force Survey), numbers employed showed the same dynamism in the first three months of the year as in previous quarters, with year-on-year growth of 4.9%, the same rate as that recorded at end-2005.

Across the different branches of activity, QNA figures for 2005 Q4 show that the modest acceleration in employment in the market economy was the outcome of the greater buoyancy of market services, which offset the loss of momentum in the other branches of activity. The year-on-year increase in market services employment was 0.5 pp, up to 3.4%. Conversely, in other services, employment slowed by more than 0.5 pp, which placed its year-on-year rate of increase at 2.7%. Construction remains the most buoyant activity in terms of job creation, too, although its rate of increase slackened at the close of the year by half a percentage point to 8.3%. While the recovery in agriculture appeared to be confirmed, albeit very slowly, with growth in employment of 0.6% (only 0.1 pp more than in Q3), the slight pick-up in employment in industry initiated in early 2005 was interrupted in 2005 Q4, and the year-on-year rate in this period stood at 0.1%, compared with 0.5% the previous quarter. On EPA figures, employment in agriculture slowed in 2006 Q1, evidencing a sharp year-on-year decline of 3.2%; in the other branches, however, the buoyancy of employment increased. Specifically, positive rates of change resumed in industry, in line with the average for 2005 (0.5%), following the decline in employment in Q4. In services and construction, employment retained the marked dynamism it had shown in previous quarters and indeed quickened slightly, to respective growth rates of 6.3% and 7.3%.

The stability in the pace of total job creation in National Accounts terms in Q4 reflects the steady rate of increase in numbers of dependent employees. Wage-earners grew by 3.7% year-on-year, unchanged on Q3, while the self-employed component once again slowed, by 0.2 pp on this occasion to 0.3%. The EPA figures point to a virtually zero change in numbers of self-employed at the start of the year, and to sustained growth in the number of wage-earners (6.1%). Overall, the dependent employment ratio climbed to 81.9%, against 81% a year earlier. Other indicators confirm the loss of steam in self-employment in 2005; this is the case of employment creation among the self-employed as reflected by Social Security registrations, a trend that has continued into the opening months of 2006.

According to the EPA information on contract duration, temporary employment in 2006 Q1 posted a 10.9% year-on-year increase, slightly lower than in the previous quarter. It was once again more buoyant than permanent employment, which quickened by 0.5 pp (to 3.8%). That made for a fresh year-on-year increase in the proportion of temporary to total employees, to 33.3%, 1.4 pp up on its level in early 2005. Official INEM (National Employment Office) statistics on contracts show that permanent contracts performed more dynamically in Q1, raising the proportion of such contracts in the total to 11.3%, 1 pp up on a year ago. Regarding the duration of the working day, following the very high year-on-year changes in part-time hiring estimated by the EPA in 2005, the year-on-year growth rates of part-time employees fell sharply in Q1, posting a decline of 0.5% compared with the same quarter a year earlier. The year-on-year rate of increase in the number of part-time employees rebounded in this quarter to a growth rate of 5.7%, following the modest increases recorded during 2005. As a result, the proportion of part-time employees fell by 0.7 pp compared with 2005 Q1 to 12.4%. In terms of educational attainment, there continues to be high growth among employees with a university or higher education (7.6%), while the figures for those with primary studies continue to show a decline (–8.9%). Box 3 offers further information on the process of human capital accumulation in the Spanish economy.

The dynamism of the labour force once again increased in 2006 Q1, with year-on-year growth of 3.6% being recorded, 0.4 pp up on the figure both for 2005 Q4 and 2005 on average. This acceleration in the labour force was based on the high increase in the participation rate to 58%, 1.1 pp above the related level a year earlier, since the population aged over 16 held at the year-on-year growth rate of 1.7% seen since mid-2003. In terms of the breakdown by gender, the increase in the labour force was sharper among women (5%), with a year-on-year increase of 1.6 pp in the participation rate to 47.5%. Among men, however, the labour force slowed slightly, and the participation rate rose by 0.6 pp to 68.9%. Finally, according to EPA information, the numbers of unemployed fell again in 2006 Q1 compared with the same period a year earlier, albeit at a lesser pace than that seen in 2005, giving rise to an increase of 94,500 unemployed compared with the previous quarter. The year-on-year decline in unemployment thus fell to 7.8%, compared with 11.6% at end-2005, and the unemployment rate stood at 9.1%, more than 1 pp below its level in early 2005, but 0.4 pp above that recorded the previous quarter. The information provided by the registered unemployment figures shows a declining trend in the reduction of unemployment as positive changes have been recorded in 2006 Q1.

4.3 Costs and prices

Compensation per employee rose by 2.5% in 2005, appreciably down on the previous year (3.3%). In the market economy the slowdown was on a similar scale, with an increase in average compensation per employee of 2.3% and fairly similar growth in the other branches of activity (with the sole exception of agriculture), standing between the increases of 2.8% in industry and 2.2% in construction. The ETCL (Quarterly Labour Costs Survey) showed somewhat different results since, according to this statistic, average monthly labour costs ended 2005 with an average increase of 2.9%, a similar figure to that in 2004. A bigger increase is expected in compensation per employee in 2006 Q1, as a result of the effect of the application of the indexation clause corresponding to 2005, the impact of which is estimated at 0.93 pp, above the figure of 0.59 pp for the clause relating to the previous year.

The start of collective bargaining in 2006 is within the framework laid down by the AINC (the Interconfederal Agreement for Collective Bargaining), the extension of which to this year was signed in late January. The information on collective bargaining agreements registered to end-March points to a slight increase in wage settlements, the rate for which stands at 3.07% (see Chart 20). More than 5 million workers are covered by these agreements, a figure 10% higher than in the same period a year earlier. In all branches except agriculture, the agreed wage increases are in line with AINC guidelines. In industry, the increase in rates is holding at 3.2%, while in construction and services it stands at 2.9%.

On QNA figures, labour costs per unit of value added held at a stable growth rate of 2% in 2005 Q4, as the slight acceleration in compensation per employee was offset by a rise on the same scale in the rate of increase of value added per employee. Against this background, the growth rate of the value-added deflator was cut by 0.3 pp, as a result of the somewhat less expansionary behaviour of margins, which continued to widen, albeit at a lesser rate. Spe-

The human capital of an economy is one of the most significant variables when it comes to understanding the process of economic growth in the medium and long term. Its importance is all the greater in a setting such as the present one in which new technologies are being developed that are complementary to human capital and that require greater versatility of the labour force. The formal education system is the main determinant of human capital accumulation. In this respect, the increase in the Spanish population's average educational attainment in recent years has been most notable: the proportion of the population aged 25-39 with university studies has risen from 23.9% in 1995 to 37.5% in 2005, while the population with secondary studies has increased over the same period from 20.5% to 24%. However, despite this growth, some polarisation continues to be seen in the distribution by educational attainment. Chart 1 shows the proportion of people aged 25-39[1] that have attained the level of primary, secondary or tertiary studies in Spain, the EU-15 and the EU-25. Whereas the bulk of the population aged 25-39 has secondary studies in the EU-15 and EU-25, the distribution for Spain is concentrated at the two extremes, primary and tertiary studies, with the weight of secondary studies being much lower.

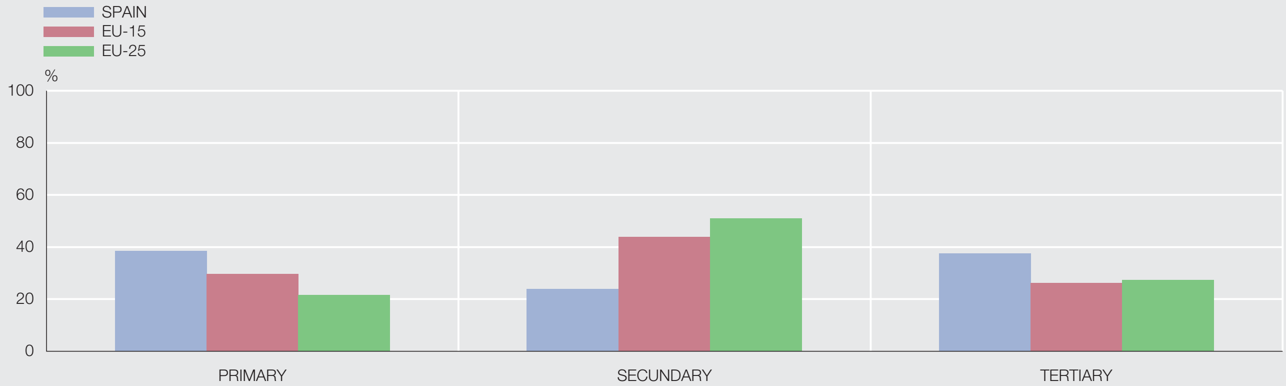
To evaluate the human capital accumulation of a specific country, regard must also be had to different indicators of educational quality. In this respect, indicators of spending on education and indicators of results are usually used. Chart 2 shows the situation in Spain relative to other European countries in respect of two measures of educational quality, one on spending and the other on outputs: spending per student in secondary education and the average score of the PISA[2, 3] project examination. Spain lies below the average in both variables, which means that the quality of Spanish studies, at least at secondary level, is probably inferior to that of our peer countries[4]. Nonetheless, while an increase in spending is to be recommended, it should be stressed that, in the light of the data in Chart 2, such an increase would not necessarily ensure better academic results. Further, taking all educational levels as a whole, spending per student in Spain has shown a tendency to converge towards the European level in recent years, although this convergence is admittedly more due to demographic and GDP convergence factors than to increases in budgetary allocations[5].

In any event, if improvements in the stock of human capital are to translate into increases in productivity, the new skills produced by the education system must be properly matched with the jobs that require them. The data provided by the Wage Structure Survey (EES)[6] allow the changes in relative wages at each educational level to be broken down into two components: i) the effect of the change in the occupational structure (to what extent individuals with different educational attainment levels are being employed in jobs with different skills requirements), and ii) the change in the returns to education for each job (to what extent, for the same job and level of educational attainment, wages are changing). As can be seen in the accompanying table, the median wage of workers with a greater level of educational attainment relative to the median wage of workers with primary studies has fallen by

1. It has been decided to use this age bracket to analyse educational attainment of individuals who have completed their studies in a recent period. **2.** The PISA (Programme For International Student Assessment) project consists of the examination of 15-year-old students to assess their knowledge of maths, language and science. The 15-year-old students are in the first cycle of secondary education, meaning that the relevant comparison would be with spending per student at secondary level. Spain is denoted by the abbreviation "es", and the two axes represent the average of both quality measures for the EU-15, excluding Great Britain, whose PISA 2003 results are not available. **3.** The data on spending per student and PISA results are for 2002 and 2003, respectively.

4. There are no reliable measures of results for the other educational levels. However, spending per student in Spain for these levels is likewise below that of the EU countries. **5.** See Puente and Pérez (2004), "Las series de *stock* de capital humano y tecnológico en los indicadores de convergencia real", *Boletín Económico*, December, Banco de España. **6.** The EES offers information on workers' wages, classified by level of educational attainment and occupation. This box considers four educational levels (primary, first and second cycle of secondary, and university) and four occupational levels (unskilled manual, skilled manual, unskilled non-manual and skilled non-manual). For further information on this breakdown, see J.F. Jimeno, M.Izquierdo and V. Herranz (2001), "La desigualdad salarial en España: descomposición y variación por niveles de salarios", *Papeles de Economía Española,* vol. 88.

1. DISTRIBUTION OF THE PEOPLE AGED 25-39 BY EDUCATIONAL ATTAINMENT IN SPAIN, EU-15 AND EU-25.

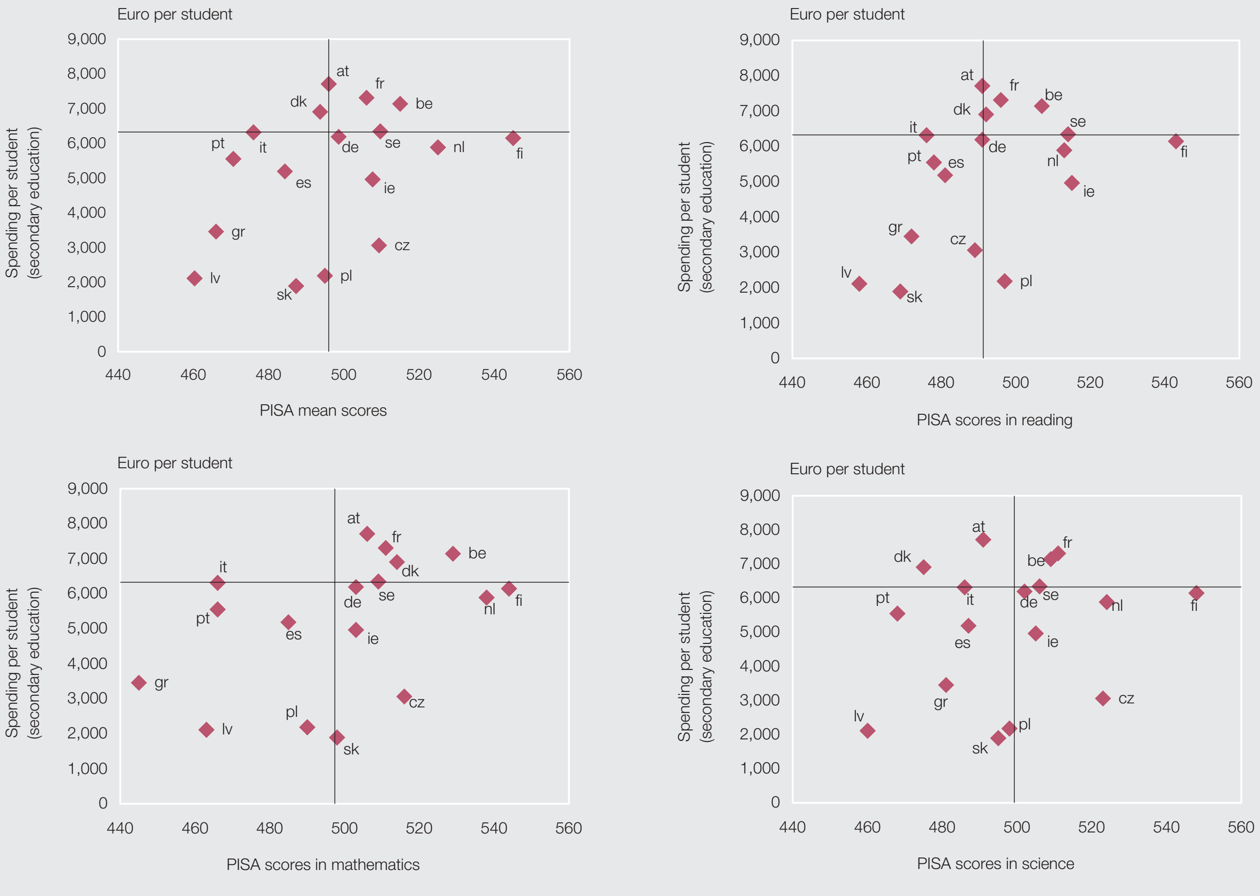


SOURCES: EUROSTAT.

almost 15%, from 1.95 to 1.67, between 1995 and 2002. The third column in the table shows what these relative wages would have been had there been no changes in the occupational structure of employment. It may be concluded in the light of this column that, even with the low level of occupational disaggregation considered, 18% of the decline seen in wage returns to university education may be attributed to the fact that workers with higher studies are in low-skill jobs.

These considerations allow us to conclude that the Spanish education system has several challenges to face. First, the number of people that have only completed primary studies should be reduced, which will necessarily involve reducing educational under-achievement. Second, particular emphasis should be placed on improving educational quality. As shown in Chart 2, an increase in the resources earmarked for education is needed, accompanied by other institutional measures so that this may translate into quality improvements. And third, initiatives should be taken to improve the matching of workers with a university educational level and the skills required by their jobs, such initiatives forming part of the ongoing deepening of labour reforms.

2. QUALITY INDICATORS



SOURCES: OECD and EUROSTAT.

3. RELATIVE WAGES BY EDUCATIONAL ATTAINMENT (a)

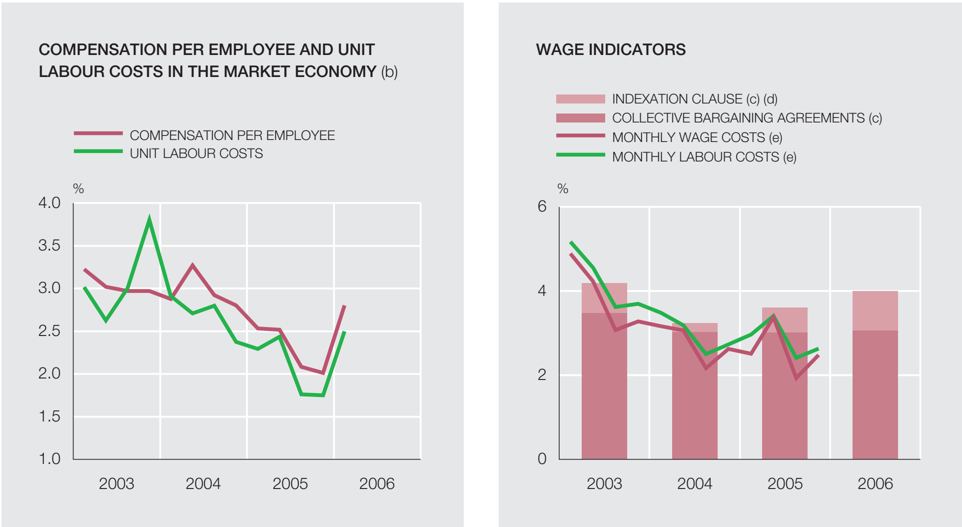
Education	Relative median wages in 1995	Relative median wages in 2002	Relative median wages in 2002 with occupational structure of 1995
Primary or Lower	1.00	1.00	1.00
First cycle of secondary	0.96	1.04	1.04
Second cycle of secondary or basic vocational training	1.33	1.26	1.24
University or Higher	1.95	1.67	1.72

SOURCE: Encuesta de Estructura Salarial (Wage Structure Survey).

a. Workers in NACE sectors C-K.

WAGES AND LABOUR COSTS (a)

CHART 20



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

a. Percentage change on same period a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information on collective bargaining agreements to March 2006.
d. Previous year's indexation clause.
e. ETCL (Quarterly Labour Cost Survey).

cifically, the unit operating surplus posted a rate of 7% at the end of last year. There was also a widening of margins in the market economy, against the backdrop of moderate cost growth.

Chart 21 reflects the behaviour of the deflator and of unit labour costs in the market economy and in its main branches. Prices performed uniformly in Q4 in the different branches of activity, with a slowdown in the value added deflator in all branches except agriculture. Conversely, unit labour costs only slowed in industry and energy, while their growth rate stepped up in the remaining branches. In any event, the widening of unit margins was common to all branches of activity. The indicators available for 2006 Q1 suggest that the growth of the deflators has continued to outpace that of unit labour costs, despite the foreseeable increase in the rate of expansion of compensation per employee.

The year-on-year rate of increase of the final demand deflator held stable in Q4 at 4.4%. However, the GDP deflator slowed by 0.1 pp, bringing its rate of expansion to 4.4% too. The growth rate of the private consumption deflator rose by 0.3 pp to 3.8%, while those of the gross fixed capital formation and exports deflators diminished to 5.7% and 4.8%, respectively. The imports deflator slowed, although much less sharply than in Q3. The upward trajectory of oil prices eased in the October-December period, following the summer highs, although this was offset partially by the depreciation of the euro against the dollar, which has contributed to dearer import prices.

Consumer prices accelerated in a similar fashion to the private consumption deflator in Q4 last year, rising to a year-on-year rate of 3.6%. This pattern intensified in 2006 Q1, taking the 12-month growth rate of the CPI to 4% on average in the first three months, while the CPI excluding unprocessed food and energy quickened by 0.1 pp to a rate of 3% (see Chart 22). Once again, the most inflationary component was energy, with an average increase in its price of 13.3%. At the beginning of the year electricity charges rose as did the prices of natural gas and

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.

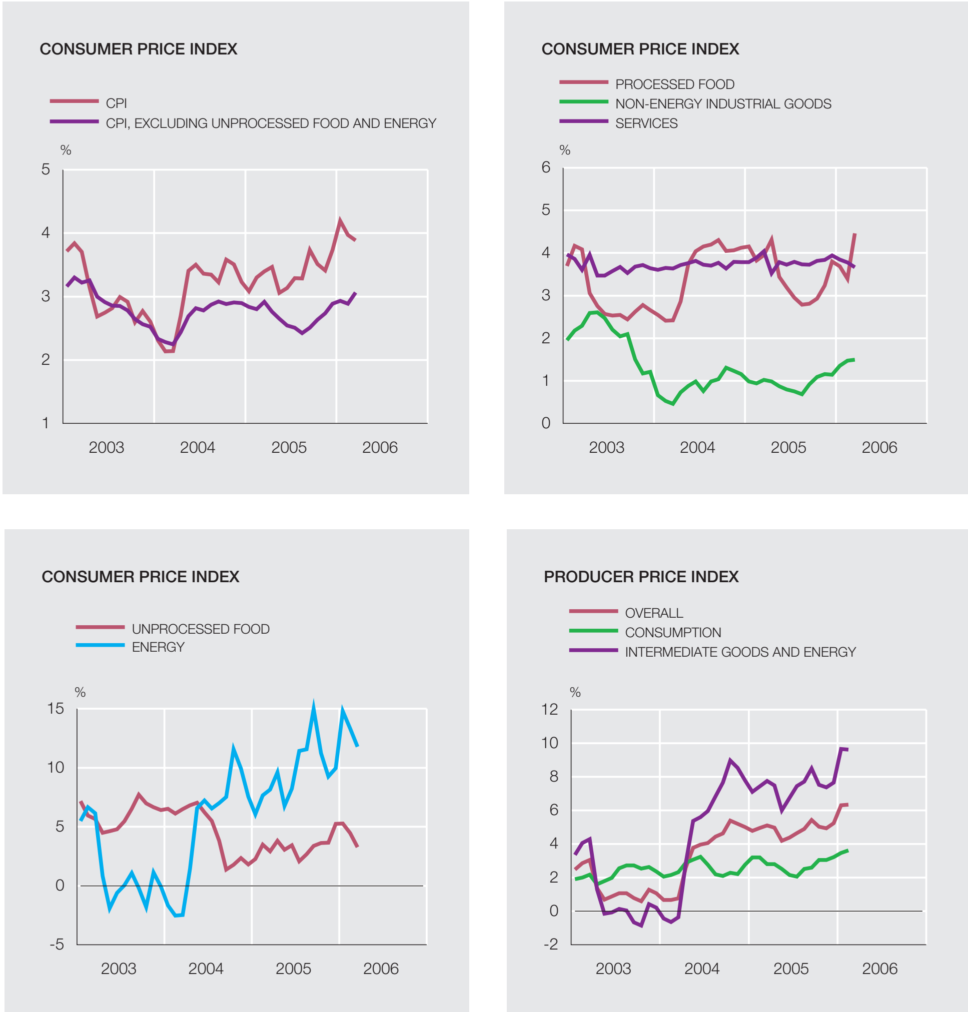
butane, while vehicle and heating fuel prices resumed an upward path in January, in line with the trend of crude oil prices on international markets. The prices of non-energy industrial goods increased by 1.4% in average year-on-year terms in Q1, 0.3 pp up on the previous quarter, owing mainly to higher car prices.

Processed food prices quickened by 0.6 pp in Q1 compared with the previous quarter, taking the related average year-on-year growth to 3.9%. The acceleration in olive and other vegetable oil prices stepped up in the first three months of the year, and their year-on-year rate exceeds 30%. After rising in the previous quarter, unprocessed food prices increased by 0.1 pp more in the opening months of 2006, to a rate of 4.3%. The renewed dynamism of this CPI caption reflects dearer meat prices and an end to the declines in poultry prices. Conversely, fresh fruit and vegetable prices eased significantly. Finally, services prices slowed by scarcely 0.1 pp in Q1 to an average year-on-year price of 3.8%, a result which partly reflects the change in month of the Easter holiday period, while the increases in transport prices recorded in the opening months of the year were on a similar scale to those of 2005.

Inflation in Spain measured by the HICP increased by 0.6 pp between 2005 Q4 and 2006 Q1 to an average rate of 4.1%. In the euro area as a whole, inflation held at 2.3% in the January-March period, giving rise to an appreciable widening of the differential between Spain and the area to 1.8 pp, a figure not seen since 2002; in March, however, the differ-

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

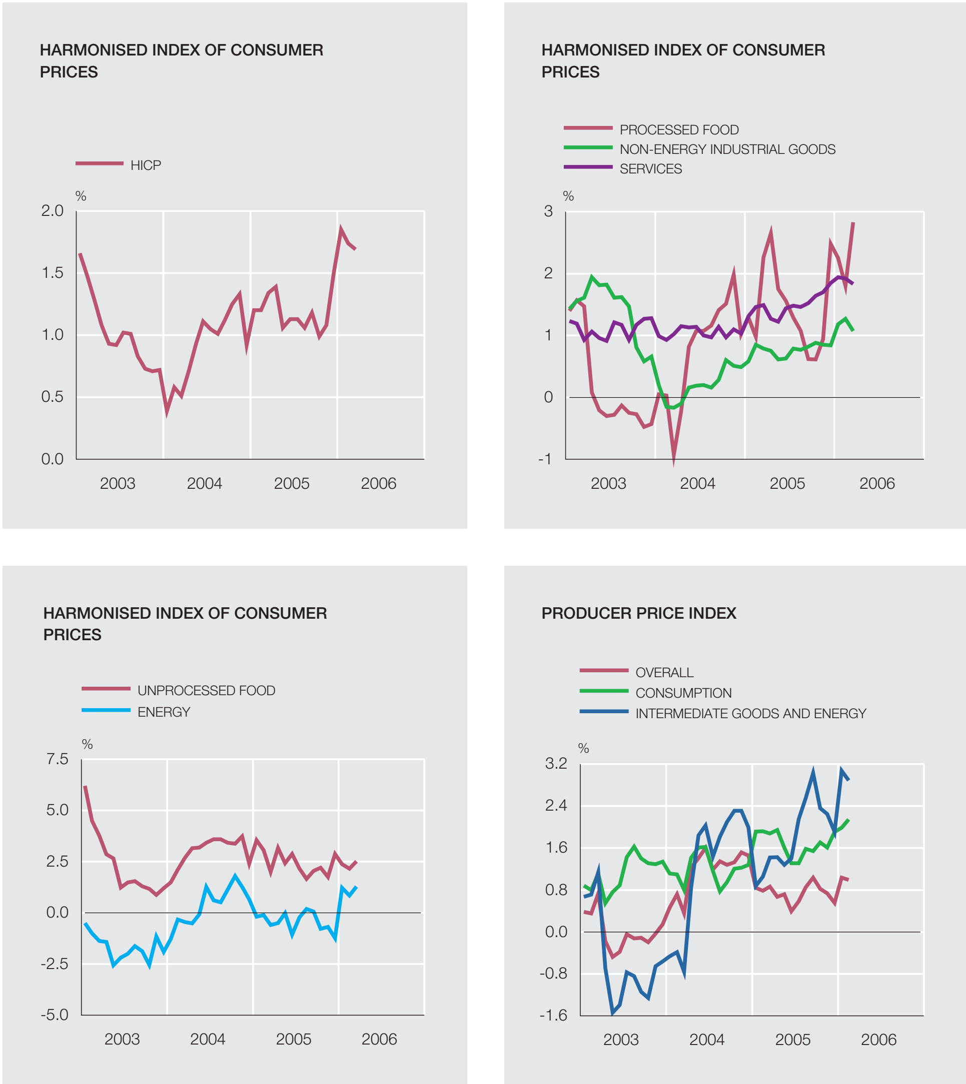
a. Twelve-month percentage change based on the original series.

ential narrowed slightly to 1.7 pp (see Chart 23). The widening of the inflation differential with the euro area is apparent both in services – where a significant part of the inflationary gap has traditionally been concentrated – and in goods, where it increased sharply during the first three months of the year. In this respect, the widening of the differential was substantial in the case of processed food and non-energy industrial goods, where in both cases the acceleration in Spain was in contrast to the slowdown in the euro area. In the case of energy, the differential has resumed positive values following the negative values recorded for most of last year.

The producer price index posted year-on-year growth of 5.8% in March, compared with 6.3% the previous month. Although the sharpest increase continued to be in energy producer prices, their year-on-year growth rate fell by almost 4 pp to 16.4%; the producer prices of consumer and capital goods also slowed, while the intermediate goods component quickened to 4.5%. In the euro area, the year-on-year rate of producer prices stood at 5.4% in February, 1 pp up on the average recorded in Q4. Prices received by farmers ended last year at a year-on-year growth rate of around 2%. Lastly, hotel prices have been behaving very moderately since last summer, growing by 1.2% in year-on-year terms to February.

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.

4.4 The State budget

The figures released on the State budget outturn in Q1, following National Accounts methodology, show some improvement in the surplus, which climbed from €3,140 million (0.3% of GDP) in March 2005 to €4,584 million (0.5% of GDP) this year. This was due to a 10.2% increase in resources, set against the 5.9% increase in uses. These figures are in contrast to the result in terms of the cash-basis balance, which posted a surplus of €244 million in 2006 Q1, compared with the deficit of €3,011 million recorded in the same period in 2005 (see Table 3). The differences in the National Accounts figures are largely due, in this case, to the different criterion for recording interest. It should be recalled, however, that the figures for the opening months of the year are highly erratic and scarcely representative of State budgetary developments over the rest of the year.

State revenue in cash-basis terms increased in Q1 by 7.2% in comparison with the same period the previous year owing to the resilience of the main taxes (personal income tax and VAT). This is in stark contrast to the budgetary forecast of a stagnation in revenue over the whole of 2006 (a rate of change of –0.1%). The buoyant takings from direct taxes are attributable to

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2005	Percentage change 2005/2004	Outturn projection 2006	Percentage change 2006/2005	Outturn		
					2005 JAN-MAR	2006 JAN-MAR	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 1 REVENUE	128,777	12.2	128,591	-0.1	31,019	33,260	7.2
Direct taxes	70,665	20.4	72,036	1.9	12,466	13,717	10.0
Personal income tax	35,953	18.2	37,992	5.7	11,091	12,144	9.5
Corporate income tax	32,496	24.9	31,681	-2.5	854	896	4.9
Other (a)	2,215	-1.3	2,363	6.7	520	678	30.2
Indirect taxes	44,618	7.9	45,302	1.5	15,638	17,012	8.8
VAT	32,009	10.0	31,438	-1.8	12,683	13,997	10.4
Excise duties	9,795	0.5	10,903	11.3	2,289	2,286	-0.1
Other (b)	2,813	12.9	2,961	5.3	666	729	9.4
Other net revenue	13,494	-8.7	11,253	-16.6	2,915	2,531	-13.2
2 2 EXPENDITURE	122,755	7.0	133,951	9.1	34,030	33,017	-3.0
Wages and salaries	20,677	6.1	22,124	7.0	4,507	4,962	10.1
Goods and services	3,388	-3.5	3,069	-9.4	813	861	5.9
Interest payments	17,831	6.4	17,443	-2.2	8,209	6,290	-23.4
Current transfers	64,541	5.8	70,968	10.0	16,426	17,287	5.2
Contingency fund	…	…	2,873	…	…	…	…
Investment	8,978	26.4	9,338	4.0	2,455	2,155	-12.2
Capital transfers	7,341	6.8	8,134	10.8	1,621	1,462	-9.8
3 CASH-BASIS BALANCE (3 = 1 – 2)	6,022	…	-5,360	…	-3,011	244	—
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Resources	126,811	11.9	127,817	0.8	29,464	32,470	10.2
Uses	123,550	0.7	131,775	6.7	26,324	27,886	5.9
NET LENDING (+) OR BORROWING (–)							
	3,261	…	-3,958	…	3,140	4,584	…
(as a percentage of GDP)	0.4	…	-0.4	…	0.3	0.5	…

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.

developments in personal income tax, which increased by 9.5% (in particular, withholdings on income from work rose by 9.3%, and those on movable capital and gains on mutual funds did so by 16.8%), and to tax on non-residents' income. Corporate income tax was 4.9% up, although this tax will not show relevant rates of change until the first prepayment in April. The most dynamic indirect tax was VAT, which posted similar growth to 2005 and increased by 10.4%, while excise duties were virtually flat owing to sluggish revenue in connection with the tax on hydrocarbons and to the decline in revenue from the tax on alcohol and spirits. As regards the items under the heading of "other revenue", the fall here was brought about by the strong reductions in revenue relating to differences between public debt redemption and issuance values and in revenue relating to capital transfers, mostly from European Union funds, which were only partly offset by the greater resources arising from Banco de España profits.

In clear contrast to the budgetary projection, which points to growth of 9.1% over the year as a whole, there was a 3% decline in cash-basis expenditure. The decline in revenue was due to interest payments (greatly affected by the timing of public debt maturities) and to capital payments. In both cases, these payments are very variable and their rates of change will foreseeably converge in the coming months to figures more in keeping with the budget projection. There was also strong growth in the two items forming part of government consumption (wages and salaries, and goods and services), and particularly in the former, with growth of around 10%, due partly to the improved compensation of certain groups. The growth of current transfers was below-budget, due – among other factors – to the lower payments directed to the European Union compared with the same period a year earlier.

Turning to the Social Security budget outturn, the related information is relatively lagged since it refers to January. Social security contributions increased by 7.5% compared with January 2005, entailing a similar growth rate to that recorded at end-2005, though lower than the figure of 8.4% envisaged in the budget, in relation to the budget of the previous year. The number of Social Security registrations rose by 5.5% in 2006 Q1, a higher figure than for the whole of 2005. On the expenditure side, pensions increased by 7.8% in January, somewhat above-budget for the year as a whole. The number of contributory pensions grew at a rate of 2.5% in Q1. As regards the State Employment Public Service, spending on unemployment benefits increased by 6.3% to February, compared with the 6.9% rise in 2005 as a whole. Among the determinants here is the decline in registered unemployment, which fell by 1.3% in February 2006 compared with the decline of 1.1% over the whole of 2005. However, the eligibility ratio stood at 83.4% in January 2006, considerably above the 2005 level.

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

In January 2006, the overall balance on current and capital account was a deficit of €6,444 million, 1.3% up on the same month a year earlier (see Table 4). The current account deficit fell slightly this same month (–1.2%) to a level of €6,744 million, while the surplus on capital transactions declined to €330 million (–32.8%). In terms of the current account items, the trade deficit and the services surplus deteriorated in January compared with the same month in 2005, while the income and current transfers deficits improved notably.

In January 2006 the trade deficit widened by €1,280 million on a year earlier, reaching the figure of €5,916 million; expressed as a year-on-year rate, the deficit increased by 27.6%, prolonging the strong deterioration that characterised it during the two previous years. Foreign trade in goods stepped up notably in January, although there remained a significant nominal growth differential between import flows (19.6%) and export flows (16.3%). Nonetheless, the pace of the non-energy trade imbalance has eased since the second half of 2005, while the energy deficit continues to grow at a burgeoning rate owing to the forceful rise in imported energy prices.

Turning to the services balance, there was a surplus of €123 million in January 2006, €1,215 million down on the same period in 2005. This was attributable both to the €583 million decline in the tourist surplus, and to the €632 million increase in the non-tourist services deficit. Tourist revenue fell by 13.7% in January, in nominal terms, furthering the negative performance of December 2005. Tourist expenditure was up 28.9% in the first month of 2006, extending the strong dynamism that has characterised it in the two previous years, against the background of sustained growth in private consumption demand.

The deficit on the income balance was significantly corrected in January and stood at -€387 million, an improvement of €1,108 million on the same month in the previous year. Revenue rose most substantially (74.4%), with notable momentum in that relating to the non-financial private sector. At the same time, the increase in expenditure was more moderate (9.7%) owing to the decline in payments by monetary financial institutions and general government, while payments by the non-financial private sector rose appreciably. Foreign direct investment flows into Spain fell in January; however, portfolio investment and, to a lesser extent, other invest-

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 4

EUR m

		ENERO	
		2005	2006
CREDITS	Current account	19,073	22,288
	Goods	11,114	12,923
	Services	5,186	5,147
	— Tourism	2,446	2,111
	— Other services	2,739	3,035
	Income	1,934	3,374
	Current transfers	839	844
	Capital account	558	489
	Current + capital accounts	19,631	22,777
DEBITS	Current account	25,926	29,062
	Goods	15,749	18,839
	Services	3,848	5,023
	— Tourism	860	1,109
	— Other services	2,987	3,915
	Income	3,429	3,760
	Current transfers	2,900	1,439
	Capital account	67	159
	Current + capital accounts	25,992	29,221
BALANCES	Current account	-6,853	-6,774
	Goods	-4,636	-5,916
	Services	1,338	123
	— Tourism	1,586	1,003
	— Other services	-248	-880
	Income	-1,495	-387
	Current transfers	-2,061	-595
	Capital account	492	330
	Current + capital accounts	-6,361	-6,444

SOURCE: Banco de España.

a. Provisional data.

ment from abroad grew notably. As to Spanish outward investment flows, direct investment also fell off in January, while both portfolio investment and, especially, other investment (essentially loans, deposits and repos) grew very sharply.

The current transfers deficit stood at €595 million in January 2006, €1,466 million down on the deficit recorded in the same month in 2005. Revenue barely increased by 0.6%: one of the main items, flows from the EU under EAGGF-Guarantee, fell off, while Community transfers from the European Social Fund trended favourably. Expenditure, for its part, declined notably (–50.4%), essentially affected by the notable fall in payments to Community coffers under GNP Resource and VAT Resource. Nonetheless, payments relating to emigrants' remittances remained very buoyant.

Finally, the capital account surplus stood at €330 million in January 2006, down €161 million on the same month a year earlier. This deterioration is partly due to the decline in structural funds from the EU's ERDF and EAGGF-Guidance, although there are usually delays in the opening months of the year, and it has come about despite the markedly favourable course of Community transfers from the Cohesion Fund.

5 Financial developments

5.1 Overview

Financing conditions for Spanish households and firms remained fairly generous in 2006 Q1, although they tightened somewhat against a background in which market rates continued on their rising path as at end-2005. The average level of the one-year Euribor stood at 3.11% in March, 33 bp above the December 2005 level, while Spanish 10-year government bond yields rose by 28 bp to 3.65%. In line with these developments, the price of bank loans to households and firms increased, as did the average cost of issuing fixed-income securities (see Chart 24).

The rising course of Spanish stock market prices continued during 2006 Q1. At end-March, the Madrid Stock Market General Index had risen by 11.3% since the beginning of the year, with a particularly notable increase in share prices for the basic materials, industry and construction sector (close to 25%). This trend, which was more favourable than that seen in the main international indices (the broad Euro Stoxx rose by 10.3% during this period, and the S&P 500 by 3.7%), was accompanied by continuing low volatility.

On data released by the Spanish Ministry of Housing, the slowing path of property prices extended into 2006 Q1. Their annual growth rate stood in March at 12%, entailing a moderate reduction (of 0.8 pp) on the end-2005 figure. These data continue to support the expected scenario of an orderly and gradual correction of the current overvaluation of these assets.

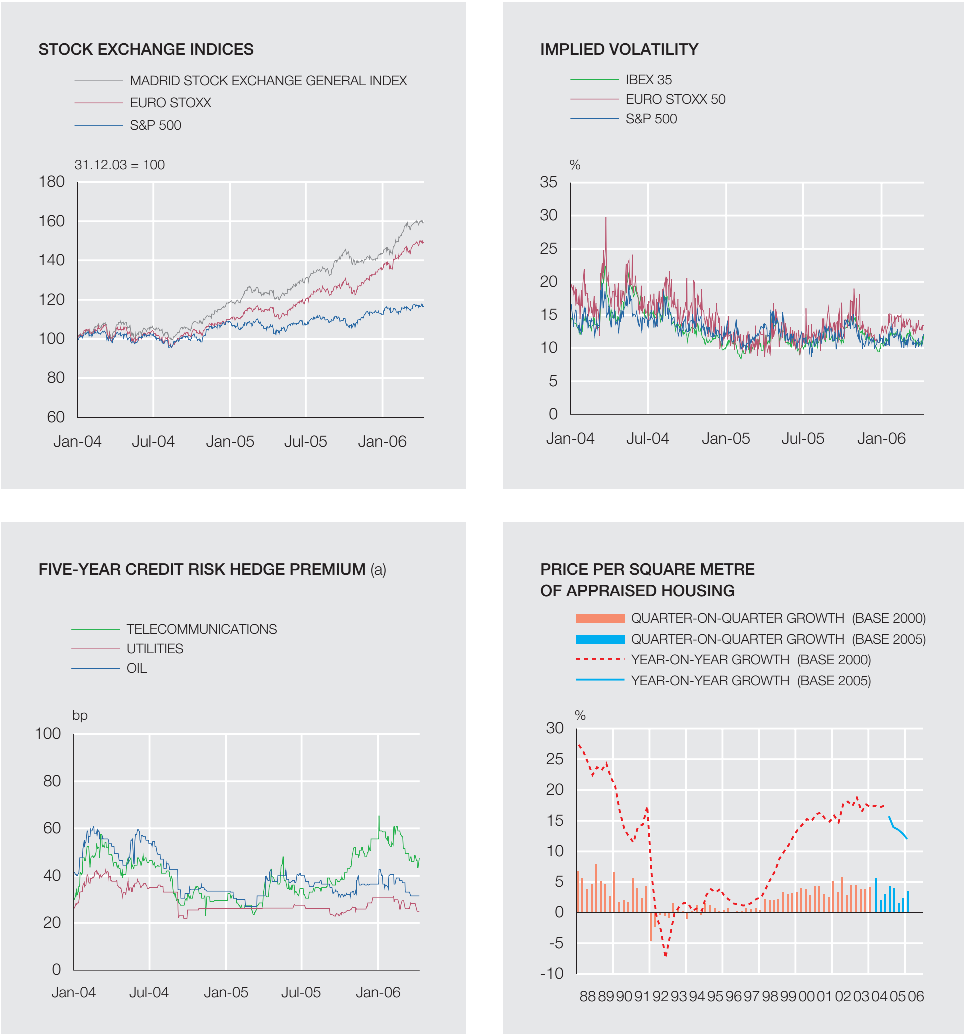
In this setting marked by low financing costs and increased asset values, the volume of financing extended to the private sector continued to grow during the closing months of 2005 at a brisk pace (at a rate of around 21%). In the case of both households and firms, this marked a rise (a sharper one in the latter case) on the September figures. The provisional information available suggests there were no significant changes in the course of this variable during the early months of 2006. The breakdown by component under household liabilities shows that debt for house purchases during 2005 Q4 continued to be the most expansionary item, although the rate of increase of financing for consumption and other ends rose somewhat. For companies, the breakdown by productive activity of credit from resident institutions shows an across-the-board acceleration during that period, while funds directed at the real estate and construction services branches were once again the most dynamic.

As a result of these developments, the indicators of household financial pressure continued to worsen between October and December 2005, and, on the provisional information available, this would have continued during 2006 Q1. The debt and financial burden ratios thus increased once again, while saving not earmarked for debt service fell off once more and the sector's borrowing requirements increased to approximately 1.5% of GDP (see Table 5). But despite the buoyancy of liabilities, household net aggregate wealth will have continued growing, albeit at a more moderate rate than in the recent past, thanks to the rise in the value of their real and financial assets.

In the case of non-financial corporations, the aggregate debt and financial burden ratios were also on a rising trajectory during 2005 Q4 and, on the provisional data available, this same trend would have held in the opening months of 2006. Moreover, both the debit balance of net financial transactions and the financing gap increased in the second half 2005, leading them to exceed 7% and 11% of GDP, respectively. In this period profit ratios held at similar levels to

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



SOURCES: Bloomberg, Credit Trade, Ministerio de Vivienda and Banco de España.

a. Average asset-weighted premia.

those observed during the summer. However, for the aggregate of corporations reporting to the Central Balance Sheet Data Office quarterly survey (CBQ), the debt and financial burden indicators showed no significant changes, while profitability continued to pick up. In combination, these indicators show a better performance in the financial position of the companies in this survey, in which major corporations have a high weight. These developments were against the background of the stability of the synthetic indicators of financial pressure on investment and of a moderate decline in the employment indicators, which in both cases are holding at low levels.

The greater financing requirements of households and firms were not offset by the improvement in the net financial resources of financial institutions and of general government. As a result, the nation had to increase its resort to saving from the rest of the world, which stood at 6.5% of GDP at end-2005 in cumulative four-quarter terms, compared with 6.1% in September. The financial sector remained the main channel through which foreign funds were obtained, these operations essentially taking the form of interbank loans and, to a greater extent, issues of securities other than shares, including most notably those linked to mortgage loans (see Box 4).

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP (a)	2000	2001	2002	2003	2004	2005			
					Q4	Q1	Q2	Q3	Q4
National economy	-3.2	-3.4	-2.6	-3.0	-4.8	-5.5	-6.0	-6.1	-6.5
Non-financial corporations and households and NPISHs	-3.1	-4.3	-3.7	-4.2	-5.4	-6.3	-7.0	-7.7	-8.5
Non-financial corporations	-4.5	-5.4	-4.4	-4.4	-4.7	-5.6	-6.3	-6.5	-7.1
Households and NPISHs	1.4	1.1	0.7	0.1	-0.6	-0.7	-0.7	-1.2	-1.4
Financial institutions	0.8	1.4	1.4	1.3	0.7	0.7	0.6	0.6	0.9
General government	-0.9	-0.5	-0.3	0.0	-0.2	0.2	0.4	1.0	1.1
Financing gap (b)	-15.5	-10.0	-8.6	-8.5	-9.0	-10.6	-10.9	-10.9	-11.2

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.

Overall, the latest information shows that households and firms have increased their exposure to adverse shocks in income, asset prices or the cost of financing. The sensitivity is, moreover, more significant in the current setting in which there is a greater likelihood that interest rates will in the near future move to levels in step with a more neutral monetary policy stance and that the slowing path onto which the value of housing has moved will continue and even intensify. Accordingly, the factors of uncertainty highlighted in previous reports concerning the medium-term course of spending by firms and, above all, by households remain in place.

5.2 Households

In 2006 Q1 there was some tightening of household financing conditions. In February, the interest rates applied by institutions on new business were 32 bp up on the December levels, in the case of credit for house purchases, and 2 bp up in that of credit for consumption and other purposes. According to the EPB (Bank Lending Survey), institutions forecast for the opening months of 2006 a slight easing in the supply-side conditions applied in the extension of credit for consumption and other purposes, and a similar movement – but in the opposite direction – in those relating to loans for house purchases.

The rise in the cost of financing observed since end-2005 did not, however, contain the marked dynamism of household debt, which in the closing months of 2005 grew at a rate somewhat higher than that seen during the summer (at round 21%). The provisional information for 2006 Q1 does not show significant changes in the course of this variable. In any event, its behaviour in the second half of 2005 was in keeping with institutions' forecasts which, according to the aforementioned EPB, foresaw an increase in the demand for loans. By end-use, credit for house purchases remained the most expansionary component over this period, with an annual rate of increase that held at over 24%, which represented a flow of over 10% of GDP in cumulative 12-month terms. It is also significant that the growth rate of funds earmarked for consumption and other purposes increased by almost 2 pp, exceeding 13%.

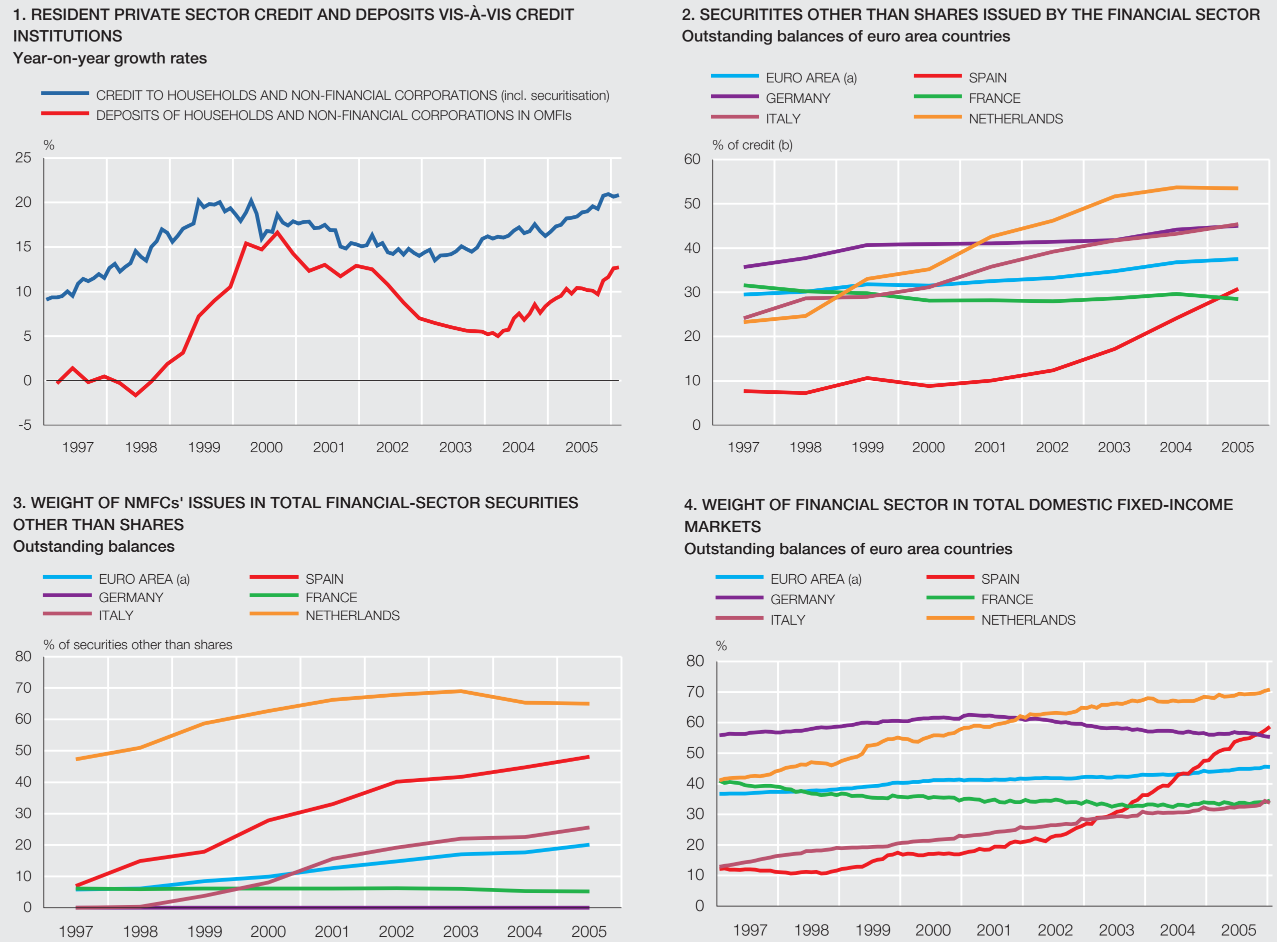
As regards portfolio decisions, household acquisitions of financial assets rose in December to an amount equivalent to 10.6% of GDP in cumulative 12-month terms, compared with 9.9% in September (see Table 6). In terms of products, the most liquid and least risky instruments (cash and deposits) remained the main component of financial investment, and their volume in

As panel 1 illustrates, in recent years the growth rate of credit granted by Spanish institutions to the non-financial private sector has persistently outpaced that of deposits vis-à-vis households and firms. Against this background, these institutions have had to resort to other, more onerous means of financing such as interbank loans and, above all, the issuance of securities other than shares, both directly and via other vehicles. This latter channel basically includes the activity of financial vehicle corporations (FVCs) and operations undertaken by subsidiaries specialising in the issuance of preference shares and other similar instruments. In the first case, the funds obtained revert to the entity that securitises the loans, and in the second, to the parent.

Accordingly, the outstanding balance of securities other than shares issued by Spanish financial institutions has increased at a notable rate in recent years. In terms of credit extended to the non-financial sector[1], the resulting volume has increased from a level below 10% in 1997, which was far below that of the euro area average, to over 30% at end-2005, a proportion closer to but still below that of the euro area (see panel 2). On the latest information, those with the highest figure among the main euro area countries were the Netherlands, Germany and Italy.

The breakdown by sub-sector also shows some significant differences within the euro area (see panel 3). In Spain, at end-2005, approximately half the outstanding balance of issues by financial institutions corresponded to non-monetary financial institutions, in which those by FVCs and by the subsidiaries of credit institutions specialising in the issuance of preference shares and other similar instruments are included. This proportion was notably higher than that of the euro area. Among the main countries in the area, only the Netherlands had a higher percentage than Spain. Conversely, in France and in Germany the bulk of the volume issued was attributable to the activity of monetary institutions, essentially credit institutions. In both cases, but especially in the latter, these operations included most notably instruments backed by mortgage loans. In Spain, the weight of securities linked to this type of liability is significant both under bonds issued by

1. Credit includes both that on the balance sheets of institutions and that which has been securitised and removed from the balance sheet.



SOURCE: Banco de España

a. Excluding Ireland Luxembourg, owing to a lack of information.
b. Measured as a precentage of the outstanding blance of credit extended by financial institutions to households, corporations and general government. Includes on- and off-balance sheet credit.

monetary institutions (35%) and especially those of the rest of the financial sector (54%).

The appreciable increase in the issuance of securities other than shares by the financial sector, in a setting marked by the diminished buoyancy of public debt, has meant that the weight of the securities in the total outstanding balance issued by the resident sector has increased by somewhat more than 10% in 1997 to a figure close to 60% in 2005, above the euro area average, where this ratio has grown moderately over the same period (see panel 4).

Reflecting the dynamism of financial institutions' issues has been the notable increase in activity on the secondary markets where these securities are traded. Furthermore, the expansion in Spain of these securities has other relevant consequences. On one hand, the fact that their cost is higher than that of traditional deposits has tended to squeeze the margin between the return on assets and the remuneration of credit institutions' liabilities. However, given the absence of domestic saving, these types of securities have become one of the main instruments for channelling the resort by our economy to external funds. From this standpoint, their growth and growing attractiveness to non-residents has smoothed the financing of national spending. In any event, the fact that a significant proportion of these securities is backed by mortgage loans means that this source of financing is linked to developments on the property

relation to GDP actually increased compared with the previous quarter. There was also a notable rise in net purchases of shares and other equities, which resumed a positive value, following the negative figures seen since early 2005.

The buoyancy of financing meant that the upward trajectory of the household debt ratio continued, reaching a value of more than 110% of GDI at end-2005 (see Chart 25). This resulted in a fresh increase in the financial burden, which stood in the same period at over 14% of GDI. The expansion of credit, along with the fresh decline in gross saving, led to a further fall-off in households' saving capacity, once the payments associated with liabilities incurred are stripped out. Likewise, according to the Financial Accounts, the sector's borrowing requirements increased to a level equivalent to 1.4% of GDP in cumulative 12-month terms. However, the microeconomic information drawn from the Household Expenditure Survey for this period does not reflect a decline in the proportion of households that can set aside money for saving or of those with difficulty making ends meet each month. Indeed, both indicators show an improvement on a year earlier and stability in relation to the September levels.

Despite the increase in debt, the sector's net wealth would have continued growing thanks to developments in the value of financial assets and the price of housing. As a result of this and of the rise in the cost of financing, the theoretical effort that buying a house requires continued to increase.

5.3 Non-financial corporations

Debt financing conditions for corporations also tightened somewhat during 2006 Q1. In the January-February period, the rise in interest rates was higher in loans of up to €1 million (24 bp) than in those of a lower amount (11 bp). In any event, the credit supply conditions forecast by institutions for this period will not have changed significantly according to the EPB. The cost of financing with fixed-income securities also increased as a result of the rise in public debt yields, which was not offset by the slight reduction in average credit risk premia. By contrast, the rising trajectory of stock market prices, along with their reduced volatility, has been conducive to the raising of funds on equity markets.

Despite the slight tightening seen in financing conditions since the end of Q3, these have remained loose. That has been supportive of the greater buoyancy of corporations' liabilities-side operations, which amounted to a volume equivalent to 25.1% of GDP at end-2005 in cumulative 12-month terms, compared with 23.5% in September (see Table 6). By instrument,

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

TABLE 6

% GDP (a)

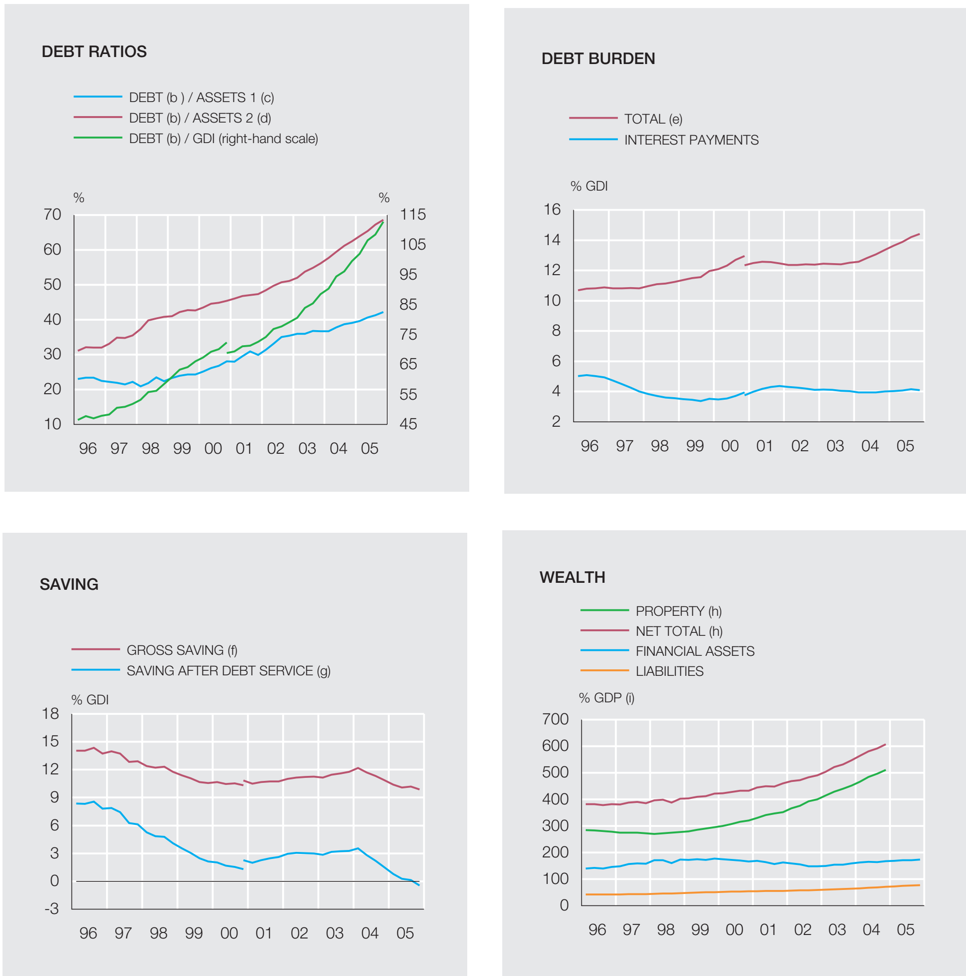
	2002	2003	2004	2005		
				Q2	Q3	Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.4	9.1	10.0	9.7	9.9	10.6
Cash and cash equivalents	3.5	4.1	4.0	4.2	4.1	4.4
Other deposits and fixed-income securities (b)	1.8	-0.1	1.7	2.4	2.3	2.3
Shares and other equity (c)	0.6	0.6	0.4	-0.1	-0.1	0.2
Mutual funds	0.2	2.3	1.5	1.4	1.8	1.9
FIAMM	0.7	0.6	-0.2	0.0	0.2	0.2
FIM	-0.5	1.7	1.6	1.3	1.4	1.5
Insurance technical reserves	2.5	1.8	1.8	1.8	1.7	1.6
Of which:						
Life assurance	1.4	0.7	0.7	0.7	0.7	0.7
Retirement	0.9	0.9	0.8	0.9	0.9	0.8
Other	-0.3	0.4	0.7	0.0	0.1	0.2
Financial transactions (liabilities)	7.7	9.0	10.7	10.4	11.1	12.0
Credit from resident financial institutions (d)	7.2	9.2	10.8	11.4	11.9	12.6
House purchase credit (d)	5.1	7.0	8.7	9.5	9.9	10.3
Consumer and other credit (d)	2.1	2.2	2.0	1.9	1.9	2.3
Other	0.5	-0.2	-0.1	-1.0	-0.8	-0.6
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.4	16.1	15.9	16.6	17.0	18.0
Cash and cash equivalents	1.6	0.9	1.0	1.1	1.2	2.1
Other deposits and fixed-income securities (b)	1.4	1.4	0.8	1.4	1.7	1.1
Shares and other equity	6.6	7.5	6.2	6.0	6.6	6.5
Of which:						
Vis-à-vis the rest of the world	4.6	4.5	3.7	4.2	4.2	3.8
Other	4.7	6.4	8.0	8.1	7.5	8.3
Financial transactions (liabilities)	18.8	20.5	20.6	22.9	23.5	25.1
Credit from resident financial institutions (d)	5.4	6.4	8.6	10.9	11.7	13.0
Foreign loans	2.7	2.7	0.7	1.2	1.6	2.0
Fixed-income securities (b)	-0.4	-0.2	0.0	0.0	-0.1	0.0
Shares and other equity	5.9	5.2	4.6	3.7	3.5	3.2
Other	5.1	6.4	6.7	7.1	6.8	7.0
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	14.0	15.9	16.2	18.4	19.6	20.9
Households and NPISHs	16.2	19.0	20.1	20.0	20.6	21.2
Non-financial corporations	12.4	13.5	13.2	17.1	18.8	20.7

SOURCE: Banco de España.

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

the funds raised through the issuance of shares and other equities were, in terms of GDP, somewhat lower than three months earlier (3.2%), whereby borrowed funds remained the most expansionary component. In year-on-year terms, the growth rate of the sector's debt stood at close to 21%, almost 2 pp above the Q3 figure and, on the provisional information available, the opening months of 2006 will not have seen significant changes in this variable. Although the flow from foreign loans increased last year, it was those granted by resident financial institutions which increased most notably, in line with institutions' forecasts which, according to the EPB, augured an increase in demand.

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 25



SOURCE: Banco de España.

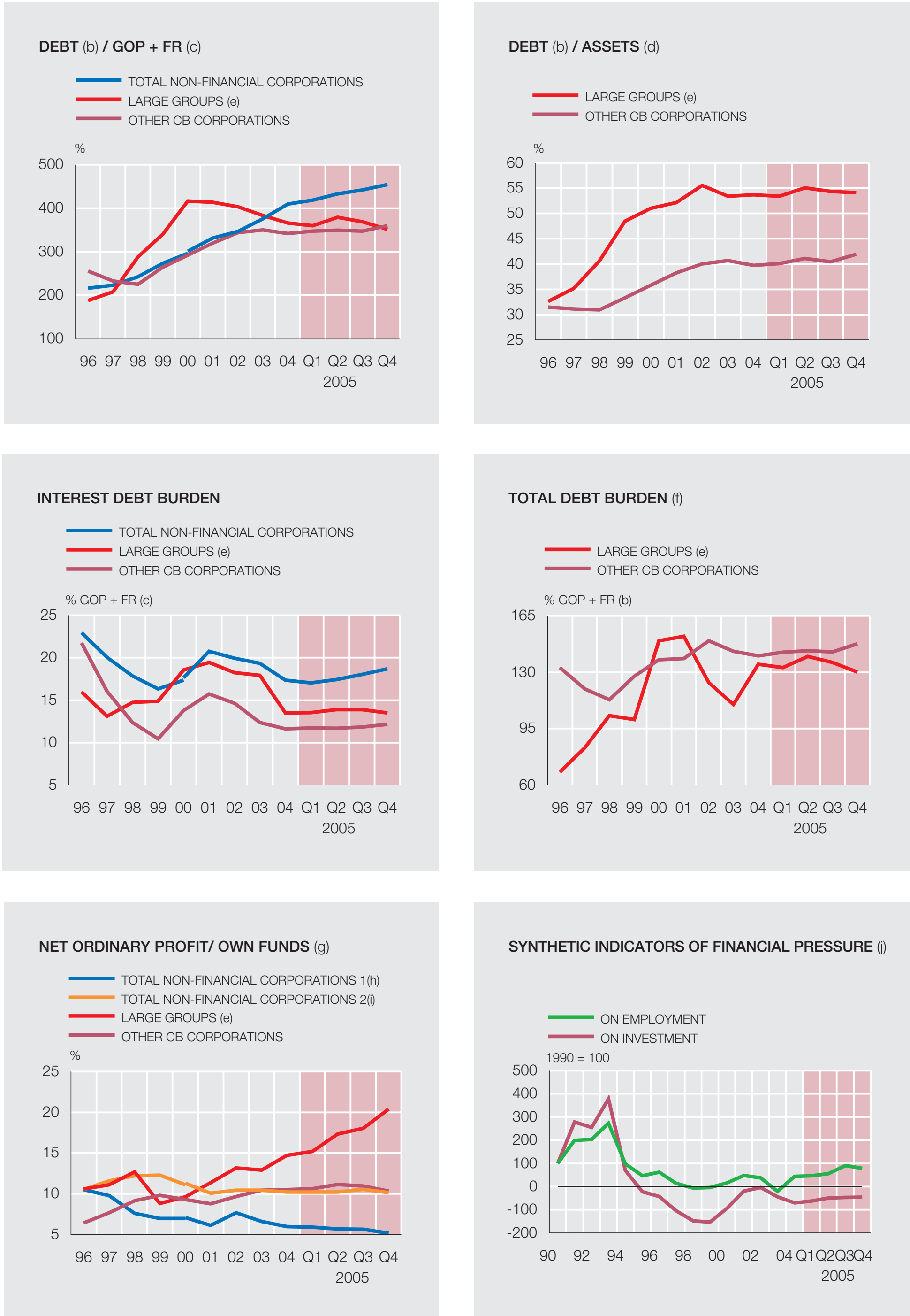
a. Until 2000, the sectoral National Accounts data correspond to the CNE with base 1995. Between 2000 and 2004 they are drawn fron the CNE with base 2000.
b. Includes bank credit and securitisation.
c. Assets 1 = Total financial assets less "other".
d. Assets 2 = Assets 1 less shares in FIM.
e. Estimated interest payments plus debt repayments.
f. Balance of use of disposable income account.
g. Gross saving less estimated debt repayments.
h. 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.

The breakdown of credit by productive activity shows that during the final months of 2005 there was an across-the-board acceleration in all branches, which was sharper in the case of real estate services and construction, where the most expansionary behaviour was seen. The path of recovery initiated in mid-2004 in industry continued, meaning that the related rate of increase was close to 15%. Conversely, on CBQ data, the debt of the major groups slowed noticeably during the same period, taking their annual growth rate to below 4%.

Corporations' asset-side operations also increased, albeit more moderately than those on the liabilities side, and came to account for 18% of GDP in December last year in cumulative 12-month terms. In terms of instruments, increases were concentrated in cash and cash equivalents and, specifically, in sight deposits, and also in the item "Other", which includes trade credit. For the remaining deposits and fixed-income securities there was, by contrast, a break in the rising path seen in previous quarters, and a fall-off of 0.6 pp was recorded. Investment

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS (a)

CHART 26



SOURCE: Banco de España.

a. Indicators calculated drawing on the annual and quarterly CBSO surveys (CBA and CBQ, respectively), except the series «Total non-financial corporations», which has been obtained from the National Accounts (CNE and FASE). To 2000, the income for the sector relates to CNE base 1995. From 2000 to 2005, it corresponds to CNE base 2000.
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. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.
f. Includes interest plus interest-bearing short-term debt.
g. For total non-financial corporations, NOP = GOS + interest and dividends received – interest paid – fixed capital consumption.
h. Own funds valued at market prices.
i. Own funds calculated by accumulating flows from the 1996 stock onwards.
j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than that of the base year.

in shares and other equities declined slightly, as a result of the fall in acquisitions in the rest of the world, which was not offset by the pick-up in the volume relating to securities issued by residents.

As a result of these developments in corporations' asset- and liabilities-side operations, their borrowing requirements increased by more than half a percentage point, exceeding 7% of GDP in cumulative 12-month terms (see Table 5). Accompanying this contraction in financial saving was a reduction in the sector's foreign direct investment, meaning that the financing gap, which proxies the resources needed to undertake permanent real and financial investment abroad, increased to a lesser extent (by around 0.5 pp) and stood slightly over 11% of GDP.

The buoyancy of borrowed funds in the closing months of 2005 translated into fresh increases in corporations' debt ratios and financial burden relative to profit generated (see Chart 26). However, the information for this period on the sector's income shows a fairly favourable performance. The gross operating surplus grew by 8.5% in the year as a whole. Adding net financial revenue and deducting depreciation gives a measure of the sector's ordinary net profit, which increased at a rate of 6.1%. The ratio of this measure of ordinary net profit to equity at market prices, which offers an approximation to the concept of the ordinary return on equity, shows a slightly declining path throughout the past. This behaviour, however, partly reflects the rise in stock market prices. Thus, if the price effects are stripped out of the denominator of the ratio, the new indicator shows greater stability and, in 2005 specifically, this ratio did not evidence significant changes.

The financial indicators of the corporations reporting to the CBQ, where the weight of the largest companies is highest, show a more favourable trend than those of the sector as a whole. The data for 2005 Q4 reveal a slight reduction in the debt ratio and the maintaining of the interest burden. These developments are linked to the behaviour of the major groups, whose debt increased, as earlier discussed, at a very moderate rate. Ordinary net profit grew last year at a rate which, though down on that of 2004, was high (12.5% year-on-year), above the rise in operating profit (5.2%). This made for an average increase in the ordinary return on equity which, however, masked heterogeneous behaviour across the different types of company. While there was a notable recovery at the major groups, there was a decline in the aggregate including the other corporations.

As a result of the developments in debt, financial burden and profitability, the synthetic indicators of financial pressure on investment and employment constructed on the basis of the CBQ sample did not undergo significant changes in the case of the former, while in the latter there was a slight reduction after the increases in the previous quarters. The two stand at low levels in historical terms.

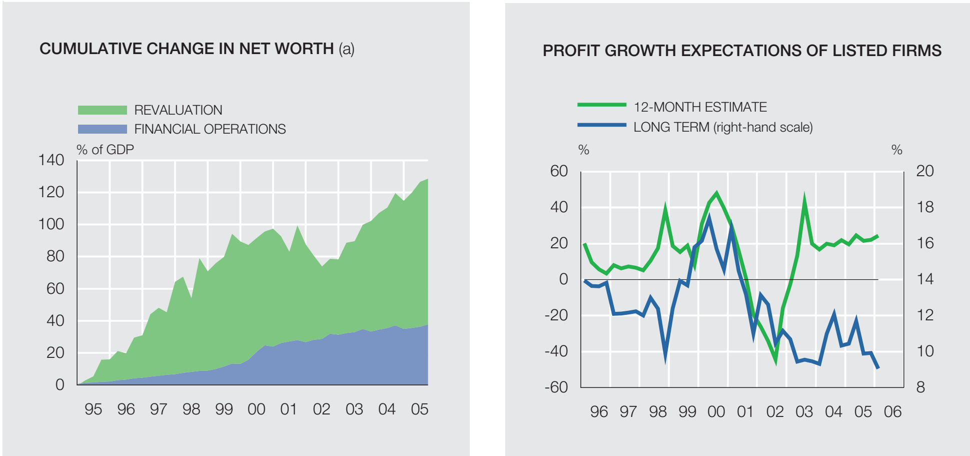
Finally, further to the rise in stock market prices, there was an increase in the net worth of non-financial corporations in relation to GDP at end-2005 (see Chart 27). The rise in equity prices came about against a background in which the growth of listed non-financial corporations' profits forecast by analysts held at a high rate, with this trend running into the opening months of 2006. Conversely, there are no signs of a pick-up in expectations concerning the growth of business profits in the long term, which are at historically low levels, although it should be borne in mind that the current profit level to which expected increases are applied is relatively high.

5.4 General government

During 2005 Q4, the lending capacity of general government increased once more and stood, in cumulative twelve-month terms, at over 1% of GDP (see Chart 28).

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 27

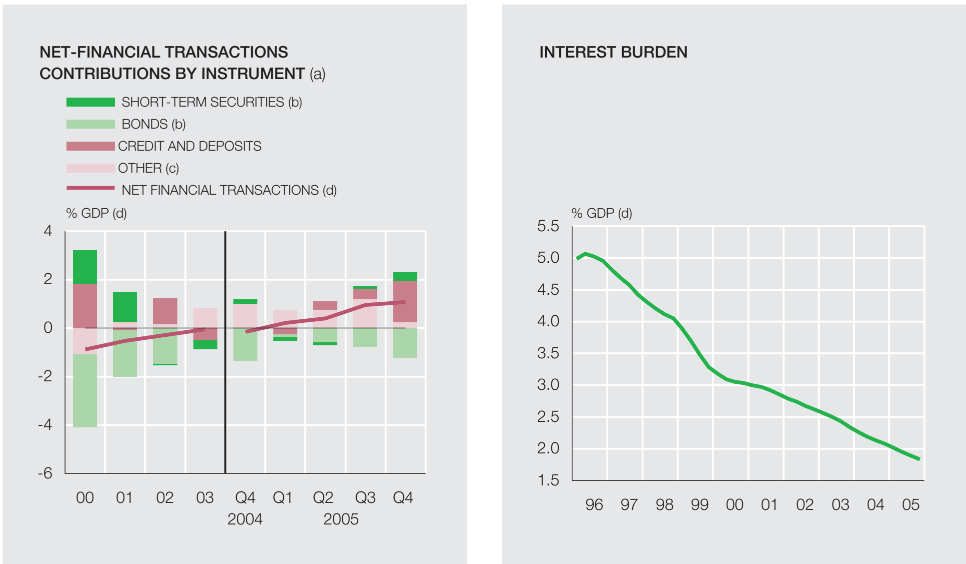


SOURCES: I/B/E/S and Banco de España.

a. Net worth proxied by the valuation at market price of shares and other participations issued by non-financial corporations.

GENERAL GOVERNMENT
Cumulative four-quarter data

CHART 28



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. Unpaid accrued interest on bonds and net investment of Social Security funds in assets issued by the rest of general government.
d. Spanish National Accounts, base 2000.

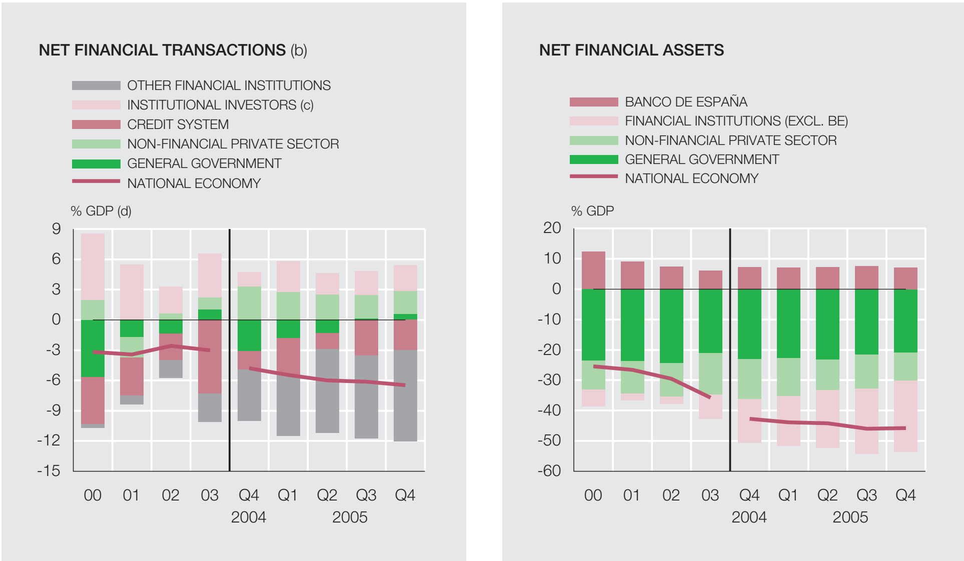
In terms of instruments, general government long-term securities issues increased, while there was a net redemption of short-term paper. The increase in deposits outgrew that in loans, making for a fresh and appreciable rise (1.3 pp) in the heading including the net balance of these two items. Interest payments as a proportion of GDP continued to fall thanks to the reduction in the debt ratio, and they stood at below 2%.

5.5 The rest of the world

In the closing months of 2005 the debit balance of the nation's financial transactions continued to increase, rising in four-quarter cumulative terms to 6.5% of GDP, compared with 6.1% in

NET FINANCIAL TRANSACTIONS AND NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)

CHART 29



SOURCE: Banco de España.

a. Cumulative four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilitities not included.
b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.
c. Insurance companies and portfolio investment institutions.

September. Sector by sector, the greater need for funds stemmed from the deterioration in household and, above all, corporate saving, which was not offset by the improved lending capacity of financial institutions and general government.

Financial institutions continued to channel the bulk of the funds from abroad and, among these entities, non-monetary financial institutions have gained in significance; their net financial transactions with the rest of the world accounted for 9% of GDP in 2005, compared with 12.3% for the sector as a whole (see Chart 29).

Investment in foreign assets by the resident sectors rose at end-2005 to 17.7% of GDP in cumulative 12-month terms, which entails an increase of 0.7 pp on the Q3 figure (see Table 7). In terms of instruments, there was a notable rise in net purchases of securities other than shares, especially by credit institutions, which accounted for a flow in this connection equivalent to 6.6% of GDP. As a result, this type of acquisition, which has gained in significance over the course of the past year, became the main asset flow heading, against the backdrop of the highly buoyant debt markets. In contrast, there was a contraction in shares and other equity of almost 2 pp, this largely coming about due to a foreign direct investment transaction in 2004 by a Spanish credit institution.

Net capital inflows stood at end-2005 at 24.2% of GDP, in cumulative 12-month terms, compared with 23.1% in Q3. Funds raised through foreign investment in securities other than shares accounted, as in 2004 and the previous months of 2005, for the bulk of the flows from the rest of the world (over 50% of the total) and, indeed, as a proportion of GDP they increased by 1.1 pp compared with the September figure. Accordingly, these securities (and, specifically, those issued by financial institutions) remain the main route through which to channel and obtain resources from abroad to cover our economy's financing requirements. Among these securities, those linked to mortgage loans remain to the fore. Interbank deposits were also a

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP

	2002	2003	2004	2005 Q2	2005 Q3	2005 Q4
NET FINANCIAL TRANSACTIONS	-2.6	-3.0	-4.8	-6.0	-6.1	-6.5
FINANCIAL TRANSACTIONS (ASSETS)	12.9	13.5	13.8	14.6	17.0	17.7
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.3	0.7	3.2	2.6	1.9	2.4
Of which:						
Interbank (a)	2.3	0.5	0.7	2.2	1.2	3.2
Securities other than shares	4.1	6.5	1.8	3.5	6.1	8.7
Of which:						
Credit institutions	0.5	3.5	1.0	1.8	4.1	6.6
Institutional investors (b)	3.1	3.1	0.0	1.0	1.7	1.9
Shares and other equity	5.0	4.7	6.8	6.2	6.8	4.9
Of which:						
Non-financial corporations	4.6	4.5	3.7	4.2	4.2	3.8
Institutional investors (b)	-0.1	1.1	0.9	0.5	0.8	0.7
Loans	0.1	0.3	0.8	1.1	0.9	1.1
FINANCIAL TRANSACTIONS (LIABILITIES)	15.5	16.5	18.5	20.6	23.1	24.2
Deposits	4.0	6.9	1.7	0.5	3.4	5.3
Of which:						
Interbank (a)	3.1	5.3	5.0	3.4	5.6	7.2
Securities other than shares	4.3	5.3	12.4	15.2	14.4	15.5
Of which:						
General government	1.2	-1.0	2.7	1.1	0.0	0.0
Credit Institutions	1.3	3.5	4.6	5.6	5.9	6.3
Other non-monetary financial institutions	1.8	2.8	5.1	8.5	8.5	9.3
Shares and other equity	4.0	1.1	2.7	2.6	2.8	0.8
Of which:						
Non-financial corporations	3.3	1.3	1.7	1.6	1.4	1.0
Loans	3.0	2.8	1.3	1.7	1.9	2.0
Other, net (c)	-0.1	-0.8	-0.6	-0.6	-0.7	-0.1
MEMORANDUM ITEM						
Spanish direct investment abroad	4.8	3.1	5.8	6.0	5.5	3.4
Foreign direct investment in Spain	5.7	2.9	2.4	2.0	2.1	2.0

SOURCE: Banco de España.

a. Correspond only to credit institutions and include repos.
b. Insurance corporations and portfolio investment institutions.
c. Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

significant source of funds (almost 4% of GDP in net terms). In contrast, a negative flow was once again recorded for other deposits, reflecting in part the net redemption of fixed-income securities issued by subsidiaries established abroad, while financing in the form of shares and other equity fell off notably (by 2 pp), in step with the decline in portfolio investment in these types of instruments. Resources obtained through foreign loans held at similar levels to those of the previous quarter.

As regards foreign direct investment in Spain, there were no significant changes, and this variable stood at 2% of GDP. Meanwhile, Spanish foreign direct investment fell, this being linked in part to the aforementioned operation last year by a Spanish credit institution, which translated into a high flow in 2004. In net terms, capital inflows held at a negative level (–1.4% of GDP).

As a result of the behaviour of financial flows vis-à-vis the rest of the world and of the changes in asset prices and the exchange rate, the debit position of the economy did not undergo significant changes and held at above 45.8% of GDP (see Chart 29). Across the different sectors, this performance was the result of an increase in the debit balance of financial institutions, which was offset by the improvement in most of the other sectors.

28.4.2006.