1 Overview

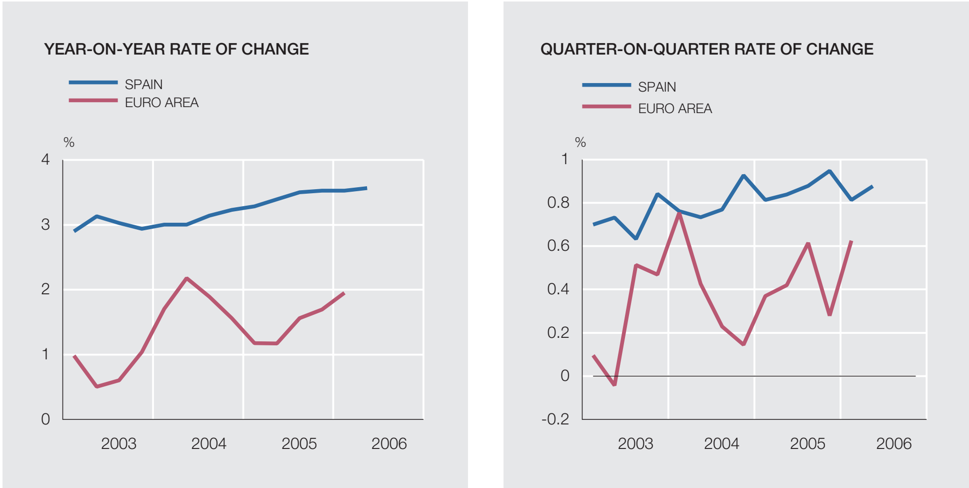
The pace of growth in the Spanish economy remains notably dynamic. During 2006 Q1, the slow deceleration in national demand throughout 2005 was brought practically to a halt, with this variable posting an annual growth rate of 4.7% on QNA data. The improvement that the contractionary contribution of net external demand had been showing was also checked. In combination, that held the rate of increase of GDP at 3.5%. In general terms, the information received for 2006 Q2 points to a resumption of the pattern observed in 2005. A slight slowdown in domestic spending is estimated, based fundamentally on the trend of consumption, along with an additional correction in the contribution of external demand, underpinned by the pick–up in exports in the first half at 2006 following the poor results last year. The negative contribution of external demand is estimated to have lessened from –1.5 pp in Q1 to –1.2 pp in Q2, whereby the annual increase in GDP would be standing at a rate of 3.6%, 0.1 pp up on the three previous quarters (see Chart 1). In quarter-on-quarter terms, estimated GDP growth in Q2 was 0.9%.

Of note under the national demand heading – along with the slight easing in private consumption which would have grown at around 3.8% – is the buoyancy of investment in equipment. This variable would have strengthened in 2006 Q2 to a rate of close to 8.5%, while the pace of investment in construction – at above 5.5% – evidenced greater inertia. On the supply side, the counterpart to the pick-up in exports and the sustained increase in investment in equipment was the upward trend of activity in industry, in train since the second half of 2005. Meanwhile, construction and services posted significant increases, set against a slight easing in their growth rates in Q2. Although the recovery in industry has not fed through to the same extent to employment in this sector, job generation continued at a rate of around 3%, concentrated especially in those activities less exposed to competition. The CPI ended Q2 at an annual rate of 3.9%, similar to that recorded three months earlier, against the background of substantial energy price rises and the notable persistence of underlying inflation at a rate of around 3%.

The strong rise in oil prices is the biggest factor of risk to an international economic setting that remains highly dynamic. In the case both of the United States and of China, the main engines of the world expansion, the Q1 figures revealed a rise in growth, which in China's case has stepped up in the subsequent months and firmed at double-digit rates. In the US economy, however, signs of some slowing in Q2 were observed, chiefly in household spending. In the other economic regions, commencing with the European and Asian economies, including Japan, growth also firmed in the opening months of the year; however, the euro area and the United Kingdom are running a notably more moderate rate of increase than the rest. Lastly, in Latin America, more balanced growth rates can be seen across the different countries, moving on a rising trend.

Against this expansionary backdrop, and a background of growing conflict in the Middle East, oil prices hit new highs, with Brent crude rising on occasions to $78 per barrel in July, although oil futures have incorporated these increases with less intensity than in the past. Inflation rates reflected dearer energy across the board, and in some cases, such as the United States, some pass-through to underlying inflation is becoming discernible. Foreseeably, therefore, the monetary authorities will continue to slacken their expansionary policy stance, although in the United States the correction has already been substantial. Mention should also be made of the start of a monetary policy tightening process in Japan, following six years of zero interest rates.

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

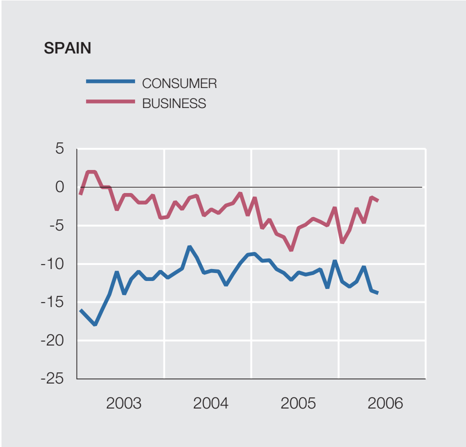
The financial markets, after several bouts of turbulence in May and June characterised by a preference for higher-quality assets, have resumed a more stable pattern in recent weeks. Overall, the situation of the oil market and the attendant geopolitical factors remain the main sources of uncertainty clouding a clearly favourable outlook for the world economy, insofar as any future disorderly correction of global imbalances will more likely be a relevant factor in the medium or long term.

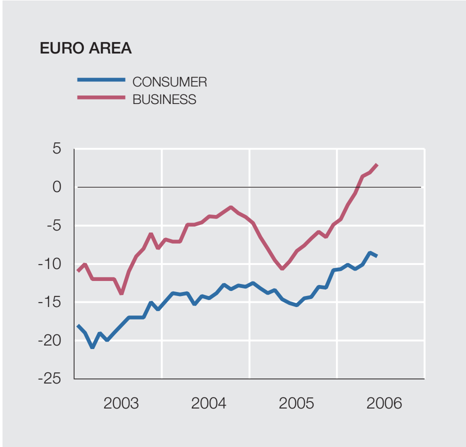
The latest information on activity in the euro area in Q2 is consistent with the continuation of the upturn seen in previous quarters. The growth rate of GDP is expected to have held at a similar or even somewhat higher level than that in the opening months of the year, when it posted a year-on-year rate of 2% (0.6% in quarter-on-quarter terms). The resilience of activity continues to be underpinned by exports, which are benefiting from worldwide economic growth, and by investment, against a background of still-propitious financial conditions and sound corporate balance sheets. Further, the gradual improvement in consumer confidence and signs of greater robustness in the labour market might translate into a somewhat more sustained increase in private consumption in the coming months. Accordingly, the outlook for the coming quarters is compatible with a central scenario in which activity would hold at a rate close to the area's growth potential. Nonetheless, the rise in the VAT rate in Germany scheduled for January 2007 may distort somewhat the timing of the increase in the area's output, insofar as certain spending decisions envisaged for the coming year may be brought forward to the closing months of 2006.

In recent months, inflation in the euro area has moved on a course marked by increases in the most variable components. That has pushed inflation above 2%, the level below which price stability in the medium term is defined. However, underlying inflationary pressures remain moderate, and the evidence of any pass-through of oil price rises to other prices is very incipient. Further, the indicators show that wages continue to grow at a rate of around 2%, without any second-round effects discernible as a result of the rise in oil prices. Nonetheless, it cannot be ruled out that the current setting of strengthening activity may ultimately encourage, to some extent, wage demands to offset the loss of purchasing power. And adding to this is uncertainty over the effects that the rise in the VAT rate in Germany may have on inflation in the area. Overall, the perception holds that the risks to price stability in the medium term remain on the

CONFIDENCE INDICATORS

CHART 2





SOURCE: European Commission.

upside. Given the strength of economic activity, that led the ECB Governing Council to decide on a 25 bp increase in official interest rates in June, the third such rise since December 2005. Following its meeting in early July, the Governing Council continued to signal the existence of risks to price stability and stated its intention to remain highly vigilant in this connection.

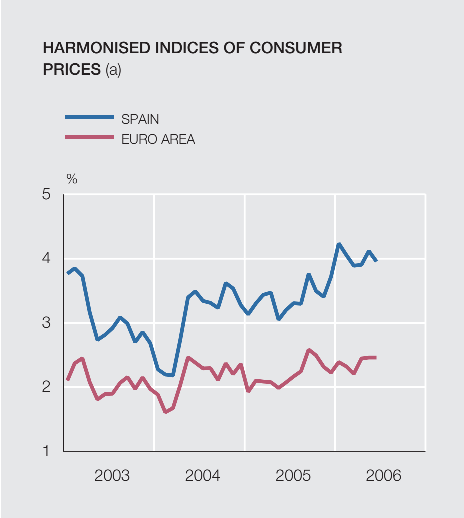
Following the progress in budgetary consolidation in 2005, the phase of more buoyant activity offers the opportunity to make a further effort to place European public finances on a path of greater sustainability. Such an opportunity should not be wasted, as occurred with the economic boom at the beginning of the current decade. However, the European Commission's spring forecasts indicate that changes in the implementation of budgetary plans this year are not foreseen, whereby the budget deficit for the area as a whole would stand at 2.4% of GDP. At the aggregate level, that means that not even the inherently undemanding objectives of the Stability Programmes, which entailed a deficit of 2.3% of GDP, would be met. It should be borne in mind, moreover, that the Programmes were drawn up before it was disclosed that the 2005 deficit was 0.5 pp lower than estimated before the year had ended, and that, therefore, the maintenance of the objectives for 2006 represents a further easing of fiscal policy.

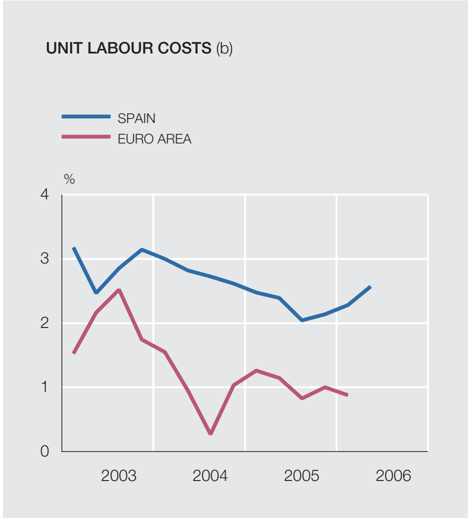
As mentioned at the start of this report, set against the expansionary background of the world economy, and in particular – albeit with less pace – the euro area, the Spanish economy remained notably dynamic, more so in fact than in the previous quarter. This dynamism was partly underpinned by the very strength of world trade, which is feeding through to exports to a greater extent than last year. Along with the recovery in exports, the sustained increase in investment in equipment and the uptrend in industrial activity are the most novel features behind the prolongation of the upturn, and features on which some re-balancing among the factors sustaining the upturn may be based. That said, the pattern of the expansion continues to be marked by the high rate of increase of household expenditure and, in general, of investment in construction. Domestic demand thus remains the chief underpinning of growth and, despite its estimated easing in Q2, its growth rate remains at around 4.5%. Set against this, as mentioned, external demand continues to detract notably from growth, with the momentum of imports contributing forcefully.

Despite the slowdown signalled by the information available, household consumption is estimated to have held at a high growth rate in Q2 of slightly below 4%, a figure higher, as has been the case for several years, than that of household disposable income (around 3% in real

PRICES AND COSTS

CHART 3





SOURCES: Eurostat, ECB and INE.

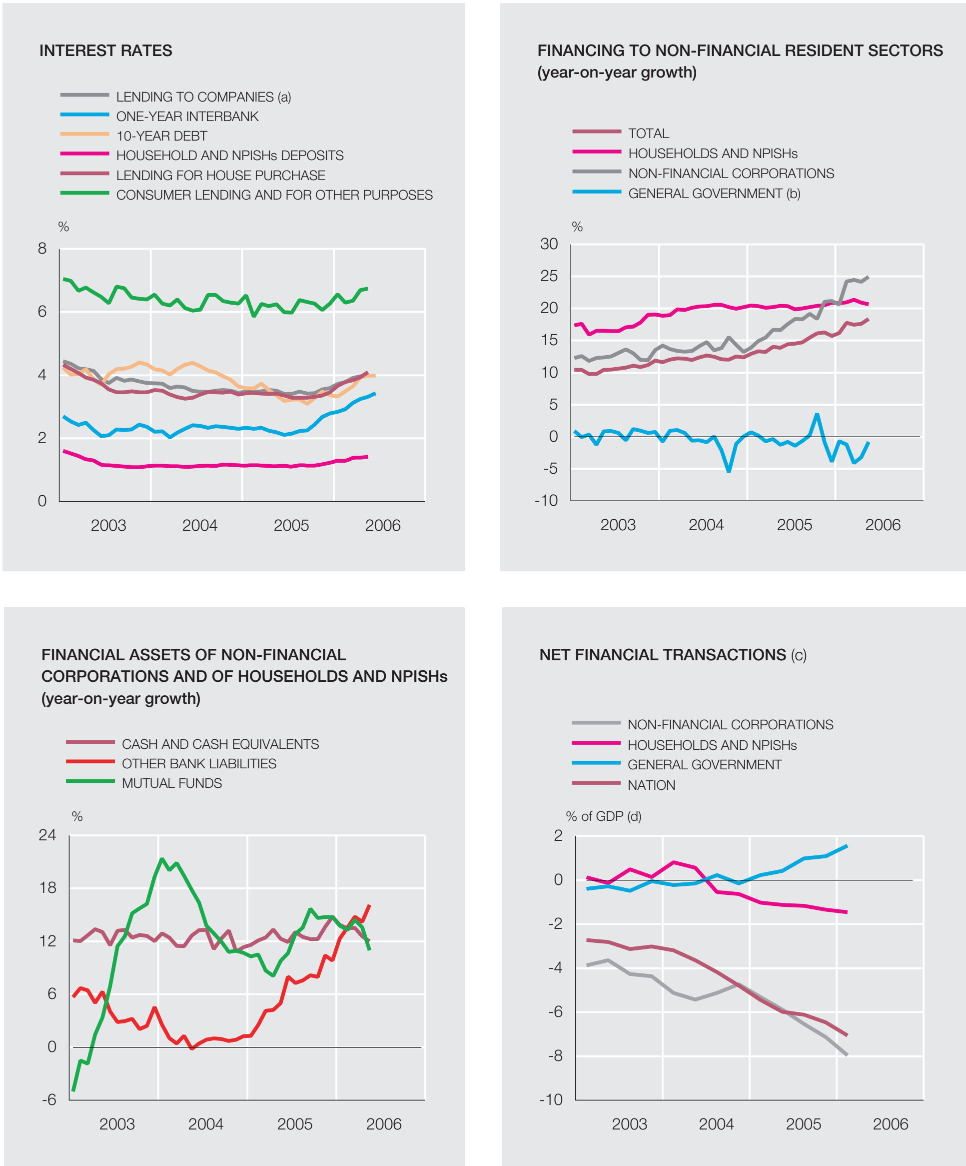
a. Year-on-year rate of change.
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

terms). Adding to this is the increase in residential investment, which is posting rates at least similar to those seen in 2005 (6% in annual average terms), according to QNA data for Q1. The substantial dynamism of spending is underpinned by job creation and by the looseness of financial conditions, which have tightened only partially following the recent rises in interest rates. Moreover, despite the slowdown confirmed by the data for Q2, house prices – another significant underpinning of household spending – remain very buoyant. From the standpoint of their financial position, households have continued to resort to credit to finance their spending, meaning that borrowing by this sector continues to grow at a rate of over 20%, and both indebtedness and the associated interest burden have continued to increase. Consequently, the safety buffer available to households to absorb adverse shocks without their spending decisions being adversely affected has once again diminished.

The greater dynamism of investment in equipment is symptomatic of the recovery witnessed in business investment in the last four quarters, which has also been reflected in the acceleration in financing to the corporate sector, which grew at a rate of over 24% in Q1, above that of household borrowing. Undoubtedly, the improved international economic outlook, particularly in the euro area, has contributed to this pick-up in investment, which continues to benefit from very easy financial conditions. However, the substantial dynamism of external borrowing is translating into an increase in debt and in the associated interest burden. And should this trend continue in the future, it might restrict the capacity of corporate spending to expand.

Foreign trade flows recovered considerably in the opening months of 2006. With some distortion due to calendar effects, this trend appears to have held in Q2, albeit with lower rates of change than in Q1. Goods imports posted somewhat higher increases than those seen in 2005, driven by the dynamism estimated for investment in equipment and by the recovery in exports. The export performance appears to confirm that the poor results last year – in which sales abroad were practically flat in real terms – were due in part to exceptional factors. In 2006, and supported by the European recovery, exports have resumed rates of increase closer to those of markets, though they are still somewhat lower, in a setting in which positive growth differentials in prices and costs remain in place. Following the notable fall-off in tourism

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. Spanish National Accounts, base 2000.

in the opening months of the year, the various indicators point to a recovery of some intensity in Q2. Overall, as indicated, it is estimated that the negative contribution of net external demand to growth declined by 0.3 pp in Q2. This notwithstanding, and although the improvement may be expected to hold for the rest of the year, the Spanish external deficit continued to increase, suggesting a fresh deterioration in this imbalance over the year as a whole.

As mentioned, despite the fact that industrial activity has picked up clearly since mid-2005, employment in this sector has remained notably slack. As a result, construction and services have continued to be the source of job generation. Although this has entailed a clear recovery in industrial productivity, very low increases – and even reductions – in actual productivity continue to be observed in the sectors less exposed to competition, and these feed through to the aggregate level. As indicated on other occasions, these low productivity gains are partly in response to composition effects on employment, but are also partly a genuine consequence of the relative moderation in labour costs, when their trend is compared with domestic prices.

As regards labour costs, wages have tended to rise in the first half of 2006, as indicated by the course of compensation per employee in the market economy, which posted an increase of 2.4% in Q1, 0.4 pp up on the previous quarter. Despite this rise, which reflects the effect of the activation of the indexation clauses for 2005, the increase in remuneration is below the increases agreed in collective bargaining agreements, which stand at over 3%, as a result of the ongoing changes in the composition of employment. In any event, the higher growth of wages has passed through to unit labour costs, against a background of sluggish productivity. And that, combined with the widening of margins that the high growth of domestic demand and the persistent rise in oil prices continue to drive, is contributing to the maintenance of a relatively high inflation rate. In terms of the CPI, the annual increase in prices held at a level of close to 4% over the first half of the year (3.9% in June), above the end-2005 level. Behind this growth is not only the upward behaviour of the more variable components, but also a higher level of underlying inflation, which rose to a rate of 3% in the first half of the year. Under these conditions, the inflation differential with the euro area held at around 1.5 pp.

In sum, the strong pressure of demand continues to drive highly dynamic output and employment, while the interaction of expanding expenditure with the rigidities persisting in the economy tend to sustain the inflation rate and its attendant risks. At the financial level, these risks are manifest in the growing debt trend. In these circumstances, the role of economic policies in containing demand pressures and in boosting the economy's supply-side response capacity must be reinforced. Turning to budgetary policy, the information received points to an outturn that would enable the plans included in the Stability Programme to be improved, along the lines required to mitigate the risks posed by the momentum of demand.

As regards supply-side measures, steps were taken in implementing certain reforms over the course of the last quarter. A package of labour market reform measures was adopted and came into force on 1 July (Royal Decree Law 5/2006 of 9 June 2006, to improve growth and employment), and an Agreement containing Social Security measures was signed by the social agents in July. The labour market reform is geared to discouraging the hiring of labour on a temporary basis, but it is a very timid step in terms of correcting the duality persisting in the labour market, since it scarcely alters any of the incentives that lead employers to use temporary hiring as the main flexibility mechanism in employment adjustments. The Social Security measures agreed are of limited scope and entail a deferral of the main reforms envisaged to give substance to the commitments undertaken in the Toledo Pact; however, mention should be made of the measures aimed at prolonging working life, since they may contribute to a more efficient use of the labour force available and they are appropriate in the light of the future process of population ageing.

2 The external environment of the euro area

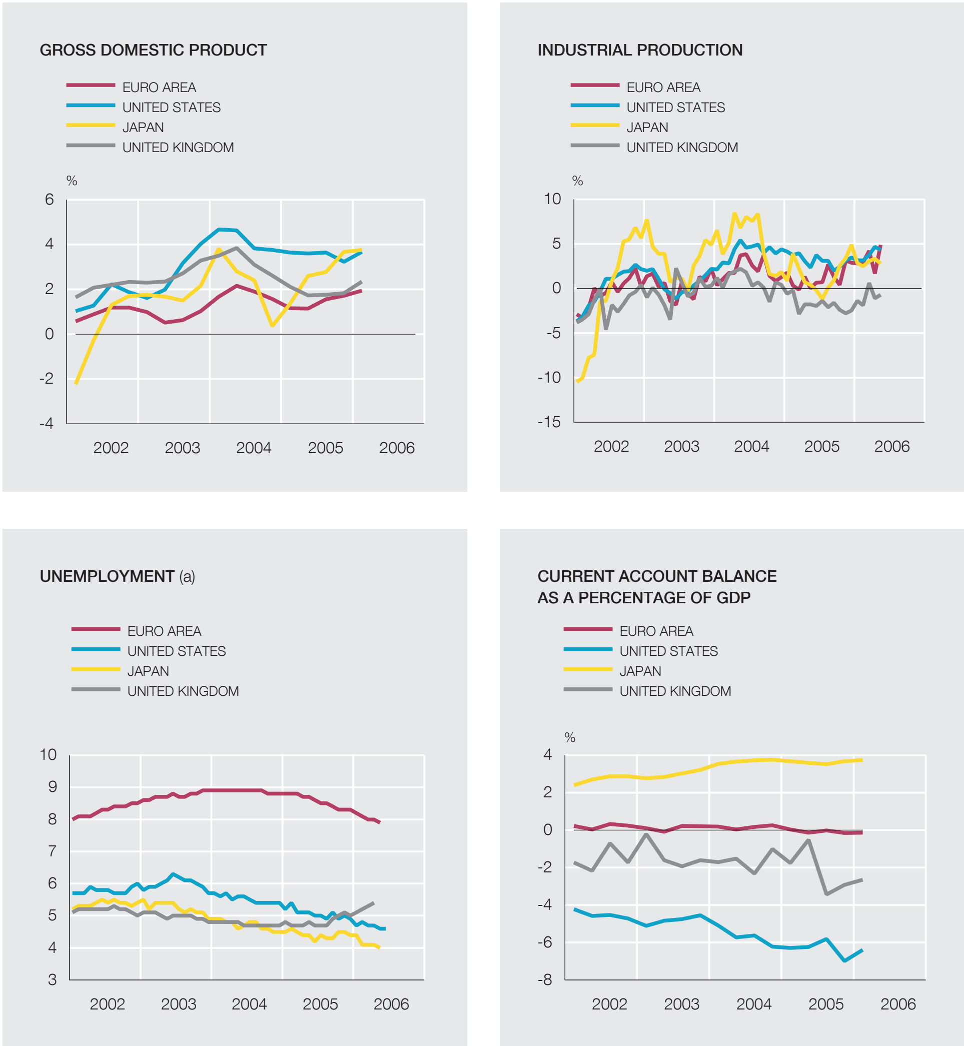
The key economic and financial developments in the external environment of the euro area between April and July were, firstly, the emergence of some signs of an as yet incipient slowdown in growth in the US economy, accompanied by a moderate deterioration in the inflation rate; secondly, the raising of official interest rates by the Bank of Japan to 0.25%, for the first time in six years; and thirdly, increased volatility on financial markets, which adversely affected risky assets, such as those on the equity, emerging and commodities markets, between May and June, though there was subsequently some recovery.

In the international financial domain, the Federal Reserve once again raised its official interest rate by 25 bp in June to 5.25%, against a background of greater uncertainty than in the recent past regarding the risk of a possible rise in inflation (due partly to high oil prices) and the risk associated with the possibility of a sharper slowdown in growth, given the weakness shown by certain indicators. On the currency markets the dollar hovered between 1.29 and 1.25 units against the euro, with episodes of appreciation owing to the turbulence on financial markets between May and June, and to the tension in the Middle East in mid-July. US long-term interest rates stood at around 5.10%, while stock markets and high-yield corporate bond spreads recovered somewhat in July following the losses in May and June. Oil prices underwent a fresh increase of close to 10% between April and July, and stood at over $78 per barrel in the third week of July, a new all-time high. Oil prices have been influenced in recent months mainly by supply-side problems, given the heightening of geopolitical risks in the Middle East, which compounded the rise in demand prompted by the start of the summer season.

In the *United States*, according to the advance estimate for the National Accounts, activity expanded at an annualised rate of 2.5% in 2006 Q2, compared with the strong expansion in Q1 (an annualised quarterly rate of 5.6%). This slowdown would be attributable to the moderation in consumption, which would appear to have been affected by the rise in petrol prices and the first incipient signs of the property market cooling, although that has not so far increased household saving (–1.7% of disposable income in May). The labour market also showed signs of weakness, since job creation in both May and June was significantly below the average for the previous quarters. However, the unemployment rate fell to 4.6%, and the favourable performance of other indicators, such as jobless claims and the number of hours worked, qualified the impression of weakness. The sustained growth of industrial production in the quarter as a whole confirmed that the slowdown in consumption would be more directly affecting imports than domestic output. Capacity utilisation rose in June to 82.4%, over 2 pp above its long-term average, while wage growth quickened in June to an annual rate of 3.9%, prompting some concern about the possibility of inflation pass-through, against the backdrop of a moderate rise in consumer prices and of their underlying component in the past three months. In this respect, the personal consumption deflator grew by 3.3% in May year-on-year (0.2 pp up on the April figure), while the underlying rate held stable at 2.1%, a level considered relatively high. The consumer price index rose more than expected once again in June, with the underlying rate at an annual rate of 2.6%, up from 2.4% in May. However, inflation expectations measured by consumer surveys and the spread between nominal and index-linked bonds did not reflect substantial changes. On the external front, exports trended favourably and the growth of imports eased off, enabling the increase in the cost of energy products to be offset and the trade deficit to stabilise, albeit at still-high levels. Consequently, and despite the fact the income balance turned positive again, the current account deficit increased by 0.1 pp in 2006 Q1 to 6.4% of GDP.

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5

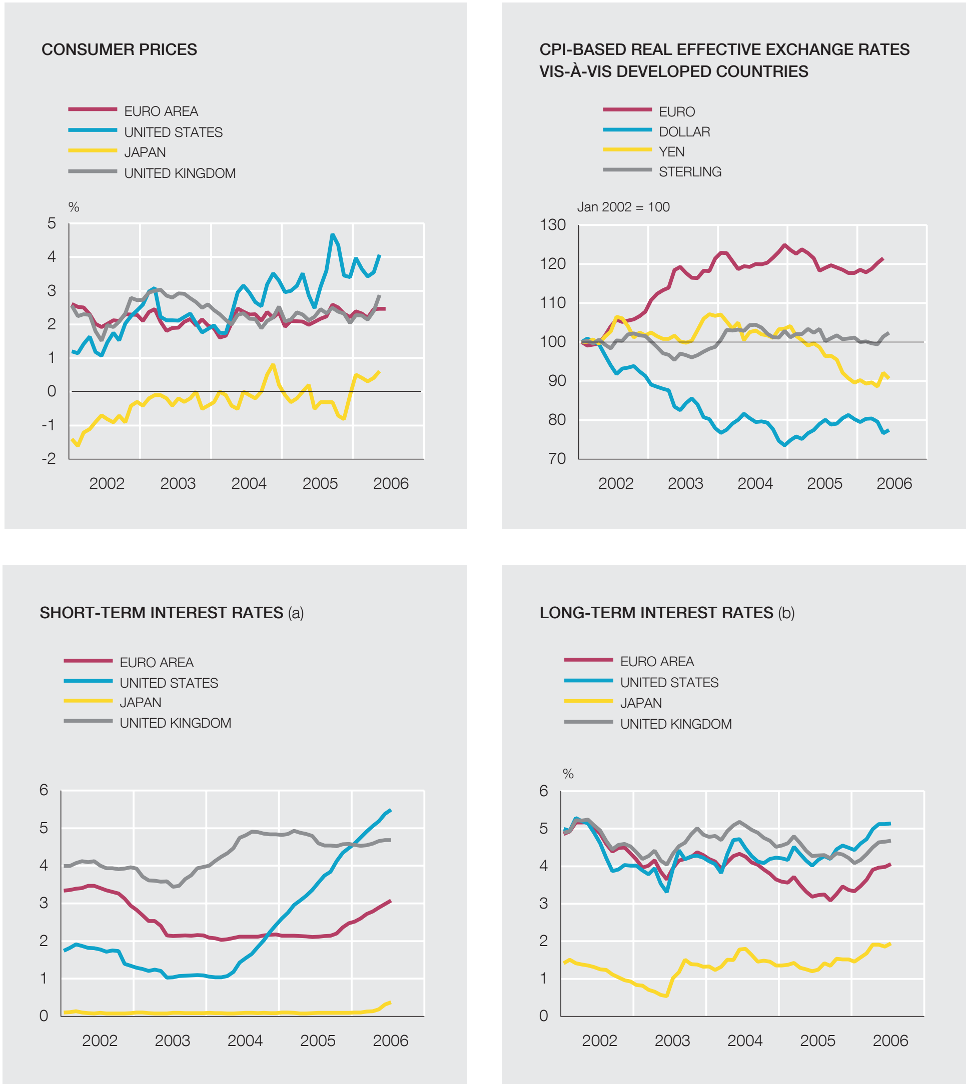


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

In *Japan*, activity remained very dynamic in 2006 Q2, though apparently somewhat down on Q1 judging by the slackness of the private consumption indicators, which are in contrast to the vigour of the investment indicators. In mid-July the Bank of Japan raised its official interest rate, which had held at close to 0% since March 2001, to 0.25%, thereby confirming the favourable outlook for activity and distancing the risk of a return to deflation. On the supply side, the Tankan business confidence survey for Q2 was once again positive (in particular the prospects for investment spending), while the annual growth rates of industrial production and machinery orders posted a fresh acceleration. On the demand side, retail sales in June recovered, and consumer confidence fell for the second month running in June, though it held at a high level. The labour market continued to display notable momentum, and the unemployment rate stood at 4.2% of the labour force in June while nominal employee remuneration quickened moderately. In the external sector the rise in exports was conducive to an improvement in the trade surplus in June, thereby interrupting the deterioration seen over the previous year. The overall index of consumer prices posted an annual increase of 1% in June, with underlying inflation holding at 0.6%, which confirms the mild upward trend of the last six months. Wholesale prices increased to an annual rate of 3.3% in June.

PRICES, REAL EXCHANGE RATE AND INTEREST RATES CHART 6



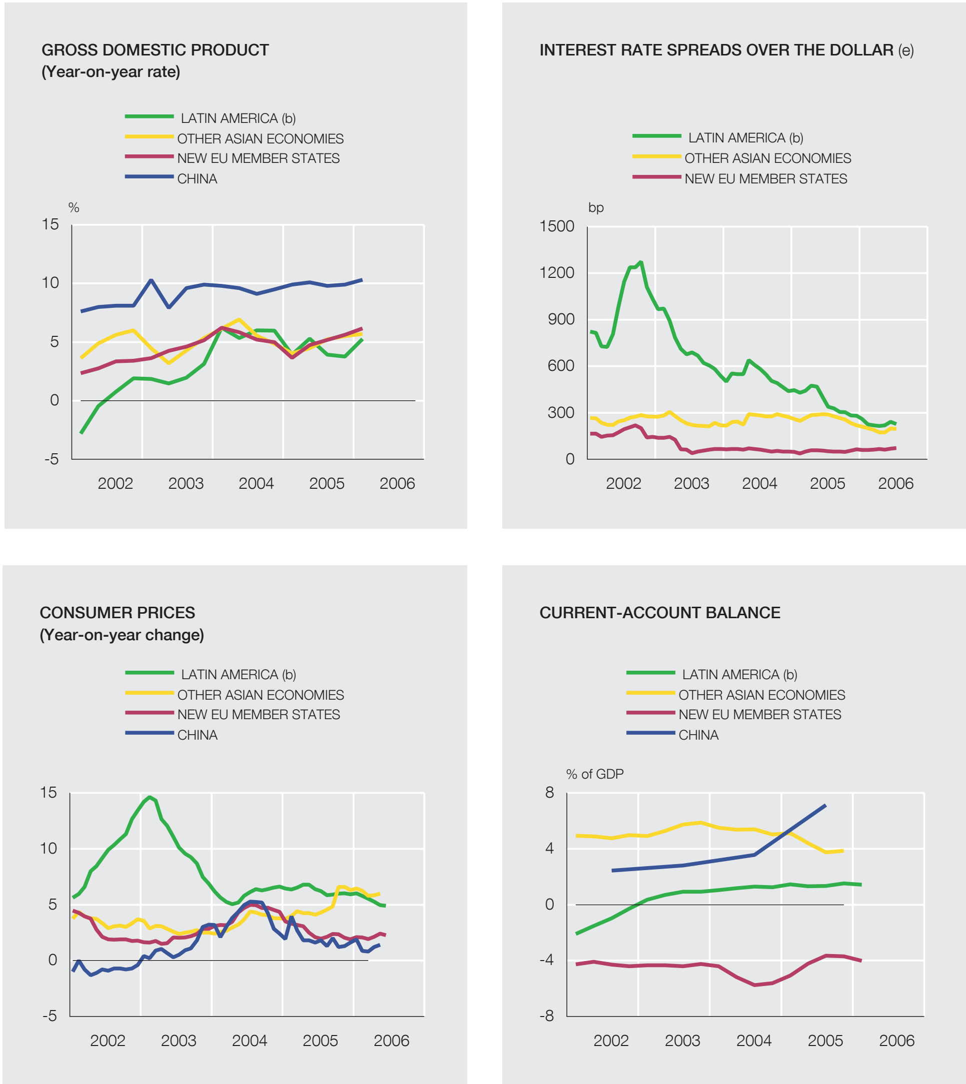
SOURCE: Banco de España.

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

In the *United Kingdom*, GDP growth in Q2 (initial estimate) was 0.8% in quarterly terms and 2.6% year-on-year. Some of the indicators for Q2, such as the Purchasing Managers Index (PMI), rose substantially in June, in keeping with a recovery in the growth rate in Q2 in relation to Q1. This pick-up was also discernible in the buoyancy of imports, which prompted a widening of the trade deficit to 4.4 billion pounds sterling in May. In the labour market, job creation fell behind the increase in participation rates, which moderately raised the unemployment rate to 5.4% in May. Consumer prices grew at a rate of 2.5% in June compared with a year earlier, 0.3 pp up on May, owing to the acceleration in energy prices and in other less volatile items. The Bank of England held interest rates unchanged at 4.5%.

GDP quickened in almost all the new *EU Member States* in Q1, with an annual average rate of 6.1%, up from 5.4% the previous quarter. This was thanks to the greater dynamism of domestic demand, which offset the lesser contribution of the external sector. The indicators of activity and demand remained favourable in 2006 Q2. Inflation rates increased across the board, owing to the rise in energy and food prices, although there is notable variability from one coun-

EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a) CHART 7



SOURCES: National statistics and JP Morgan.

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

try to another. Despite the rise in prices, official interest rates held stable in most countries. The exceptions were Hungary and Slovakia, where rates were raised owing to the upward revision of inflation expectations and, in the case of Hungary, to pressures on the financial markets in the face of worsening public finances. Indeed, in early June the Hungarian government revised its budget deficit forecast for 2006 upwards from 6.1% to 9.5% of GDP. In the remaining countries the fiscal targets for 2006, which foresee a generalised reduction in budget deficits, are likely to be met. In May and June, the turbulence on international financial markets worsened the economic outlook for Turkey, owing to the high vulnerability of its public debt and to other internal factors, such as its worsening current account deficit and inflation. From mid-June, the Turkish central bank tightened its monetary policy stance and intervened on the currency markets. In the institutional domain, the EU Council, following the analysis of the convergence reports for Slovenia and Lithuania prepared by the ECB and the European Commission, approved Slovenia's entry into the euro area on 1 January 2007. Lithuania, meantime, will have to wait as it does not meet the price stability criterion.

In *Asia*, China's GDP growth in Q2 was 11.3%. That confirms a significant rise in activity in relation to the already-high growth of the previous quarter, along with the persistence of risks of the economy overheating. The growth rate of the money supply increased during the quarter (and stands some way off the official target) as did domestic credit, despite the moderate increase in official interest rates on loans, the tightening of mortgage financing conditions and the rise in the bank reserves ratio. The renminbi appreciated by only 0.3% against the dollar during the quarter. Consumer prices accelerated progressively over this period, posting a year-on-year rate of 1.5% in June, as did producer prices, which stood at 3.5%. The trade surplus widened to $38 billion in Q2, 63% up on the previous year. However, foreign direct investment inflows continued to slow. In India, GDP in Q1 quickened to a year-on-year rate of 9.3%, driven by the resilience of domestic demand and by very high annual growth of around 30% in bank credit. In the rest of Asia, economic activity remained buoyant thanks to the favourable performance of exports and domestic demand in most countries. Inflation tended to increase slightly in Q2 owing to the rise in energy prices, which gave rise to some tightening of monetary policies.

In *Latin America*, GDP growth quickened considerably in Q1. Following the release of the figure for Colombia (5.4% year-on-year), GDP growth stood at an annual rate of 5.3%, compared with 3.8% in 2005 Q4. The mild slowdown in the countries that had previously posted the highest rates and the rise in the countries most behind in the cycle contributed to a lesser dispersion in regional growth. The contribution of domestic demand was notable (at over 6 pp), while the negative contribution of external demand increased slightly. The latest indicators for Q2 point to a slowdown in activity to which the financial turbulence recorded between May and June might have contributed. Nonetheless, the financial indicators have partially reversed what was a strong deterioration the previous month, reflecting the improvement in fundamentals and the lesser financial vulnerability of the area. Market volatility has not significantly disrupted access to financing, and some countries such as Chile and Brazil have even benefited from sovereign rating upgrades. Price developments remained favourable, leading the inflation rate to stand below 5% in the area as a whole, 1 pp below the end-2005 rate. Nonetheless, only in Brazil did the gradual lowering of interest rates continue (125 bp). Colombia, by contrast, joined the countries in an upward rate cycle. On the fiscal front, Mexico and Chile posted sizable surpluses, assisted by the proceeds from their production of commodities, while the primary balance target continues to be met in Brazil (4.25% of GDP), despite a certain rise in public spending. Finally, mention may be made of the intense activity in connection with trade agreements, where progress in the bilateral agreements with the United States is giving rise to appreciable tension in intra-regional treaties, in particular in the Andean Community and Mercosur.

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

The information available on economic developments in the euro area in 2006 Q2 points to a continuation of the upturn which began in the summer of last year. In a context in which the various indicators are consistent with rates of increase in activity that are perhaps outpacing the potential growth rate, greater consumer confidence and the incipient strengthening of the labour market are very positive signals, insofar as they might augur higher growth in private consumption over the next few months. Furthermore, the buoyancy of the economy continues to be sustained by strong exports, driven by vigorous global economic growth, and strong investment, boosted by favourable financing conditions and the robustness of corporate earnings. In the medium term, the outlook is compatible with a central scenario in which activity would continue to grow at rates close to those witnessed in Q1. However, this encouraging outlook is not free from uncertainty, notably the possibility that the escalation in the Middle East conflict could trigger fresh oil price increases. In addition, there is the persistent risk of a potentially disorderly correction of global imbalances. Lastly, the recent turbulence in the financial markets warrants increased vigilance in developments on these markets.

As regards price developments, underlying inflationary pressures remain moderate. Although the growth rate of the Harmonised Index of Consumer Prices (HICP) has remained clearly above the level defined in the medium-term objective of price stability, it has only done so as a result of the increase in its more volatile components. Foreseeably, the behaviour of these components will continue to affect the overall HICP over the next few months and, given the VAT rise in Germany, inflation will not drop to below 2% until well into next year. For the time being, evidence of a pass-though of the increase in oil prices to other prices in the economy and to wages is relatively negligible. However, the firming of activity and the incipient recovery of the labour market are heightening the risks of more pronounced inflationary pressures appearing, thereby justifying the monetary authority's vigilance. In fact, the European Central Bank has already begun a gradual withdrawal of the stimulus provided by monetary policy, reflected in three rises of 25 basis points since December 2005. As far as fiscal policy is concerned, following the progress made in 2005, greater buoyancy in activity should speed budgetary consolidation. Lastly, in July, the ECOFIN Council, after examining the Convergence Reports of the European Commission and the ECB, decided that Slovenia has reached a high and sustainable level of convergence, thereby fulfilling the requirements to adopt the euro from 1 January 2007. Only three years after joining the European Union, Slovenia is thus the first of the ten new Member States to accede to Economic and Monetary Union.

3.1 Economic developments

Euro area GDP grew by 0.6% in 2006 Q1, confirming the strength of the economic recovery as predicted by various indicators. A comparison of this rate with the rise in the previous quarter (0.3 pp lower) appears to substantiate the anomalous nature of the GDP growth figure over this period, possibly as a result of the incomplete adjustment for calendar effects. This effect may have been partially offset in 2006 Q1. In any case, the robustness of the dynamics of the increase in activity is confirmed by the upturn in the year-on-year growth rate, which rose 0.3 pp to 2%.

The acceleration in GDP was based on both domestic demand (excluding inventories) and net external demand, which contributed 0.6 pp and 0.4 pp respectively to output growth, while inventories subtracted 0.4 pp (see Chart 8). Of note is the recovery in the various components of domestic demand. Thus, private consumption and gross fixed capital formation grew by 0.6% and 0.9% respectively, rates very close to those observed in 2005 Q3 and considerably

EURO AREA ECONOMIC INDICATORS TABLE 1

	2004	2005				2006		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
GDP								
Year-on-year growth	1.6	1.2	1.2	1.6	1.7	2.0		
Quarter-on-quarter growth	0.1	0.4	0.4	0.6	0.3	0.6		
European Commission forecasts (c)							(0.4 ; 0.8)	(0.3 ; 0.7)
IPI (d)	1.2	0.8	0.7	1.5	2.2	3.3	*3.3*	
Economic sentiment	100.5	98.7	96.1	97.7	100.1	102.6	106.5	
Industrial confidence	-3.7	-6.7	-10.3	-7.7	-6.0	-2.3	2.0	
Manufacturing PMI	51.4	51.4	49.3	51.0	53.0	54.7	57.1	
Services confidence	11.3	10.7	9.0	11.0	13.7	14.7	19.0	
Services PMI	52.9	53.1	53.1	53.8	55.6	57.8	59.2	
Unemployment rate	8.8	8.8	8.7	8.5	8.3	8.1	*7.9*	
Consumer confidence	-13.0	-13.3	-14.3	-14.7	-12.3	-10.7	-9.3	
HICP (d) (e)	2.4	2.1	2.1	2.6	2.2	2.2	2.5	
PPI (d) (e)	3.6	4.2	4.0	4.4	4.7	5.1	*6.0*	
Oil price in USD (e)	39.7	53.3	54.0	62.6	56.5	61.6	68.1	*73.8*
Loans to the private sector (d) (e)	7.2	7.6	8.1	8.8	9.2	10.8	*11.4*	
Euro area ten-year bond yield	3.8	3.7	3.4	3.3	3.4	3.6	4.0	*4.1*
US-euro area ten-year bond spread	0.36	0.67	0.80	0.98	1.12	1.06	1.08	*1.06*
Dollar/euro exchange rate (e)	1.362	1.296	1.209	1.204	1.180	1.210	1.271	*1.254*
Appreciation/Depreciation of the euro (e)	7.8	-4.8	-11.2	-11.6	-13.4	2.6	7.8	*6.3*
Dow Jones EURO STOXX Broad index (e)	9.9	4.3	8.9	17.7	23.0	10.3	4.2	*0.0*

SOURCES: Eurostat, ECB and Banco de España.

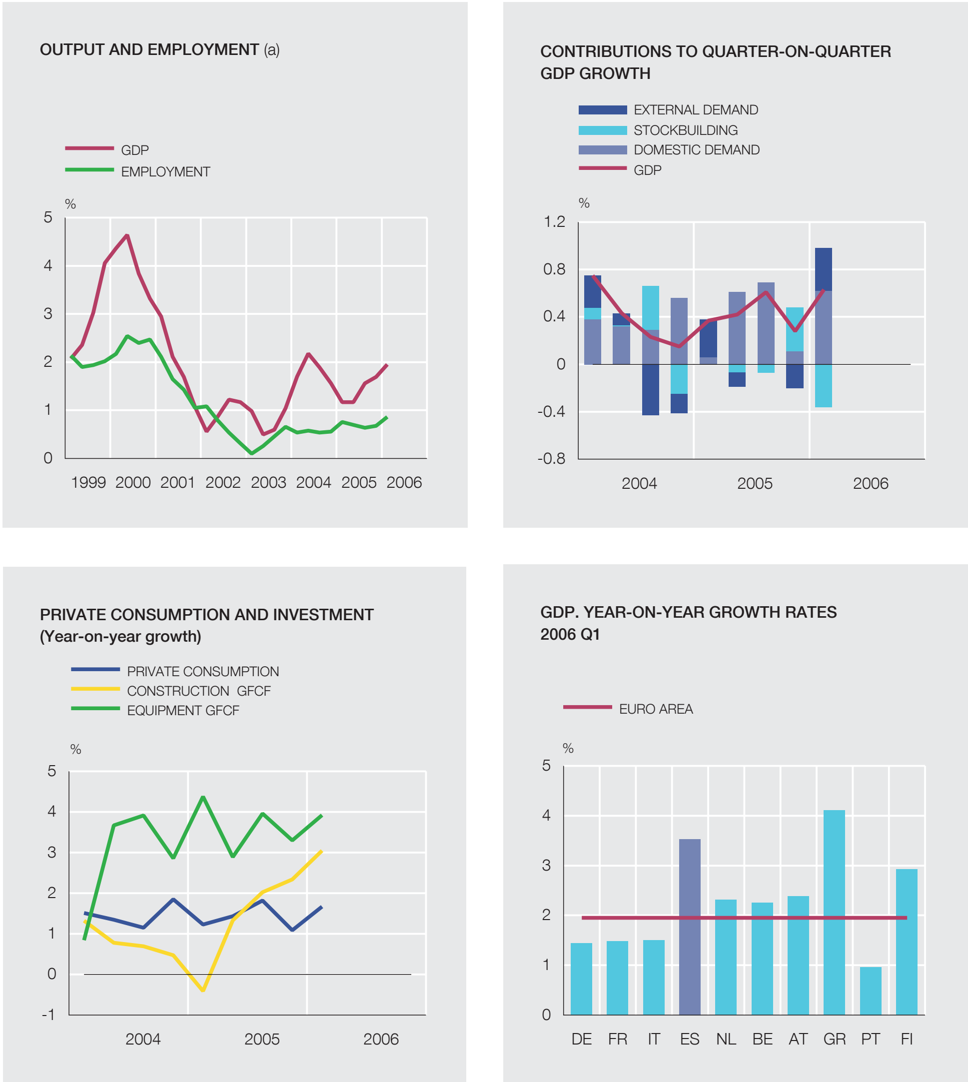
a. The information in italics does not cover a full quarter.
b. Information available up to 17 July 2006.
c. Quarter-on-quarter growth forecasts.
d. Year-on-year growth.
e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

higher than the almost zero growth rates observed in Q4. The resilience of gross fixed capital formation was based above all on the capital goods component, although developments in the construction component were also favourable, especially bearing in mind that the weather caused this aggregate to perform poorly in some central European countries. Lastly, as far as the external sector is concerned, the sound increase in exports, against the backdrop of increased growth in imports, resulted in net external demand making the biggest contribution to growth in more than two years (see Box 1).

Analysis of the National Accounts country data shows how there was a fairly widespread improvement in the rate of increase of activity. Particularly noteworthy, albeit with the above-mentioned caveats concerning the data for 2005 Q4, is the greater dynamism in the three main economies of the euro area, and particularly Germany and Italy, whose GDP rose by 0.4% and 0.6% respectively, after recording zero rates of increase in the previous quarter. In both countries, consumption expanded forcefully following falls in Q4. Similarly, there was a recovery in capital goods investment in both countries. However, this did not prevent a decline in gross capital formation as a whole in Germany, given the fall-off in construction investment. Across the different production branches, the greatest buoyancy was seen mainly in financial and business services and industry, the gross value added of each of which grew by 1%, amounting to accelerations of 0.9 pp and 0.5 pp respectively. Conversely, construction activity declined by 0.5%, in contrast to a 0.7% rise the previous quarter.

EURO AREA NATIONAL ACCOUNTS

CHART 8



Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

As regards the labour market, employment posted quarter-on-quarter growth of 0.3% in Q1, an identical rate to that in 2005 Q4. Job creation, which continues to be relatively modest, occurred mostly in the various services branches. Significantly, though, for the first time since 2001 Q1, there was an increase in the number of employees in industry. In year-on-year terms, the increase in employment stood at 0.9%, 0.2 pp higher than in 2005 Q4. Given output growth, the rate of increase in apparent labour productivity was 1.1%, 0.1 pp up on the previous period. Compensation per employee continued to rise at a rate of 2%, resulting in a 0.1 pp slowdown in unit labour costs to 0.9%, a rate in line with the average for the second half of last year. Lastly, although growth of the GDP deflator eased by 0.2 pp to 1.8%, it continued to outpace the increase in unit labour costs, as it has done since the end of 2003, which led to a fresh widening of corporate margins.

The information available on activity in Q2 points to a continuation of the current phase of economic buoyancy, with the rate of growth around that of potential output growth. As regards supply indicators, the industrial production index rose in April and May to an average annual rate of 3.3%, unchanged on Q1 (see Chart 9). The qualitative indicators drawn from sector confidence surveys conducted by the European Commission and Reuters showed net im-

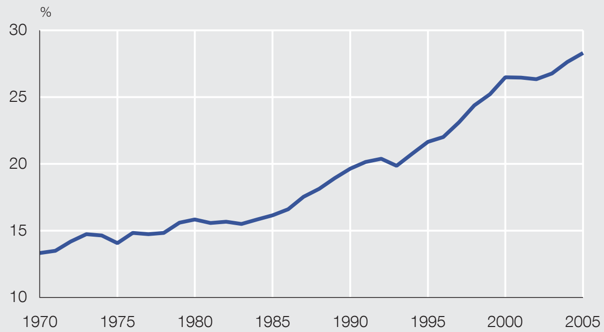
In 2006 Q1, the percentage of euro area countries' final demand for goods and services met by purchases made beyond their borders underwent a fresh increase. As can be seen in the accompanying panels, this rising trend of the degree of import penetration is part of a process that began back in the 70s. While at the beginning of that decade imports accounted for approximately 14% of final demand, this figure stood at 28% in 2005. However, the rate at which imports have progressively accounted for a greater share of final demand has not been constant over the course of this period: in the mid-80s, the rate of increase of the share intensified, and from 1995 it expanded notably.

Since 1995, the greater penetration of purchases abroad has been generalised in all the euro area countries, albeit to a differing degree of intensity. Spain in particular, along with Luxembourg and the Netherlands, is one of the countries that has recently experienced the highest growth recently (of around 9 pp between 1995 and 2005) in the penetration of goods and services. That has meant that the percentage of imports in final demand is currently similar to or higher than that of the biggest euro area countries. Notable at the other extreme are countries such as Italy and Greece, where the ratio has grown below the euro area average.

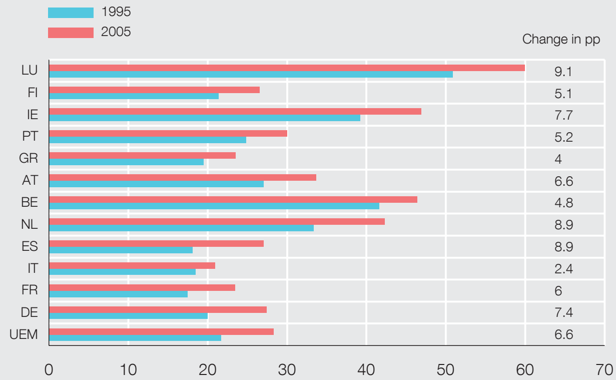
The growing role of foreign purchases in the euro area countries is part of the process of European integration and of the globalisation and liberalisation of the world economy. Indeed, the modelling of total euro area imports on the basis of their relative prices (proxied by the ratio of import prices to domestic prices) and of an income variable (measured by final demand) for the sample period 1970-2005 shows signs of a structural change around the mid-90s[1]. In particular, the re-estimation of the equation for recent years points to an increase in

1. The estimation of the euro area imports equation is with an error correction mechanism with quarterly data from 1970 to 2005.

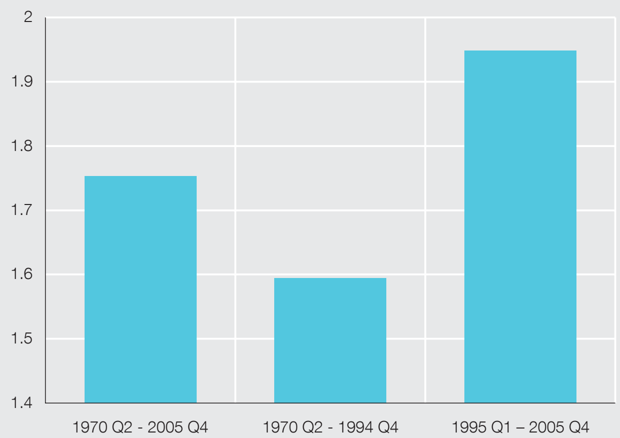
1 IMPORT PENETRATION IN EURO AREA FINAL DEMAND (a)
Constant prices



2 IMPORT PENETRATION IN FINAL DEMAND BY COUNTRY (a)



3 LONG-RUN ELASTICITY OF IMPORTS TO FINAL DEMAND (a)



4 CONTRIBUTION OF EACH AREA OF ORIGIN TO THE INCREASE IN GOODS IMPORTS BETWEEN 2001 AND 2005

	Euro imports by origin			Contribution to growth of euro area imports
	Weights		Growth	
	Year 2000	Change 2001 - 2005		
Total				11.1
Intra-euro area	52	-0.5	9.4	4.9
Extra-euro area	48	0.5	13.0	6.3
EU-10 (b)	3.6	1.1	34.3	1.2
EU-4 (c)	13.8	-2.0	-6.3	-0.9
United States	6.9	-1.8	-9.2	-0.6
Japan	3.3	-0.9	-12.4	-0.4
China	2.2	2.0	160.7	3.5
South east Asia (d)	3.7	-0.2	29.6	1.1
Rest of Asia	3.4	0.4	38.1	1.3
Latin America	1.8	0.2	36.1	0.6
Rest of the world	9.3	1.7	3.9	0.4

SOURCES: European Commission, ECB and Banco de España.

a. Includes intra- and extra-euro area trade.
b. New EU Member States.
c. United Kingdom, Switzerland, Sweden and Denmark.
d. South east Asia (DAEs: Korea, Taiwan, Thailand, Singapore, Malaysia and Hong Kong).

the elasticity of purchases abroad to final demand in the long run of 0.4 pp to 2 (see accompanying panel). The reasons for this greater sensitivity may be related not only to the possible effects of trade creation following the introduction of the euro, but also to new emerging economies entering the world trade arena. In fact, from 1995 to 2005 trade from countries not belonging to the euro area was more dynamic than intra-euro area trade (5.5% compared with 4.9% in annual average growth terms).

If analysis is confined to imports of goods and to the period from 2001 (the first year for which imports by place of origin are available in real terms), it can be seen in panel 4 that the volume of goods imports from outside the euro area has also grown more than trade between euro area member states. Admittedly, while the prices of goods imports from outside the euro area increased to a lesser extent than those of domestic goods during these years, this differential does not appear to be sufficient to explain the changes in relative volumes.

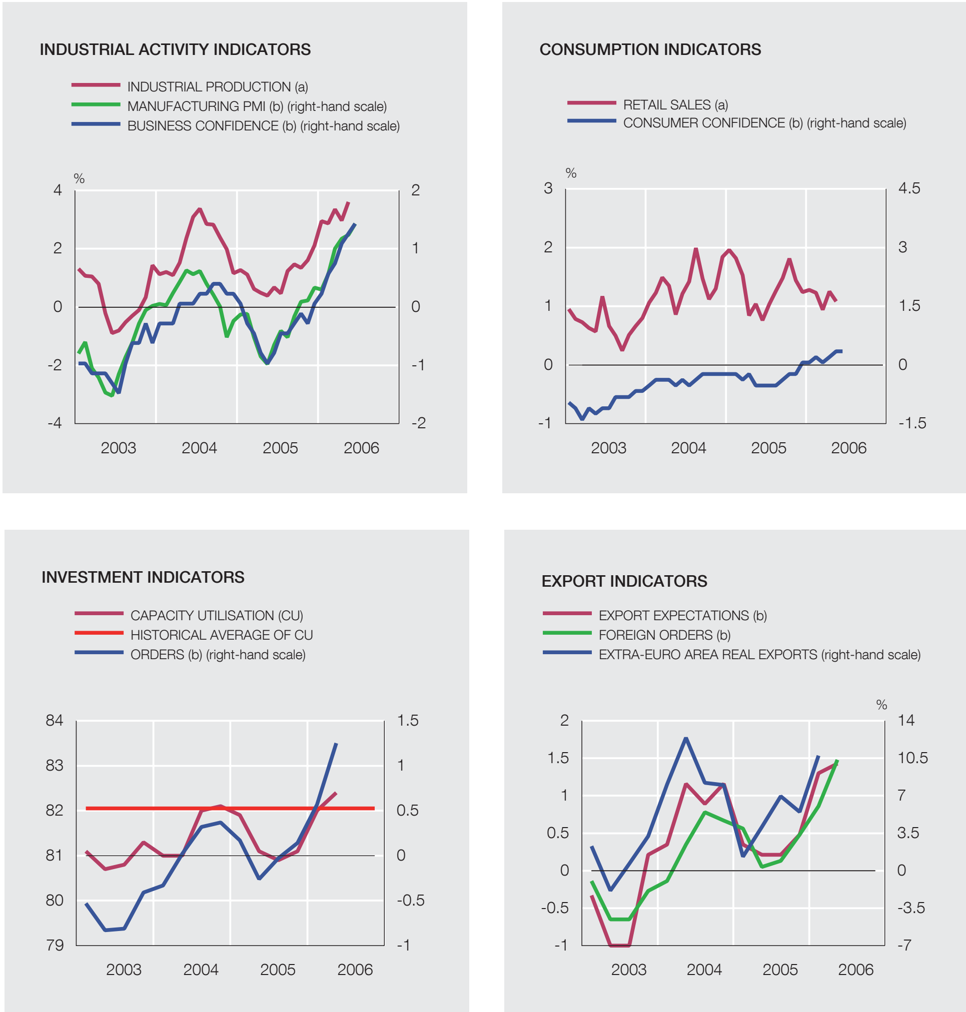
By country of origin of imports, penetration has been driven by the notable growth in sales of goods to the euro area from Latin America, the countries that have recently acceded to the European Union and the Asian economies in general. China is prominent among the latter, with sales to the euro area that have grown by more than 150% in only five years and at a higher rate of expansion than other regions. As a result, the weight of Chinese products in euro area imports has doubled in the period under study to 4.2%. Trending in the opposite direction have been imports from the EU countries not belonging to the euro area, from the United States and from Japan, the recent deterioration in which has entailed a negative contribution to the growth of import penetration.

provements in Q2. Services industry surveys displayed a similar performance. As a result, all these surveys recorded their highest levels in over five years. Turning to employment, survey expectations improved substantially in the first half of the year (see Chart 10).

On the demand side, the indicators available show signs of a moderate improvement in household expenditure. Thus, the expansionary course of new car registrations evident since the end of last year became firmer in Q2. In addition, the retail confidence indicator continued to rise sharply throughout the quarter, to stand significantly above its long-term average, while the related indicator for consumers rose moderately over the same period, driven by future unemployment expectations. However, household perceptions about their future financial situation remain flat, at levels close to those seen at the beginning of the year. Moreover, the retail sales indicator has continued to grow at a very low rate (around 0.1%, in terms of the quarterly moving average). As to indicators relating to investment in equipment, the strong pick-up in businesses' assessment of order books confirms the buoyancy of this demand component. Furthermore, capacity utilisation has exceeded its long-term average for the first time since 2001. Finally, in line with the spring half-yearly survey of investment in industry, companies in this sector hope to increase their capital goods expenditure by 7% in real terms during the current period, 2 pp more than six months ago. As to export demand, the assessment of foreign orders in Q2 further enhanced the substantial improvement witnessed since the beginning of the year. Substantiating this pattern is the performance of the quarterly business survey of export expectations.

To conclude, the indicators available point to a plausible scenario of output growth in the euro area in Q2 in line with that observed in Q1 and, therefore, around the midpoint of the range estimated by the European Commission, which puts expected GDP growth at between 0.4% and 0.8%. At the same time, the prevailing conditions are favourable to the pattern of growth remaining at around the potential rate of output growth for the rest of the year. As has been the case so far, it is likely that the external sector and investment will continue to drive GDP, thanks to robust global growth, the strength of corporate profits and, despite the recent official interest rate rises, the still-generous monetary and financial conditions. However, the improvement in the labour market, evident in terms of both the data observed over the past few months and the recent behaviour of indicators, lends itself favourably to household disposable income

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.

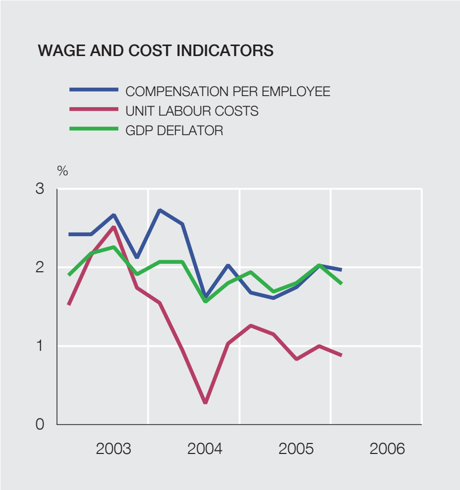
gathering greater momentum and, therefore, to household expenditure making a growing contribution to this scenario of buoyant activity. In any event, the pattern of output growth in the euro area may be distorted by the VAT increase in Germany, planned for January 2007, insofar as German households may decide to bring forward some of their expenditure planned for next year to 2006.

In this context, the strength of the latest indicators suggests that, in the short term, output may grow at even higher-than-expected rates. However, over the medium term, the risks to GDP growth remain on the downside, given the possibility that a worsening of the geopoliticial tensions in the Middle East could give rise to further oil price rises and a repeat of the instability on the international financial and exchange markets at the beginning of May, against a background of persistent global macrofinancial imbalances. Lastly, in spite of the buoyancy of private consumption in the first few months of the year, doubts remain as to whether this will be sustained.

After easing moderately during Q1, the HICP performed somewhat less favourably in Q2. The year-on-year rate of growth was 2.5% in June, 0.3 pp higher than in March (see Chart 11). The

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.

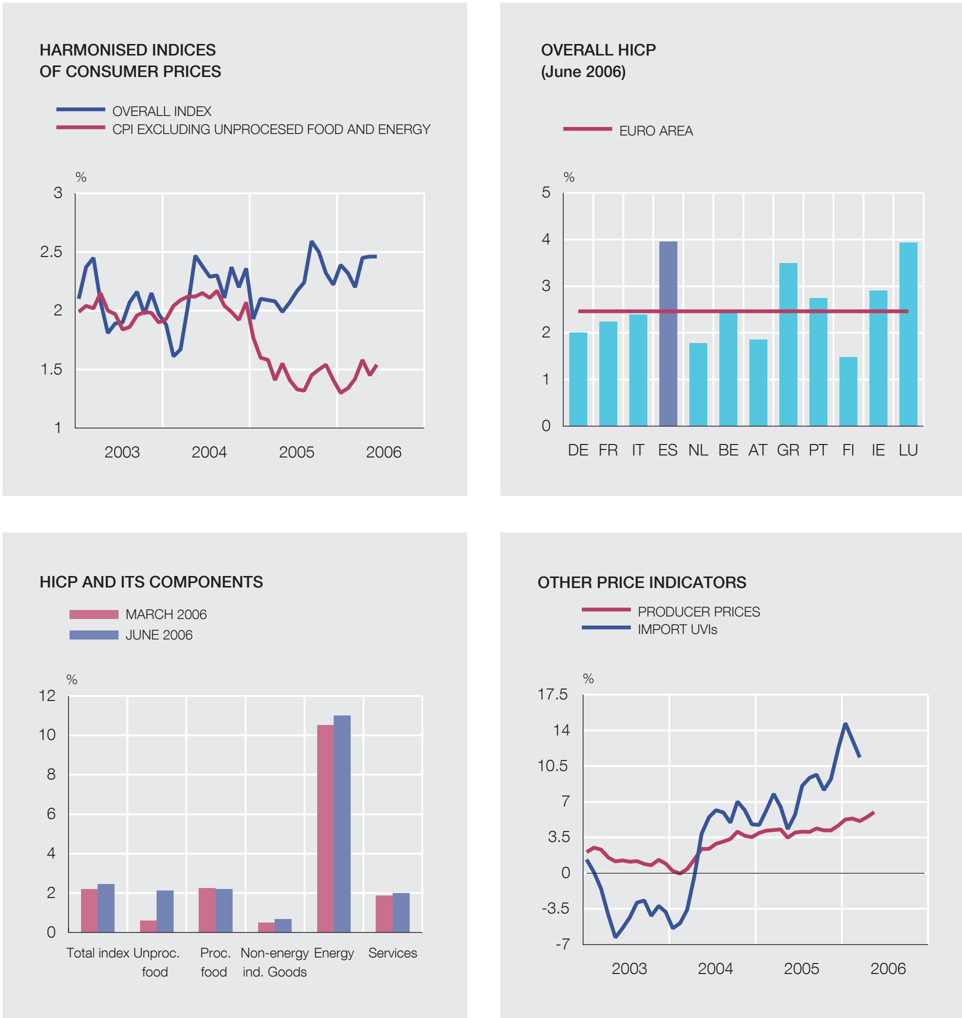
pick-up in inflation has resulted from the increase in all the related components, with the exception of processed food. The acceleration in energy and unprocessed food prices, which are the most volatile components of the overall index, has contributed 0.2 pp to the increase in the overall rate. The rate of change in the CPI excluding energy and unprocessed goods, which measures underlying inflation, rose by 0.1 pp in Q2, growing at a rate of 1.5% in June. All countries recorded increases in their year-on-year rates in the period between March and June, except for Portugal, where the rate fell. For its part, the year-on-year increase in producer prices stood at 6% in May, almost 1 pp higher than in March. All components increased to a greater or lesser extent, with the exception of capital goods.

Recently the first – albeit very tenuous – signs of a pass-through from past price increases in the energy component to final prices have been observed. The slight acceleration, since the start of the year, in the CPI excluding energy and unprocessed goods, in the producer prices of intermediate goods and, to a lesser extent, of consumer goods is along these lines. The assessment of inflationary trends in business confidence surveys is another example. Finally, in accordance with what has been published by other price surveys, the ECB's Survey of Professional Forecasters for 2006 Q2 contains a slight upward revision – by 0.1 pp – of short-term inflation expectations, although longer-term expectations remain anchored at below 2%. In any case, the various wage indicators continue to grow at rates close to 2%, indicating that second-round effects are not discernible as a result of the rise in oil prices, i.e. there are no signs that workers are taking this increase into account in their wage demands; were they to do so, it might ultimately feed back into final prices. However, it cannot be ruled out that the current strengthening of activity may, to some extent, provide for the spread of such effects.

The cumulative balance of payments current account deficit in the 12 months to April 2006 stood at EUR 32.4 million (around 0.4% of GDP), with a slighter lower surplus than a year earlier. This is principally the result of a decline in the trade surplus, although there was also a slight increase in the deficits in the income and transfers balances. Turning to the financial account, in the 12-month period to April 2006, net portfolio investment inflows of €189.6 billion were recorded (compared with €51.7 billion a year earlier), while net outflows in the form of direct investment reached €122.3 billion (double that observed in the 12 months to April 2005).

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

CHART 11



SOURCES: Eurostat and European Central Bank.

Consequently, the basic balance posted an accumulated positive balance of €34.9 billion, €10 billion higher than the related 12-month period ending in April 2005.

In the area of fiscal policy, it is not expected that the imbalances in public finances will be corrected in 2006. As such, according to European Commission forecasts, the deficit for the euro area as a whole will remain at 2.4% of GDP this year, the same as last year (see Table 2). The Commission's estimate of the cyclically adjusted primary balance confirms the lack of changes at the aggregate level in the fiscal policy stance, since the slight expected worsening of 0.1 pp – to 1% of GDP – can be explained by a modest fall in the use of temporary measures to reduce the deficit. Were these results to be confirmed, however, the unambitious budgetary objectives contained within the Stability Programmes would not even be met.

Of the five countries in the euro area with an excessive budget deficit, Greece and Portugal will, according to Commission forecasts, fulfil in 2006 their undertaking to improve their structural balance by at least 0.5% of GDP (i.e. the cyclically adjusted balance net of temporary measures). France would only correct its structural deficit by 0.4% of GDP, while Germany would only comply with the Commission's condition averaging the envisaged adjustment over the course of 2006 and 2007 taken together. Lastly, it is expected that

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2003	2004	2005	2006 (b)	2006 (c)
Belgium	0.0	-0.1	-0.1	0.0	-0.5
Germany	-4.0	-3.7	-3.3	-3.3	-3.1
Greece	-5.8	-6.8	-4.4	-2.6	-2.9
Spain	-0.1	-0.2	1.1	0.9	0.9
France	-4.2	-3.7	-2.9	-2.9	-3.0
Ireland	0.2	1.6	1.0	-0.6	0.1
Italy	-3.5	-3.5	-4.3	-3.5	-4.1
Luxembourg	0.2	-1.1	-1.9	-1.8	-1.8
Netherlands	-3.2	-2.1	-0.3	-1.5	-1.2
Austria	-1.7	-1.2	-1.6	-1.7	-2.0
Portugal	-3.0	-3.2	-6.0	-4.6	-5.0
Finland	2.4	2.1	2.4	1.6	2.6
MEMORANDUM ITEM: Euro area					
Primary balance	0.3	0.3	0.6	0.7	0.6
Total balance	-3.1	-2.8	-2.4	-2.3	-2.4
Public debt	69.3	69.8	70.8	70.8	70.5

SOURCES: European Commission and national stability programmes.

a. As a percentage of GDP. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. Stability programme targets.
c. European Commission forecasts (spring 2006).

Italy will violate the requirement by a wide margin. However, all these countries, with the exception of Germany, would post a higher-than-forecast deficit in their Stability Programmes. In Q2, the only institutional news in the application of the corrective arm of the Stability Pact concerned the opening of the excessive deficit procedure against Portugal. In June, the European Commission issued a communication in which it deemed the measures adopted by the authorities of that country – a long list of measures on both the income and expenditure sides – to be in line with the recommendations made by the Council in September 2005, and in particular deemed that these measures should enable, in principle, the excessive deficit to be corrected within the stipulated timeframe (by 2008 at the latest). Nevertheless, this would depend, inter alia, on all the corrective measures that have been announced becoming law very soon. In the light of the Commission's communication, the ECOFIN Council confirmed that, for the time being, it was not necessary to put subsequent steps of the procedure into action.

Of the other countries with an excessive deficit, the coalition government in Germany formed in November 2005 has continued to implement the measures initially agreed upon, though the occasional difficulties of the government partners in forging compromises has been evident. Although a reform of the healthcare system has been agreed upon and will take effect in 2007, there is the perception that not enough has been done to achieve the initial objectives, which include a change in the sources of financing and the introduction of greater competition among health service providers. The difficulties of controlling public expenditure in this sector are analysed, from a broader perspective for the area as a whole, in Box 2. In addition, Germany is looking into a reform of its corporate taxation, which should take effect in January 2008 and see the tax rate reduced from 39.7% to just under 30%. The resulting loss of revenue would be partially offset by a broadening of tax bases.

Health spending in the euro area as a whole stood at 9.7% of GDP in 2004, with the portion relating to the general government sector amounting to 74.9% of the total. There is cross-country divergence in these figures, meaning that total health spending as a percentage of GDP ranges from 10.9% in Germany to 7.1% in Ireland, and the proportion of the public-sector component varies from 90.5% in Luxembourg to 52.8% in Greece (see Chart 1). In addition to this disparity in the share of general government in financing the health system, the differences are even greater regarding the provision of services which, in some countries, is public (such that most workers in the sector are public-sector employees), while in others services are privately provided. In any event, the phenomenon - common to other OECD countries - of a strong expansion in public spending on health as a proportion of GDP between 1970 and 2004 (4% for the weighted average of the 11 countries in the area for which there are data throughout the period) warrants its growing significance in economic policy discussion (see Chart 2).

There are several determining factors behind the changes in public spending on health. Firstly, the increase in spending on this item is partly the result of social preferences; on one hand, universal coverage has become generalised in all countries and, on the other, the demand for health services appears to have been viewed in the past as a “luxury good”, increasing more than commensurately with the level of per capita income. However, the evidence is not conclusive in this respect since it is difficult to isolate the effect of the different course of GDP and health spending deflators. Secondly, although technological improvements have occasionally given rise to treatment whose unit cost is, in many cases, lower, the resulting rise in demand has been so great that it has prompted an increase in the total cost. In other cases, medical innovations have entailed a greater cost, although they have also led to an improvement in the quality of the services offered.

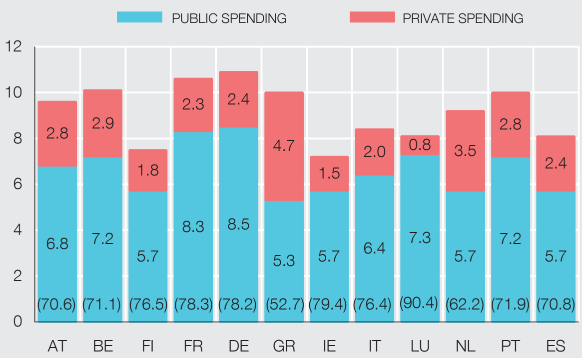
Other determinants of health spending are the result of the institutional structure underpinning the provision and financing of these services by general government. There is therefore scope for the authorities to intervene through reforms to the system that allow for more efficient (though not necessarily more desirable in terms of equality) allocation. Thus, for instance, there is evidence that total health spending tends to be greater in countries in which the public sector share is higher or in which primary care professionals are remunerated for each act of medical assistance instead of with a salary or on the basis of the total number of patients assigned.

Awareness of the inadequacy of incentives has led governments to introduce a series of reforms that have frequently not yielded the desired results. On occasions, attempts to control costs have been made using the administrative power of the authorities to set prices (especially in the case of drugs). However, suppliers have often been able to offset the effects of these measures by substituting other products beyond the reach of administrative controls. The introduction of patient co-payment mechanisms has proven more effective, these being more widespread in the pharmaceutical field than in the primary care and hospital medicine areas.

In several euro area countries, ceilings have been set for overall spending or for its growth rate, although they have rarely been effective because they merely act as a guideline or because they are not accompanied by mechanisms to ensure that non-compliance is corrected in successive years. The problem with these restrictions is that they often result in a reduction in services offered and do not succeed in altering their unit cost. Accordingly, other reforms have attempted to provide the same level of services at a lower cost. By way of example, measures have been taken in several countries so that a greater proportion of patients receive ambulatory treatment, in view of the lower cost compared with treatment in hospitals.

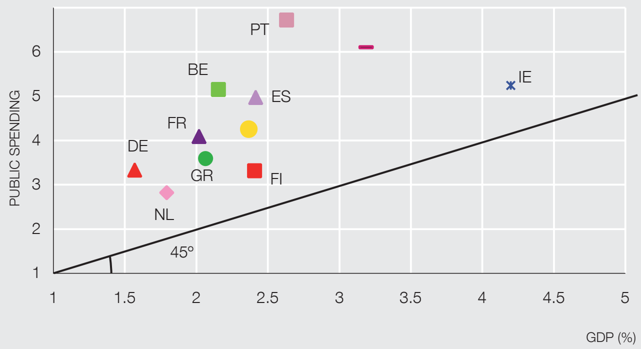
As regards potential future developments, one interesting aspect concerns the impact of demographic trends. In principle, the propensity of health spending to increase should conceivably be exacerbated by population ageing, insofar as older individuals tend to have poorer health. However, it is not clear whether longer life expectancy will be accompanied or not by an increase in the number of years of

1 HEALTH SPENDING AS A PERCENTAGE OF GDP, 2004 (a) (b)



SOURCE: OECD.

2 ANNUAL AVERAGE GROWTH PER CAPITA OF PUBLIC SPENDING ON HEALTH AND OF GDP IN REAL TERMS, 1970-2004 (a)



a. The data on the breakdown between public and private spending in Belgium and Germany are for 2003. The rest of the data are provisional.
b. The figure in brackets at the foot of each column depicts public spending on health as a percentage of total spending on this item.

life in a poor state of health. The February 2006 Economic Policy Committee report on the budgetary effects of population ageing between 2004 and 2050 considers a central scenario in which it is assumed that half of the total number of years by which life expectancy is expected to increase will be lived in poor health. Further, income elasticity is assumed to be 1.1 at the start of the projection horizon, converging linearly to 1 at the end of the horizon. Given these assumptions, the report concludes that public spending on health will increase by 1.5% of GDP over the period considered. Several combinations of changes in the initial assumptions give rise to a range for the total increase in public spending of between 0.9% and 2.2% of GDP. In particular, if the number of years lived in poor health were to hold constant, the growth of total spending would fall by 0.4 pp on the central scenario.

The sensitivity of the calculations to the assumptions used illustrates the difficulties of projecting health spending over the long term. In any event, the increase may, under certain scenarios, be substantial. And that highlights the need to exert greater control over this spending item and to improve the management thereof by introducing the necessary changes in public health systems so that an appropriate level of services can be provided at the least possible cost.

Lastly, the Government has sent Parliament the draft budget for 2007 for discussion in the autumn. The text seeks a reduction in the federal deficit to 0.9% of GDP, 0.7 pp lower than in the 2006 budget.

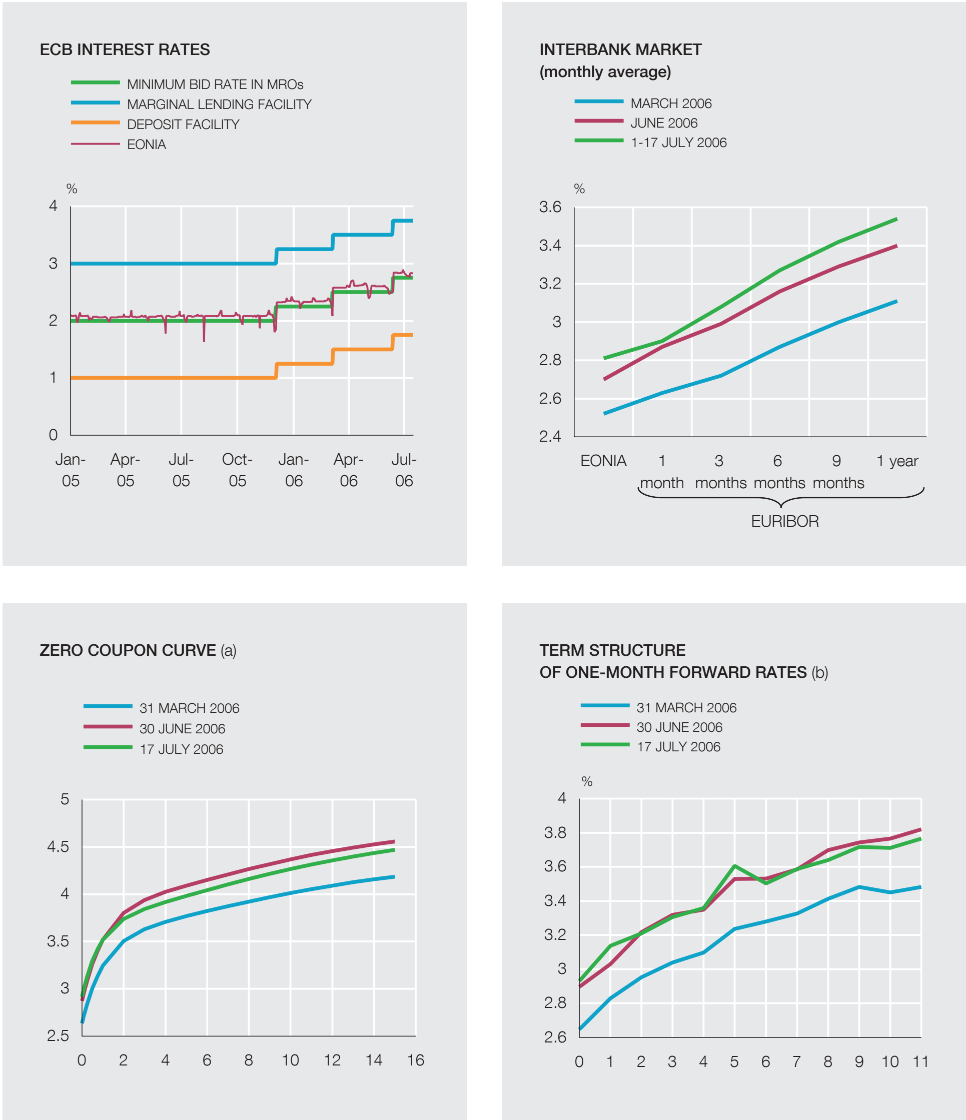
In early July the Italian Government set out its medium-term budgetary plans. The intended deficit for this year was revised upwards by half a percentage point to 4% of GDP. For 2007, the Government hopes to achieve a deficit of 2.8% of GDP, thereby falling within the margin laid down in the Council Recommendation. This challenge seems to be particularly ambitious given that it has been announced that next year's budget will contain a reduction in labour income tax and that the heterogeneity of the government coalition will make it difficult to reach a consensus on those expenses to be cut. Finally, in the case of France, the authorities have cut their deficit objective for the current year by one percentage point, to 2.8% of GDP, in the light of better-than-expected taxation revenue.

3.2 Monetary and financial developments

In April and May, the perception of continued upward risks to price stability over the medium term, against a background of a gradual strengthening of activity, led the Governing Council of the ECB to announce that it would continue to monitor economic developments very closely to ensure that risks to price stability over the medium term did not materialise. Consequently, at its meeting on 8 June, it raised minimum interest rates on its main refinancing operations by 25 basis points to 2.75%. Interest rates on the marginal lending facility and the deposit facility also increased by a quarter of a percentage point to 3.75% and 1.75% respectively (see Chart 12). Subsequently, at its meeting on 6 July, the Governing Council indicated that, in a context in which the monetary policy stance continued to be accommodative, a hypothetical confirmation of the continuation of output growth at rates similar to the potential growth rate and of the persistence of risks to price stability would justify the gradual withdrawal of the monetary stimulus in the near future.

This gradual change in monetary policy stance over Q2 was reflected by a gradual upward movement in the money market yield curve. The increases were somewhat greater in the longer-dated terms, which resulted in a moderate increase in the slope of the curve, reflecting some acceleration in the expected pace of interest rate rises over the coming months. In the debt markets, ten-year yields, which recovered strongly in early April, continued to do so subsequently, albeit at a slower pace (see Chart 13). In mid-July, ten-year yields stood at around 4.1%. In the United States, the related rates trended similarly to their European counterparts over the period in question. As a result, the differential vis-à-vis the euro area ten-year bond

EURO AREA INTEREST RATES CHART 12



SOURCES: European Central Bank and Banco de España.

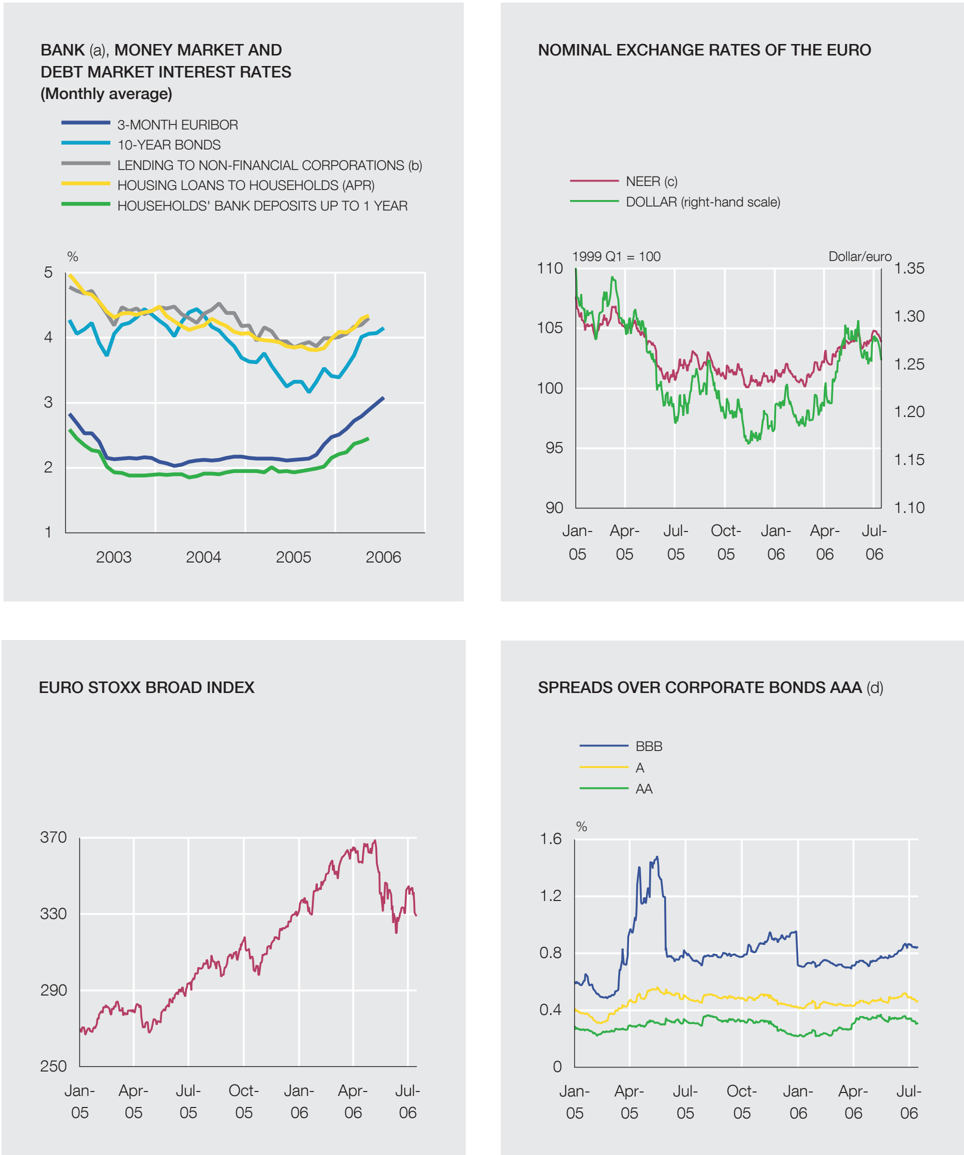
a. Estimated using swap market data.
b. Estimated using Euribor data.

continues to stand at around 1.1 pp. Finally, according to the data available to May, the interest rates applied by credit entities to both their liabilities-side and, in particular, asset-side transactions continued to rise. However, the increases were somewhat lower than those observed in financial market interest rates.

Throughout Q2, the euro tended to appreciate against the main currencies; as a result, the trend of the exchange rate contributed to subtracting laxity from the financial conditions in the area. The gains by the European currency, which may possibly be due in part to the heightening of expectations about further interest rate increases in the area, were sharper against the dollar than against other currencies and, in nominal effective terms, the size of the appreciation was almost 2%. On the euro area's stock markets, the main indices attained their highest levels since June 2001 in early May. However, a severe correction ensued thereafter - accompanied by an increase in volatility - on all world stock markets, the apparent trigger for which was an increase in the perceived risk for the global economic outlook. Following a temporary pick-up in share prices, there were heavy declines once again in mid-July and, as of the date

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX

CHART 13



SOURCES: Banco de España and European Central Bank.

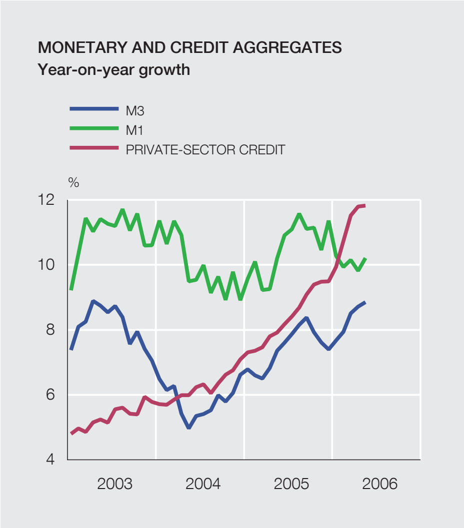
a. Data drawn from new statistics on interest rates compiled by the ECB for new operations.
b. Interest rates over five years.
c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

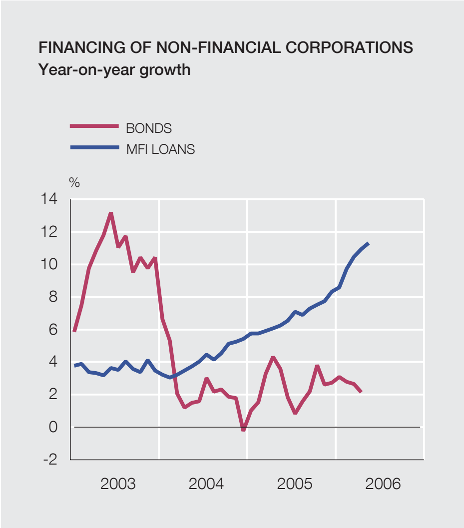
of this Bulletin going to press, the broad Euro-Stoxx index stood almost 10% below its peak in early May.

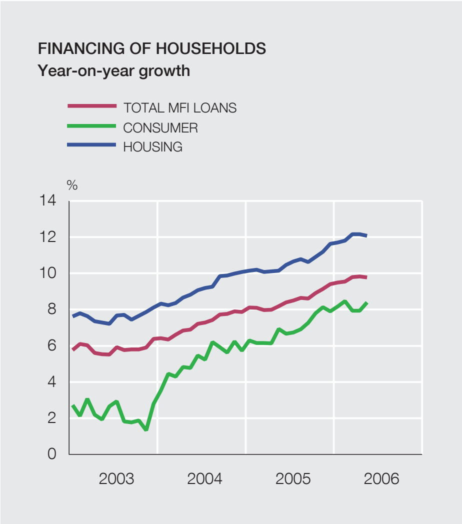
The acceleration in the M3 monetary aggregate which began at the onset of 2006 continued during Q2. In May the rate was at 8.9%, 1.5 pp up on that seen at the end of 2005 (see Chart 14). The reflection of this, on the side of the counterparts, was in the path of expansion of credit extended to the private sector, which grew at a rate of 11.8% in April and May, i.e. 2.4 pp more than in December. Loans from monetary financial institutions, which make up close to 90% of total credit to the private sector, expanded in May at 11.4%, the biggest rate of increase recorded since the start of EMU. That reflects the strengthening of economic activity, against a background in which the cost of lending, despite progressively rising, remains low in

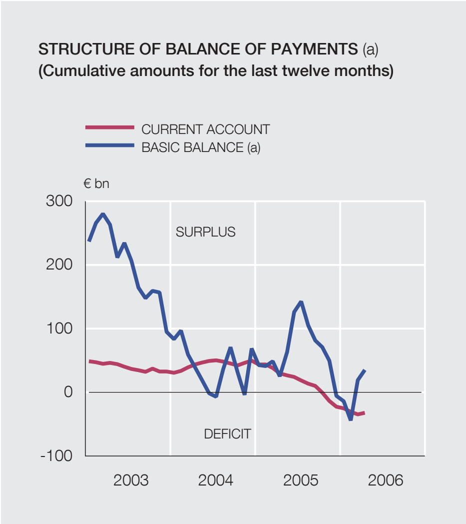
MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS

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.

historical terms. In respect of agents, loans to non-financial corporations were notably more dynamic, while those to households did not quicken, although they continued to show a high rate of expansion. Among the biggest countries in the area, total lending in France and Italy was more dynamic, while in Germany, by contrast, the growth rate of this variable remained very low.

On QNA estimates, GDP growth in 2006 Q1 held stable at a year-on-year growth rate of 3.5%. In quarter-on-quarter terms the increase was 0.8%, somewhat down on the figure in the two previous quarters. During this period national demand continued to slow, albeit very slightly, while net external demand continued to subtract 1.5pp from output growth. The information available for Q2 points to an increase in the year-on-year growth rate of GDP to 3.6%, consistent with a rise of 0.9% in quarter-on-quarter terms. Bearing on this result will have been a further easing of domestic demand, the slowdown in which continued on the basis of the lesser momentum in private consumption and in gross fixed capital consumption, and a less negative contribution by the external sector, which more than offset the smaller increase in domestic spending (see Chart 15). The improved external sector contribution came about, in turn, against a background of deceleration in both exports and imports of goods and services, compared with the high increases in Q1, although exports, underpinned by the pick-up in external markets (and European ones in particular), held at a higher rate of change than that recorded in 2005.

Activity across the various branches shows that there has been some change in the composition of growth. Accordingly, the forceful momentum of services appears to have stabilised and even eased off in Q2. By contrast, the recovery in value added in manufacturing, which began in the second half of 2005, has intensified. The main employment indicators for Q2 also reflect the continuing high rate of expansion. Against this background, it is estimated that apparent labour productivity once again moved at a very moderate rate (0.3%), which has not offset the upward trend of compensation, as a result of which the growth in unit labour costs has increased. This, together with the persistent rise in energy prices, has contributed to keeping inflation rates high, in a setting moreover in which unit operating surpluses have continued to expand. The 12-month growth rate of the CPI stood at 3.9% in June, after having exceeded 4% at the start of the year, while the rate of increase of the CPI excluding unprocessed food and energy moved on a rising path from mid-2005, stabilising at 3% in 2006 Q2.

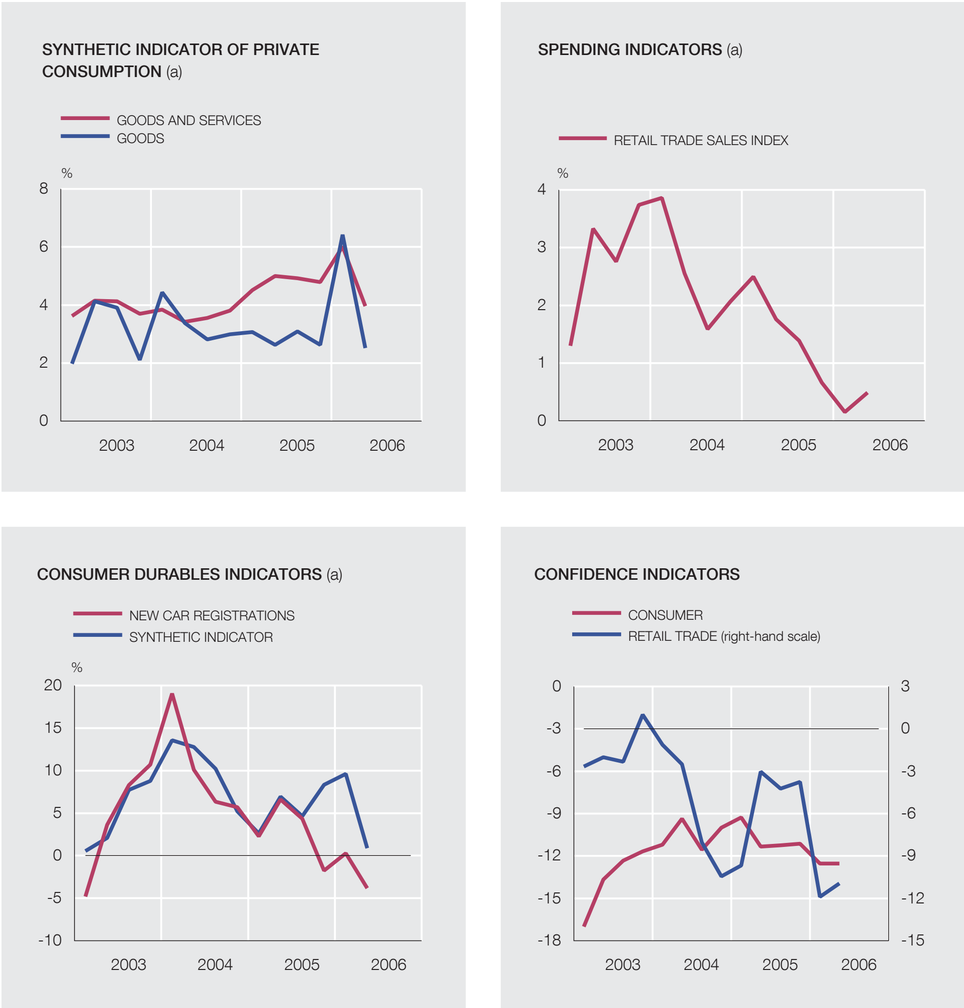
4.1 Demand

In 2006 Q1, private consumption grew at a rate of 3.9%, 0.1 pp down on 2005 Q4. It thus continued on the mildly slowing path on which it embarked in mid-2005. The indicators available for Q2 point to the moderation of private consumption growth, the intensity of which is difficult to gauge owing to the effect of the different dates for the Easter holiday week in 2005 and 2006 on several of these indicators (see Chart 16).

Car sales slowed strongly in Q2, after posting a rise in Q1. The same profile was apparent in the synthetic indicator of durable goods, which includes cars and other durables, and in that of goods, both durables and non-durables. Conversely, other indicators of spending on consumer goods, such as the index of apparent consumption of consumer goods and that of retail sales, improved in Q2 in step with the surveyed business opinions in the indicator published by the European Commission. The synthetic indicator of goods and services, which summarises much of this information, showed a slowdown, which was further amplified by the Easter holiday week effect; but this was more modest than the deceleration in the goods indicator, which is consistent with the information on sales by large corporations drawn from the State tax revenue agency, suggesting a more stable behaviour of consumer services. Finally, consumer confidence showed scarcely any changes in relation to Q1.

The tendency towards a lesser rate of increase of household consumption marking recent developments has several explanations. It is due, first, to the lower growth of disposable in-

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.

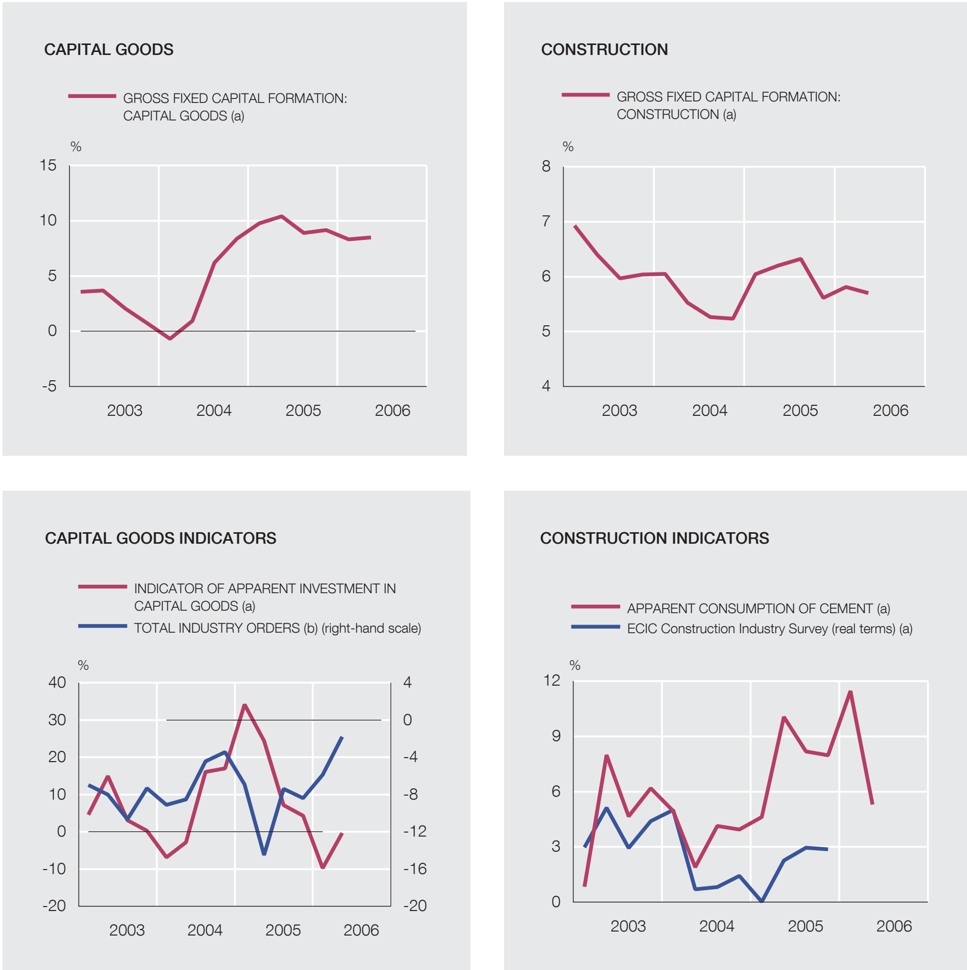
come, affected both by the erosion of purchasing power which lies behind the increase in the inflation rate and by the more negative contribution of net interest payments, owing to the rising course of interest rates. Employee compensation, by contrast, has contributed to a greater expansion in income, as a result of the rise in employment and bigger wage increases. Further, household wealth, although it continues to increase at a high rate, has tended to slow owing to the lower growth of house prices. Finally, the rise in interest rates is an additional factor containing current consumption, to the benefit of saving and future consumption.

In 2006 Q1, final general government consumption increased at a rate of 4.7% year-on-year, a similar figure to that of the previous quarter. The information available, drawn from State budget outturn figures, points to some deceleration in this spending component in Q2 that is related to the trend of spending on wages and salaries.

The rate of increase of gross fixed capital formation eased in 2006 Q1 to a rate of 6.2% compared with the same period a year earlier, 0.6 pp below the figure for 2005 Q4. This was the outcome of a slight slowdown in investment in capital goods, the growth of which stood at 8.3%, and, above all, of a smaller increase in investment in other products (a component

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.

linked to real estate promotion and intermediation and to software purchases), the year-on-year rate of which declined by 2.5 pp. Conversely, investment in construction quickened by 0.2 pp on the previous quarter, posting growth of 5.8% (see Chart 17). The information provided by the indicators for Q2 signals that gross fixed capital formation continued to expand at a rate close to, although somewhat below, that of Q1. This was the result of a slight slowdown in investment in construction, which nevertheless continued to display notable momentum, and of the resilience of spending on capital goods, which remains the most dynamic component of domestic demand.

The indicators of spending on capital goods offer a more positive outlook than in Q1. The indicator of apparent investment in capital goods, obtained with as-yet incomplete figures for Q2, points to something of a recovery following the sharp slowdown at the start of the year. The path of this indicator in the opening months of 2006 is a result of the most significant increase in the domestic output of capital goods (the cumulative growth of which to May was 8%), which replaced imports of this type of good as a basic source of incorporating new productive capital, compared with the experience in the two previous years. Survey-based indicators, such as business confidence in the capital goods industry and confidence in industry as a whole, improved appreciably in Q2, as did orders. The assessment of the level of capacity utilisation also increased in this period, while the number of firms that consider their plant capacity excessive fell.

Investment in construction quickened slightly in 2006 Q1 to an annual rate of 5.8% after slowing in the final quarter of 2005. This buoyancy was due to a 2.3 pp rise in investment in housing, while other construction segments – civil engineering works and non-residential building – slowed by 2 pp. On the latest conjunctural information, investment in construction remained highly dynamic in Q2, although it might have decelerated slightly. All the coincident indicators of activity showed signs of slowing in this period, although some of them, such as inputs (production of construction materials and consumption of cement), might be influenced by the Easter holiday week calendar in 2005 and 2006. Employment indicators, such as Social Security registrations and registered unemployment, also eased off in Q2. Finally, the opinions of employers in the sector included in the European Commission's confidence indicator worsened slightly, holding below the levels reached the previous year.

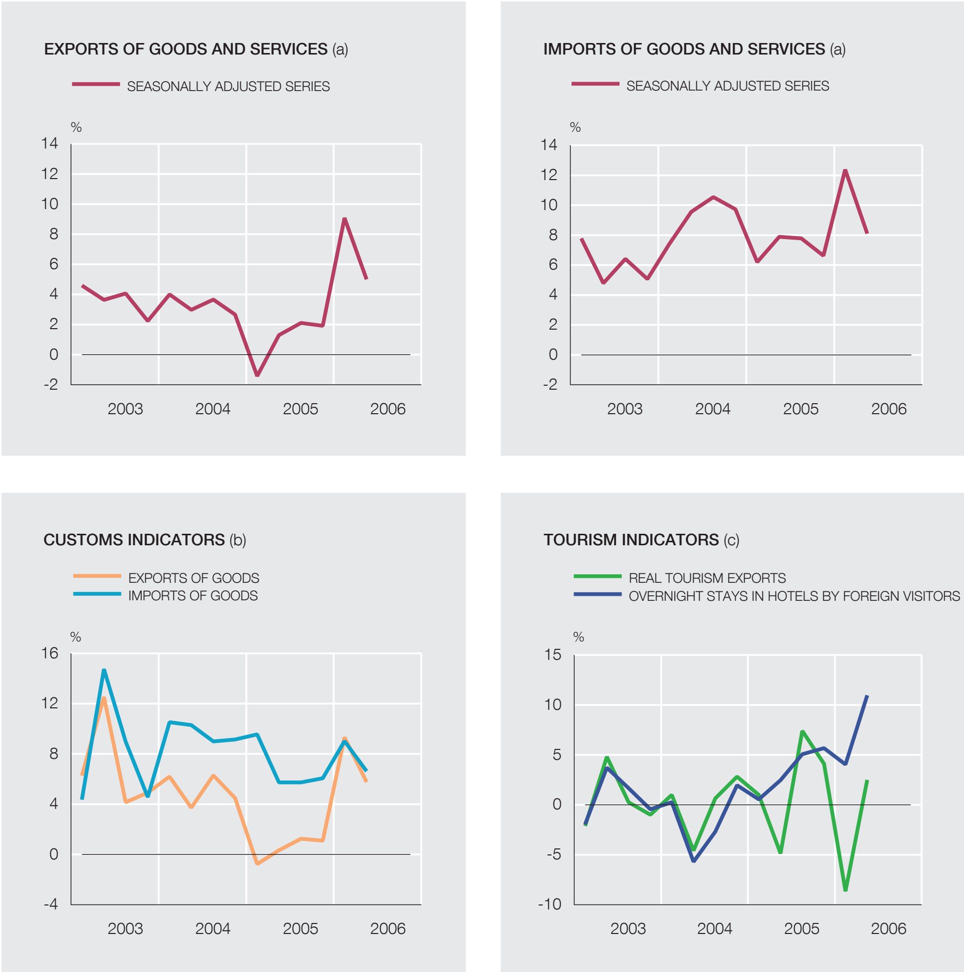
By type of work, the leading information provided by the Ministerio de Fomento's work approvals statistic, allocated in time according to a project execution schedule, points to a mildly slowing path of investment in housing during 2006, and to the maintenance of a high growth rate for housing starts. Non-residential building continues to pick up in the opening months of 2006, as denoted by the strong expansion in official procurement in this type of work in 2005 promoted by general government and by the State-owned companies in the Fomento group (EPEGF). The latest procurement data, while evidencing lower growth, remain along these lines, as do the approvals figures (both for new works and refurbishments), though they fell significantly in April, influenced perhaps by the effect of the Easter holiday week. Finally, concerning civil engineering works, the projection for official general government procurement – distributed according to an average execution schedule and deflated – is one of slight growth in 2006. Civil engineering works in the private sector have maintained their growth in the first half of 2006, since the slowdown in EPEGF projects has been offset by the greater procurement of the territorial general government entities under concession arrangements, which is also part of private-sector non-residential construction.

As regards the financial situation of corporations, data from the quarterly Central Balance Sheet Data Office survey (CBQ) for 2006 Q1 indicate a widespread acceleration in the activity of the corporations reporting to this survey, both by sector and by company size. This momentum of corporate activity has been accompanied by a slight increase in the return on investment and the maintenance of the cost of borrowing, making new investment more attractive. The indicators of financial pressure, calculated with CBQ data, are holding at favourable levels, despite having worsened slightly. It should be qualified, however, that these results are essentially representative of the situation at large corporations (included in the CBQ) and that the financial position of smaller companies may be subject to greater pressures stemming from the rise in the cost of borrowing. The borrowing requirements of non-financial corporations as a whole, which increased notably in 2006 Q1, point in this direction.

On QNA estimates, net external demand subtracted 1.5 pp from GDP growth in 2006 Q1, a similar figure to that for 2005 Q4. In the former quarter there was sizeable growth in foreign trade flows which gave rise to a marked acceleration in goods and services exports, which grew by 9.1% in real terms, accompanied by a strong rise in the growth of imports, which stood at 12.4%. The as-yet incomplete information for Q2 indicates that the contribution of net external demand in this period was less contractionary, against a background of lower growth in both exports and imports.

FOREIGN TRADE CHART 18

Percentage change on year ago



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

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

The rate of increase of goods exports rose exceptionally in 2006 Q1, posting year-on-year growth of 12.7% in real terms, which partly reflects the comparison with the low levels observed in the same period the previous year (see Chart 18). The latest Customs figures for foreign trade for April and May (with a 2.4% increase in annual terms) are distorted by the slackness of exports in April, owing to the Easter holiday week. If an adjustment is made for this effect, the growth rate of goods exports in Q2 stands below the very high rates in the opening months of the year, although it is significantly above the rates observed in 2005 and shows a return by sales abroad to growth rates more in keeping with the increase in worldwide trade. By geographical area, exports to countries other than those in the euro area, in particular to Latin America, continued to prove more dynamic during Q2. Inside the euro area, the market where Spanish sales grew at the highest rate was Italy.

On QNA figures, real exports of tourist services in 2006 Q1 once again fell significantly, posting a year-on-year rate of -8.7%. The main real indicators of tourism also weakened at the start of the year, although they gathered momentum as from March. The information available for Q2 indicates that overnight stays in hotels by foreign visitors grew by 13.1% in this period, while numbers of tourists rose by 9.5%, clearly higher than the growth of world tourism, although the upward effect of the Easter holiday week has a bearing on these figures. However, average spending per tourist continued to fall in April and May as a result of both a decline in average daily spending by tourists, and of the shortening of average stays, meaning that total spending by tourists increased by only 5.2% in nominal terms according to EGATUR figures. This downtrend in average spending per tourist would be connected with their new behavioural habits; they tend to shorten their stays and opt, more frequently, for lodging off the habitual tourist circuit or stay in their own property. Regarding Spain's main markets of origin for tourists, the British market grew very moderately while French tourism remains buoyant and German tourism has tended to pick up.

Real exports of non-tourist services grew by 13.4% in 2006 Q1, on QNA figures, prolonging the uptrend of the previous quarters and in line with the expansionary course shown by the nominal Balance of Payments indicator. In this period both foreign sales of transport services and exports of business services, which are the main items, trended very favourably, while there were substantial increases in construction, financial and IT services.

In 2006 Q1, the year-on-year growth rate of real goods imports increased to 11.6%, up from 5.3% the previous quarter. According to Customs data, this rise in imports during Q1 was most clearly manifest in purchases of intermediate goods and of consumer goods, influenced by the atypical entry of a large quantity of textile imports in January. As in the case of goods exports, purchases abroad in the April-May period slowed considerably, with a real year-on-year rate of 1.8%, having been highly influenced by the slackness of foreign trade in April. As earlier discussed for exports, if the April effect is adjusted for, imports display a lower growth rate in Q2 than in Q1, but one in line with that recorded in the second half of 2005. By type of product, energy purchases abroad in April and May behaved very expansively, increasing by almost 10%, as did imports of consumer durables. By contrast, purchases of capital goods, which had been one of the components with the highest rates of expansion in 2005 and 2006 Q1, fell by 6% in real terms.

Finally, QNA data indicate that real imports of services continued to quicken in 2006 Q1, placing the year-on-year rate of increase at 15.8%. This was due to the marked dynamism of real imports of non-tourist services (16.1%), driven by transport services and business services. Real imports of tourist services, by contrast, slowed in Q1, placing the related year-on-year growth rate at 14.6%, after having sustained growth of over 20% throughout the previous year.

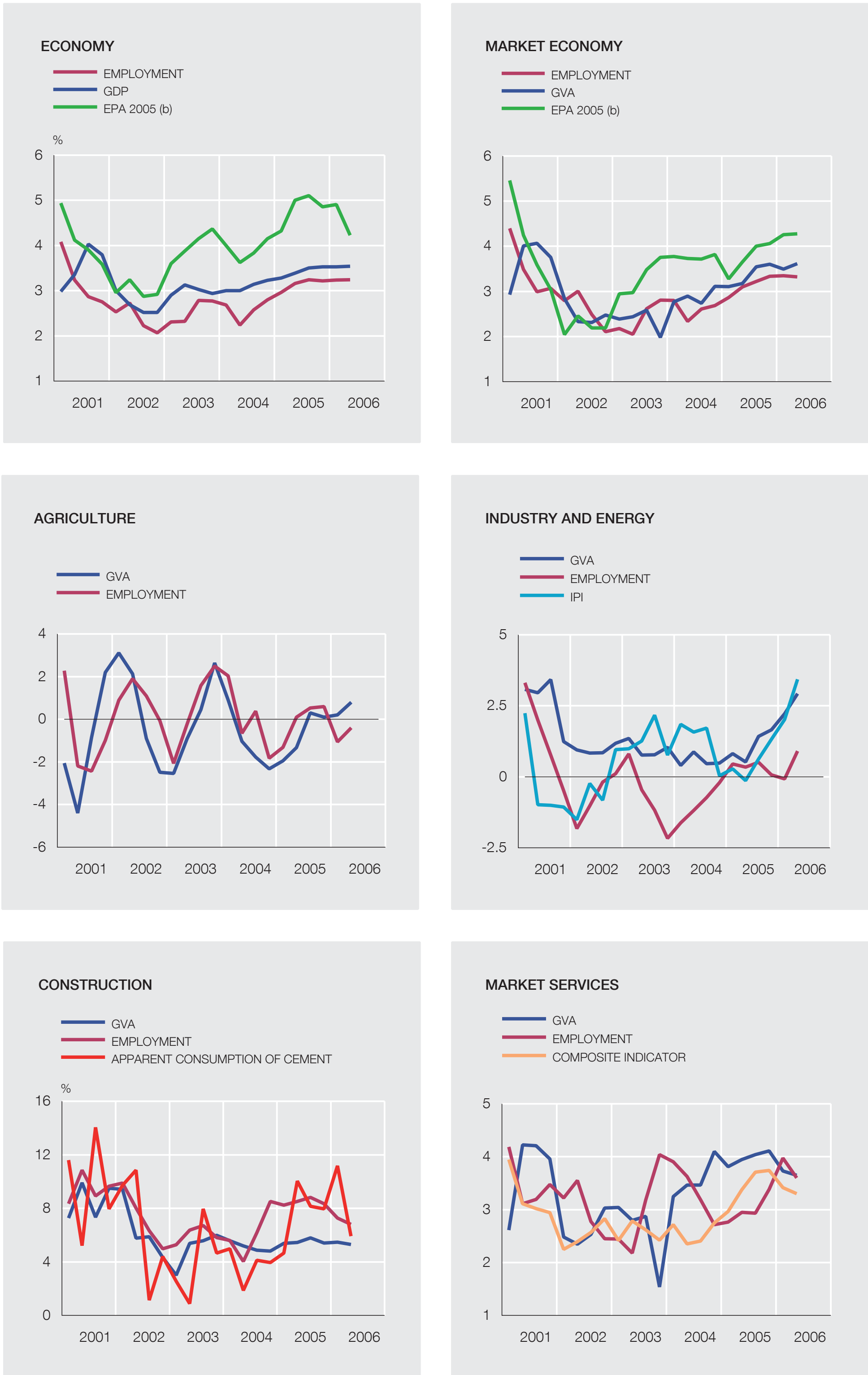
4.2 Output and employment

Value added in the market economy began 2006 showing considerable dynamism, although its year-on-year rate (3.5%) was slightly down on 2005 Q4. This moderate loss in momentum was due to the slowdown in the market services branch, which held sway over the increases posted in the other branches of activity of the market economy and, in particular, over the notable improvement in the rate of expansion of industry (see Chart 19).

Less unfavourable weather than in 2005 allowed for something of an increase (albeit an extremely moderate one) in activity in the agricultural and fisheries branches. On QNA figures, the year-on-year growth of value added in Q1 was 0.2%, 0.1 pp up on the preceding quarter. Nonetheless, activity in these branches will foreseeably be more dynamic in the coming quarters, in view of the better yields estimated for certain crops, including most notably – due to their higher magnitude – cereals, pulses and fruit.

The recovery in the industrial and energy branches since mid-2005 continued into 2006 Q1. In this latter period the year-on-year rate rose to 2.2%, on QNA figures, entailing an

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, except on gross series in the EPA. Employment in terms of full-time equivalent jobs. EPA in persons. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b. Series linked by the DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

acceleration in activity of 0.5 pp. The increase in the growth rate of value added in this quarter was concentrated in industry, since the energy branch underwent a slowdown of 1.1 pp to 3.9%. Conversely, the year-on-year rate of activity in the industrial branches increased by 0.9 pp to 2%, a figure not seen since 2001. The focal point of this greater buoyancy was the production of non-food consumer goods and, above all, the manufacture of capital goods. On the conjunctural information available for Q2, this ongoing expansion in industrial activity is proving even sharper than in the previous quarters. The industrial production index increased by around 3.5% over the course of April and May (in calendar-adjusted terms), compared with the growth of 1.9% seen in 2006 Q1, reflecting an increase in all the industrial sectors. The employment indicators, specifically the number of Social Security registrations, improved in Q2, albeit more moderately. The survey-based indicators, such as the PMI and the European Commission's confidence indicator, also trended favourably in Q2.

According to QNA figures, value added in the construction branch commenced 2006 with a slight acceleration of the order of 0.1 pp, taking its year-on-year rate of increase to 5.5% in Q1. As discussed in the previous section, the strength of this sector was essentially underpinned by residential building, since the growth rates of other building and civil engineering works eased during this quarter. Information drawn from the leading indicators and the high inertia characterising this branch of activity, as a result of the long lead times of the works involved, ensure that its rate of expansion will remain relatively high in Q2 and over the rest of the year. However, as also mentioned, the coincident indicators point to some loss of momentum in construction activity during Q2.

Services activity slowed in 2006 Q1, placing the related year-on-year rate at 3.7%, 0.3 pp less than in the final quarter of 2005, which was a year marked by a continuous, though moderate, acceleration in this sector. This loss of momentum was centred on market services, which decelerated by 0.4 pp to a year-on-year rate of 3.7%, while the remaining services displayed a growth rate similar to that of the previous quarter. This slowdown in value added might have continued in 2006 Q2, albeit in a much more diluted fashion, according to the conjunctural indicators of real activity. Both the composite market services indicator (ISIS) and turnover in real terms, drawing on the indicators of activity in the services sector (IASS) compiled by INE, and the Tax Revenue Service's figures on large corporations' sales (adjusted for the effect of price growth) have seen their growth decline in the months in Q2 for which data are available. However, the improvement in the survey-based indicators (the PMI and the European Commission's confidence index for the sector) and the substantial dynamism of Social Security registrations in this branch indicate a sustained rate of activity in this period. Among the tertiary branches, there was some momentum in the hotel and catering trade, as indicated by the number of overnight stays in hotels by tourists, the number of Social Security registrations and the IASS turnover figure. Transport, for its part, was also more dynamic than in Q1, as were inter-company services. The wholesale and retail trade branch, by contrast, continued to be the activity showing the most unfavourable situation.

On QNA estimates, job creation remained as stable in 2006 Q1 as in recent quarters, with its year-on-year rate of increase holding at 3.2% for the fourth quarter running. This performance, along with that of GDP in 2005 Q4 and 2006 Q1, made for a low economy-wide increase in apparent labour productivity of 0.4%, 0.1 pp up on the figure posted in the two previous quarters. Job creation in the market economy held on the mildly accelerating path of the past two years. Against this background, the slowdown in value added in Q1 gave rise to a meagre 0.1% rise in productivity. The conjunctural indicators point to a prolongation of growth in employment in Q2, at a similar rate to that of its recent path.

The year-on-year growth of Social Security registrations, having stripped out the immigrant regularisation effect, stood at 2.8% in Q2, 0.1 pp up on the previous quarter's figure. The registered unemployment figures once again showed declines in the number of unemployed, placing the annual change at -0.6% in 2006 Q2, set against the stability of this variable in Q1. Finally, information from the EPA for Q2 shows year-on-year growth of 4.2% in employment, which also remains very buoyant, although the figure marks a slowdown on the preceding quarter (4.9%), due in part to the base effect derived from the strong rise in employment recorded in the same quarter in 2005.

Across the different branches of activity, and on QNA estimates for 2006 Q1, employment in the services branch and, more specifically, in market-sector activities was notably dynamic, holding stable in other services. The year-on-year increase in employment in market services rose substantially to 4%, 0.6 pp up on the previous quarter, while in other services the rise in employment was 2.7%, similar to that of the preceding three-month period. Conversely, employment in construction slowed to a year-on-year growth rate of 7.3%, although this continues to be by far the most dynamic branch in terms of job creation. In agriculture and industry there was a return to job destruction, with year-on-year rates of change of -1.1% and -0.1%, respectively, thereby interrupting the pick-up in employment initiated the previous quarter in both branches. The EPA data for Q2 show a similar behaviour for employment across the sectors. Specifically, employment in agriculture during this quarter fell to a similar rate to that in Q1 (- 3%). Nonetheless, a marginal recovery in employment in the industrial branches is perceptible and the year-on-year growth rate rose to 0.7%. According to the EPA, the dynamism of employment in construction increased once again, taking the year-on-year growth rate to 7.8%, while in the services branches employment slowed to growth of 5% (6.3% the previous quarter). However, this diminished buoyancy was centred on the non-market services branches, where employment grew by 4.1%, compared with 6.8% the previous quarter. Overall, the growth rate of employment in the market economy stabilised at 4.3%.

On QNA estimates, the stability of job creation in Q1 chiefly reflects changes in the group of dependent employees, which grew by 3.6% year-on-year, 0.1 pp less than in the previous quarter, while the self-employment component recovered slightly, growing by 1%. In general, most economic indicators coincide in reflecting greater robustness in dependent employment than in self-employment. However, the EPA data for Q2 show a slowdown in dependent employment, which posted a year-on-year growth rate of 4.3% after growth of around 6% in the previous three quarters. As a result, dependent employees as a proportion of total numbers employed in the economy declined by 0.1 pp on the preceding quarter (to 81.8%). In the registrations statistic, job creation in the self-employment segment continues to increase at a lesser pace than in the case of dependent employees, once the immigrant regularisation effect is stripped out.

EPA data on contract duration in 2006 Q2 indicates that temporary employment, though its year-on-year rate of increase slowed to 7.9%, was once again more dynamic than permanent employment, which slowed by 1.2 pp to 2.6%. That made for a fresh year-on-year increase in the ratio of temporary to total employees, to 34.4%, 1.1 pp above the level a year earlier. The strong dynamism seen in hiring at the start of the year, far higher than that in dependent employment, gave rise to some increase in labour turnover, following the relative stability marking 2005. Nonetheless, information drawn from the INEM statistics on contracts shows, in the first half of the year, a more dynamic performance in the case of permanent hiring, which has raised the weight of this type of contract in proportion to the total to 10.7%, almost 2 pp up on a year ago.

On EPA data for 2006 Q2, part-time hiring once again underwent a year-on-year decline (of 0.6%), as in the previous quarter, after having posted most sizeable growth during 2005. The year-on-year rate of increase in the number of full-time employees remained strongly dynamic, standing at 4.9%. As a result, the proportion of part-time employees fell to 12.2%, 0.6 pp less than in 2005 Q2.

The labour force increased by 3.3% in 2006 Q2, 0.3 pp below the growth recorded the previous quarter, but in line with the average growth over the past two years. The dynamism of the labour force is due to a notable increase in the participation rate to 58.3%, 0.9 pp above its level in the same period a year earlier, and to growth in the working population aged over 16 similar to that in previous quarters (1.6%). By sex, the increase in the labour force was sharper among women (4.6%), which gave rise to an annual increase of 1.4 pp in the female participation rate, which stood at 47.9%. Among men, the labour force increased by 2.4%, raising the related participation rate by 0.4 pp on the same period a year earlier to 69.1%.

Finally, the EPA data indicate that the number of unemployed fell once again in 2006 Q2, albeit at a lower year-on-year rate (5.5%) than in the preceding quarters. Compared with the previous quarter the number of unemployed fell by 98,800, and the unemployment rate dipped to 8.5%, against 9.1% in Q1 and 9.3% in the same quarter in 2005. The information drawn from the registered unemployment figures once again shows a decline in the number of unemployed in Q2.

4.3 Costs and prices

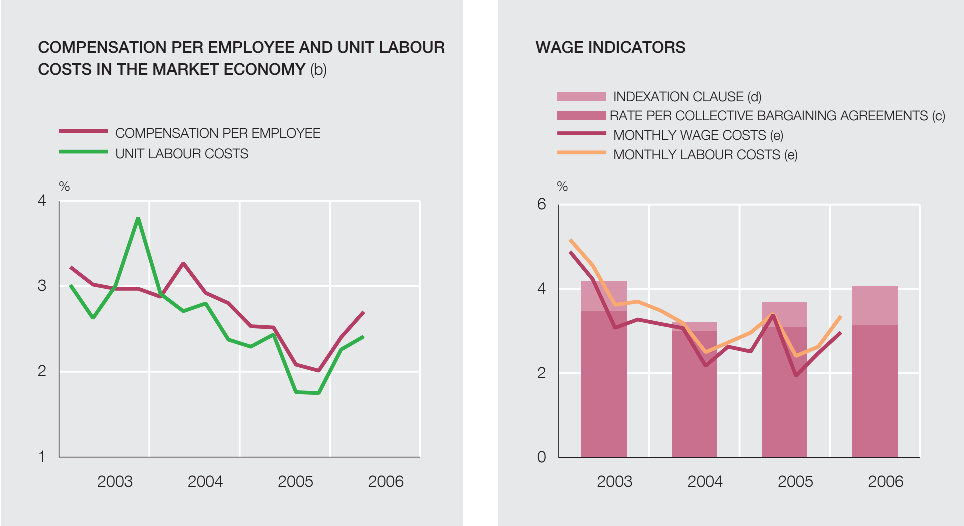
In 2006 Q1, the annual growth rate of compensation per employee rose by 0.2 pp to 2.6% on QNA figures (see Chart 20). In the market economy, the acceleration was higher, and the year-on-year rate stood at 2.4%, compared with 2% at end-2005. Across the branches of activity there was a generalised increase in the growth of average compensation, with the exception of industry, whose year-on-year rate of increase held at the figure of 2.4% posted at the end of the previous year. The smallest rise was in construction, with the biggest acceleration in agriculture and services. The ETCL (quarterly labour costs survey) also showed a higher increase in monthly labour costs per employee, growing by 3.4% year-on-year, 0.8 pp higher than the rate for 2005 Q4. The wage component quickened more moderately (by 0.5 pp) to 3%, with the rate of change of non-wage costs undergoing the strongest increase between December and March.

The information on agreed wage settlements in collective bargaining agreements in the first six months of 2006 shows a wage increase of 3.15%, somewhat higher than that agreed the previous year, before considering the effect of the indexation clauses. In the case of revised agreements, the increase was 3.16%, affecting 6.3 million workers, and in newly signed agreements a rise of 3.01% was agreed, below that of the previous year, though the number of workers covered is still low. The outcome of collective bargaining is at the upper limit of the wage recommendations implicit in the Interconfederal Agreement for Collective Bargaining, which was extended in late January by the social agents. In the current year workers will also have to receive back-pay relating to 2005 owing to the application of the indexation clauses, the impact of which on the growth of employee compensation in 2006 is estimated at 0.94 pp, up on the figure of 0.59 pp the previous year. These clauses are present in 82% of the agreements signed between January and June 2006.

The bigger increase in compensation per employee in 2006 Q1, along with the smaller increase in value added per employee, meant that the year-on-year growth rate of labour costs per unit of value added increased to 2.3% for the economy as a whole. The growth of the value added deflator, by contrast, dipped by 0.2 pp to 3.7% year-on-year, reflecting a less

WAGES AND LABOUR COSTS (a)

CHART 20



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

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

expansionary performance by the surplus per unit of value added, which continued to increase, albeit at a lower rate than in 2005 Q4. The pattern in the market economy was similar, with higher labour costs and a somewhat sharper slowdown in prices.

The lower rate of increase of the value added deflator in Q1 was the result of a slowdown in the deflator in all branches, with the exception of agriculture (see Chart 21). The reduction in the growth of prices was especially sharp in construction, though it remained the activity with the highest growth. The acceleration in unit labour costs was due to the strong rise in market services, with the rate of increase falling in the remaining branches. Given these differences, surpluses continued to widen in all branches of activity, though at different rates. The indicators available for Q2 show a continuation of these patterns of behaviour, with the growth of the deflators outpacing that of unit labour costs, despite the increase foreseen in compensation per employee.

The year-on-year rate of the final demand deflator rose by 0.2 pp to 4.5% in 2006 Q1, driven by the notable increase in the imports deflator, whose rate climbed to 5%, against 4.3% the previous quarter. The higher growth rate of imported energy prices largely explains this acceleration in the imports deflator. Although the exchange rate of the euro against the dollar held virtually stable in the opening months of the year, oil prices rose again in this period, after easing in 2005 Q4. The GDP deflator was somewhat less expansionary, since it slowed by 0.1 pp to a year-on-year rate of 4.3%. On the expenditure side, both the private consumption deflator, whose growth rate increased by 0.3 pp year-on-year to 4.1%, and the gross fixed capital formation deflator, which rose by only 0.1 pp, saw their rate of increase rise. Conversely, the growth of the exports deflator continued to decline in 2006 Q1, standing at 4.3%.

In the first quarter of the year consumer prices quickened in a similar fashion to the private consumption deflator, reaching a year-on-year growth rate of 4.1%, a figure not recorded since late 2002. In the April-June period, by contrast, consumer prices slowed by 0.1 pp, while the rate of the CPI excluding unprocessed food and energy held at 3% (see Chart 22). In Q2, the most inflationary component was once again energy, which increased at a rate of 12.9% com-

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.

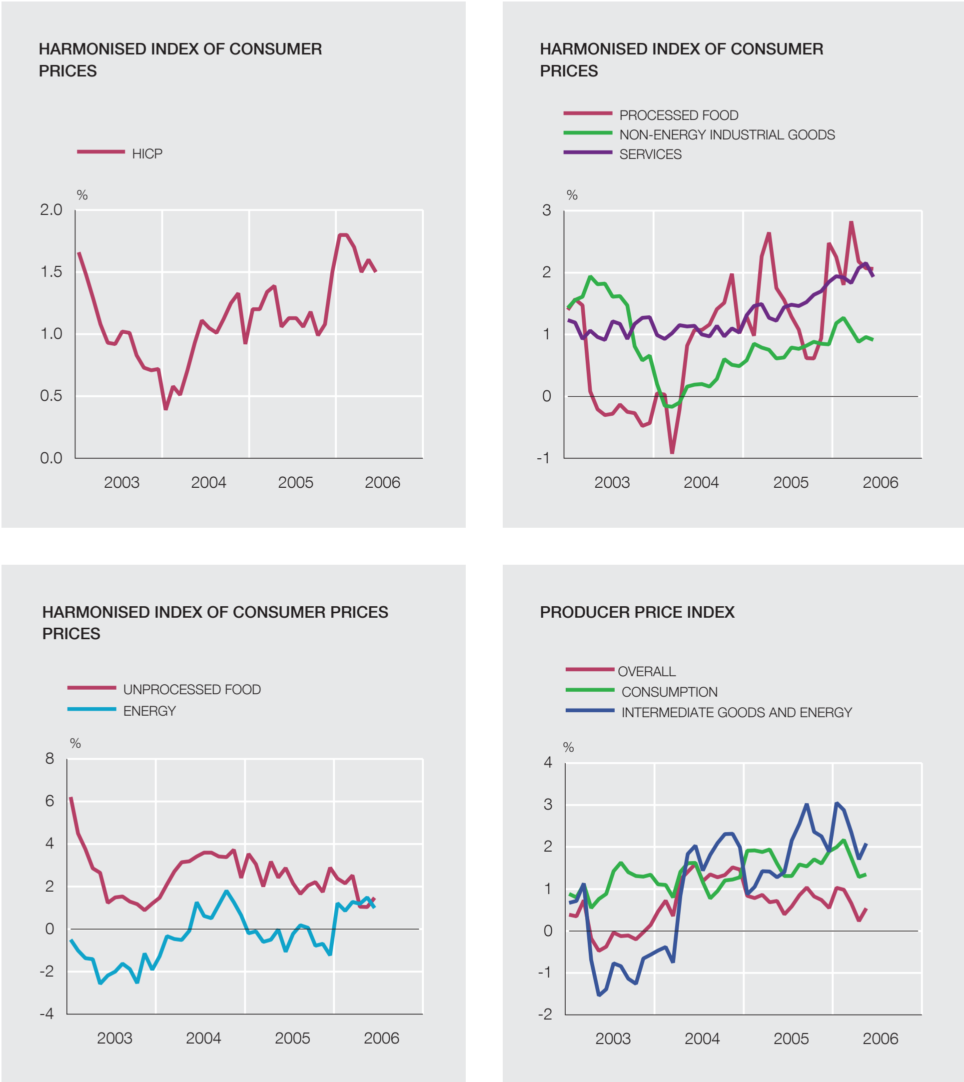
pared with the same period a year earlier, 0.4 pp below the Q1 figure. The rise in oil throughout this period and the increase in the price of butane gas in April were the main factors behind the maintenance of such a high rate. Non-energy industrial goods prices increased by 1.4% in Q2, a similar figure to that posted in Q1.

Among the components of the measure of underlying inflation (CPI excluding unprocessed food and energy), the average growth of processed food prices was 3.9% in Q2, unchanged on the previous quarter. The price of olive and other oils began to fall in Q2, following the successive increases recorded since September 2005; conversely, however, the prices of alcoholic beverages quickened. Unprocessed food prices slowed substantially in Q2, posting average year-on-year growth of 2.8%, compared with 4.3% in Q1. In the April-June period, the rate of change of both poultry prices, and those of fruit and vegetables, fell considerably, turning negative. Meanwhile, the year-on-year growth rate of beef, fish and potato prices increased. Finally, services prices accelerated by 0.2 pp in Q2 to an average annual rate of 4%. The most notable development was the rise in the growth rate of tourism-related items in April, owing to the Easter holiday week falling in a different month than in 2005. The behaviour of the remaining components of the services aggregate was similar to that in Q1.

Inflation in Spain, measured by the HICP, fell by 0.1 pp in Q2 to a rate of 4%. Conversely, inflation in the euro area as a whole increased by 0.2 pp to 2.5% in this same quarter. Conse-

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.

quently, the differential narrowed to 1.5 pp after peaking at 1.8 pp in the previous quarter (see Chart 23). Nonetheless, the services differential widened slightly owing to the acceleration caused by the Easter holiday week effect, which was more acute in Spain than in the euro area. By contrast, the differential for the unprocessed food component diminished substantially, owing to the decline in rates recorded in Spain. In the case of processed food and non-energy industrial goods, the narrowing of the differential took place as a result of the greater dynamism of the prices of these goods in the euro area. Finally, energy prices have slowed similarly in both Spain and the euro area, with the differential having widened slightly.

The growth rate of the producer price index has been on a rising trend for somewhat more than two years. On the information available, the 12-month growth rate of the index was 6.1% in 2006 Q1, rising to 6.2% in Q2 on average, albeit with oscillations. Energy production prices remain the most inflationary component, although their growth rate has fallen in relation to Q1 to a year-on-year rate of 14.6% in June. Among the remaining producer price index components, the manufacturing prices of intermediate goods quickened, rising to a year-on-year rate

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2005	Percentage change 2005/2004	Outturn projection 2006	Percentage change 2006/2005	Outturn JAN-MAR percentage change 2006/2005	Outturn 2005 JAN-JUN	Outturn 2006 JAN-JUN	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	128,777	12.2	128,591	-0.1	7.2	55,775	61,315	9.9
Direct taxes	70,665	20.4	72,036	1.9	10.0	23,592	27,130	15.0
Personal income tax	35,953	18.2	37,992	5.7	9.5	16,572	18,593	12.2
Corporate income tax	32,496	24.9	31,681	-2.5	4.9	6,011	7,293	21.3
Other (a)	2,215	-1.3	2,363	6.7	30.2	1,009	1,244	23.3
Indirect taxes	44,618	7.9	45,302	1.5	8.8	25,418	28,542	12.3
VAT	32,009	10.0	31,438	-1.8	10.4	19,320	22,334	15.6
Excise duties	9,795	0.5	10,903	11.3	-0.1	4,733	4,710	-0.5
Other (b)	2,813	12.9	2,961	5.3	9.4	1,366	1,498	9.7
Other net revenue	13,494	-8.7	11,253	-16.6	-13.2	6,764	5,643	-16.6
2 EXPENDITURE	122,755	7.0	133,951	9.1	-3.0	59,278	60,162	1.5
Wages and salaries	20,677	6.1	22,124	7.0	10.1	10,217	10,999	7.7
Goods and services	3,388	-3.5	3,069	-9.4	5.9	1,582	1,640	3.7
Interest payments	17,831	6.4	17,443	-2.2	-23.4	9,257	7,484	-19.2
Current transfers	64,541	5.8	70,968	10.0	5.2	31,345	33,207	5.9
Contingency fund	…	…	2,873	…	…	…	…	…
Investment	8,978	26.4	9,338	4.0	-12.2	3,709	3,889	4.8
Capital transfers	7,341	6.8	8,134	10.8	-9.8	3,169	2,944	-7.1
3 CASH-BASIS BALANCE (3 = 1 – 2)	6,022	…	-5,360	…	…	-3,503	1,153	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	126,811	11.9	127,817	0.8	10.2	54,972	62,500	13.7
Uses	123,550	0.7	131,775	6.7	5.9	56,166	59,942	6.7
NET LENDING (+) OR BORROWING (–)								
	3,261	…	-3,958	…	…	-1,194	2,558	…
(as a percentage of GDP)	0.4	…	-0.4	…	…	-0.1	0.3	…

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.

of 6.7% in the last month. Producer prices for capital goods and consumer goods are holding at rates of slightly over 2% and 3%, respectively. The rate of change of prices received by farmers fell, posting negative rates in March and April, owing to the marked decline in fruit, vegetable and poultry prices. Lastly, the year-on-year rate of increase in hotel prices stood at 2.3% in June, closing the quarter with an increase of 2.7%.

4.4 The State budget

The figures released on the State budget outturn to June 2006, following National Accounts methodology, show a surplus of €2,558 million (0.3% of GDP). This is in contrast to the deficit of €1,194 million (0.1% of GDP) recorded in the same period of the previous year. The budget performance was due to the resilience of taxes, which boosted growth in resources to 13.7%, while uses increased by only 6.7% in the period considered (see Table 3). The cash-basis balance improved notably in relation to the first half of 2005. Following the cash-basis convention, the State posted a surplus of €1,153 million, compared with a deficit of €3,503 million in the same period the previous year. Against this background, and although an acceleration in expenditure is expected in the second half of the year, the robustness shown by taxes in comparison with what was initially budgeted points to a better close for the year than initially foreseen. Box 3 offers details on the Social Security budget outturn.

State revenue in cash-basis terms increased by 9.9% to June, owing to the buoyancy of the main taxes. This marked a clear difference from the slight decline of 0.1% for the year as a whole that the outturn projection (on comparison with the previous year's outturn) had augured. Personal income tax quickened in Q2 to growth of 12.2%, sustained by high revenue from withholdings on movable capital (a year-on-year rate of 18.9%) and on gains on mutual funds (an increase of 36.5%) and by growth of 9.9% in withholdings on income from work. Corporate income tax, after the first prepayment (in April), posted growth of over 20%. Indirect taxes also quickened notably in Q2 owing to VAT, although applications for refunds of this tax have increased notably, which might lead to a slowdown in revenue in the coming months. Takings from excise duties, however, were virtually flat throughout the first half of the year owing to the moderation in the consumption of the goods (hydrocarbons and tobacco products) on which the two main taxes here are levied. As regards the items under the heading Other net revenue, the acceleration in the rate of decline in Q2 came about due to lower revenue as a result of differences between government debt redemption and issuance values, and to transfer payments (both current and capital transfers). In both cases, developments in the coming months should bring them gradually closer to the initially budgeted rates of change. In the other headings there are no notable overruns in expenditure which is, to some extent, foreseeable since total expenditure is subject to the ceiling set under the Budgetary Stability Law.

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

In the first four months of 2006, the overall balance on current and capital account was a deficit of €31,116 million, 41.3% up on the same period in 2005. During this four-month period the current account deficit widened notably (by 36.9%), rising to €32,095 million, while the surplus on capital transactions declined (-31.2%) to €979 million. Under current transactions, there was a generalised deterioration in the balances of the main items, proving especially acute in the case of the trade deficit. Both the surplus on services and the income deficit worsened, as did, to a lesser extent, net current transfers.

The trade balance deficit increased by €4,533 million in the first four months of 2006 compared with the same period a year earlier, up to a figure of €24,988 million. In year-on-year terms, the deficit increased by 22.2%, prolonging the strongly deteriorating path of the two previous years. Despite the exceptional pick-up in real export flows in this period, the rise in the rate of increase of real imports and the strong deterioration in the terms of trade – owing to dearer oil – prompted the unfavourable course of the deficit in nominal terms. Nonetheless, the deficit on the non-energy trade balance has worsened more moderately since the second half of the previous year, while the energy deficit continues to grow at a burgeoning rate as a result of the persistent increase in energy import prices.

The services balance posted a surplus of €2,050 million euro in the first four months of 2006, down on the figure of €2,417 million recorded in the same period a year earlier. This strong deterioration was due to the €910 million decline in the tourist surplus and, to a greater extent, to the increase in the deficit on the non-tourist services balance, which increased by €1,507 million. Tourist revenue fell by 4.2% in the January-April period, in nominal terms, prolonging the adverse performance dating back to December 2005. Tourist expenditure rose by 15.5% in the first four months of 2006, entailing a slowdown from the robustness of the two previous years. As a result of these revenue and expenditure developments, the tourist surplus declined by 15.7%.

The deficit on the income balance widened significantly over the course of the first four months of 2006 to a negative figure of €6,054 million, €1,367 million more than the same period a year

The Social Security system posted a surplus of €8,432 million in the four months to end-April 2006, €944 million up (12.6%) on the same period a year earlier. Revenue grew by 9.1% and expenditure by 8% (see accompanying table). There was notable growth in the *Other* heading which, though a minor item, shows a growth rate of 45.7% owing to the increase in returns on the Reserve Fund.

Revenue from Social Security contributions increased by 8.6% to April. The number of Social Security registrations rose by 5.1% to June 2006. However, if the 504,404 registrations of foreign workers in the six months to end-June as a result of the regularisation process are discounted, the growth of the number of registrations in the first half of 2006 would stand at 2.7%, slightly down on the rate for the whole of 2005.

Turning to expenditure, that earmarked for contributory pensions grew by 7.7% to April, slightly up on the figure budgeted for the year as a whole. The number of contributory pensions is sustaining a high growth rate, standing at 2.6% to April, far above that posted in 2005 as a whole (1.3%). This is partly due to the effect of the former Elderly and Disability Insurance pensions (SOVI) being recognised as compatible with widowhood pensions[1]. Expenditure on sickness benefits increased by 6.2% during the first four months, far below the budgeted figure.

As regards the SPEE (State Employment Public Service), the information on which is received with a greater lag, contributions received rose by 9% to February, above budget. Rebates on contributions in respect of employment-promoting contracts, meanwhile, increased by 10% in the first two months of 2006, also above the initial budget projection.

SPEE expenditure on unemployment benefits rose by 6.6% to April (a similar level to the 6.7% increase recorded in 2005 as a whole), and the number of beneficiaries grew by 4%. This was in turn due to the two main determinants at play here: first, the 1.4% year-on-year decline in registered unemployment in April 2006, compared with the 1.1% fall over 2005 as a whole; and further, the increase in the eligibility rate, which stood at 62% to April 2006, above the end-2005 level (60.7%).

1. Law 9/2005 of 6 June 2005.

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

EUR m and %

	Budget			Outturn JAN-APR		
	2005	2006	% change	2005	2006	% change
	1	2	3 = 2/1	4	5	6 = 5/4
1 REVENUE	90,040	97,547	8.3	30,917	33,739	9.1
1.1 Social security contributions (c)	83,915	90,625	8.0	28,840	31,317	8.6
1.2 Current transfers	4,874	5,295	8.6	1,646	1,794	9.0
Other (d)	1,251	1,628	30.1	431	628	45.7
2 EXPENDITURE	84,100	90,562	7.7	23,429	25,307	8.0
2.1 Wages and salaries	1,998	2,165	8.4	647	676	4.4
2.2 Goods and services	1,566	1,733	10.7	417	487	16.6
2.3 Current transfers	80,060	86,133	7.6	22,328	24,115	8.0
Benefits	80,059	86,131	7.6	22,328	24,115	8.0
Contributory pensions	68,905	73,832	7.2	19,234	20,720	7.7
Sickness	5,925	6,656	12.3	1,686	1,790	6.2
Other	5,229	5,644	7.9	1,409	1,605	13.9
2.4 Other (e)	476	530	11.4	36	29	-18.7
3 BALANCE	5,940	6,986	17.6	7,488	8,432	12.6

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

a. Only data relating to the system, not to the entire Social Security Funds sector, are given. This is because the figures for other Social Security funds are not available until April 2006.
b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.
c. Including surcharges and fines.
d. Excluding surcharges and fines.
e. Reduced by the disposal of investments.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 4

EUR m

		JANUARY-APRIL	
		2005	2006
CREDITS	Current account	83,729	92,039
	Goods	50,274	56,118
	Services	20,377	21,793
	— Tourism	9,178	8,790
	— Other services	11,200	13,003
	Income	9,108	9,927
	Current transfers	3,970	4,201
	Capital account	1,671	1,585
	Current + capital accounts	85,400	93,624
DEBITS	Current account	107,171	124,134
	Goods	70,730	81,106
	Services	15,911	19,744
	— Tourism	3,370	3,893
	— Other services	12,541	15,850
	Income	13,795	15,981
	Current transfers	6,736	7,304
	Capital account	249	606
	Current + capital accounts	107,420	124,740
BALANCES	Current account	-23,442	-32,095
	Goods	-20,456	-24,988
	Services	4,467	2,050
	— Tourism	5,808	4,897
	— Other services	-1,341	-2,847
	Income	-4,687	-6,054
	Current transfers	-2,767	-3,103
	Capital account	1,422	979
	Current + capital accounts	-22,020	-31,116

SOURCE: Banco de España.

a. Provisional data.

earlier. Revenue grew by 9% in this period, with proceeds from the financial sector gathering notable momentum, while the increase in expenditure was higher, at 15.8%, as a result of the strong rise in expenditure by monetary financial institutions and, to a greater extent, by the non-financial private sector, the expenditure by general government having fallen.

In the four months to April, the current transfers deficit totalled €3,103 million, €336 million up on the deficit recorded in the same period in 2005. Revenue increased by only 5.8%, as one of its main items – flows from the EU under EAGGF-Guarantee – fell off, while Community transfers from the European Social Fund trended favourably. Expenditure, meanwhile, grew at a somewhat higher rate of 8.4%, as a result of a strong increase in emigrants' remittances and a rise in expenditure earmarked for Community coffers under the VAT resource and Traditional own resources.

Finally, the capital account surplus amounted to €979 million over the course of the first four months of 2006, a decline of €443 million on the same period a year earlier. This deterioration was partly due to the decline in structural funds from the ERDF (though there are frequently delays in the opening months of the year), and this despite the favourable trend of Community transfers from the Cohesion Fund. Furthermore, expenditure increased notably, especially capital transfers by the private sector.

5 Financial developments

5.1 Overview

In 2006 Q2, the financing conditions for the private sector were affected by the continuation of the upward trend in market interest rates that began in the second half of 2005. In June, one-year EURIBOR stood on average at 3.4%, up 29 bp from March, while Spanish ten-year government bond yields rose over the same period by 34 bp to 4%. In line with these developments, the price of bank loans to firms and households and the cost of fixed-income-security issuance rose, although the latter is still at low levels.

Developments on domestic and international stock markets were marked by the sharp fall in prices from mid-May, which cut short the upward path of previous months and was accompanied by a notable increase in volatility. These developments appeared to reflect an increase in the uncertainty of the international macroeconomic outlook, against a background characterised by high oil prices and persistent global imbalances. In the second half of June there was a certain recovery, but it was not sufficient to avoid a loss of 2.7% in the value of the Madrid Stock Exchange General Index at the end of the month, relative to March. Following these movements, the Spanish index showed a gain on the year of 8.3%, which was higher than those recorded by the euro area Euro Stoxx index (4.2%) and the US S&P 500 index (1.8%) (see Chart 24).

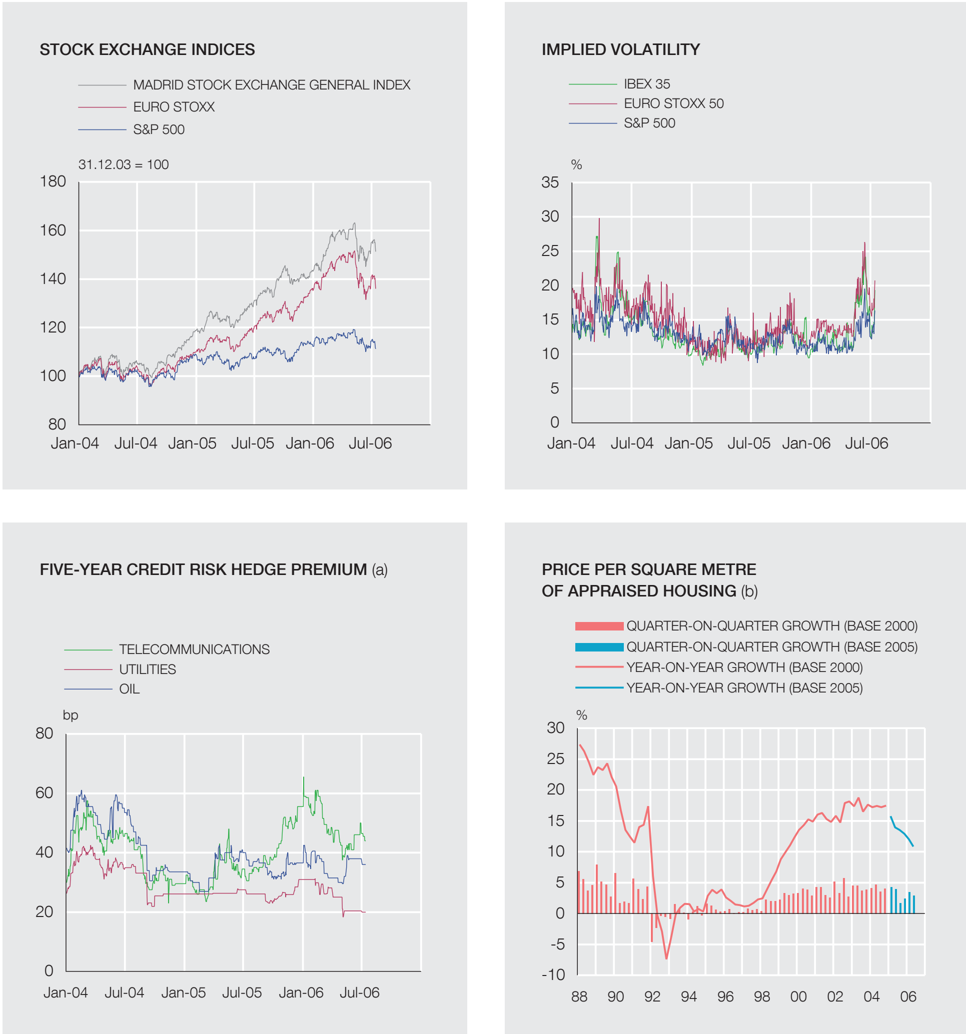
On the property market, according to the latest data published by the Ministry of Housing, the slowdown in prices seen in previous months continued in Q2. Thus the year-on-year rate of growth in the price of appraised unsubsidised housing stood at 10.8% in June (down 1.2 pp from March). This is consistent with the expected scenario of a gradual and orderly correction of the current overvaluation of these assets.

Notwithstanding the rises in interest rates and the slowdown in property prices, there were still no clear signs in Q1 of a slowdown in the volume of household and corporate debt. In the case of households, the rise in liabilities (by around 21% year-on-year in March) continued to be sustained by the expansionary behaviour of lending for house purchase, which grew by 24%, and by the increasing momentum of consumer credit and other loans, which is now growing at a rate of more than 14%. For its part, corporate borrowing accelerated to a rate of more than 24%, relative to the same period of the previous year, basically driven by the greater buoyancy of financing from abroad and by fixed-income-security issuance by the resident financial subsidiaries of non-financial corporations (see Box 4). The breakdown of lending by productive activity shows that in the first three months of 2006 borrowing by the real-estate sector accelerated sharply to a year-on-year growth rate of 50%, which is in line with the increase in the activity of new housing development. By contrast, in most cases loans to other sectors slowed, most markedly in industry, where the rate of change fell by 3 pp to 12%. On the provisional information available, private sector debt continued to grow at a high rate in Q2.

As a result of the buoyancy of financing, the indicators of household financial pressure deteriorated again in 2006 Q1 and, according to the provisional information available, this trend continued in Q2. Thus the debt and debt burden ratios, relative to gross disposable income (GDI), continued to rise, while the sector's net saving, after deducting debt principal and interest payments, fell again and its net borrowing, as measured over the twelve months to March, rose to 1.5% of GDP (see Table 5). However, the behaviour of household net wealth, which continued to rise strongly, underpinned by house prices, is still providing a safety valve for this growing pressure.

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



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

a. Average asset-weighted premia.
b. New statistic from 2005.

In the case of corporations, the debt and debt burden ratios also continued to rise between January and March and, according to provisional data, this same trend extended into 2006 Q2. In addition, according to the financial accounts, both the debit balance of net financial transactions and the sector's financing gap increased significantly, so that they represented, respectively, 8% and over 14% of GDP, as measured over the twelve months to March. At the same time, there was a moderate decline in corporations' return on capital. For their part, the quarterly data of the Central Balance Sheet Data Office (CBQ) establish a sharp rise in indebtedness, that basically reflects the financing of the acquisition of the firm O2 by Telefónica. Interest payments also rose relative to profits for this sample of companies, mainly as a reflection of the rise in the cost of borrowing. The impact of these movements on synthetic indicators that approximate the degree of financial pressure on investment and employment was partially offset, however, by the favourable trend in financial results. There was thus a slight deterioration in such statistics, although they are still at low levels.

Once again, the higher net borrowing of households and corporations was not offset by the increase in net financial resources of general government, so that the nation had to increase its recourse to foreign savings to more than 7% of GDP in March, as measured over the four

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP (a)	2001	2002	2003	2004	2005				2006
					Q1	Q2	Q3	Q4	Q1
National economy	-3.4	-2.6	-3.0	-4.8	-5.5	-6.0	-6.1	-6.5	-7.1
Non-financial corporations and households and NPISHs	-4.3	-3.7	-4.2	-5.4	-6.3	-7.0	-7.7	-8.5	-9.4
Non-financial corporations	-5.4	-4.4	-4.4	-4.7	-5.3	-5.9	-6.5	-7.1	-8.0
Households and NPISHs	1.1	0.7	0.1	-0.6	-1.0	-1.1	-1.2	-1.3	-1.5
Financial institutions	1.4	1.4	1.3	0.7	0.7	0.6	0.6	0.9	0.8
General government	-0.5	-0.3	0.0	-0.2	0.2	0.4	1.0	1.1	1.6
MEMORANDUM ITEM:									
Financing gap (b)	-10.0	-8.6	-8.5	-8.9	-10.4	-10.5	-11.2	-11.3	-14.3

SOURCE: Banco de España.

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

quarters to that month, as against 6.5% at end-2005. Financial institutions continued to channel the bulk of these funds from abroad.

In short, recent information shows that financial conditions remain conducive to buoyant economic activity, although less so than in previous quarters. At the same time, the increase in the debt of companies and households and in their debt burden has further narrowed the margin the private sector has to absorb possible adverse shocks without their having a negative effect on its consumption and investment decisions. Accordingly, the elements of uncertainty of a financial nature surrounding the medium-term macroeconomic outlook mentioned in previous reports have not been reduced.

5.2 Households

According to the information available on Q2, financing costs for households continued to rise. In May, the interest rates on new credit relating to housing and on consumer credit stood at 4.1% and 6.7%, respectively (up 26 bp and 38 bp from March). The rise from the low levels of last autumn is approximately 80 bp in both cases. However, according to the latest available Bank Lending Survey (BLS), institutions were expecting to relax their criteria for the approval of loans for house purchase slightly during Q2, while keeping those for consumer credit unchanged. Overall, therefore, financing conditions tightened further, although they remain loose.

Despite the increase in financing costs since end-2005, household debt has continued to grow at high rates. In March it grew by around 21%, similar to the December 2005 rate. Lending for house purchase was once again its most dynamic component, growing at a rate of more than 24%. For its part consumer and other credit accelerated further to year-on-year rates of over 14%, almost 2 pp higher than three months earlier, in line with the sharp increase in the demand for this type of loan reflected in the BLS. The most recent provisional information on developments in the sector's financing show no significant changes with respect to Q1.

Meanwhile, investment in financial assets in March represented 10.8% of GDP, as measured over the twelve months to March, up 0.1 pp from 2005 (see Table 6). By instrument, purchases were again concentrated in the least risky ones (cash and deposits). Especially notable was the growth of funds invested under the heading other deposits and fixed-income securi-

ISSUANCE OF FIXED-INCOME SECURITIES BY NON-FINANCIAL CORPORATIONS. RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FINANCING INDICATOR

BOX 4

One of the instruments used by non-financial corporations (NFCs) to finance their activity is the issuance of fixed-income securities. In the past, this sector has issued such securities either directly or indirectly, through foreign subsidiary SPVs (located mainly in tax havens). In the latter case, the securities issuer distributes the funds raised among the group companies by means of loans. The NFC financing indicator compiled by the Banco de España includes these funds as foreign loans, the information being obtained from the balance of payments.

As seen in the left-hand panel of the adjoining chart, this type of financing began to become more important from 1999, coinciding with the greater borrowing requirements of large companies associated with the process of international expansion, and the outstanding amount of such securities eventually came to exceed that corresponding to the issues of resident NFCs. Contributing to the greater relative growth in this means of raising funds were, inter alia, fiscal factors. From 2001, the financial restructuring carried out by large companies (the ones that use this type of financing), resulted in a decline in the outstanding amount of fixed-income securities issued abroad.

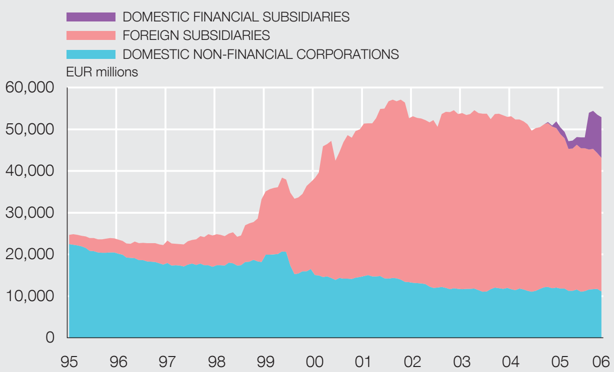
More recently, Law 19/2003 has promoted the issuance of fixed-income securities by subsidiaries resident in Spain (or in any other EU territory that is not a tax haven) of financial and non-financial firms. Among other benefits, foreign investors who acquire securities issued by these companies receive the same tax treatment as those who purchase Spanish public debt securities, so that the income paid on these securities is exempt from the tax on the income of non-residents. Also, the interest on the loan of the funds raised from the issuance of these securities to group companies is exempt from withholding tax and these issues are exempt from the tax on property transfers and documented legal acts.

Following the approval of this law, credit institutions, which also tended to use foreign subsidiaries to issue debt, began to transfer the operations of such subsidiaries to domestic institutions[1]. This movement has also been seen in the case of NFCs, although their activity did not begin to be significant until early 2006 (see left-hand panel of the adjoining chart). For the most part, the securities are issued in the form of euro-denominated bonds and, given that they are basically marketed to foreign investors, they are traded on international markets. As in the case of the funds raised through foreign subsidiaries, the funds obtained are channelled to the other firms of the group in the form of loans.

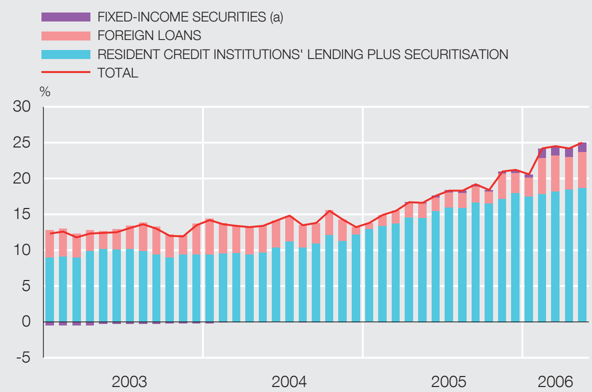
The growth of this type of issuance has important implications for the NFC financing indicator compiled by the Banco de España, which is used, inter alia, to monitor the sector's debt ratio. Unlike in the case of issues made directly by NFCs or indirectly through foreign subsidiaries, the funds raised in this way have, in the past, not been included in the definition of debt, as the transactions are not carried out by the parent company and there is no information on loans granted by institutions other than credit institutions. Given the importance recently gained by this means of raising funds, it has been decided to include in the fixed-income issuance of NFCs that carried out by their resident financial subsidiaries. The right-hand panel of the chart shows how in recent months the latter has explained more than one percentage point of the rate of growth of the sector's borrowing.

1. For further details see Box 5.2 of the 2005 Annual Report of the Banco de España.

NON-FINANCIAL CORPORATIONS' FIXED-INCOME SECURITIES
(outstanding amount)



FINANCING OF NON-FINANCIAL CORPORATIONS
(contributions to year-on-year growth)



SOURCE: Banco de España.

a. Not including the issues of foreign subsidiaries. The flows of financing obtained from these operations are included as credit from the rest of the world, when they are transferred to resident non-financial firms.

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

TABLE 6

% GDP (a)	2002	2003	2004	2005		2006
				Q3	Q4	Q1
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.6	9.0	9.7	9.9	10.7	10.8
Cash and cash equivalents	3.5	4.1	4.0	4.1	4.4	3.8
Other deposits and fixed-income securities (b)	2.0	-0.3	1.3	1.9	2.0	3.2
Shares and other equity (c)	0.6	0.6	0.5	0.2	0.2	0.0
Mutual funds	0.2	2.3	1.5	1.8	1.9	1.8
Insurance technical reserves	2.5	1.8	1.8	1.9	1.8	1.7
Of which:						
Life assurance	1.4	0.7	0.7	0.8	0.8	0.7
Retirement	0.9	0.9	0.8	0.9	0.8	0.8
Other	-0.3	0.5	0.7	0.0	0.4	0.2
Financial transactions (liabilities)	8.0	8.8	10.3	11.1	12.0	12.2
Credit from resident financial institutions (d)	7.2	9.2	10.8	11.9	12.5	13.1
House purchase credit (d)	5.1	7.0	8.7	9.8	10.3	10.5
Consumer and other credit (d)	2.1	2.2	2.1	1.9	2.2	2.4
Other	0.8	-0.3	-0.5	-0.8	-0.5	-0.8
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.6	15.9	15.8	17.5	18.5	20.0
Cash and cash equivalents	1.6	0.9	1.0	1.2	2.1	2.1
Other deposits and fixed-income securities (b)	1.6	1.2	0.4	1.8	1.3	1.6
Shares and other equity	6.6	7.5	6.4	6.8	6.6	8.6
Of which:						
Vis-à-vis the rest of the world	4.6	4.5	3.8	4.5	3.8	6.2
Other	4.7	6.4	8.0	7.7	8.5	7.7
Financial transactions (liabilities)	18.9	20.3	20.5	24.1	25.7	27.9
Credit from resident financial institutions (d)	5.4	6.1	8.4	11.6	13.0	13.5
Foreign loans	2.7	2.7	0.7	1.6	2.0	3.7
Fixed-income securities (b)	-0.4	-0.2	0.0	0.2	0.3	0.9
Shares and other equity	5.9	5.2	4.6	3.5	3.2	3.2
Other	5.3	6.5	6.8	7.3	7.2	6.6
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	14.0	15.9	16.3	19.6	21.0	23.1
Households and NPISHs	16.3	19.1	20.2	20.2	20.9	21.3
Non-financial corporations	12.4	13.5	13.2	19.2	21.2	24.5

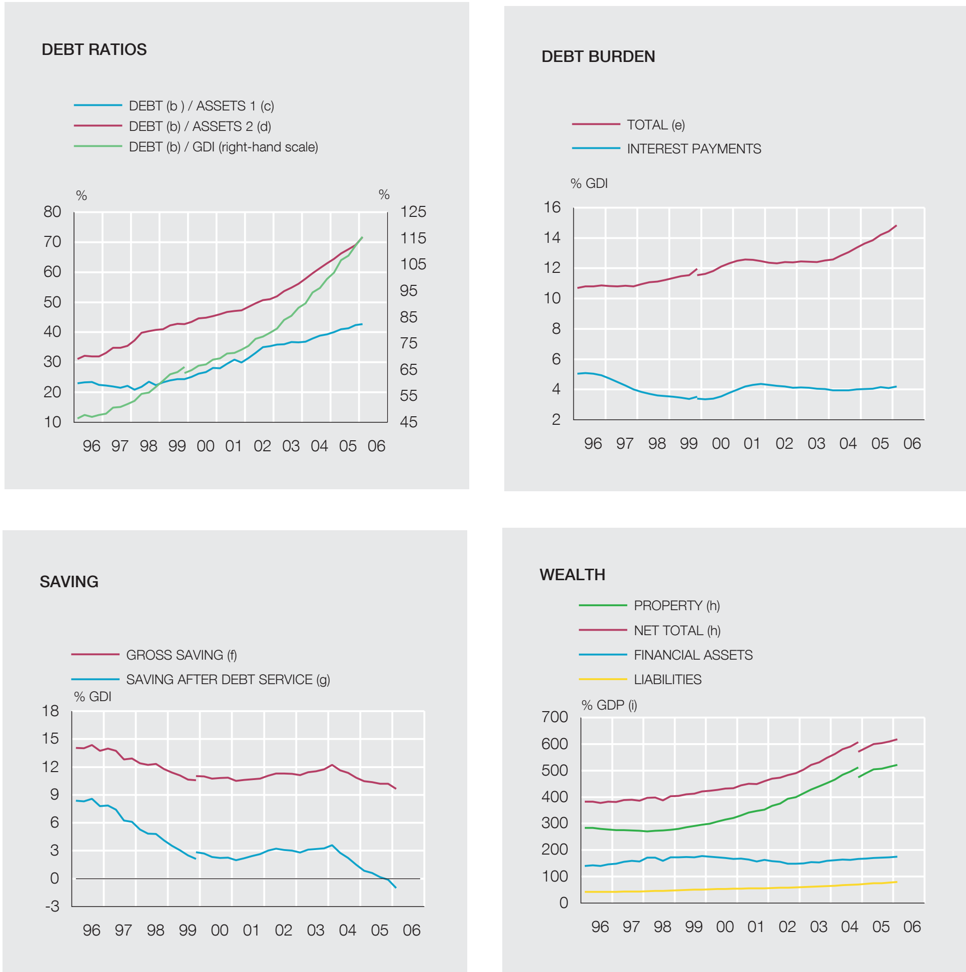
SOURCE: Banco de España.

a. CNE base 2000.
b. Not including unpaid accrued interest, which is included under "other". Includes the issues of resident financial subsidiaries.
c. Excluding mutual funds.
d. Including derecognised securitised loans.
e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation special purpose entities.

ties, whose volume increased by more than one percentage point of GDP, while cash and cash equivalents grew by a lower amount than during the last two years. Net equity purchases were equal to zero, while net subscriptions for shares in mutual funds and the flows in the form of insurance technical reserves remained at similar levels to those of December last year.

The buoyancy of financing resulted in a further increase in household debt which reached 115% of GDI in March (see Chart 25). The associated debt burden was also affected by the increase in interest rates and stood at close to 15% of GDI. The further decline in the gross savings ratio, together with the increase in estimated principal payments on liabilities, led to

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs (a) CHART 25



SOURCE: Banco de España.
a. Until 1999 the sectoral National Accounts data correspond to the CNE base 1995. From 1999 they correspond to the CNE 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. There is a new house price statistic from 2005.
i. CNE base 2000.

another decline in savings not used to service debt, an indicator that has now turned negative. Also, according to the financial accounts, household net borrowing continued to grow during 2006 Q1 and now represents 1.5% of GDP, as measured over the twelve months to March.

Despite its higher debt, the sector's net wealth continued to rise in Q1, basically as a result of the rise in the price of property (12% year-on-year), the main component of household wealth. These developments, together with the increase in financing costs, led to a further deterioration in the affordability of housing.

5.3 Non-financial corporations

Financing conditions for corporations also tightened during Q2, although they remain loose. In May, the interest rates charged by financial institutions on new loans stood at 3.6% and 4.5%, depending on the volume of the transaction, up 2 bp and 18 bp relative to their March levels, and up 65 bp from the low levels of last autumn. However, according to the BLS, the institutions expected to relax their criteria for granting credit slightly in Q2. The cost of issuing fixed-income securities also rose as a result of the increase in public debt yields and unchanged risk premiums. Finally, the conditions for raising funds on equity markets worsened as a result of the decline in prices and rise in volatility.

Despite the pattern of rising financing costs since last autumn, the sector's debt accelerated, reaching a year-on-year rate of over 24% in March, up more than 3 pp from December 2005. According to the provisional information available, this momentum was sustained in Q2. By instrument, resident bank lending was again the most important component, although in terms of changes the higher growth in foreign loans and in fixed-income-securities issuance, especially by resident financial subsidiaries, were notable. These flows represented 3.7% and 0.9% of GDP respectively (as measured over the twelve months to March), as against 2% and 0.3% in the previous quarter (see Table 6). Funds raised through capital increases represented 3.2% of GDP, the same level as at end-2005.

With regard to the purpose of the credit, in 2006 Q1 there was a notable increase in the rate of expansion of funds raised by the property sector (50% year-on-year), while in most of the other branches of activity rates of change were more moderate than at end-2005. Thus, lending to construction grew by 27% (down more than one percentage point from December) and lending to industry by 12% (as against 15% three months earlier).

Corporations' assets side transactions also increased, although more moderately than those on the liabilities side, reaching 20% of GDP in March, as measured over the 12 months to March. By instrument, the increases were concentrated in investment in shares and other equity, as a result of larger acquisitions in the rest of the world, which amounted to 6.2% of GDP (as against 3.8% in the previous period), basically reflecting Telefónica's purchase of O2. The flow in the form of cash and cash equivalents remained at similar levels to the previous quarter, while deposits and fixed-income securities recovered somewhat.

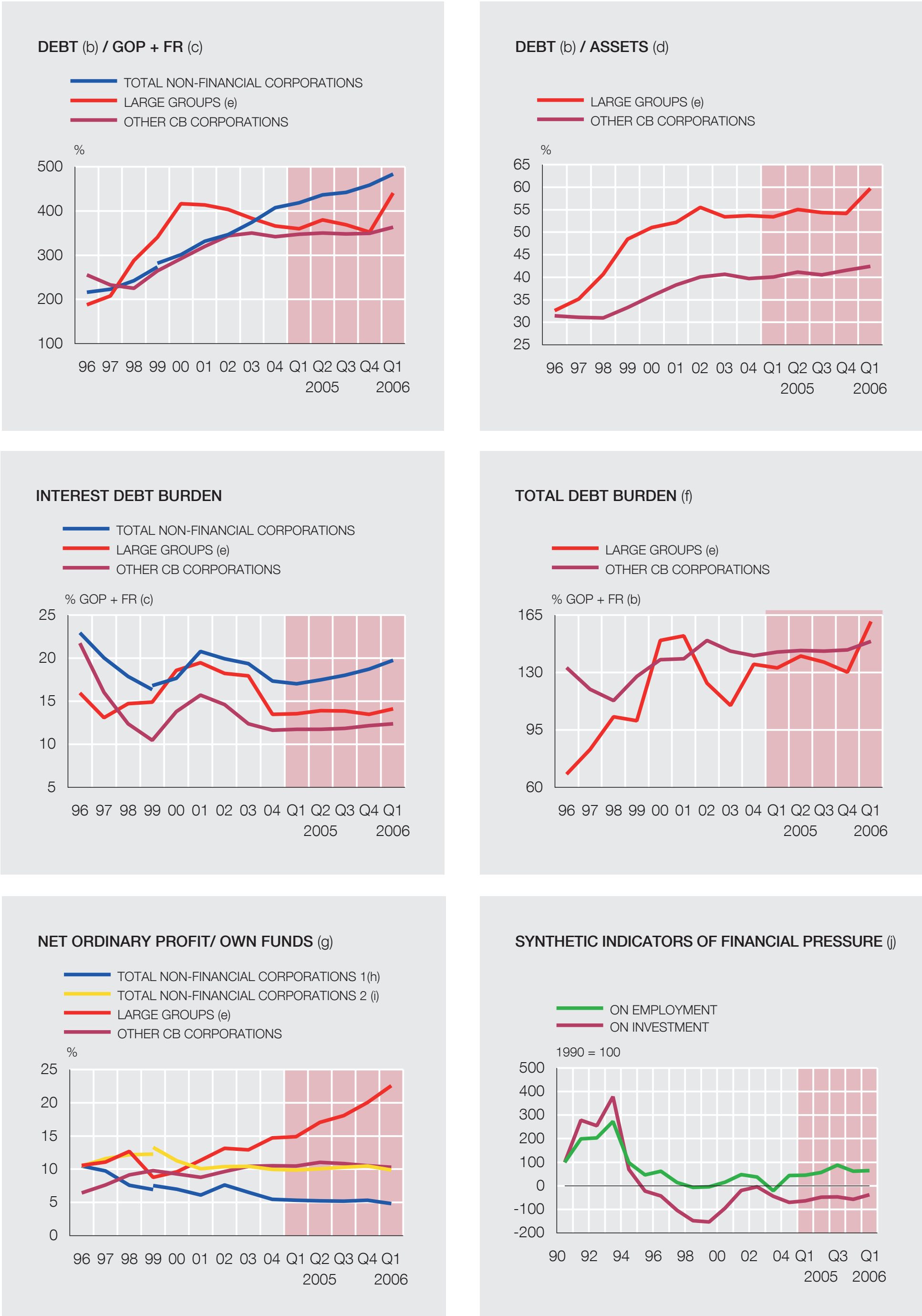
As a result of these flows of assets and liabilities, corporations' net borrowing increased by almost 1 pp, to 8% of GDP, as measured over the twelve months to March (see Table 5). This contraction in financial saving came on top of the increase in the sector's foreign direct investment (2.1% of GDP), causing the financing gap, which approximates the resources needed to undertake permanent real and financial investment abroad, to grow by 3 pp, to more than 14% of GDP.

The notable rise in financing caused the sector's aggregate debt to stand in Q1 at over 480% of gross operating profit plus financial revenue (see Chart 26). Also, interest payments rose again relative to profits, to reach levels of close to 20%, reflecting both the greater volume of external funds received and the rise in their cost. At the same time, as measured over the twelve months to March, there was a slowdown in the gross operating surplus and an increase in the rate of growth of net interest payments, which led to a slight reduction in the return on capital of non-financial corporations.

CBQ data also show a rising trend in the debt and debt burden ratios in 2006 Q1. The rise was especially large in the former case, basically reflecting the impact of the financing of the acquisition by Telefónica mentioned above. However, the ordinary return on equity of the CBQ corporations improved again, which is explained by the behaviour of large groups, since this ratio declined somewhat for other corporations. As a result of the changes in the variables mentioned above, the synthetic indicators of financial pressure on investment and employment constructed on the basis of the CBQ sample worsened slightly, although they are still at low levels.

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

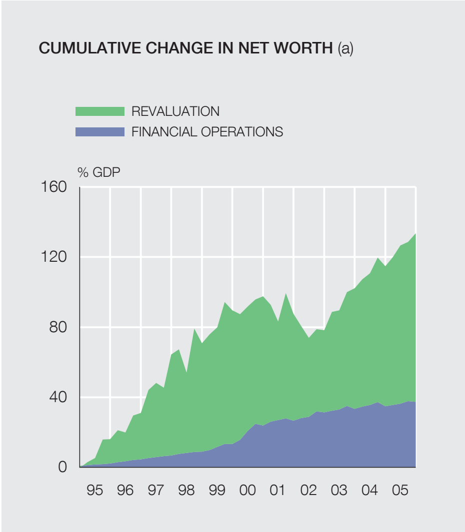
CHART 26



SOURCE: Banco de España.

a. Until 1999 the sectoral National Accounts data correspond to the CNE base 1995. From 1999 they are drawn from the 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 in the base year.

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 equity issued by non-financial corporations.

Finally, analysts' expectations regarding the growth of listed non-financial firms' profits were reduced in Q2, both at long and, especially, at short horizons, although in the latter case the rate of change remained high (see Chart 27).

5.4 General government

In 2006 Q1, general government net lending increased again, to stand, as measured over the four quarters to Q1, at over 1.5% of GDP (see Chart 28). By instrument, there was a net redemption of short-term securities, while the net issuance of long-term securities remained positive, though lower than three months earlier. At the same time, there was a rise in the "other" heading, which reflects the net acquisition by Social Security funds of assets issued by the sector, while investments in the form of deposits continued to grow at a higher rate than the volume of loans, so that the net balance of these two items remained positive, at 1.6% of GDP. Finally, despite the increase in financing costs, interest payments remained on a downward path relative to GDP, thanks to the decline in the debt ratio.

5.5 The rest of the world

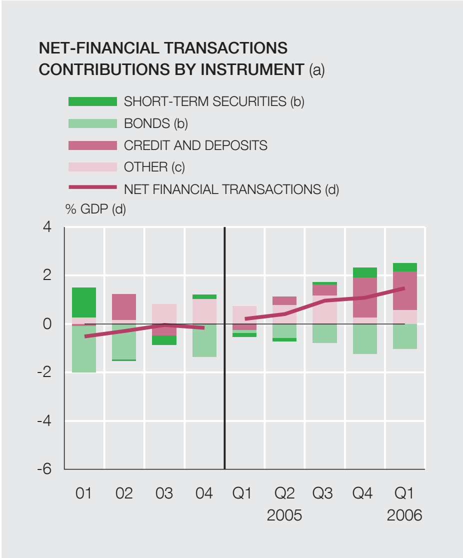
In 2006 Q1, the debit balance of the nation's financial transactions continued to increase, to stand (as measured over the twelve months to March) at 7.1% of GDP, as against 6.5% in December. By sector, the greater need for funds stemmed from the decline in household and, especially, corporate saving, which was not offset by the improvement in general government net lending.

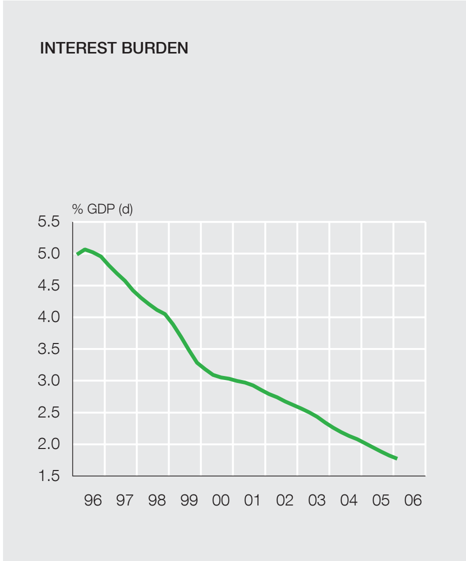
Between January and March 2006, the importance of financial institutions in channelling funds from abroad to the Spanish economy increased. Within this sector, non-monetary intermediaries continued to contribute most to the financing of the external deficit, so that the debit balance of their net financial transactions with the rest of the world now represents more than 10% of GDP (see Chart 29).

Financial investment in the rest of the world by resident sectors represented 22.8% of GDP in March (as measured over the twelve months to March), up 5 pp from 2005 (see Table 7). With regard to instruments, the main use of funds was for the net purchase of securities other than shares, especially by credit institutions, which accounted for a flow equivalent to 6.2% of GDP.

GENERAL GOVERNMENT
Four-quarter data

CHART 28



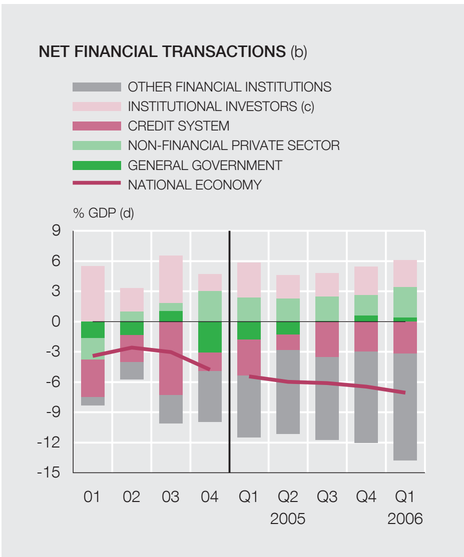


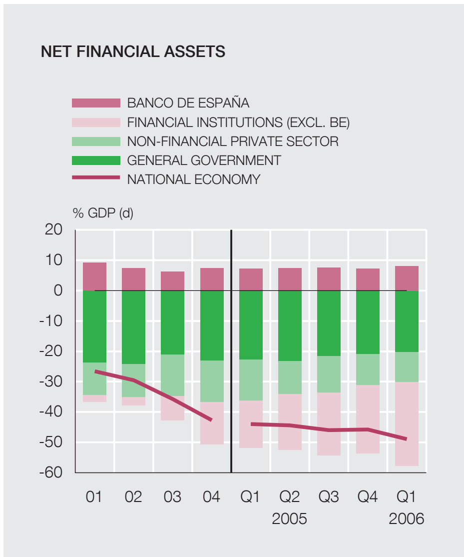
SOURCE: Banco de España.

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. CNE base 2000.

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

CHART 29





SOURCE: Banco de España.

a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities 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.
d. CNE base 2000.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2002	2003	2004	2005		2006
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-2.6	-3.0	-4.8	-6.1	-6.5	-7.1
FINANCIAL TRANSACTIONS (ASSETS)	12.9	13.5	13.8	17.1	17.7	22.8
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.3	0.7	3.2	1.9	2.4	3.4
Of which:						
Interbank (a)	2.3	0.5	0.7	1.2	3.2	2.3
Securities other than shares	4.1	6.5	1.8	6.1	8.7	8.4
Of which:						
Credit institutions	0.5	3.5	1.0	4.1	6.6	6.2
Institutional investors (b)	2.7	3.5	0.3	1.9	2.1	2.0
Shares and other equity	5.0	4.7	6.8	6.8	4.9	8.1
Of which:						
Non-financial corporations	4.6	4.5	3.8	4.5	3.8	6.2
Institutional investors (b)	-0.1	1.1	0.8	0.5	0.8	1.6
Loans	0.1	0.3	0.8	0.9	1.1	1.7
FINANCIAL TRANSACTIONS (LIABILITIES)	15.5	16.5	18.5	23.2	24.2	29.9
Deposits	4.0	6.9	1.7	3.4	5.3	6.2
Of which:						
Interbank (a)	3.1	5.3	5.0	5.6	7.2	7.5
Securities other than shares	4.3	5.3	12.4	14.4	15.5	18.7
Of which:						
General government	1.2	-1.0	2.7	0.0	0.0	0.8
Credit institutions	1.3	3.5	4.6	5.9	6.3	7.1
Other non-monetary financial institutions	1.8	2.8	5.1	8.5	9.3	10.8
Shares and other equity	4.0	1.1	2.7	2.8	0.8	0.9
Of which:						
Non-financial corporations	3.3	1.3	1.7	1.4	1.0	0.8
Loans	3.0	2.8	1.3	2.0	2.0	3.5
Other, net (c)	-0.1	-0.8	-0.6	-0.8	-0.1	-0.6
MEMORANDUM ITEM						
Spanish direct investment abroad	4.8	3.3	5.8	5.5	3.4	5.6
Foreign direct investment in Spain	5.7	2.9	2.4	2.1	2.0	1.8

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.

The purchase of shares and other equity is also notable, its amount (equivalent to 8.1% of GDP, up 3.2 pp from December 2005) being affected by the foreign acquisition made by Telefónica.

Net capital inflows in 2006 Q1 stood at close to 30% of GDP, as measured over the twelve months to March, up 5.7 pp from end-2005. The funds raised through securities other than shares again accounted for the bulk of the flows from the rest of the world (more than 50% of the total), and in fact increased by 3.2 pp of GDP with respect to December. Thus, these securities, and in particular those issued by financial institutions remained the main instrument for financing the Spanish external deficit. The flows in the form of interbank deposits also increased in net terms to 5.2% of GDP. Also, the funds raised through borrowing rose by 1.5 pp, to 3.5% of GDP, basically reflecting the financing of the foreign acquisition by Telefónica.

Foreign direct investment in Spain continued to fall in 2006 Q1, to stand at 1.8% of GDP, while Spanish foreign direct investment recovered, partly as a result of the Telefónica transaction mentioned above. Net inflows of foreign direct investment thus remained negative, representing 3.8% of GDP.

As a result of these developments in the financial flows with the rest of the world and of the changes in asset prices and the exchange rate, the debit position of the Spanish economy increased to around 49% of GDP (see Chart 29). By sector, this increase stemmed from a rise in the debit balance of financial institutions, which was not offset by the improvement in the other sectors.

28.07.2006