QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

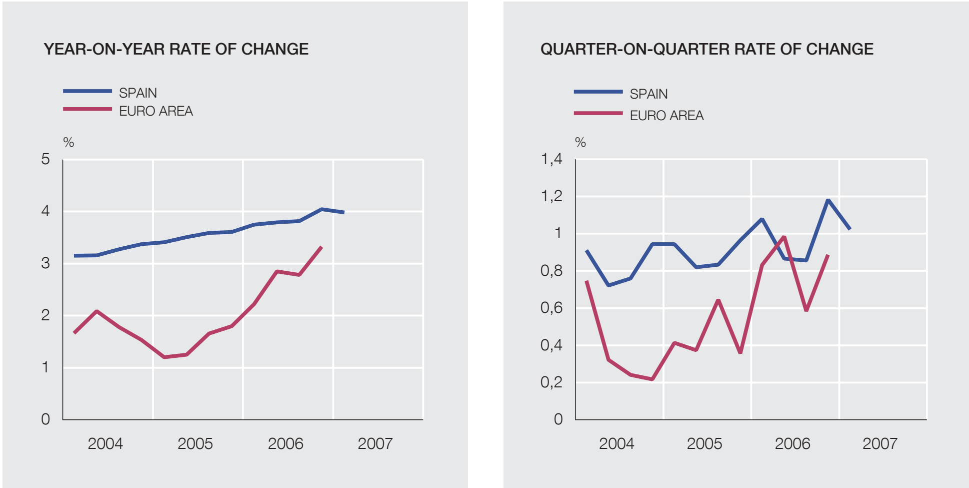
The Spanish economy ended 2006 on a very buoyant note and with slightly quicker growth. As a result, on the latest QNA estimates for Q4, GDP stood at a year-on-year rate of 4% (see Chart 1). Contributing to this performance were both the small rise in national demand, which grew at a rate of 4.7%, and the improvement by 0.1 pp of GDP of the contribution of net external demand to growth, which stood at –0.9 pp.

In the opening months of 2007 the estimates made drawing on as yet incomplete conjunctural data point to the continuing vigour of activity, without any appreciable changes being apparent in the contribution of the main components of GDP, either on the supply or the demand side. According to these estimates real GDP grew at a year-on-year rate of 4% in Q1 (1% in quarter-on-quarter terms), and the contributions of national demand and of net external demand stabilised at similar levels to those of the previous quarter. In terms of national demand, which is expected to have posted a year-on-year rate of 4.7%, household consumption was resilient and investment in equipment dynamic, while the mild slowdown in investment in construction initiated in the closing months of 2006 continued. There were no further improvements in the contribution of the external sector to growth, which is expected to have held at –0.9 pp, marking a pause in the rebalancing of the contribution of national demand and of net exports to GDP growth. Employment continued to evidence robustness and industry momentum. Finally, inflation, measured by the HICP, continued to slow in the opening months of 2007. Driven by the decline in energy prices, the HICP posted a 12-month rate of 2.5% in March, while underlying inflation, which also registered year-on-year growth in March of 2.5%, held stable at the December 2006 level. The price differential with the euro area narrowed once more in Q1 to 0.6 pp.

The world economy began the year with high growth rates, which on the latest available IMF forecasts point to a 4.9% increase in world GDP in 2007. The tendency towards more widespread world growth has continued in these early months now that Japan, but also the euro area, have moved onto more dynamic paths and that the emerging economies are maintaining a robust pace of growth. Inflation rates in the developed economies evidenced some downward stickiness. Only in the United States is a slowdown in growth perceptible, this being closely linked to the adjustment in the real estate sector, which began last year, and to the uncertainty stemming from a recent bout of defaults in the riskiest segment of the mortgage market, which has rapidly borne on the financial markets. Signs of sluggishness in corporate investment are beginning to be detected, and there is a risk that all these developments will ultimately affect employment and household spending, the dynamism of which has acted as a counterbalance during the real estate sector adjustment. Further, the easing in activity has not been accompanied by a sizeable decline in US inflation, which remains at a relatively high level. Accordingly, interest rates have held stable at 5.25%.

On the financial and foreign exchange markets, which had begun the year on a stable footing, there was a generalised reduction in late February in the valuation of high-risk assets; however, by mid-March this had been corrected. As to exchange rates, the depreciation of the dollar against the euro continued during the quarter, with the euro close in late April to its all-time high against the dollar, at around 1.36. Meanwhile the yen, which had appreciated significantly during the bout of financial turbulence, once again lost ground subsequently. Finally, there was a reversal in the downtrend in oil prices seen throughout the second half of 2006, driven by the harshness of the final winter months and by some worsening in geopolitical ten-

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

sions. As a result, the price of a barrel of Brent in late April was close to $68, almost 30% above its end-year value.

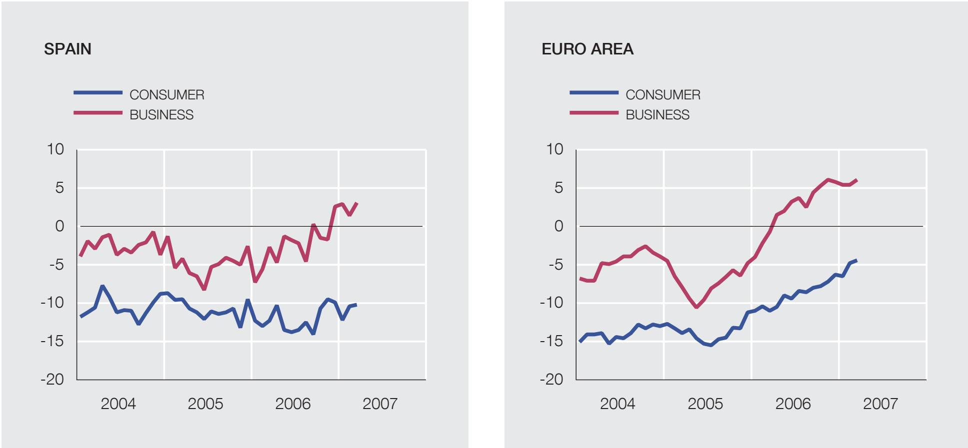
In the euro area, after the final figures for 2006 confirmed the soundness of the economic recovery, making for an average growth rate of 2.8%, the information for the opening months of 2007 points to the continuity of this scenario. GDP growth in the euro area should have remained robust in Q1, albeit slightly down on the previous quarter, owing to the mild slowdown in the German economy as a result of the effect of the VAT rise in January on German spending. Stripping out this effect, euro area dynamism has a sound base and is underpinned both by the resilience of domestic demand, driven by robust employment, and by the momentum of exports.

Inflation in the euro area, measured by the HICP, held at below 2% during Q1, posting a year-on-year rate of 1.9% in March (see Chart 3). The favourable behaviour of energy prices compared with a year earlier and the course of unprocessed food prices have offset the effect on the overall index of the VAT rise in Germany at the start of the year. This meant that the CPI excluding unprocessed food and energy moved on an accelerating path during the quarter, posting a year-on-year rate of 1.9% in March. However, as reflected in the ECB's assessment in its latest meetings, risks remain for the containment of inflation in the medium-term. These are largely related to the high probability that wage increases, set against the current strength of the labour market, will be higher than envisaged. Against this background, the ECB raised the minimum bid rate on its main refinancing operations by 25 bp at its March meeting to 3.75%. Then, at its April meeting, although it did not alter the monetary policy stance, it warned of the persistence of upside risks to price stability.

The external environment of the Spanish economy thus continued to be conducive to expanding activity, mainly through the continuing buoyancy shown by Spanish export markets. The tightening of monetary conditions by the ECB led to a moderate rise in borrowing costs (see Chart 4), although the effect on agents' spending decisions has remained limited. Finally, the gradual slowdown in house prices and the more contained increases in equity prices over the quarter as a whole, further to a bout of turbulence in late April in real estate sector prices, has entailed milder increases in wealth, prompting a more moderate demand pattern.

CONFIDENCE INDICATORS

CHART 2



SOURCE: European Commission.

Against this backdrop, household spending decelerated mildly in the opening months of 2007, reflecting the slight decline in residential investment, since household consumption showed renewed signs of momentum. The estimated rate of increase for this latter variable was 3.7%, similar to that at the end of 2006. Behind the strength of consumption lies the favourable behaviour of disposable income, further to the continuing buoyancy of employment and lower tax payments following the personal income tax reform, which would have offset the effect of the rise in interest rates on net tax payments. But consumption decisions were also taken in a setting of favourable expectations and, as indicated, of fresh – though increasingly moderate – increases in wealth. In the case of residential investment, where the impact of higher borrowing costs is in principle more forceful, the gradual slowdown that began to become apparent in late 2006 is expected to have continued. In this setting, the increase in lending extended to households continued to ease, though it still posted rates slightly higher than 18% in February, reflecting the deceleration in lending for house purchases which had begun a year earlier. The pace of lending for consumption and other purposes, which had risen significantly in 2006, began to show signs of stabilising.

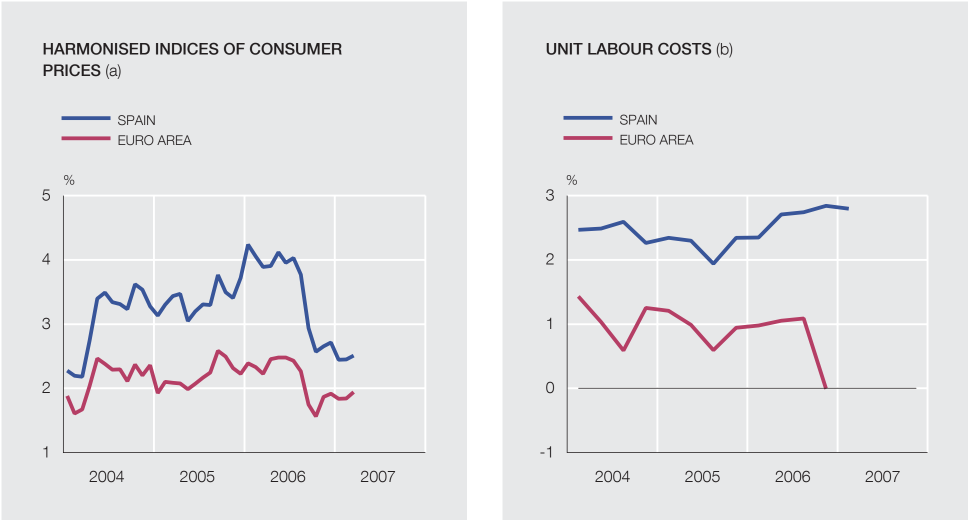
Business investment remained very expansionary in the opening months of 2007. Investment in equipment, in particular, was notably strong, holding at a similar growth rate to that of the previous quarter, at over 11%. The momentum of domestic demand and, in particular, greater export activity (which are necessitating increases in plant capacity), the favourable trend of these companies' profitability and expectations of future earnings are factors that have proven conducive to the expansion in business investment, offsetting the effect of higher borrowing costs. Investment in non-residential construction should have retained some vigour, proving less affected, in principle, by the tightening of financing conditions. All told, the rise in interest rates prompted a minor downturn in the growth rate of financing extended to non-financial corporations, interrupting the upward course that had taken shape over the previous year.

The general government sector contributed in the opening months of 2007 to sustaining expenditure, mainly through the maintenance of high rates of gross fixed capital formation, in a setting marked by the completion of numerous civil engineering projects. General government final consumption is estimated, in contrast, to have slowed somewhat, following its rise in late 2006.

In the first few months of 2007, the growth rates of exports and imports moderated, in real terms, from the high levels recorded in late 2006. Foreign sales continued to benefit from the

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.

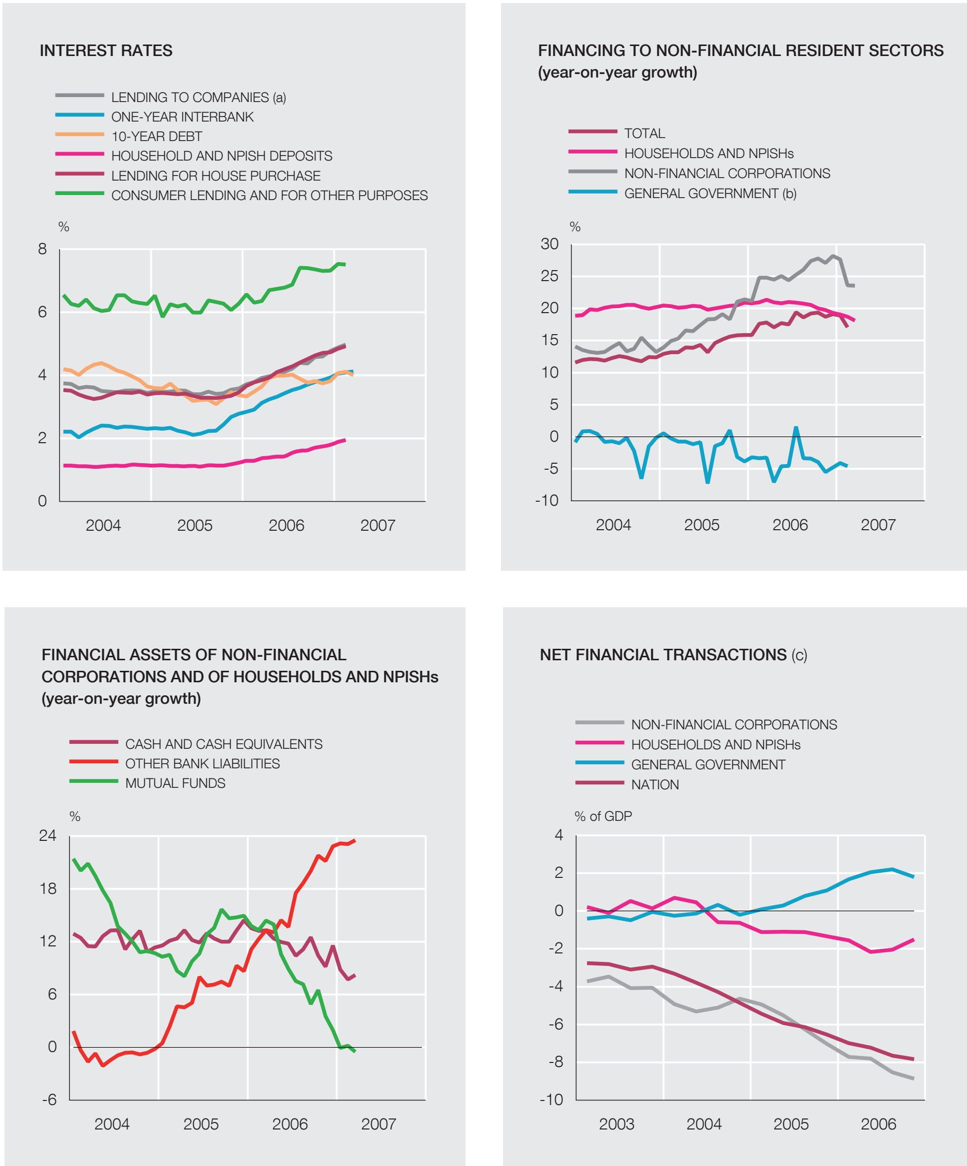
buoyancy of Spain's export markets, although the latter underwent a mild change in trend as a consequence of the smooth slowdown in the German economy during the quarter. Competitiveness and price indicators, for their part, deteriorated further, albeit only slightly, owing to the appreciation of the euro, so that the loss of competitiveness was sharper against those economies not participating in Stage Three of EMU. Despite this, the volume of sales of Spanish products outside the EU, according to the incomplete information available, was relatively high. As for goods imports, their growth was closely linked to the behaviour of final demand, although they can also be seen to have been boosted by the effect of the appreciation of the euro on import prices, which enabled further price cuts to be made, in addition to those taking place in response to ongoing transformation of the structure of world trade. Finally, the growth rate of services trade moderated, although exports and imports of tourism services improved.

From the standpoint of activity and the labour market, the trend in 2007 Q1 was a prolongation of tendencies that had been taking shape during 2006. Against the generally dynamic backdrop to activity, the strength of manufacturing and the slight moderation in construction activity were notable. The latter was concentrated exclusively in residential building, since civil engineering projects and non-residential building remained highly buoyant. With regard to employment, meanwhile, solid progress was made, with similar growth rates to those of late 2006. Labour force survey (EPA) data for 2007 Q1 confirm the strength of employment, against a background of significant rises in the population of working age. The number of persons employed increased at a year-on-year rate of 3.4% in Q1, while the ratio of temporary to total employment fell to 32%.

The collective bargaining results available for 2007 point to settlements of around 3%, a slight reduction compared to those of the last two years, under the guidelines of the Interconfederal Agreement for Collective Bargaining, which was extended at the beginning of the year. At the same time, it is estimated that the impact of the activation of indexation clauses in 2006 will also be smaller, owing to the significant slowdown in inflation in the closing months of last year. As a result it is expected that compensation per employee will have slowed in Q1 and that this

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 NEDR (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.

change in trend will be passed through to unit labour costs, especially in industry, where productivity gains continued to be comparatively large, despite the recovery in employment. This would mean the end of the upward trend in labour costs seen in the second half of 2006. As indicated in the introduction, inflation, as measured by the HICP, continued to decline in 2007 Q1, although this was largely due to the fall in oil prices from their levels a year earlier. In fact, underlying inflation has been more stable, despite the slowdown in non-energy industrial prices, owing to the downward stickiness of services prices, which have held systematically at rates of close to 4%.

In sum, the Spanish economy has performed most robustly in the opening months of 2007, with somewhat more balanced growth in spending – with investment in equipment more to the fore and residential investment playing a lesser role – and high employment generation. The relative tightening of monetary and financial conditions over the past year and the mild slowdown in house prices are factors that are prompting a gradual process of normalisation involving movement towards a more moderate and sustainable pace of spending and indebtedness. Moreover, the favourable juncture at which the world economy and, in particular, the euro area find themselves is helping increase the contribution of the external sector to GDP growth, although this process has been slowing in recent quarters. So that the rebalancing of the factors driving growth may continue, it is important that the subtraction of income generated in the external sector should continue to lessen. Accordingly, the easing in costs and prices must go beyond that witnessed in the recent episodes, linked largely to developments in energy prices.

2 The external environment of the euro area

Developments in the international financial markets went through three clearly differentiated stages during the quarter. From the beginning of the year until late February there were gains on the stock markets and in the prices of higher-risk assets. In the second stage, analysed in Box 1 and coinciding with greater pessimism as to the growth prospects of the United States, an increase in risk aversion prompted widespread falls in stock market prices and caused the spreads on emerging-country sovereign bonds and lower-rated corporate bonds to widen. At the same time, the higher demand for safer assets was manifested in the declining yields on long-term bonds, especially in the United States. The appreciation of the yen during this period was explained by the unwinding of some of the substantial short-term positions in this currency, associated with carry trade. Finally, from mid-March, investors flocked back into higher-risk assets and the earlier falls in their prices reversed. Hence, sovereign spreads as measured by the EMBI+ reached new historical lows, while in this period the appreciation that the yen had experienced during the period of market turbulence was largely reversed. The dollar tended to depreciate against the euro during the quarter, posting rates around $1.36 per euro. The price of Brent oil rose by 20% in the past quarter as a result of lower temperatures in the northern hemisphere in the second half of the quarter and of geopolitical tension in the Middle East.

In the United States, the final National Accounts figures for 2006 Q4 showed GDP growth of 2.5% in annualised quarterly terms, putting growth for the year as a whole at 3.3%, up 0.1 pp on 2005 (see Chart 5). The information published during Q1 was generally negative, prolonging the adjustment of the real estate market and the symptoms of weakness in non-residential investment. Housing starts thus stood below their end-2006 levels, while sales of new houses continued to fall and some measures of house prices showed negative year-on-year rates of change. Durable goods orders performed worse than expected, suggesting that firms were taking a cautious approach to investment spending. This caution contrasts with the marked buoyancy of job creation, which amounted to 180,000 jobs in March, and with the drop in the unemployment rate, which stood at 4.4%. The recruitment in the services sector and the downward stickiness of employment in construction (underpinned by non-residential construction) permitted this buoyancy to continue despite the job losses in manufacturing. The healthy labour market performance favoured consumption, and this was reflected in the positive retail sales figures for the quarter. Regarding the external sector, the trade balance showed a downward trend until February, although it was moderate and partly explained by the contraction of imports. Overall inflation increased throughout the quarter to 2.8% in March (see Chart 6), although core inflation moderated to 2.5% after a sharp rise in February. The Federal Reserve held the official interest rate unchanged at 5.25% and ratified the importance of inflationary pressures in its risk assessment.

In Japan the indicators at the beginning of the year pointed to ongoing buoyancy (although more subdued than in the previous quarter), underpinned by unexpectedly vigorous private consumption and by the continuing good performance of investment and exports. The indicators of consumption were generally positive, with significant advances in retail sales and in household spending, underpinned by the buoyancy of the labour market, where the unemployment rate held at 4% in February despite a further fall in wages. The supply indicators, however, suggested that industrial activity in the quarter moderated, since the Tankan confidence index for large manufacturers fell by two percentage points in

A period of financial market turbulence which began in late February 2007 and extended well into March affected both the emerging and developed markets. The prices of riskier financial assets underwent a sharp correction and there was a marked increase in volatility, against a background of flight to quality by investors. Although these movements reversed almost completely, this recent bout of volatility (after a prolonged boom in the financial markets), and how it compares with previous episodes, invite some reflection on the outlook and risks of global financial markets.

The onset of turbulence coincided with the fall of 9% in the Chinese stock market on 27 February and with the publication of certain figures suggesting that the US economic slowdown might be bigger than expected. The most noteworthy feature of the financial turbulence was its global nature and rapid onset, which reflects the finely-adjusted nature of market valuations and the increasingly sensitivity of investors to adverse events. The assets that suffered most during the turbulence were those that in previous months had recorded the largest gains. Stock markets in emerging and developed countries fell sharply and the spreads on low-rated US corporate bonds and on emerging-country sovereign bonds widened significantly (see Chart 13 for the effect of the turbulence on the European stock market). The turbulence had a lower impact on exchange rates. The currencies most affected were those linked to carry-trade transactions, such as the Japanese yen on the short side of the investor's position, and the New Zealand dollar on the long side. The increased risk aversion led to a flight to quality which was reflected in a fall in long-term interest rates in the United States and, to a lesser extent, in Europe.

The period of turbulence was notable for the sharp increase in financial market volatility. For example, the most widely followed index of implied volatility (the VIX S&P500), whose movement tends to be associated with changes in aversion to or appetite for risk in the markets, rose by 60% on 27 February (see Chart 1). Despite this, volatilities remained very low if this variable is analysed from a historical perspective.

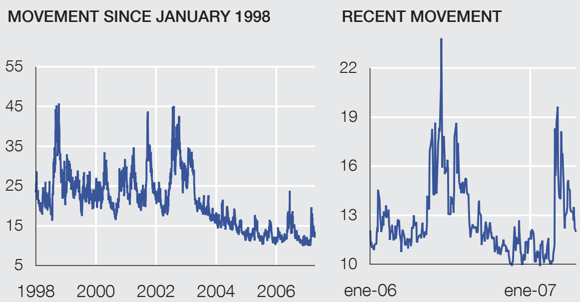
After the days of turbulence, recovery was very rapid and investor demand for riskier assets again became strong. A large portion of the stock market rebounded to the levels prior to the onset of the episode. Moreover, in certain cases sovereign spreads as measured by the EMBI+ posted new historical lows.

Comparison of this bout of market turbulence with that of May 2006 shows that both took place in periods when world liquidity expectations were downward and when US and Japanese monetary policies were in transition or highly uncertain, although this latest episode exhibited certain well-defined characteristics. First, in May 2006 the focus of attention was the inflationary pressure in the United States, while this time it has been the uncertainty about US growth – against a background in which inflation does not seem to be settling at sufficiently low levels – that has triggered the upturn in volatility. This difference in the situation can be appreciated in the comparison of forecasts in Chart 2. In addition, the deterioration in the riskier segment of the US mortgage market (subprime lending) posed the question of possible transmission to other segments of the credit market. Second, the role of China, as a possible factor triggering financial shocks at global level in the latest turbulence, is new. Finally, the settlement of carry-trade positions seems to have had a greater impact on foreign exchange markets than in previous episodes.

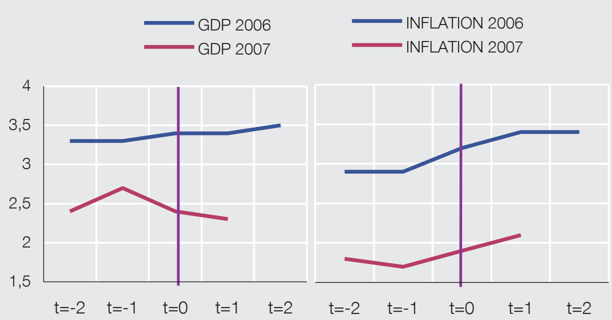
The fall and subsequent recovery of the financial markets confirmed that the recent turbulence was a technical correction that seems to have been more influenced by financial arguments than by a deterioration of economic fundamentals. Therefore, to the extent that these movements have corrected possible signs of excessive exposure in certain markets, these corrections should be interpreted as healthy.

Nevertheless, it is interesting to reflect on the longer-term behaviour of volatility. There are factors supporting the hypothesis that the current low market volatility will persist, while others tend to refute it. Among the arguments supporting the optimism of markets are: the greater transparency and improved communication of monetary pol-

1 VIX VOLATILITY INDEX



2 UNITED STATES: CONSENSUS FORECASTS (a)



SOURCES: Datastream and Consensus Forecasts.

a. t = 0 corresponds to May 2006 or March 2007, depending on the bout of turbulence.

icy decisions by central banks, which has diminished uncertainty; the development of the financial sector in numerous respects, e.g. improved market liquidity, financial innovation or the role of institutional investors; and the greater soundness of the corporate sector.

By contrast, other factors support the view that the observed low volatility may be a temporary phenomenon. Noteworthy in this respect is, first, the current economic slowdown in the United States, which may be affecting the volatility of financial asset prices, and second, the gradual decrease in the current financial buoyancy and the low interest rates may contribute to correcting the current risk aversion and to heightening volatility. Moreover, the increasingly finely tuned valuations by market agents and the uncertainty as to when the downturn in interest rates will commence in the United States make for greater market sensitivity to adverse economic or financial news.

In the future, fresh bouts of volatility cannot be ruled out. They may be more frequent, intense and persistent than the recent one and may affect financial stability. For this reason, investors have to show a sufficient degree of caution while avoiding excessive complacency.

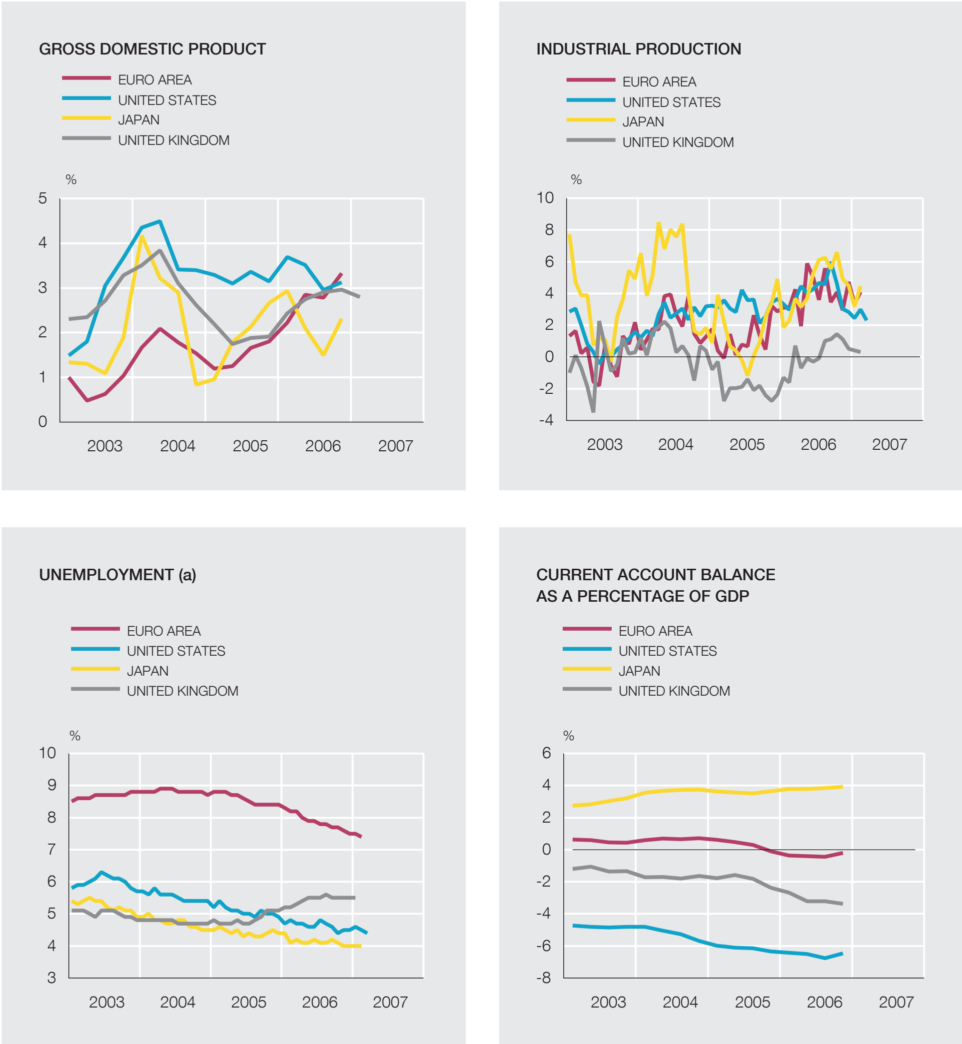
March, industrial production fell for the second month running and the purchasing managers' index (PMI) of manufacturing activity contracted in March to the lowest levels for the last two years. As regards the external sector, the strength of the surplus on the income balance did not offset the decline in the trade balance in February, and, as a result, the current account surplus decreased. Inflation turned negative again in February owing to the year-on-year drop in the price of oil and to the fall-off in mobile telephony rates. Thus the year-on-year rate of change of the overall index stood at –0.2% and that of the core index (which in Japan includes energy) at –0.1%. By contrast, wholesale prices rose in March for the first time in seven months, from 1.7% to 2% year-on-year. Against this background, the Bank of Japan held the official interest rate unchanged at 0.5% in its April meeting.

In the United Kingdom, the preliminary National Accounts figures for Q1 showed quarterly GDP growth of 0.7%, the same as in 2006 Q4. The year-on-year rate was down by 0.2 pp to 2.8%. Inflation rose significantly in March to 3.1% year-on-year. The Governor of the Bank of England, in an obligatory open letter to the Treasury explaining why the inflation target of 2% had been exceeded by more than one percentage point, attributed part of the upturn in inflation to temporary factors, although he indicated his concern for the increasing pressure on productive capacity. The unfavourable inflation figure, together with the minutes of the April meeting, heightened expectations of a rise in official rates by summer.

In the countries which joined the EU in 2004, GDP accelerated in Q4. In 2006 as a whole, GDP growth rose to 6.1%, compared with 4.9% in 2005 (see Chart 7). This expansion was driven by the strength of domestic demand (particularly investment and, to a lesser extent, private consumption) and, in some countries, also by external demand, driven by the economic recovery of the euro area. This setting of intense growth, along with the oil price rises of 2007 Q1, produced a widespread rise in inflation, although the rates differed widely from country to country. Nevertheless, official interest rates remained unchanged in most of these countries during the quarter. There was downward pressure on the exchange rate in Latvia, the currency of which came close to the lower limit of its fluctuation band of ±1% in the exchange-rate mechanism (ERM II), while in Slovakia, after intense upward pressure, the central rate of the koruna in the ERM II was revalued by 8.5%. 2006 saw a widespread decrease in fiscal deficits and public debt, underpinned by the buoyancy of revenue. The

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

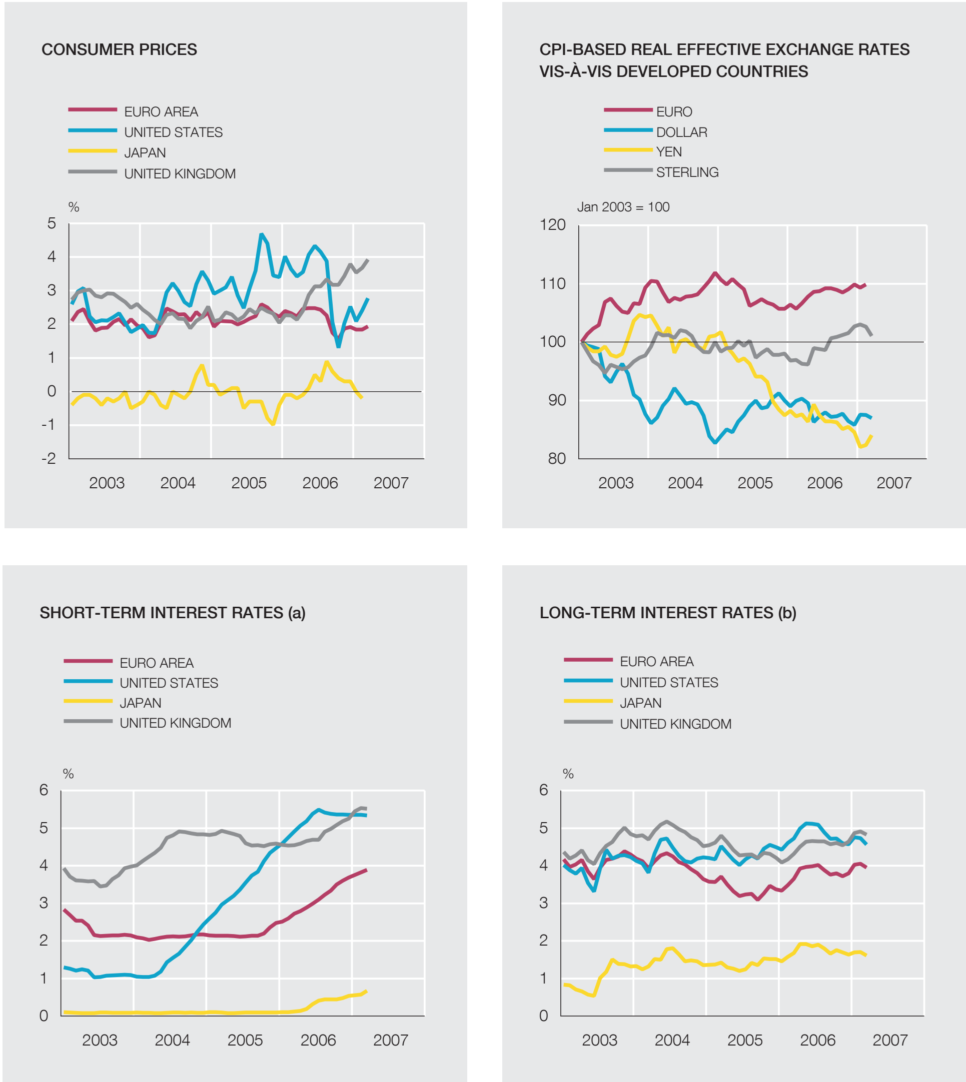
a. Percentage of labour force.

already-high current account deficits widened further, and in some countries stood above 10% of GDP.

China's economic activity rose notably in Q1, growing at 11.1% year-on-year, 0.7 pp more than in the previous quarter. Concurrently, the indicators of industrial production, investment in fixed assets and retail sales grew more quickly in the first three months of the year. The money supply and domestic credit accelerated slightly with respect to the already-high growth rates in the last two quarters of 2006, prompting the central bank to raise the reserve ratio three times (a total of 150 bp) and, in March, to increase the official interest rate by 27 bp. Furthermore, the renminbi continued to appreciate gradually against the dollar and the external reserves continued to increase rapidly, exceeding $1.2 trillion. The trade surplus reached $46.5 billion in the quarter, nearly twice that a year earlier. Against this background, the United States decided to impose punitive tariffs on certain imports of Chinese paper, the first measure of this type in the last 23 years. In regard to prices, inflation as measured by the CPI increased to 3.3% year-on-year in March, from an average of 2% in Q4, although the growth rate of producer prices fell slightly with respect to the levels at end-2006. As for the main economies in

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

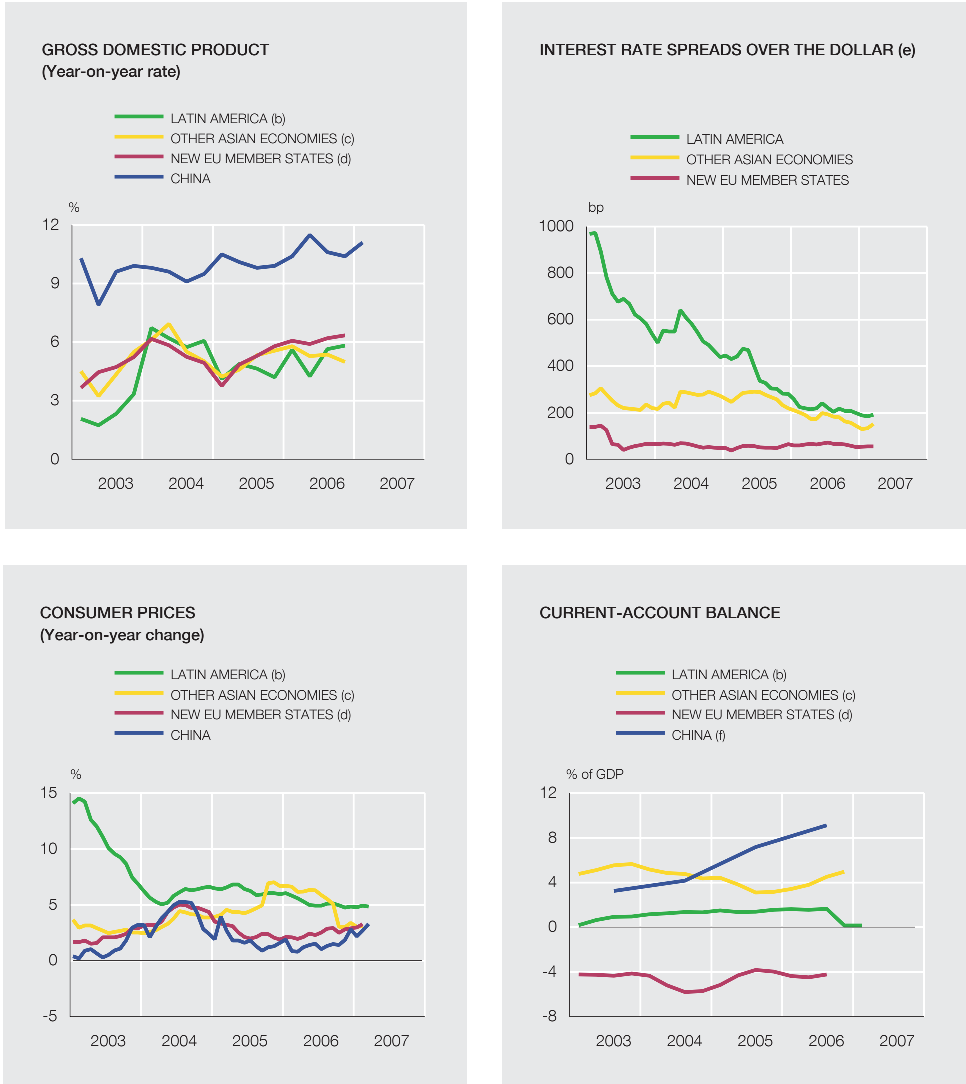
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

the rest of Asia, after robust growth in 2006 Q4, the latest indicators remained firm as inflationary pressures tended to moderate and, in certain countries (including Thailand), official interest rates fell.

In 2006 Q4, Latin America's GDP growth of 5.8% year-on-year was 0.1 pp more than in the previous quarter. For the whole of the year, the growth of this region stood at 5.3%, against 4.5% in 2005. In Brazil there was a substantial upward revision of the National Accounts figures for 2002 to 2006, including GDP and the GDP growth rate. The available indicators for 2007 Q1 point to a pick-up in activity in Brazil, Chile, Peru and Colombia, and to an additional moderation in Mexico and Argentina. Inflation in the aggregate of the region stood at 4.9% in March, down from 5% in February. The divergences between countries remained in place in March, with an increase in the inflation rate in Colombia and Mexico, while it stayed very low (3%) in Brazil and decreased in the other countries. Against this backdrop, Colombia raised its interest rates to 8.25%, while in Mexico the expectations of a forthcoming increase strengthened as the central bank adopted a harder line in its announcements. In Brazil the

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, Philippines and Taiwan.
d. Excluding Cyprus, Malta, Bulgaria and Romania.
e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
f. Annual data.

official rate was lowered three times to stand at 12.5%. The external sector ended the year with high current account surpluses in all countries except Mexico and Colombia. At the beginning of 2007 the trade balance worsened in Brazil, Mexico, Colombia and Peru, and improved in the other countries. On the fiscal side, good results were recorded at the beginning of the year in Brazil and Mexico, the latter country also approving a reform of the pension system of public-sector workers; however, Argentina saw a substantial increase in primary expenditure. Finally, the rating agencies raised the rating of Colombia and the outlook in Mexico improved.

The euro area National Accounts data for 2006 Q4 corroborate the firming of buoyant activity in 2006. GDP grew by 2.8%, well above the previous year's rate. The information available in the first few months of 2007 suggests that GDP retained its strength throughout the year, underpinned by dynamic world demand and the recovery in employment, against a background of low financing costs. More in the medium term, however, the economy is subject to certain downside risks, such as a sharper slowdown in the US economy and those associated with the persistence of global imbalances.

Inflation in the euro area was 1.9% in March, the same rate as in December 2006; the favourable developments in the energy component, helped by the base effects related to its behaviour a year earlier, offset the impact of the increase in VAT in Germany at the beginning of the year. This fiscal measure is also the main factor explaining the upward trend in underlying inflation since the end of last year. More in the medium term, the upside risks to inflation predominate. These arise from the possibility that the strength of the economy and the improvement in employment may drive wage demands higher than expected, but also from the uncertainty over the future behaviour of oil prices.

Against this background, the Governing Council of the ECB, at its March meeting, noted the existence of risks to the maintenance of price stability in the medium term and, in consequence, decided to raise official interest rates by a quarter of a point to 3.75%. Notwithstanding this, the monetary policy stance remains accommodative and, therefore, a stimulus to economic growth and job creation.

As regards fiscal policy, according to the latest information available in the Member States' notifications to the European Commission in spring, the budget deficit was reduced to 1.6% in 2006, from 2.5% in 2005, a more favourable result than estimated by the Commission in its autumn report. Also, it was decided in January to abrogate the excessive deficit procedure opened against France in June 2003.

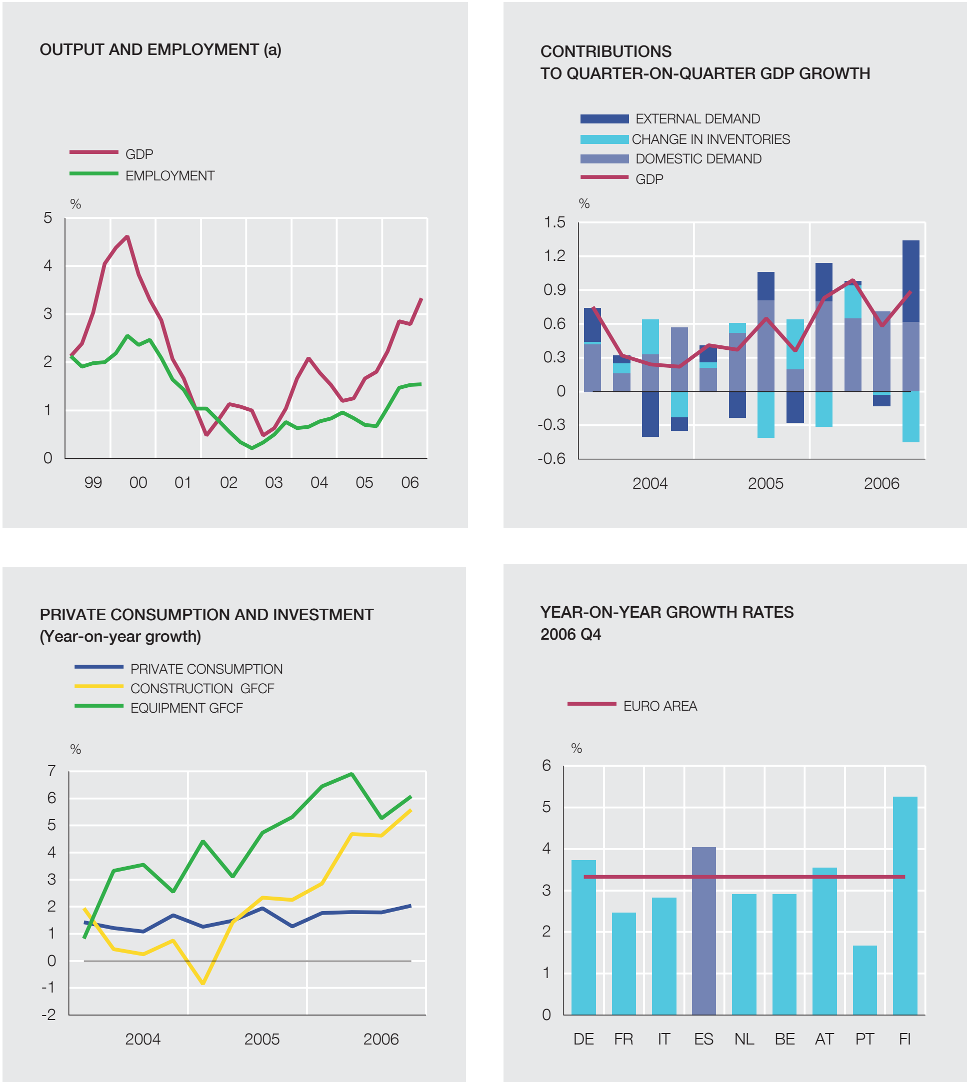
3.1 Economic developments

According to the second estimation of the National Accounts, in 2006 Q4 euro area GDP grew by 0.9% quarter-on-quarter, 0.3 percentage points more than in Q3, basically as a result of the rise in net external demand. The latter contributed 0.7 pp to the increase in GDP, offsetting the sharp decline in the contribution to growth from the change in inventories, which deducted 0.5 pp (see Chart 8). For its part, the strength displayed by domestic demand (excluding inventories) in previous months extended into Q4. This component increased by 0.6%, only 0.1 pp less than in Q3. Among its components, private consumption and government consumption slowed, while the growth of gross fixed capital formation rose. In year-on-year terms, the rate of change of GDP reached 3.3% in Q4, up from 2.8% in the previous quarter (see Table 1). Thus, in 2006 as a whole, output increased by 2.8% (1.3 pp more than in the previous year), thanks to the firming of domestic demand and net exports.

By branch of activity, all sectors, other than industry, contributed to the acceleration in gross value added. In accordance with the National Accounts country breakdown, the upturn in activity in the latter months of the year was a feature common to the major economies of the area. Thus, among the latter, the significant acceleration in GDP in France and Italy (whose growth rates reached 0.7% and 1.1% quarter-on-quarter, respectively) was notable. In line

EURO AREA NATIONAL ACCOUNTS

CHART 8



Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

with the performance observed for the euro area as a whole, gross fixed capital formation drove the contribution of domestic demand (excluding inventories) in both economies, while exports, especially in the case of Italy, grew at a significantly higher rate than in the previous quarter. Germany also saw an extraordinary increase in the contribution of the net external balance to GDP growth, to 1.9 pp. However, the slowdown in consumption and the very negative contribution of inventories meant that, in Q4, GDP only accelerated by 0.1 pp to 0.9% quarter-on-quarter.

The recovery in the labour market continued to firm in late 2006. Employment increased in 2006 Q4 by 0.3% (as in the previous quarter), which meant that its year-on-year growth rate held at 1.5%. This employment behaviour, together with the greater dynamism of euro area economic activity in the final quarter of 2006, gave rise to a notable acceleration in productivity, the growth rate of which rose to 1.8% (from 1.2% in the previous quarter). At the same time, compensation per employee increased by 1.8% year-on-year, 0.5 pp less than in the preceding quarter. However, this figure was strongly influenced by the 1% fall in compensation per employee in Italy, since the growth rate of this variable was slightly higher or remained

EURO AREA ECONOMIC INDICATORS TABLE 1

	2005		2006				2007	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1 (a)	Q2 (b)
GDP								
Year-on-year growth	1.7	1.8	2.2	2.8	2.8	3.3		
Quarter-on-quarter growth	0.6	0.4	0.8	1.0	0.6	0.9		
European Commission forecasts (c)							(0,4 ; 0,8)	(0,4 ; 0,9)
IPI (d)	1.6	2.2	3.5	4.3	4.2	3.9	3.7	
Economic sentiment	97.5	100.1	102.6	106.8	108.2	109.9	110.0	
Industrial confidence	-7.3	-5.7	-2.3	2.3	3.7	5.7	5.3	
Manufacturing PMI	51.0	53.0	54.7	57.1	56.9	56.7	55.5	
Services confidence	10.7	14.0	14.7	18.7	19.0	19.7	20.7	
Services PMI	53.8	55.6	57.8	59.2	57.3	57.1	57.6	
Unemployment rate	8.4	8.4	8.2	7.9	7.8	7.6	7.4	
Consumer confidence	-15.3	-12.3	-10.7	-9.7	-8.3	-7.0	-5.3	
HICP (d) (e)	2.6	2.2	2.2	2.5	1.7	1.9	1.9	
PPI (d) (e)	4.4	4.7	5.1	5.8	4.6	4.1	2.9	
Oil price in USD (e)	62.6	56.5	61.6	68.1	61.2	62.8	62.3	68.0
Loans to the private sector (d) (e)	8.7	9.2	10.8	11.0	11.4	10.8	10.3	
Euro area ten-year bond yield	3.3	3.4	3.6	4.0	4.0	3.9	4.1	4.2
US-euro area ten-year bond spread	0.98	1.12	1.06	1.08	1.00	0.82	0.66	0.55
Dollar/euro exchange rate (e)	1.204	1.180	1.210	1.271	1.266	1.317	1.332	1.361
Appreciation/depreciation of the dollar against the euro (e)	-11.6	-13.4	2.6	7.8	7.3	11.6	1.1	3.3
Dow Jones EURO STOXX Broad index (e)	17.7	23.0	10.3	4.2	11.9	20.3	3.4	8.3

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available up to 20 April 2007.
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.

steady in the rest of the countries. The zero increase in unit labour costs (as against 1.1% in the previous quarter) entailed a sharp rise in profit margins, since the GDP deflator increased by 1.7% (see Chart 9).

The latest information for 2007 Q1 points to robust GDP growth in the euro area, albeit at more moderate rates than in the previous quarter, partly as a result of the increase in German VAT in January (see Chart 10). From the viewpoint of supply, following its decline in January, industrial production picked up again in February, the IPI recovering its end-2006 level. At the same time, comparing with 2006 Q4, the qualitative indicators provided by the European Commission's confidence surveys and the purchasing managers' surveys fell slightly on average in industry and improved in the services sector. In construction, business sentiment, according to the Commission's surveys, deteriorated significantly in the first few months of the year. With regard to employment, the signs emanating from the indicators are generally positive. Thus, both sets of surveys reflected greater optimism in the first quarter of 2007 regarding future employment levels in all sectors, with the sole exception of the Commission's services sector survey. Moreover, the rate of unemployment continued to fall in January and February (to 7.3%, its lowest level since 1993, the first year for which aggregate euro area data exist for this variable), prolonging a downward trend that began two years ago and which, according to various estimates, could stem partly from a fall in the structural rate of unemployment, prompted by some of the labour reforms undertaken in various countries of the area in recent years (see Box 2).

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

CHART 9

SOURCES: Eurostat and European Central Bank.

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

On the demand side, indicators generally anticipate a favourable trend for activity in Q1, although the consumption indicators have reflected the negative effect of the increase in German VAT. This effect was especially strong in January, but it eased as the quarter progressed. Specifically, retail sales (on data to February) and, above all, new car registrations, decelerated on average in Q1, dragged down by Germany. The qualitative information provided by the European Commission's surveys shows considerable optimism among consumers in 2007 Q1, while the confidence of retailers remained high. With respect to investment in capital goods, the indicators can be interpreted as pointing to a favourable outlook for this component of GDP, given the improvements in the degree of use of productive capacity according to the Commission's quarterly survey and in the assessment of order books. At the same time, the data published in January in the Commission's six-monthly investment survey show an acceleration in capital expenditure for 2007 as a whole. Finally, the favourable export expectations, the improvement in the assessment of external order books and the buoyancy of exports, according to foreign trade data to February, anticipate an expansion of sales to the rest of the world in Q1.

In short, output growth can be expected to have moderated in the first months of 2007, following its exceptional buoyancy in the final quarter of 2006 (partly affected by the fiscal reform in Germany), to around the mid-point of the 0.4%-0.8% interval estimated by the European Commission. Over the coming months, activity in the euro area is expected to retain its momentum, underpinned by the robust growth in world trade and the strength of domestic demand, driven in turn by job creation and favourable financing conditions. More in the medium term, a sharper than expected slowdown in the United States and a possible repetition of the turmoil that hit international financial and currency markets at the beginning of March, in a context in which global macro-financial imbalances persist, remain as downside risks to activity in the euro area.

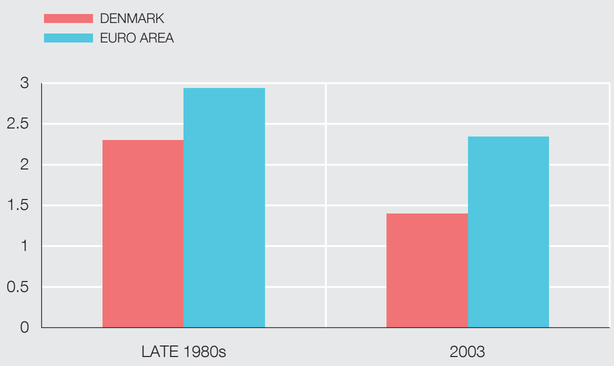
In 2007 Q1 inflation held below the 2% mark, standing in March at 1.9%, the same level as in December last year, despite the rise in German VAT in January (see Chart 11). The latter

The labour market model that traditionally prevailed in European countries in the first few decades after the second world war, in which the employees were predominantly men, was based on permanent contracts, high firing costs and standard working hours. However, the economic and social transformations that took place in the final quarter of the last century required profound adaptation of labour markets. Specifically, phenomena such as the growing globalisation of economic activity, the acceleration of technological change and the incorporation of women into the labour market called for the emergence of more flexible ways of organising work.

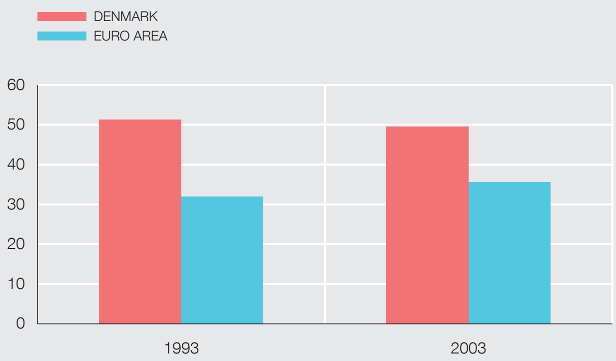
The requirement for greater flexibility in a context of resistance to change, rooted in the perception that it may result in less security, has given rise to partial reforms that have not managed to increase the degree of labour utilisation sufficiently. Against this background, European economic policy debate has tended to seek, from among the range of labour markets existing in the various countries, those that provide a valid model for the other Member States. Such an example is thought to have been found in the Nordic countries (and, in particular, in Denmark), in view of their good employment figures. The Danish market is characterised by the co-existence of a high degree of flexibility with a high level of social protection (which has been termed "flexicurity"). The main elements of flexibility and security are, respectively, the existence of relatively low firing costs and high unemployment benefits (see Charts 1 and 2). However, receipt of benefits is conditional upon acceptance of job offers and participation in training programmes, in order to provide the appropriate incentives. In this way, it is sought to facilitate the adjustment of company workforces while guaranteeing workers who lose their jobs a certain level of income during the transition to a new job.

The third basic ingredient of the Danish labour model is the emphasis on active labour market policies, the aim of which is to keep individuals' professional qualifications constantly up to date, so that the

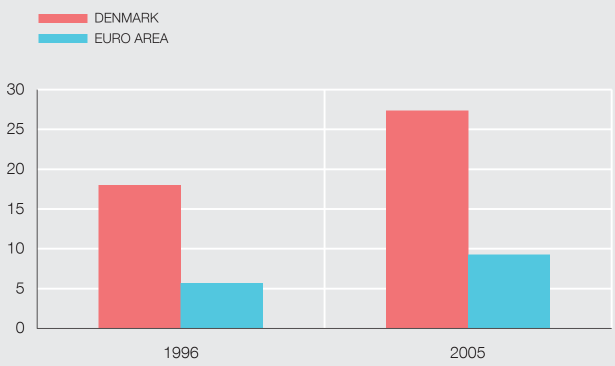
1 EMPLOYMENT PROTECTION LEGISLATION (a)



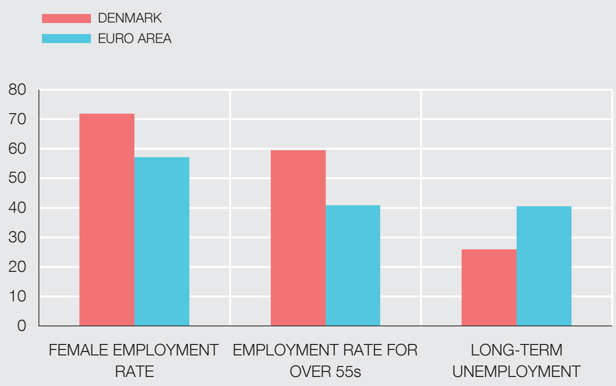
2 REPLACEMENT RATE (b)



3 LIFELONG LEARNING (c)



4 LABOUR MARKET RESULTS IN 2005 (d)



SOURCES: Eurostat and OECD.

a. Synthetic indicator that measures the costs of dismissal and takes values from 0 to 6. A higher value indicates stricter legislation.
b. This measure is calculated as the average of the gross replacement rates of unemployment benefits for two wage levels, three family situations and three unemployment durations.
c. Refers to the percentage of the population aged 25-64 years who declared that they had received training or education in the four weeks preceding the survey (European Union Labour force Survey).
d. Long-term unemployment (more than one year) is expressed as a percentage of total unemployment.

transition between jobs can be as short as possible (see Chart 3). In this model, therefore, security is not identified with having the same job throughout one's working life, but with the successive linking of different jobs, the skills accumulated being assumed to enable workers to be at least as productive as in their previous job. The correct functioning of this scheme will thus lead not only to higher rates of employment, but also to higher rates of productivity growth.

The results achieved by the Danish labour market suggest that the "flexicurity" model has been a success (see Chart 4). In particular, in 2005 the total rate of employment and the rates for females and the over 55s stood at 75.5%, 71.9% and 59.5%, respectively (i.e. 11, 15 and 19 pp higher than in the euro area as a whole), while the total unemployment rate and, above all, the long-term rate are particularly low. The signs that this healthy labour market may have something to do with its institutional arrangements have led to the inclusion of "flexicurity" in the European economic policy debate and, in particular, in the assessments of progress in implementation of the Lisbon Agenda. In addition, the employment policy guidelines approved by the European Council in July 2005 propose to "promote flexibility combined with employment security and reduce labour market segmentation".

The Danish model contains elements which the euro area countries should consider introducing, but this does not necessarily mean that the model should be fully replicated. In particular, the Danish unemployment benefit and lifelong learning systems are very costly to public finances, and so may require a high tax burden. Indeed, a severe shock to the economy as a whole could lead to an inability to absorb the resulting unemployment and a large increase in public spending. Thus, this model may not adapt well to countries with a small public sector and may be inappropriate, at least initially, for countries in an unfavourable fiscal situation, with high unemployment. Moreover, the experience of other countries (Spain and Ireland and, outside the euro area, the United Kingdom) shows that it is possible to reduce unemployment with social models very different from the Danish one. Finally, the hypothetical transfer of this model to other European countries may meet with objections from social agents, which could lead to an unbalanced application of the various components of the scheme and a consequent reduction in its effectiveness.

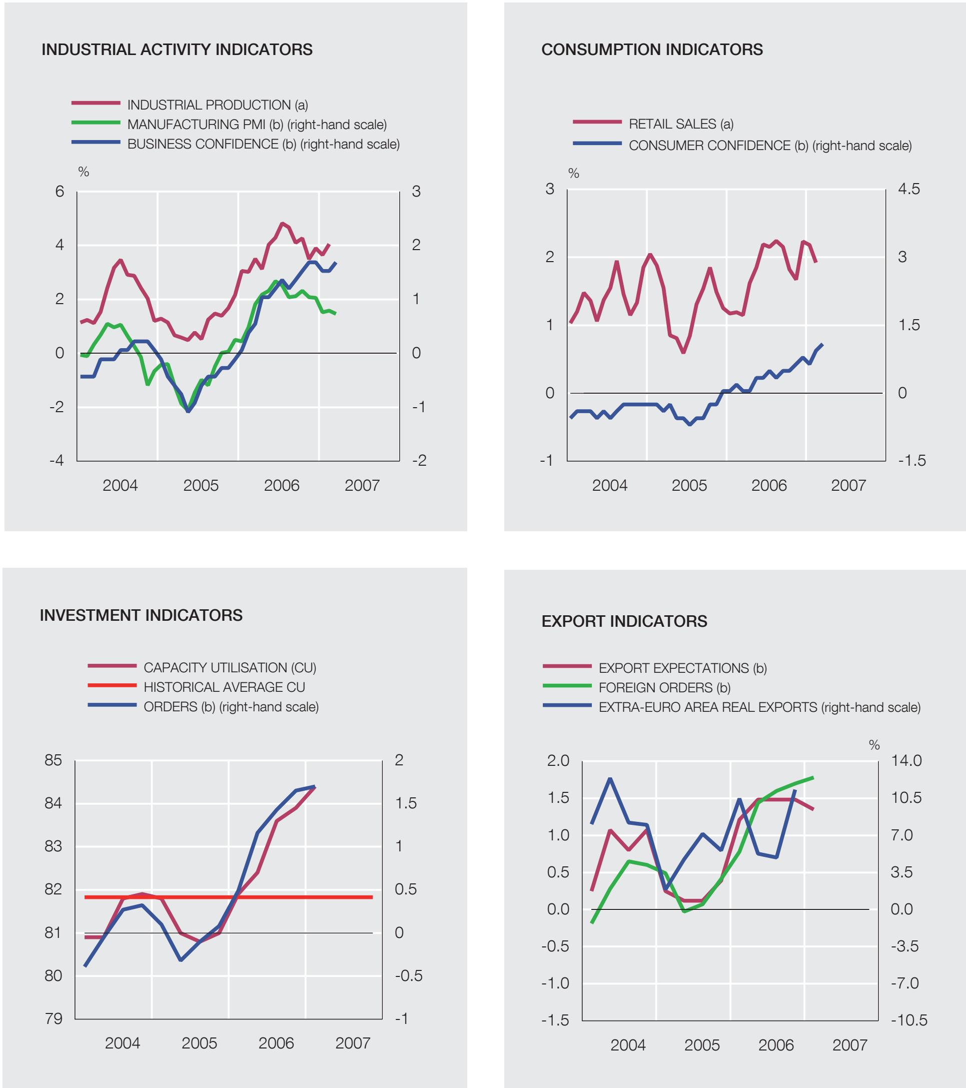
had an impact on the less volatile items of the HICP, but its effect on overall inflation was offset by the slowdown in the energy and unprocessed food components. As a result, the HICP excluding unprocessed food and energy accelerated from end-2006 and currently stands at 1.9% (up from 1.6% in December), its highest level since December 2004. The notable slowdown in energy prices was also behind the fall in the rate of growth of producer prices from November, although the prices of consumer durables and capital goods have accelerated, which may be a sign of the emergence of some indirect effects of past increases in the oil price.

Although the various forecasts available, and the indicators of inflation expectations, point to the maintenance of inflation in the short and medium-term at levels compatible with price stability, the risks are on the upside. First, the re-emergence of tensions in the oil market has led to a significant increase in the price of oil and further rises cannot be ruled out. Above all, however, there is a risk of higher-than-expected wage settlements, against a background of robust economic growth and continuous improvement in the labour market, which may also be conducive to a greater degree of pass-through of changes in the oil price to other consumer prices. The appreciation of the euro effective exchange rate in the first part of the year, if maintained, would tend to mitigate these risks.

According to estimates published by the ECB, the current account deficit amounted to €6 billion in January 2007, as against €10.1 billion in the same month of 2006. This reduction in the current account deficit was prompted by the decline in the goods deficit (thanks to higher year-on-year growth of exports than imports) and the transfers deficit. At the same time, there was a significant inflow of capital in the form of portfolio invest-

EURO AREA. REAL INDICATORS

CHART 10



SOURCES: Eurostat and European Commission.

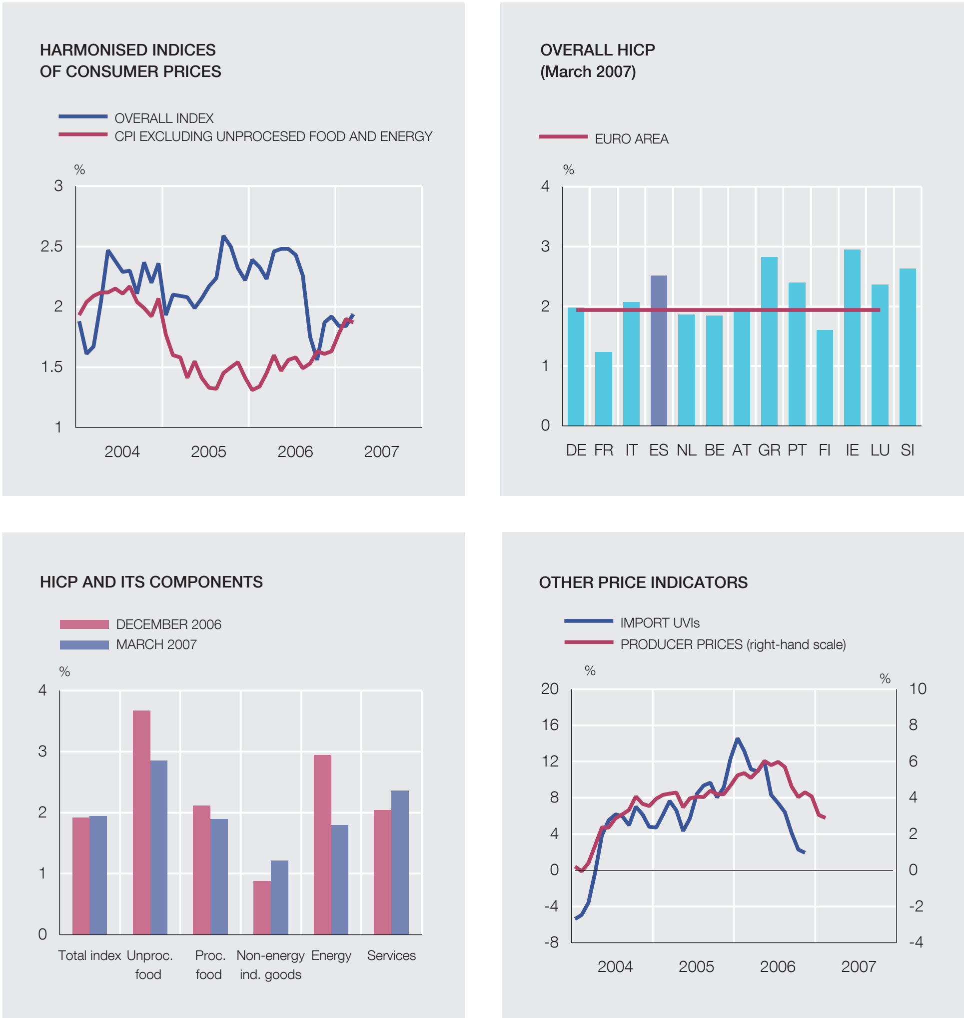
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.

ment in January, of €39 billion, which far exceeded both the net outflows of direct investment and the current account deficit, so that, in that month, there was a positive basic balance of €28 billion, in stark contrast to the cumulative deficit of €49.4 billion in January 2006.

With regard to fiscal policy, the latest notifications made by the euro area Member States to the European Commission in spring indicate that the budget deficit for the area as a whole may have been 1.6% of GDP in 2006, down 0.9 pp from 2005 (see Table 2). The reduction of the general government deficit would have been the result of higher-than-expected revenues and the strength of activity in the area. This estimate contrasts with the more pessimistic forecast published by the European Commission in its autumn report last November, which put the deficit at 2% of GDP. As regards the debt ratio, according to the most recent notifications it fell from 70.5% in 2005 to 69% in 2006.

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

CHART 11



SOURCES: Eurostat and European Central Bank.

The improvement in budget balances was seen across all the members of the euro area. Among the countries subject to an excessive deficit procedure, Italy was the only one to record a deterioration (of 0.2 pp) in its budget balance in 2006, to 4.4%, owing to certain exceptional factors. Among the rest, Germany, Greece and Portugal significantly reduced their fiscal deficits, to below 3% in the case of the first two countries (1.7% and 2.6%, respectively) and to 3.9% in the case of the latter. Finally, the budget deficit in France improved by 0.5 pp in 2006 to 2.5% and, since the balance was below 3% for the second consecutive year, the ECOFIN Council decided in January to abrogate the excessive deficit procedure for this country.

The Commission has not yet published the cyclically adjusted primary balance based on the new information provided by the notifications. Preliminary estimates anticipate that the fiscal policy stance during 2006 may have been neutral or contractionary (see Box 3). As for 2007, the Stability Programmes presented between December 2006 and January 2007 assume that the deficit will fall to about 1.4% of GDP. However, it should be noted that, since the reduction in the deficit in 2006 was sharper than foreseen in these programmes and that the growth outlook for 2007 is also favourable, one might have expected a more ambitious improvement this year.

GENERAL GOVERNMENT BUDGET BALANCES
OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2004	2005	2006 (b)	2006 (c)	2007 (d)
Belgium	0.0	-2.3	-0.3	0.2	0.3
Germany	-3.7	-3.2	-2.3	-1.7	-1.5
Greece	-7.9	-5.5	-2.5	-2.6	-2.4
Spain	-0.2	1.1	1.5	1.8	1.0
France	-3.6	-3.0	-2.8	-2.5	-2.5
Ireland	1.4	1.0	1.2	2.9	1.2
Italy	-3.5	-4.2	-4.7	-4.4	-2.8
Luxembourg	-1.2	-0.3	-1.0	0.1	-0.9
Netherlands	-1.8	-0.3	0.0	0.6	0.2
Austria	-1.2	-1.6	-1.4	-1.1	-0.8
Portugal	-3.3	-6.1	-4.6	-3.9	-3.7
Slovenia	-2.3	-1.5	-1.6	-1.4	-1.5
Finland	2.3	2.7	2.8	3.9	2.8
PRO MEMORIA: Euro area (including Slovenia)					
Primary balance	0.3	0.5	0.9	1.4	
Total balance	-2.8	-2.5	-2.0	-1.6	-1.4
Public debt	69.7	70.5	69.4	69.0	68.0

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. European Commission forecasts (autumn 2006).
c. Spring 2007 EDP notification.
d. Targets of the stability programmes presented in late 2006 and early 2007.

3.2 Monetary and financial developments

In 2007 Q1, at its March meeting, the Governing Council of the ECB raised official interest rates by a further 25 bp, after identifying the existence of upside risks to the maintenance of price stability over the medium term. These were principally related to the possibility (in the current context of strong growth in activity and employment) of higher-than-initially-projected wage settlements. At its April meeting, the Governing Council of the ECB decided to keep interest rates unchanged, but confirmed the existence of the same risks and assured that it would monitor economic and monetary developments very closely in order to avoid such risks materialising. As a result of these decisions, the interest rate on its main refinancing operations stood at 3.75%, while those on its marginal deposit and lending facilities were 2.75% and 4.75%, respectively (see Chart 12). Despite the somewhat more restrictive nature of monetary policy, its stance continued to be accommodative.

Financial variables in 2007 Q1 followed the same trend as at the end of 2006, although in March it was temporarily interrupted by the bout of turbulence that hit world markets. This episode demonstrated the low level of risk aversion that seems to predominate among investors, which means that this turbulence may be repeated in future.

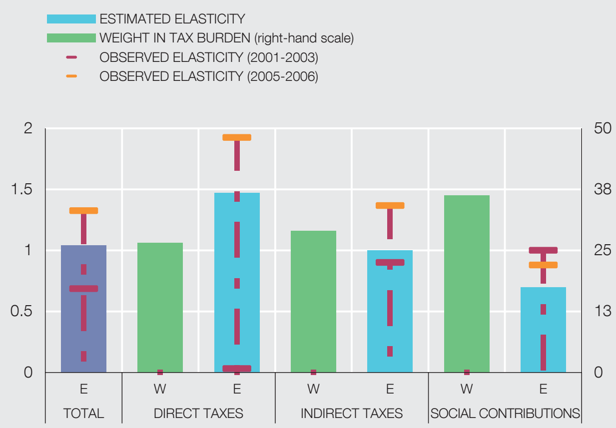
The money market yield curve shifted gradually upwards during Q1, in step with expectations of official interest rate rises. On public debt markets, long-term yields are currently slightly above the levels at which they held, subject to some fluctuation, during the first two months of the year, having recovered from their fall in the first half of March. Despite behaving very

As a percentage of GDP, the general government primary surplus of the euro area as a whole rose by 0.8 pp last year. The size of this improvement immediately raises the question of the respective contributions of the business cycle and the discretionary actions of the authorities, given the significant implications of the answer for economic policy. This is not obvious, however, since the methods used to obtain the cyclical component of budget balances are somewhat imprecise. Essentially, these measures are based on the result of multiplying the weighted elasticities of the various revenue and expenditure items with respect to the output gap (taken as a measure of the economy's cyclical position) by the output gap itself, there being two specific features of the procedures that may give rise to imperfections in the calculations.

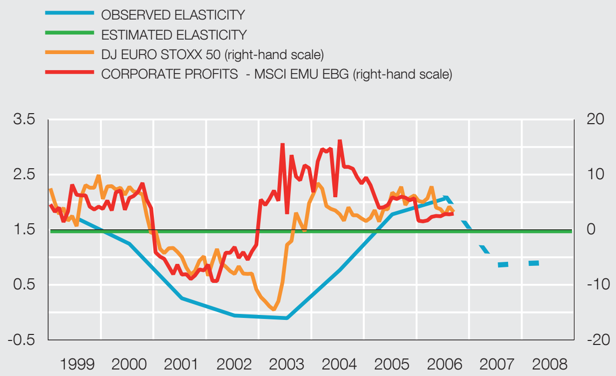
The first of these features is that the budgetary elasticities with respect to the output gap are estimated on the basis of historical data, being considered constant for the sample as a whole. However, elasticities, far from being fixed, fluctuate considerably. Thus, the aggregate elasticity of revenues as a whole (whose estimated value is approximately equal to one) stood, in practice, at around 0.7 on average over the period 2001-2003 and 1.3 between 2005 and 2006 (see Chart 1). By category of revenue, the largest fluctuations corresponded to direct taxes, whose elasticities in each of these two stages were 0 and 1.9, respectively, so that this component explains a very high proportion of the changes in total elasticity. This elasticity has a very high correlation with the business cycle itself, as measured by the changes in the output gap. Consequently, the cyclical adjustment through these procedures may be incomplete, so that the size of the cyclical component of the budget balance may be, in absolute terms, underestimated. As a result, during expansionary phases, the assessment of the underlying position of public finances, based on the usual calculations, may be more favourable than the real one, the opposite being the case in periods of reduced economic buoyancy.

To understand the reasons behind the cyclical fluctuations in the estimated elasticities, it should be borne in mind that these are, in fact, calculated as the product of the elasticities of the various budget headings with respect to their bases and of the bases themselves

1 TAX ELASTICITIES WITH RESPECT TO GDP IN THE EURO AREA

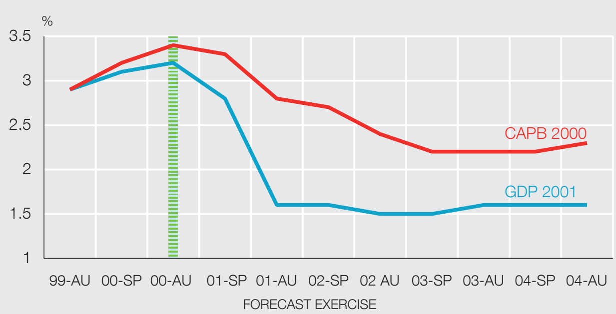


2 ELASTICITIES OF DIRECT TAXES AND CORPORATE PROFITS WITH RESPECT TO GDP



3 REVISION OF CAPB ESTIMATES (a)

4 ESTIMATES OF CAPB FOR 2000 AND OF GDP FOR 2001 (b)



SOURCES: Thomson Financial Datastream and EC spring and autumn forecasts (various numbers).

a. For each year t three forecast exercises are depicted: those of the autumn of t, the spring of t+1 and autumn of t+1. The direction of the arrows indicates the direction of the revisions.
b. SP and AU denote the spring and autumn forecast exercises respectively. The broken line centred on the autumn 2000 forecast indicates the point from which the revisions to the 2000 CAPB cannot be explained by the inclusion of discretionary measures.

with respect to the output gap. Chart 2 illustrates two possible causes that would explain the cyclical fluctuations in the elasticity estimated for direct taxes as a whole. First, when calculating the elasticity of the taxes on household and corporate income, the bases are approximated, respectively, by wage income and the gross operating surplus, without taking into account other components thereof, such as capital gains on real estate and financial assets. Since the prices of housing and shares behave cyclically (as seen in the chart in the latter case), the estimated elasticity tends to underestimate the cyclical component of the direct taxes levied on households and firms. Second, the profits of euro area companies (the corporate income tax base) grew at negative rates in 2001 and 2002, which makes it very likely that, in comparison with other phases, a larger proportion of firms recorded losses in this period. Given the possibility of deducting previous years' losses from the base, it is possible that, in the immediately following years, revenues rose less than proportionately relative to profits.

The second feature relates to the fact that, in order to obtain the output gap, the level of potential output has to be calculated. This is done using moving averages of GDP growth, including forecasts to make up for the lack of future observations. This fact influences the cyclical position estimated in the latter years of the sample; a downward revision to the forecast growth results in a lower estimate of potential output for the immediately preceding periods already elapsed and, consequently, a larger output gap and cyclical component for the budget balance and, for a given actual balance, a lower cyclically adjusted primary balance (CAPB). Chart 3 shows, for each year since the start of monetary union, the estimates of the CAPB made by the European Commission in the autumn of each year and in the spring and autumn of the following year, as well as the GDP growth forecasts for this latter period made at each of these three times. As can be seen, in the period 2000-2004 (except in 2003), the successive downward revisions to the short-term GDP growth outlook led to revisions of the same sign in the estimate of the CAPB. It is important to stress that the changes in the calculated CAPBs, which are shown in the chart, are not due to the adoption of discretionary measures, since, for each year, the first of these three assessments was made in October or November, i.e. when the budget year was practically over. In particular, the revision to the CAPB after one year was more than half a percentage point in 2000 and 2002.

The combination of these two features provides a plausible explanation for the deterioration in the euro area's public finances over the period 2001-2003. The year 2000 was one of highly buoyant economic activity and, therefore, the observed elasticity of direct tax revenues was relatively high, so that the CAPB tended to be overestimated. In this context, various governments of the area reduced taxes, probably partly as a result of their interpreting the underlying situation of public finances as being sufficiently solid to enable such measures to be adopted. However, from 2001, there was a sharp, unexpected (and, moreover, prolonged) slowdown in GDP which, given the method of calculating output gaps, led to successive downward revisions to the CAPB for 2000, the result being that the current estimate of this variable is 1.1 pp lower than the one available in the autumn of that year (see Chart 4).

In any event, the experience of 2000 is, in the current situation, particularly valuable from the point of view of economic policy. This is because there is a risk that the portion of the improvement in the actual primary balance in 2006 that is attributable to discretionary factors may be interpreted as being greater than it really was, which may lead to a relaxation of the drive to correct imbalances. The consequences of such a mistaken interpretation would be more serious should the current favourable cyclical conditions change, so the authorities need to be prudent when designing their fiscal policy for the coming year.

similarly, bond rates in the United States declined further than in the euro area causing the yield spread to narrow in April, to 50 bp. The rise in official interest rates has also continued to drive up the rates applied by credit institutions in their loan and deposit transactions (see Chart 13).

During the first three months of the year, the average euro nominal effective exchange rate stood in line with its value in December, given that the appreciation of the European currency in February and March made up for the depreciation in January, basically reflecting the behaviour of the euro against the US dollar and the pound sterling. However, in the first few weeks of April, the upward trend in the euro strengthened, with a rise (relative to the average of the previous month) of almost 1% in nominal effective terms and close to 2% with respect to the US dollar.

As regards equity markets, the favourable outlook for corporate earnings (in a context of solid economic growth) enabled stock markets to remain on the upward path they were following in

EURO AREA INTEREST RATES

CHART 12

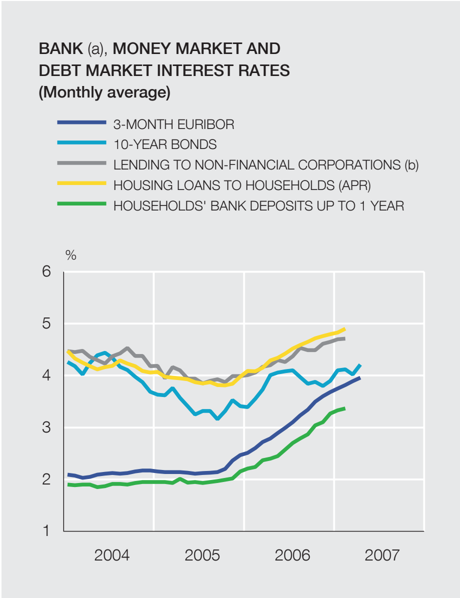
SOURCES:European Central Bank and Banco de España.

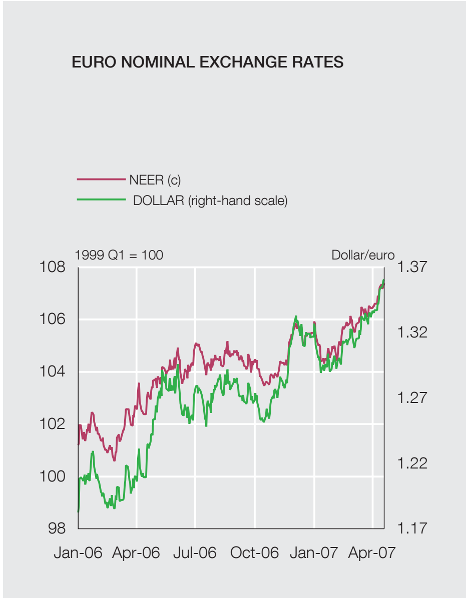
a. Estimated using swap market data.
b. Estimated using Euribor data.

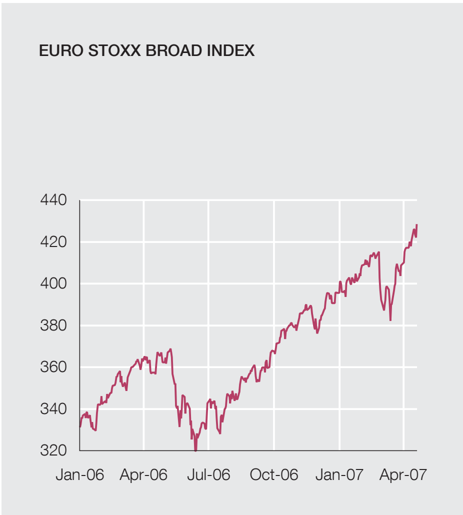
2006 Q4. However, dragged down by world stock markets, European markets recorded significant losses between end-February and mid-March, although they have since resumed their upward trend. Thus, in 2007 Q1 the EURO STOXX index rose by 3.4%, while in April it rose by a further 5%. However, these gains have taken place amid greater volatility and, according to some analysts, the assumption of greater risk. In any case, corporate bond spreads have narrowed gradually during the year to date, and were unaffected by the market turmoil.

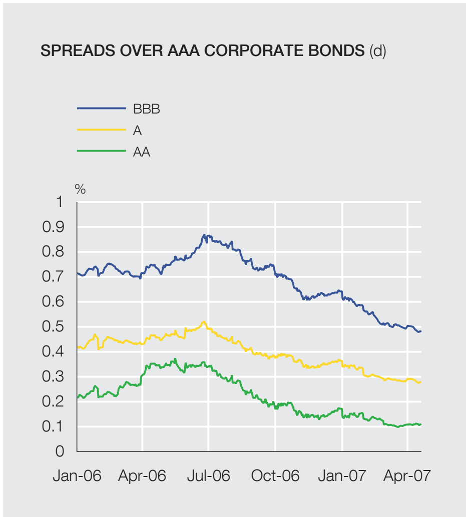
With regard to monetary aggregates, M3 grew by 10% in February, prolonging the upward course displayed by this aggregate since the middle of last year (see Chart 14). This strong monetary expansion reflects the still moderate level of interest rates and the strengthening of economic activity in the euro area. The slight acceleration of M3 in February also extended to M1, owing to the higher growth in deposits, although the growth rate of this aggregate held steady with respect to its average level in 2006 Q4.

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









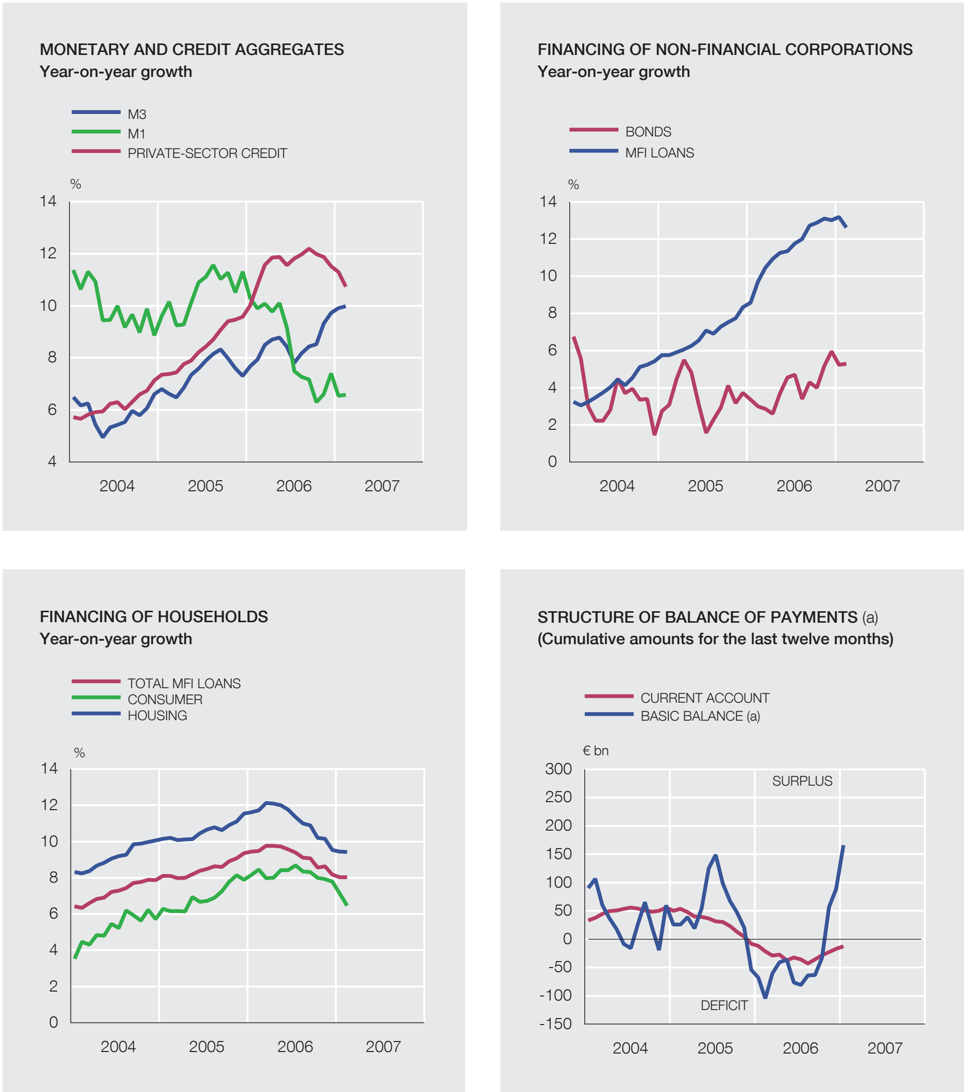
SOURCES: Banco de España and European Central Bank.

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 (EER-23) . Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

By contrast, credit to the private sector, and its main component, loans, recorded falls in their rates of growth in February, for the fifth consecutive month (in the latter case to 10.3%, from 10.8% last December). By agent, the loans granted to non-financial corporations remained highly buoyant and only slowed in February, to a rate of 12.6%. According to the Bank Lending Survey corresponding to 2006 Q4, this buoyancy was a result of the large financing needs linked to investment in fixed capital and inventories and to working capital, as well as, once again, to mergers and acquisitions. In the first two months of 2007, loans granted to households continued the slowdown initiated in 2006 Q2, thanks to the notable deceleration of consumer loans (partly offset by the acceleration in those for other purposes) and, to a lesser extent, in loans for house purchase, which still grew at very high rates however (9.4% in February). Finally, developments in credit to the private sector con-

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.

tinued to vary greatly across countries. That said, moderation in the growth rate of credit to the private sector is a characteristic common to the main countries of the euro area, except Italy.

On QNA estimates, year-on-year GDP growth in 2006 Q4 was 4%, 0.2 pp up on the previous quarter. This was due to the 0.1 pp acceleration in national demand to 4.7%, and to an improvement by the same proportion in the contribution of net external demand to output, to –0.9 pp. In quarter-on-quarter terms, GDP increased by 1.2%, the highest rate for the year. The information available suggests the GDP growth rate will hold at 4% in 2007 Q1 (1% in quarter-on-quarter terms), the result of the stability of both national demand and of the contribution of the external sector (see Chart 15). National demand is expected to have been underpinned this quarter, as in the last, by the dynamism of investment in equipment and by the resilience of private consumption, while investment in construction is estimated to have eased off slightly. A slowdown in both exports and imports of goods and services is projected for this period compared with the end-2006 rates, leaving the contribution of net external demand unchanged.

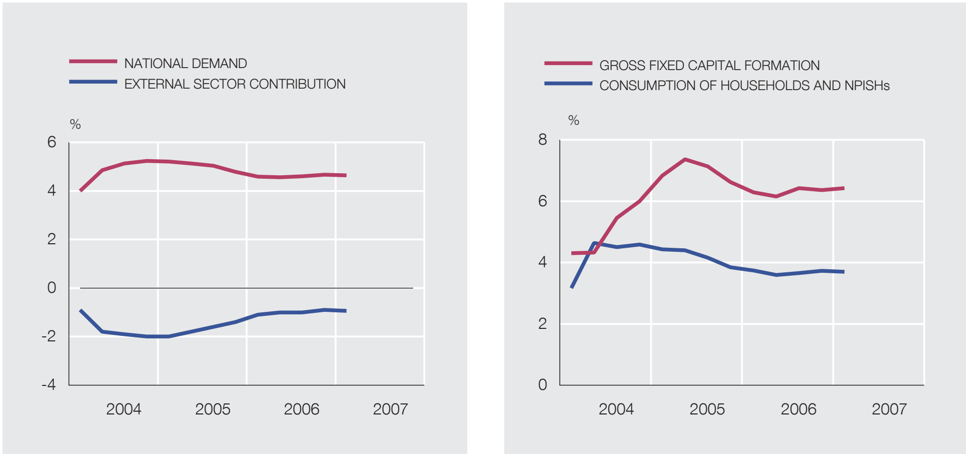
From the standpoint of value added, the stability in the rate of expansion of output in the opening months of 2007 was broadly reflected in all branches of activity, with the firming of the pick-up in the industrial branch to the fore. Turning to employment, it is estimated that numbers employed continued to grow at a high rate of around 3% in 2007 Q1, meaning there will have been no further advances in apparent labour productivity. Unit labour costs are forecast to have slowed slightly as a result of the moderation of compensation per employee, which evidences a limited impact of the activation of the indexation clauses in 2006 collective bargaining agreements, thanks to the lower rate of inflation at which that year ended. The slowdown in inflation continued in the opening months of 2007, albeit with less intensity than in the previous quarter. The 12-month growth rate of the CPI dipped by 0.2 pp to 2.5% in March, owing to the fall in energy prices on a year earlier, while underlying inflation stood in March at the same level as in December 2006 (2.5%).

4.1 Demand

In 2006 Q4, Spanish household final consumption spending held at 3.7% in year-on-year terms, prolonging the path of relative strength observed practically throughout the year. The latest conjunctural information suggests that private consumption will have grown at a similar rate in 2007 Q1. The synthetic indicator of private consumption of goods and services offers a distorted profile in the opening months of 2007 as it is affected by a base effect, linked to the exceptional volume of imports recorded in early 2006; however, its underlying trend is one of stability. Along these same lines are the January and February figures drawn from the tax authorities for large corporations' sales, which point to a mild acceleration in consumer services, and in the retail sales index, which showed a significant increase in the same period. Consumer confidence held virtually stable in 2007 Q1, following the improvement in late 2006. New car registrations fell in the first three months of the year (see Chart 16).

Drawing on figures for 2006 Q4 from the non-financial accounts of the institutional sectors, private consumption in 2006 outpaced the related disposable income, meaning that the saving ratio fell once again, to 10.1%. For the current year, an acceleration in real household disposable income is expected, based on the moderation of inflation and on lower tax payments (the result of the personal income tax reform which came into force at the beginning of the year), which would offset the income-reducing effect exerted by net interest payments. Foreseeably, however, consumption will not grow by the same proportion as income in 2007 and the saving ratio will recover, against a background of interest rate increases. Household wealth has continued slowing, with stock market prices showing less momentum and real estate

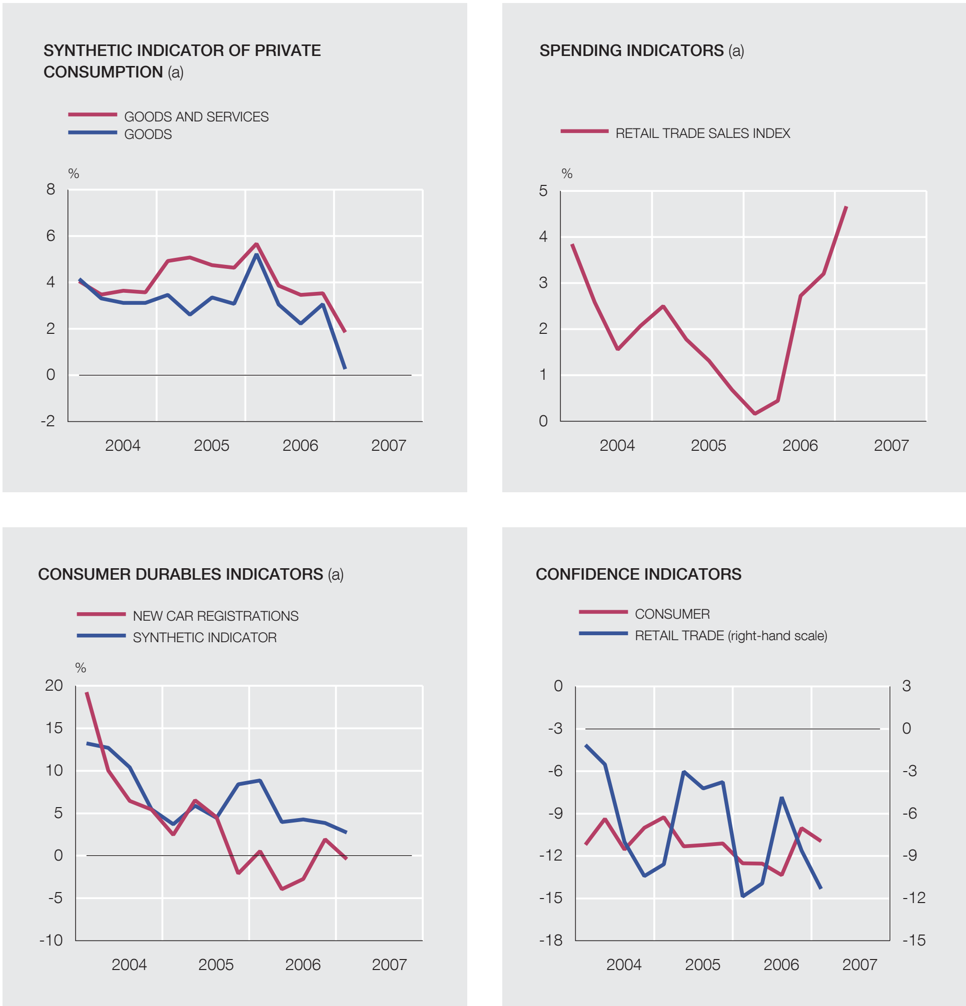
MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION INDICATORS CHART 16



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

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

wealth posting a more modest growth rate, in view of the moderation in house prices, which increased at a year-on-year rate of 7.2% in 2007 Q1 compared with 9% in 2006 Q4.

General government final consumption rose by 0.7 pp in 2006 Q4 to 4.9%. This component is forecast to slow in 2007 Q1 on the basis of a smaller increase both in compensation per employee and in net purchases of goods and services.

Gross fixed capital formation held in 2006 Q4 at the notable pace recorded the previous period (6.4% year-on-year). This was the outcome of a 1.8 pp acceleration in investment in capital goods, to 11.4%, and of a smaller expansion in investment in construction and other products, which posted rates of 5.7% and 1.7%, respectively. The information available for Q1 points to the continuing strength of fixed capital investment, with growth by component relatively similar to that recorded at end-2006.

In fact, the indicators relating to investment in capital goods reveal the continuing dynamism of this component. The indicator of apparent investment in capital goods, calculated with incomplete data for 2007 Q1, is holding at a notable growth rate, based on the robustness of the domestic output of these goods. Further, the business confidence indicator for the industry improved in Q1, accompanied by the favourable trend of orders, specifically those relating to the capital goods industry (see Chart 17).

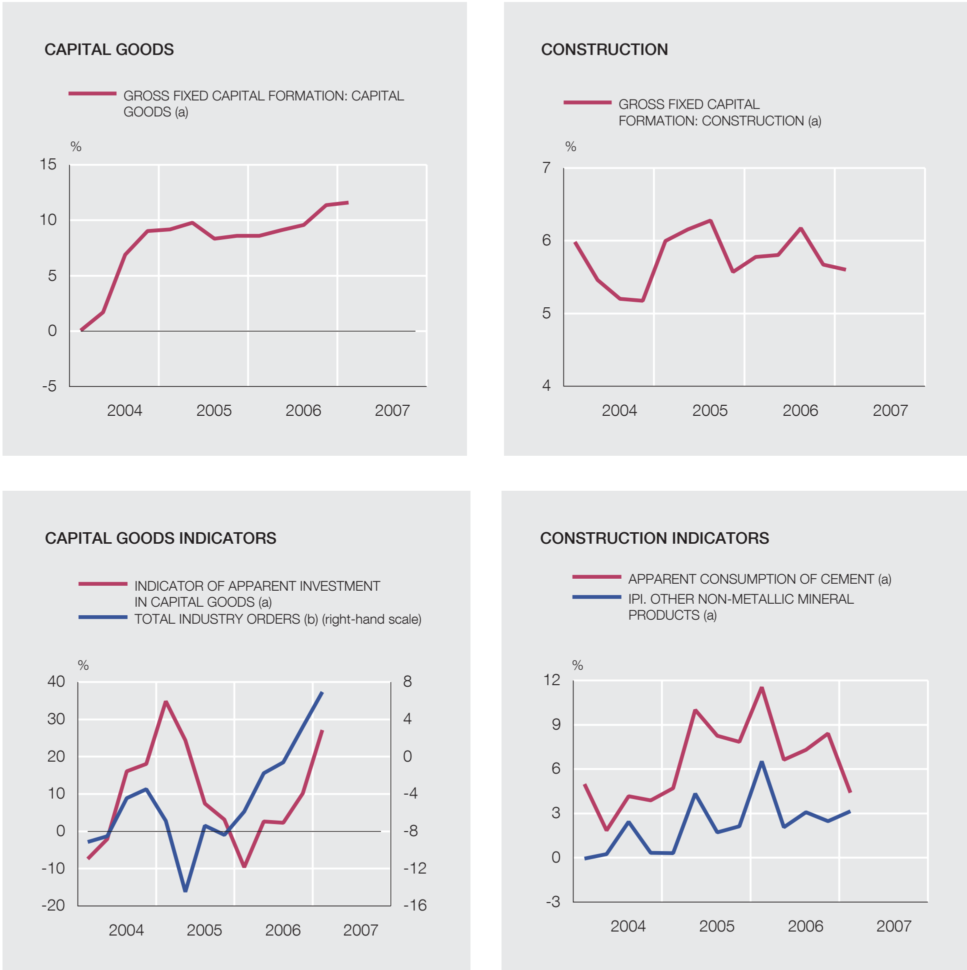
The recent trend of investment in equipment has been underpinned by the buoyancy of business activity, favoured by the strength of domestic demand and by the recovery in exports. This has countered the adverse effect of tighter financing conditions. Drawing on figures from the quarterly non-financial accounts of the institutional sectors for 2006 Q4, non-financial corporations' profits were quite favourable, with the gross operating surplus quickening to 7.5%. However, there was also a significant increase in the financial burden and in the debt ratio, the reflection of which was a worsening in the indicator of financial pressure on investment in 2006.

Investment in construction climbed by 5.7% in 2006 Q4, down on the growth rate the previous quarter. The latest conjunctural information points to a slight easing in 2007 Q1. The production of construction materials posted a similar rate of increase in January and February as a whole as in the closing months of 2006, while the apparent consumption of cement slowed mildly during this period (see Chart 17). The rate of increase in Social Security registrations in this sector dipped slightly in Q1, though it remained on a high scale, and registered unemployment fell at a similar rate to that of the previous quarter. Finally, confidence among construction companies eased off in the opening months of the year, as a result of a decline in expected demand for the coming months.

By type of work, housing increased by 5% in 2006 Q4, clearly down on the previous quarters, while other construction rose to 6.4%. According to the information provided by the Ministerio de Fomento's work approvals statistic, allocated in time according to a project execution schedule, residential construction in 2007 Q1 might maintain the growth rate in line with 2006 Q4, although there is uncertainty about the pace at which work projects approved in 2006 may be executed, as such projects increased significantly before the entry into force of the Spanish Technical Building Code. As regards non-residential building and civil engineering works, the admittedly scant and uncertain conjunctural information suggests the vigour of the previous quarter will be maintained in the first three months of 2007. Specifically, government procurement figures point to some stability in the growth of this type of work, consistent with the completion of certain public investment projects before the elections next May.

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.

On the latest QNA data, the contribution of net external demand to GDP growth improved by 0.1 pp in 2006 Q4 to -0.9 pp, prolonging the path of correction in place since mid-2005. This slight recovery in net external demand was due to a pick-up in exports of goods and services to a year-on-year rate of 7.3%, and to an acceleration in total imports to 8.8%. In 2006 as a whole, the external sector subtracted 1 pp from GDP growth (0.7 pp less than in the previous year), in a year in which foreign trade flows gained momentum, reflecting a sizeable recovery in goods and services exports (to 6.2%), which was accompanied in turn by a rise in imports (to 8.4%). The as yet incomplete information for 2007 Q1 points to a mild slowdown in both exports and imports, meaning that the contribution of net external demand should have held stable (see Chart 18).

In 2006 Q4, the year-on-year rate of increase in real goods exports rose to 5.7%, up from 3.4% the previous quarter, though it failed to attain the rates posted at the beginning of the year. The latest Customs information shows lower growth in real exports in the first two months of the year, with a rate of change of 3.8%, compared with 4.7% in 2006 Q4. By geographical area, real goods sales to the euro area grew by 3.5% in the January-February period, slightly down on the end-2006 figure, when they climbed by 4%. Real non-euro area sales were more robust in the first two months of the year, posting a rate of expansion of 7.5%, similar to that in 2006 Q4. In terms of goods, the most dynamic components in the January-February period

FOREIGN TRADE
Percentage change on year ago

CHART 18

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

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

were sales of food and non-energy intermediate goods, whose real growth rates were 8.2% and 6.8%, respectively.

On QNA figures, real exports of tourist services grew by 2% year-on-year in 2006 Q4, thereby prolonging the slightly slowing profile initiated from 2006 Q2. The latest available data point to some improvement. In Q1, the rate of increase in overnight stays by foreign visitors rose to 6.2%, compared with 2.8% at end-2006, while the number of foreign tourists increased by 5.3%, up on the figure of 2.5% the previous quarter. The nominal indicators of tourist expenditure were also more positive in the first two months of the year, with total tourist expenditure rising by 3.6%, though this was accompanied by a decline of 0.6% in average spending per tourist. In terms of national markets, there was a decline in the number of British tourists in Q1 (-1.9%) which ran counter to the favourable figures for tourists from Germany and France (increases of 6.1% and 8.2%, respectively), while the numbers of other European tourists were generally on an expanding course.

Real exports of non-tourist services rose in 2006 Q4 to 21.2%, according to QNA figures, discontinuing the slowing profile evident in Q2 and Q3. In 2006 as a whole, they grew by

13.7%, virtually doubling the rise recorded the previous year. This was thanks to the buoyancy of some of their main items, such as freight and passenger transport and business services. Other lesser items, such as construction and financial services, audiovisual services and royalties, showed most sizeable growth.

In keeping with QNA figures, real goods imports quickened in 2006 Q4 to a year-on-year rate of 8.6%, up from 7% the previous quarter. Customs data for January and February show moderation in the related growth rate to 8%. In terms of products, exports of capital goods (23% in real terms) were notably buoyant, this figure being partly affected by an exceptional shipbuilding order. The resilience of real imports of non-energy intermediate goods (13.3%) continued in this period, owing to the vigour shown by intermediate products aimed at the metalworking, transport equipment, electrical and chemical industries. In contrast, consumer goods imports fell off in the first two months of the year (-3.3% in real terms) due to a base effect, since the first two months of 2006 saw abnormally high volumes of imports of these goods, especially textiles.

Finally, in QNA terms, the performance of real services imports resumed a very favourable course in 2006 Q4, posting a year-on-year growth rate of 9.8%. This was the outcome of the momentum of non-tourist services imports (10.4%), especially those relating to business services and to transport, and of imports of tourist services, which grew by 7.3%, driven probably by the strength of the euro in this period.

4.2 Output and employment

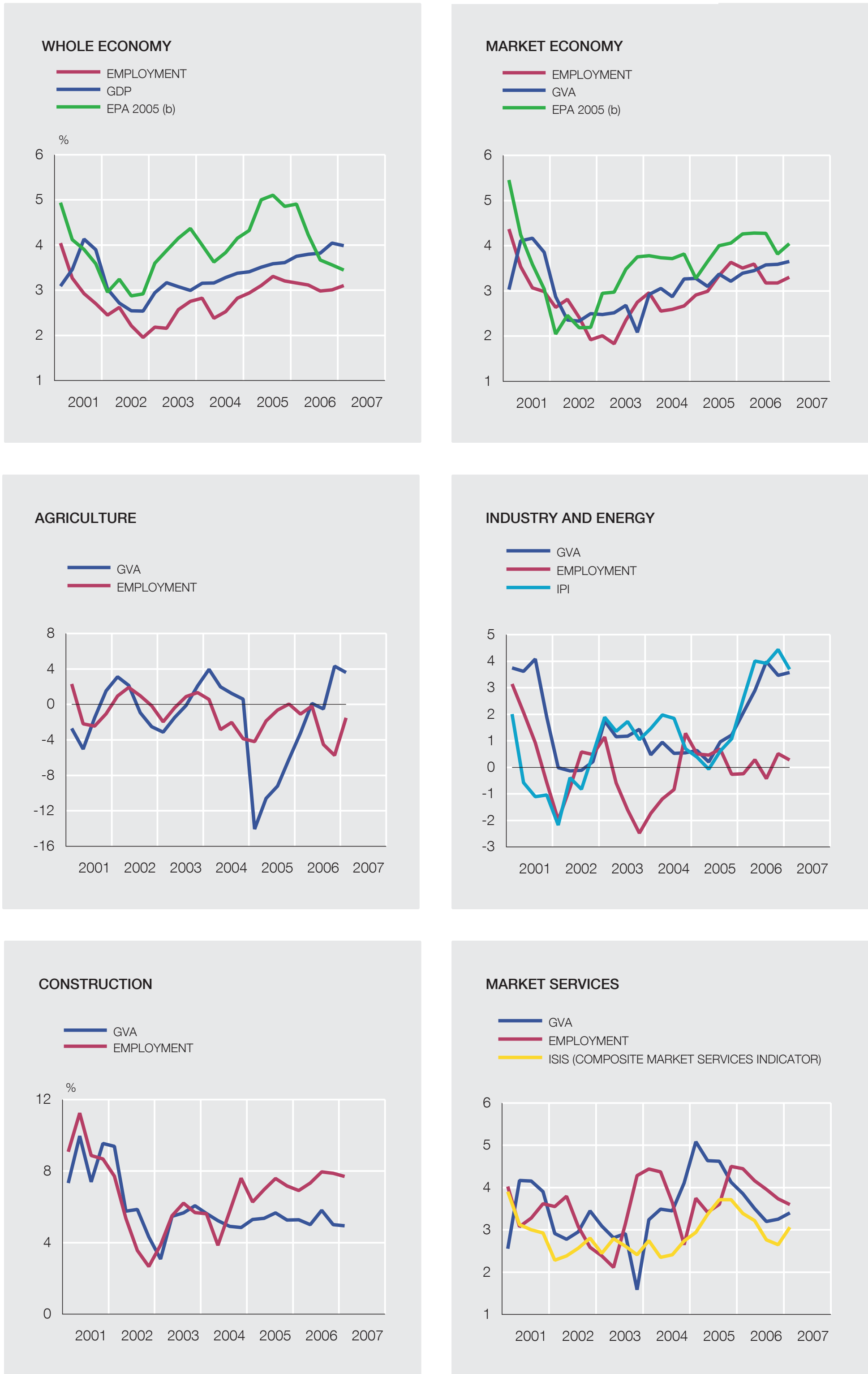
The market economy ended 2006 showing dynamism similar to that in Q3. As a result, growth in the related gross value added held stable at 3.6%, according to QNA figures. In terms of the productive branches, the strength of the manufacturing sector and the recovery in the agriculture and fisheries branches were salient, while the rate of increase in construction declined. The indicators available for 2007 Q1 suggests these patterns will continue, whereby value added is expected to post a similar annual rate of change to that of the previous quarter (see Chart 19).

Activity in the agricultural and fisheries branches increased appreciably in late 2006, following several quarters of practically nil or negative growth. On QNA data, GVA in this branch grew by 4.3%, compared with the contraction of 0.5 pp in Q3. This recovery was due to favourable weather which boosted vegetable output. In contrast, livestock production contracted in 2006 as a whole following its recovery in 2005. The outlook for 2007 points to a mild slowdown, insofar as the rainfall observed during the winter has not been abundant, although the final outcome will depend on the pattern of rainfall during the spring.

The energy and industrial branches slowed in 2006 Q4, with growth per QNA figures of 3.5%, compared with 4% three months earlier. However, this loss of momentum was prompted by activity in the energy branch which, given the lower consumption of energy caused by mild November and December temperatures, contracted by 2.1%. In contrast, industrial activity continued to quicken, reaching a growth rate of 4.4%, 0.4 pp up on Q3. This was thanks to the force of the demand for intermediate goods in the market services branch, exports and investment in capital goods. On the information available, the robustness of industry has been sustained in 2007 Q1. The non-energy component of the industrial production index grew at a year-on-year rate of 5.7% in the January-February period (in calendar-adjusted terms) and turnover indices remained highly dynamic in the same period. The employment indicators confirm the robustness of this branch, with Social Security registrations accelerating and registered unemployment diminishing. Regarding the opinion-based indicators, the European Commission's confidence indicator improved in Q1 and the manufacturing PMI continued to show the sector to be expanding in this period, albeit less sharply than in the previous months.

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

CHART 19



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

a. Year-on-year percentage rates based on seasonally adjusted series, except in the case of EPA, when they are based on gross series. 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.

Following a rise in 2006 Q3, construction activity slowed in the final quarter to a similar rate of change as that in the first half of the year (5%). As discussed in the previous section, this loss of steam was centred on residential building, while the other components of construction, namely civil engineering works and non-residential building, remained very strong. On the information available, activity in this branch is expected to have eased slightly in 2007 Q1.

Services activities gathered momentum in 2006 Q4, with a 0.2 pp rise in the related year-on-year rate of growth to 3.5%. This increase was more sharply seen in non-market services, which quickened by 0.7 pp to 4.5%. In the case of market services, there was a much more moderate increase of 0.1 pp to 3.3%. On the conjunctural information available, it is believed this greater momentum might have continued in 2007 Q1. The respective growth rates of sales by large corporations, with information to February, and Social Security registrations in this branch, with figures to March, have increased on 2006 Q4. However, the European Commission's confidence indicator for the sector and the related PMI fell off in 2007 Q1 as a whole.

In 2006 Q4, on QNA figures, the pace of employment creation economy-wide remained highly dynamic, with a year-on-year rate of increase holding stable at around 3%. Given the greater vigour of the economy in this final quarter, there was a recovery in apparent labour productivity for the whole economy, which stood at 1%, 0.2 pp up on the Q3 figure. The main employment indicators paint a favourable picture for the opening months of 2007, in which the level of employment might be expected to expand at a slightly higher rate than that at the end of the previous year. Social Security registrations were more dynamic in 2007 Q1, with growth of 3.5%, 0.3 pp up on Q4. New hires, following the rise posted in late 2006, resumed the mildly slowing path seen in the rest of the year, with growth in the period January-March 2007 of 5.3%, 2 pp down on 2006 Q4. Finally, the EPA (Labour Force Survey) data for Q1 pointed to a continuing high rate of job creation, with year-on-year growth of 3.4%, 0.2 pp below the rate observed a quarter earlier.

In terms of the productive branches, the last quarter of the year was marked by greater dynamism in job creation in industry and in non-market services, which offset the loss of momentum in the remaining branches. As a result, employment in 2006 Q4 in the market economy branches grew at the same rate as in the previous period, at 3.2%. Consequently, in the market economy there was no additional gain in apparent labour productivity, which stabilised at 0.4% following the significant pick-up in Q3. According to the EPA, employment in 2007 Q1 is expected to recover notably in agriculture, although it posted a negative rate of change in the industrial branches following the muted pick-up the previous quarter. In construction, the pace of job creation once again rose, to 9.4%, while in the services branches in slowed to 3.5%, compared with 4.3% in 2006 Q4.

The buoyancy of dependent employment in Q4 was somewhat greater than that in total employment, according to National Accounts figures, with a slight acceleration both in the whole economy (by 0.2 pp to 3.2%) and in the market economy (by 0.1 pp to 3.4%). The EPA figures for 2007 Q1 indicate stability in the growth of dependent employees (3.9%). The information drawn from Social Security registrations points to the strong dynamism of dependent employment, with a growth rate of 4.5% in Q1, while registrations in the self-employed segment remained as slack as in previous quarters.

On EPA data, the number of foreign employees increased in annual terms by 15.4%, somewhat down on the related rise in the previous period (18.7%). The number of national employees grew by 1.8%, 0.2 pp up on 2006 Q4. With regard to contract duration, the year-on-year growth in numbers of dependent employees with a temporary contract rose notably in 2007 Q1 to a rate of 6%, more than 0.2 pp up on the previous quarter. The year-on-year growth rate of employees with a temporary contract turned negative (-0.4%), following the strong increases in the preceding quarters. This entailed a quarterly decline in the ratio of temporary to total employees of almost 2 pp to 32%, which would reflect the sharp rise in the conversion of temporary contracts into permanent ones in late 2006, under the exceptional rebates process for such conversion which ended on 31 December. According to INEM hiring statistics, once this process had concluded, permanent hires slowed, although they moved at a higher rate than that of temporary hires. In February and March the volume of permanent contracts grew by 9.5%, following what was still high growth of close to 60% in January. Meanwhile, temporary contracts increased by 2.6% in Q1.

The labour force continued to be notably dynamic in Q1, although there was a slight slowdown in its growth to 2.8% year-on-year, 0.3 pp less than in the previous quarter. This slowdown in labour supply is attributable to a somewhat lower increase than in previous quarters in the participation rate, which stood at 58.6%, 0.6 pp higher than in the same quarter of the previous year, as the growth rate of the labour force held at a similar rate to the previous quarters (1.7%). If the participation rate is calculated with regard to the working population aged 16-64, as is usually the case in international comparisons, it rises to 72.2%. Finally, the number of unemployed increased in 2007 Q1 by around 45,000 in relation to 2006 Q4, although compared with the same period a year earlier it fell by 4.1%, a higher figure than in 2006 Q4. The INEM registered unemployment figures also show a sharper year-on-year rate of decline in unemployment, with a fall of 4.2% in 2007 Q1, compared with 3.4% in 2006 Q4. In Q1 the unemployment rate stood at 8.5%, 0.2 pp up on the previous quarter, but 0.6 pp down on a year earlier.

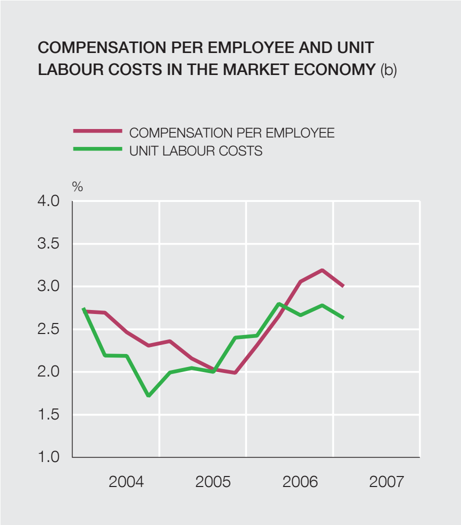
4.3 Costs and prices

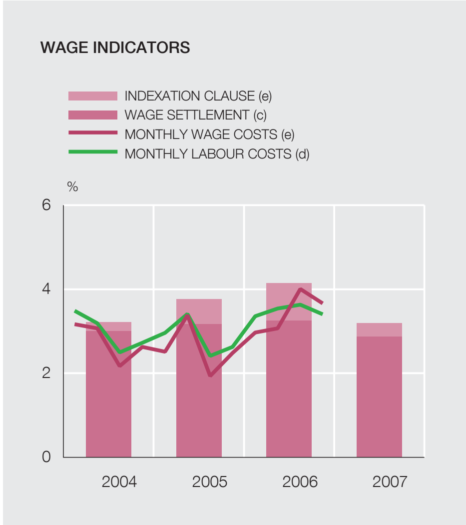
On QNA estimates, compensation per employee continued to move in 2006 Q4 on the accelerating path seen throughout 2006. Its rate of increase economy-wide rose by 0.3 pp to 3.9%. This rise was across the board, with the exception of industry, and was particularly sharp in non-market services. Indeed, compensation per employee in the market economy quickened by only 0.1 pp to 3.2%. This upward trend in wages is expected to be checked in 2007 Q1, partly because the estimated effect of the application of the 2006 indexation clause (0.3 pp) is far less than that of the previous year (0.9 pp), as a result of the lower inflation at the end of that year (2.7% in December 2006, 1 pp below that of the previous year) (see Chart 20).

The start of bargaining in 2007 remains within the framework set under the Interconfederal Agreement for Collective Bargaining (IANC), the extension of which for 2007 was signed in early February. The information on collective bargaining agreements registered in 2007 Q1 reflects a slight fall in the rate of increase of wage rates to 2.9%, a figure consistent in principle with the IANC wage guidelines. Across the different branches, the biggest increases in wage rates were signed in construction (close to 4%) and in agriculture, while in industry and in services they slowed to 2.8%.

The acceleration in compensation per employee in 2006 Q4 was not fully offset by the slight improvement in apparent labour productivity. As a result, unit labour costs rose by 0.3 pp to a year-on-year growth rate of 3.2%. In contrast, the growth rate of the value added deflator declined by 0.7 pp to 3.1% year-on-year, reflecting some stability in unit margins. This same behaviour could be seen in the market economy, albeit with less intensity (see Chart 21). The indicators available for 2007 Q1 point to a more moderate expansion in unit labour costs economy-wide, which might be reflected not in a fresh slowdown in the deflator but in a recovery in the growth of margins.

WAGES AND LABOUR COSTS (a) CHART 20





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

a. Percentage change on same period a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information from collective bargaining agreements to March 2007
d. Settlement in the year to date.
e. ETCL (quarterly labour costs survey).

The year-on-year rate of increase in the final demand deflator fell by 0.3 pp in 2006 Q4 to 3.5%. This was the result of the slowdown both in the imports deflator, which posted a year-on-year rate of 3.2%, and in the GDP deflator, whose rate of increase declined by 0.2 pp to 3.6%. From the expenditure standpoint, the year-on-year growth rate of the private consumption deflator dipped by 0.5 pp to 3%, while the CPI slowed more sharply.

In fact, in 12-month terms the CPI fell by 0.9 pp in 2006 Q4 to a growth rate of 2.6%. The slowdown has continued in 2007 Q1, albeit less markedly. Average year-on-year growth has dipped by 0.2 pp to 2.4% in the January-March period. Component by component, the growth rates of energy, manufacturing and unprocessed food prices have eased, while processed food and services showed a slight rise. Accordingly, the CPI excluding unprocessed food and energy posted average year-on-year growth of 2.7% in the first three months of the year, 0.1 pp up on the figure the previous quarter (see Chart 22).

Oil prices continued falling at the start of the year, subsequently rising sharply in March; however, the average price of a barrel of oil in 2007 Q1 has stood slightly below the end-2006 price. Moreover, the appreciation of the euro against the dollar has contributed to tempering the growth of the energy bill. The year-on-year growth rate of unprocessed food prices dipped by 0.8 pp to 4.1% in the January-March period, entailing a similar slowdown to that in the previous quarter. The growth of prices of non-energy industrial goods fell once more by 0.2 pp in Q1 compared with the same period a year earlier to 1%, while services prices quickened by 0.1 pp in Q1 to 3.8% as a result of the increase in hotel and restaurant prices. Finally, processed food prices rose by 0.2 pp in Q1 to an average year-on-year rate of 3%.

Inflation in Spain, measured by the HICP, stood at 2.5% in Q1, 0.1 pp down on the previous quarter, while in the euro area as a whole inflation increased by 0.1 pp to 1.9%. As a result the differential narrowed once more, standing at 0.6 pp, a figure not reached since 2004 Q1 (see Chart 23). The improvement in the differential was extensive to all components, with the ex-

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

SOURCES: INE and Banco de España.

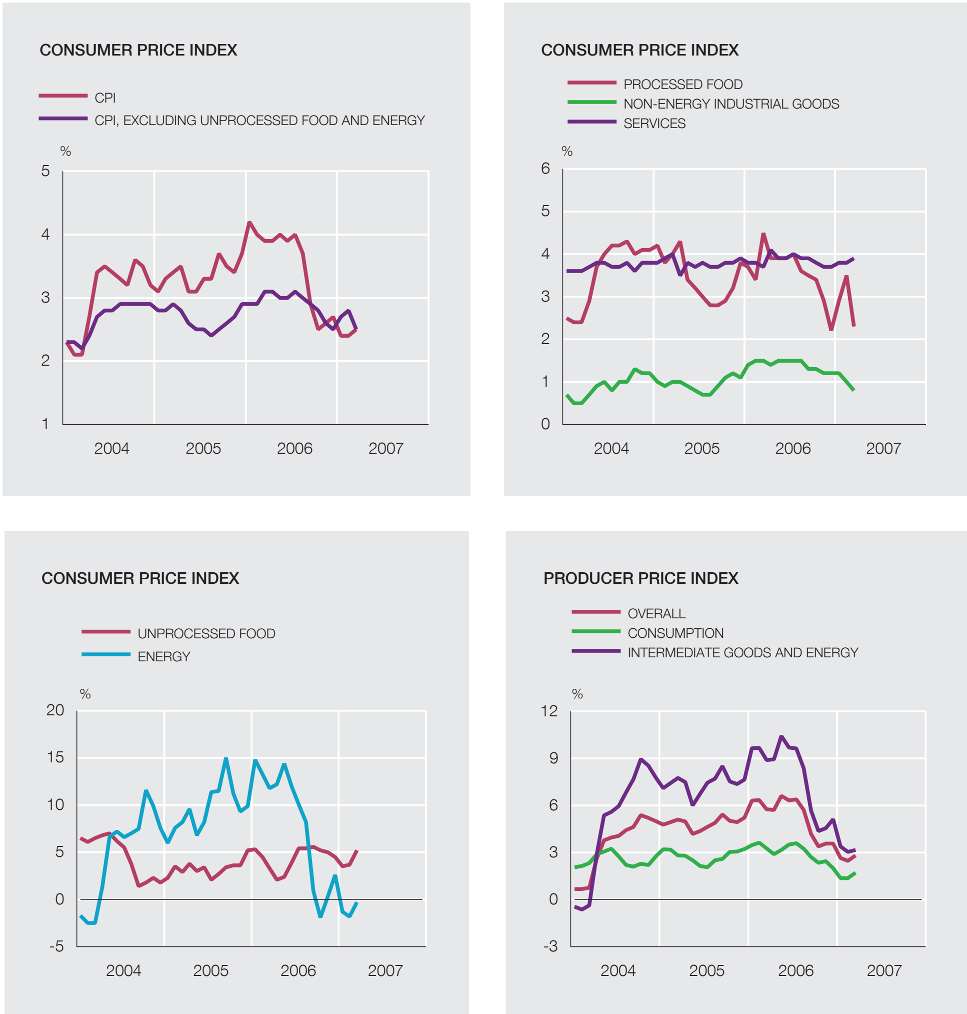
a. Percentage change on a year ago based on QNA seasonally adjusted series.

ception of food, and was particularly sharp in energy prices. In services, the differential narrowed by 0.1 pp owing to the 0.3 pp rise in the euro area, while in the case of Spain's non-energy industrial goods prices, the differential with the euro area has disappeared in 2007 Q1. However, it should be borne in mind that the reduction in the differential is partly linked to the effect of the VAT rise in Germany, which has increased German consumer prices, with an appreciable effect on the area as a whole.

Finally, the producer price index slowed once more in Q1, furthering the declining path on which it has moved since the second half of last year. The year-on-year growth rate in 2007 Q1 was 2.7%, compared with the end-2006 rate of 3.6%. In the euro area as a whole, producer prices increased by 2.9% in February compared with a year earlier, 1.2 pp less than in December. The slowdown in the producer price index in Spain is due to the lesser dynamism of energy production prices, the year-on-year rate of change in which declined by 4 pp between December and March, turning negative. The growth rate of the producer prices of consumer goods and intermediate goods lessened by 0.3 pp and 0.6 pp, reaching respective growth rates in March of 1.7% and 6.2%. Lastly, the producer prices of capital goods rose at the start of the year to a growth rate of 3.3% in March. Prices received by farmers continued to slow in the closing months of 2006 and hotel prices held at a very moderate year-on-year growth rate in the first two months of 2007, at around 2%.

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

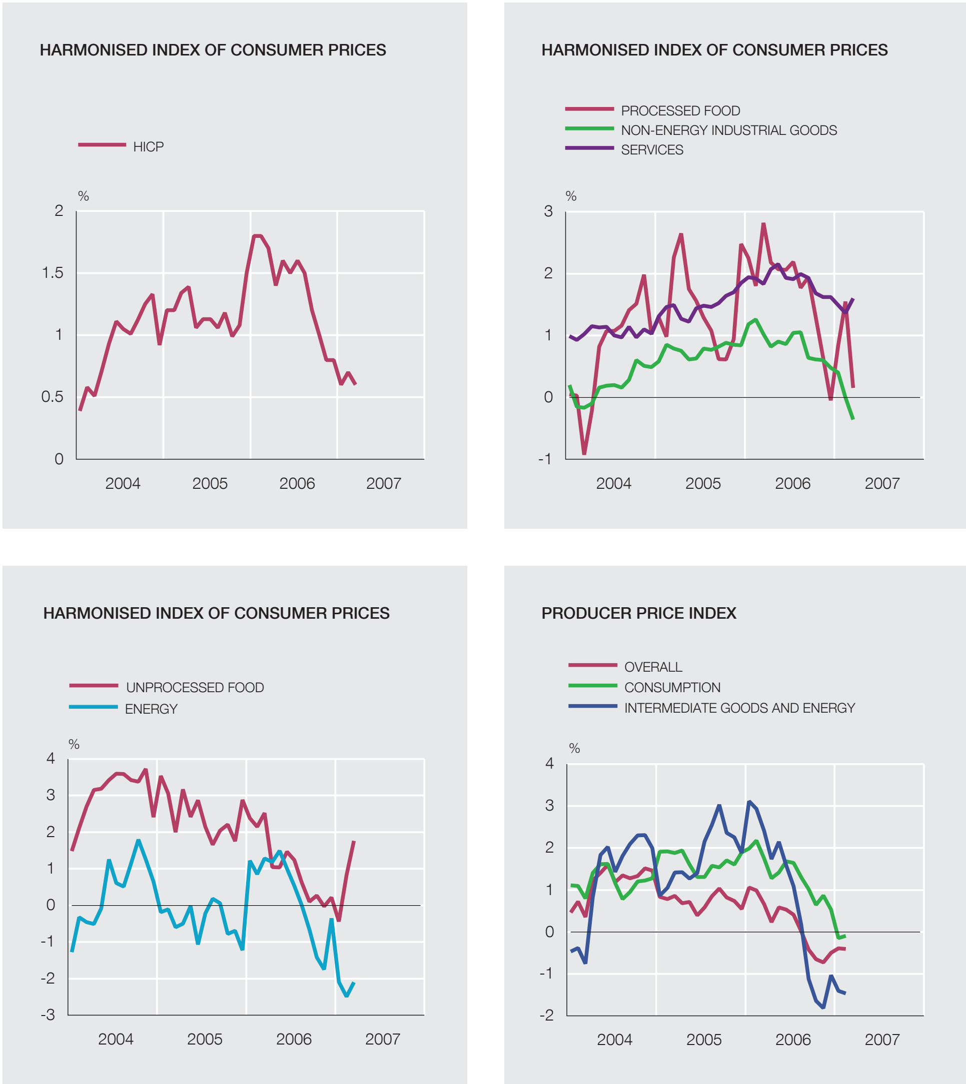
4.4 *The State budget*

According to National Accounts methodology, the State budget outturn in Q1 showed a notable improvement in the surplus, which rose from €4,621 million (0.5% of GDP) in March 2006 to €6,857 million (0.7% of GDP) a year later in 2007. This result was due to a 13.3% increase in revenue compared with a 7.6% rise in expenditure.

In cash-basis terms, the State posted a surplus of €2,316 million in the three months to end-March 2007, compared with a surplus of €244 million in the same period in 2006 (see Table 3). The differences with the National Accounts figures are largely due to the adjustments for the different interest imputation criterion. It should be recalled, however, that the figures for the opening months of the year are highly erratic and hardly representative of State budget developments in the rest of the year. This is particularly the case in 2007, as the personal and corporate income tax reforms will have the gradual effect over the course of the year of moderating revenue.

In cash-basis terms, State revenue increased by 13.6% in Q1 compared with the same period a year earlier owing to the strength of the main tax items (personal income tax and VAT). This

PRICE INDICATORS CHART 23
Differentials vis-à-vis the euro area (a)



SOURCES: Eurostat and Banco de España.

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

result is in contrast to the budgetary forecasts of sluggish revenue growth[1] for 2007 as a whole (a rate of change of 3.3%), suggesting that this forecast might be exceeded at the end of the year. The buoyancy of direct tax revenue in the opening months of the year is partly due to the high growth of withholdings on movable capital and gains on mutual funds, which amounted to 39.7%. Conversely, as regards withholdings on income from work, the personal income tax reform has already begun to be reflected, with takings dipping from year-on-year growth of 14.5% in January to 5.7% in March, compared with the same month a year earlier. Under indirect taxes, VAT posted similar growth to 2006, with an increase of 10%. Excise duties picked up owing to the course of takings on tobacco products. As regards the items under the *Other revenue* heading, these posted high growth, despite the fact that charges and other revenue showed negative rates of change owing to the increase in interest revenue, to Banco de Es-

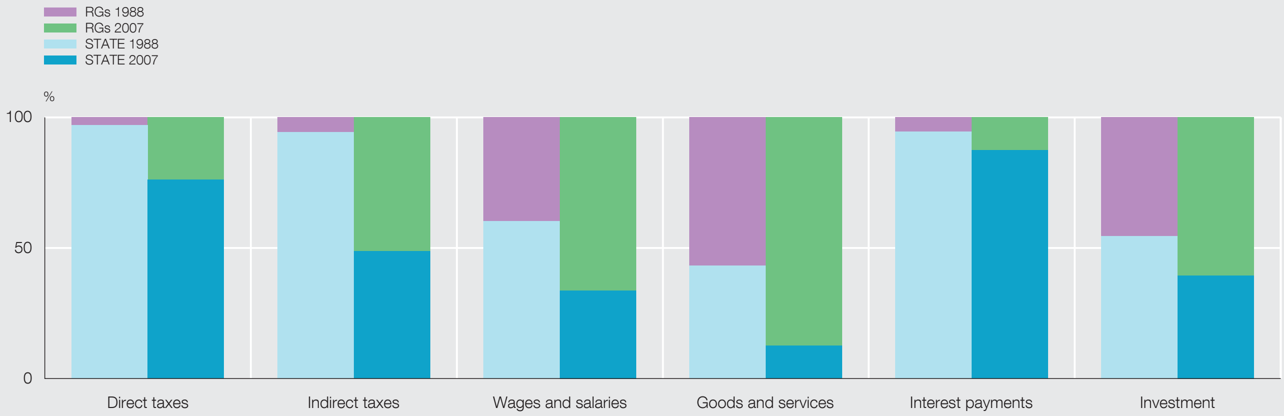
1. This comment refers to the comparison of budgetary figures with the 2006 outturn. In contrast, the figures for the State presented in Box 4 (“Regional (Autonomous) Government budgets for 2007”) arise from the comparison of the initial budgetary figures in 2007 and 2006.

Spain's government structure has entailed the ongoing decentralisation of budgetary powers towards the Regional (Autonomous) Governments (RGs). As a result, the regional tier of government has progressively increased its share in tax revenue and in expenditure (see accompanying chart[1]). On the revenue side, the weight of the RGs now slightly exceeds that of the State in indirect tax revenue. Regarding expenditure, the share of the State is only greatest in interest payments, while in the remaining items the weight of the RGs now largely exceeds 50%, rising to 88% in the case of current expenditure on goods and services.

These changes underscore the need to pay attention to RGs' activity in order to analyse fiscal variables and, in particular, the importance of these governments for ensuring the aim of maintaining sound public finances. In this respect, on 27 June 2006 the Fiscal and Financial Policy Council approved the itemised distribution of the budgetary stability objective for the RGs for the three-year period 2007-2009. The latest update of the Stability Programme reflected this agree-

1. By way of illustration, the chart shows the change in relative State/RG weights in certain revenue and expenditure captions from 1988 to 2007. Indexed at 100 is the sum total of items budgeted by both government tiers.

STATE AND REGIONAL GOVERNMENT BUDGETS



REGIONAL (AUTONOMOUS) GOVERNMENT BUDGETS FOR 2007

	Regional (Autonomous) governments							State
	€ m				Rate of change			
	2004	2005	2006	2007	05/04	06/05	07/06	07/06
REVENUE	115,590	126,475	140,662	154,770	9.4	11.2	10.0	14.0
Current revenue	107,358	118,147	132,093	145,978	10.0	11.8	10.5	14.0
— Direct taxes	19,589	21,590	24,396	27,215	10.2	13.0	11.6	16.5
— Indirect taxes	38,060	42,753	47,765	54,692	12.3	11.7	14.5	12.0
— Rates, prices and other revenue	3,637	3,723	3,852	4,220	2.4	3.5	9.6	8.2
— Current transfers	45,629	49,655	55,671	59,454	8.8	12.1	6.8	2.7
— Interest received	444	425	409	396	-4.3	-3.7	-3.1	5.2
Capital revenue	8,232	8,328	8,569	8,792	1.2	2.9	2.6	12.8
— Disposal of investments	705	651	678	717	-7.7	4.2	5.7	10.9
— Capital transfers	7,527	7,677	7,891	8,075	2.0	2.8	2.3	13.0
EXPENDITURE	116,040	127,882	141,540	154,891	10.2	10.7	9.4	6.7
Current expenditure	94,711	103,301	113,951	124,830	9.1	10.3	9.5	6.2
— Wages and salaries	36,761	40,300	43,576	47,442	9.6	8.1	8.9	7.1
— Goods and services	17,452	19,490	22,047	24,834	11.7	13.1	12.6	11.8
— Interest payments	2,073	2,171	2,269	2,376	4.7	4.5	4.7	-8.6
— Current transfers	38,387	41,289	45,910	50,021	7.6	11.2	9.0	8.8
— Contingency fund and other unforeseen expenses	38	51	150	157	34.4	194.4	4.6	18.0
Capital expenditure	21,329	24,582	27,589	30,061	15.2	12.2	9.0	10.2
— Investment	10,742	12,563	13,787	15,337	16.9	9.7	11.2	7.0
— Capital transfers	10,587	12,019	13,802	14,724	13.5	14.8	6.7	13.8
CASH-BASIS BALANCE	-451	-1,408	-879	-120	...	...	...	...

ment, taking the specific form of a forecast deficit of 0.1% of GDP for the RGs as a whole both for the close of 2006 and of 2007. However, according to the initial end-2006 estimate, the RGs would have posted a slight surplus. The five RGs that submitted restructuring plans will be able to post deficits[2] in 2007. In budgetary terms, all of them expect to improve their balances in 2007 compared with 2006.

The main figures arising from the RGs' budgets for 2007 show that RGs as a whole[3] budget an improvement in the aggregate balance when compared with the initial 2006 budget (see accompanying table), the result of a higher growth forecast for revenue than for expenditure. In any event, and as in recent years, both items show high rates of changes, outpacing actual or forecast nominal GDP growth.

The RGs' budgets forecast the continuing buoyancy of tax (direct and indirect) revenue. Nonetheless, it should be borne in mind that the comparison is made between initial budgets and that the forecasts for 2007 have already taken into account the revenue increases recorded in 2006. In the case of indirect tax, for instance, the growth rate budgeted by the RGs is above that of the State, which might be due to the fact that transfer tax, the revenue-raising powers for which have been fully assigned to the RGs, has a most considerable weight in the RG tier and takings grew by 21% in 2006. Of note regarding other revenue, due to the volume accounted for, is the budgeted slowdown in current transfer revenue, which is in line with that forecast for the so-called "Sufficiency Fund" (a fund-levelling mechanism), made up of State funds. This is partly due to the increase from 98% to 100% in prepayments to the RGs in 2006, which overstates the growth rate for that year.

As regards the various expenditure items, the budgeted growth rate for wages and salaries is higher than that of the State. That confirms the pattern observed in recent years, which would be warranted only in part by the successive assignments of powers. In the case of expenditure on goods and services and current transfers, which are closely linked to RG health-care and education responsibilities, high growth has been budgeted. Conversely, interest payments are forecast to grow moderately, although their positive rate of change contrasts with the decline budgeted for the related State item. In this respect, it should be borne in mind that most of the reduction in public debt seen in recent years has been centred on the State tier. Finally, capital expenditure shows a strong increase, albeit below that budgeted by the State. Further, in the RGs, the biggest rise in this item is under real investment (with growth of 11.2%, against 6.7% for capital transfers), while in the State, the biggest increase is routed through capital transfers.

2. Remember that the objective is evaluated in National Accounts terms. The five RGs in question are: Balearic Islands, Canary Islands, Catalonia, Castile-La Mancha and the Valencian Community. **3.** The city-enclaves of Ceuta and Melilla are not taken into consideration.

paña profits and to the strong increase in capital transfers from the European Union, especially under the ERDF.

Cash-basis expenditure increased by 7.4%, somewhat below the budgetary forecast (9.6% for the year as a whole). With the exceptions of wages and salaries and interest payments, the remaining headings showed above-budget growth rates. Of particular note were the strong increases in capital expenditure. Current transfers posted above-budget growth, due in part to the growth of payments to sectors other than general government and payments abroad.

As regards the Social Security budget outturn, only those variables for which information relating to the opening months of the year is available are discussed. The number of Social Security registrations increased by 3.6% in 2007 Q1, a figure below that for 2006 as a whole, which was marked by the regularisation process. The number of contributory pensions rose by 1.5% in 2007 Q1, down on the growth of 2.3% for 2006, which was affected by the former Elderly and Disability Insurance Pensions (SOVI) being recognised as compatible with widowhood pensions[2]. Expenditure earmarked for unemployment benefits, according to SPEE (National Public Employment Service) data, increased by 7% to February (a growth rate up on the 6.7% increase recorded in 2006 as a whole), and the number of beneficiaries grew by 2.6% in the same period (compared with 2.7% in 2006). These developments came about owing to the acceleration in the eligibility rate, which climbed to 67.8% to February 2007 (far above the

2. Law 9/2005 of 6 June 2005.

STATE BUDGET OUTTURN

TABLE 3

EUR m and %

	Outturn 2006	Percentage change 2006/2005	Outturn Projection 2007	Percentage change 2007/2006	Outturn		
					2006 JAN-MAR	2007 JAN-MAR	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	141,846	10.1	146,547	3.3	33,260	37,782	13.6
Direct taxes	81,130	14.8	83,925	3.4	13,717	15,980	16.5
Personal income tax	*41,451*	*15.3*	*39,474*	*-4.8*	*12,144*	*13,896*	*14.4*
Corporate income tax	*37,207*	*14.5*	*41,641*	*11.9*	*896*	*1,258*	*40.3*
Other (a)	*2,472*	*11.5*	*2,810*	*13.7*	*678*	*826*	*21.9*
Indirect taxes	48,328	8.3	50,740	5.0	17,012	18,725	10.1
VAT	*35,424*	*10.7*	*36,538*	*3.1*	*13,997*	*15,393*	*10.0*
Excise duties	*9,895*	*1.0*	*10,961*	*10.8*	*2,286*	*2,559*	*11.9*
Other (b)	*3,009*	*7.0*	*3,241*	*7.7*	*729*	*773*	*6.0*
Other net revenue	12,388	-8.2	11,882	-4.1	2,531	3,077	21.6
2 EXPENDITURE	130,375	6.2	142,927	9.6	33,017	35,467	7.4
Wages and salaries	22,209	7.4	23,686	6.7	4,962	5,223	5.3
Goods and services	3,799	12.1	3,431	-9.7	861	967	12.3
Interest payments	15,619	-12.4	15,946	2.1	6,290	5,701	-9.4
Current transfers	72,225	11.9	77,338	7.1	17,287	18,981	9.8
Contingency fund and other unforeseen expenses	…	…	3,028	…	…	…	…
Investment	9,037	0.7	9,956	10.2	2,155	2,579	19.6
Capital transfers	7,487	2.0	9,541	27.4	1,462	2,016	37.9
3 CASH-BASIS BALANCE (3 = 1–2)	11,471	…	3,620	…	244	2,316	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Resources	147,205	13.1	146,328	-0.6	33,336	37,755	13.3
Uses	140,135	10.6	144,152	2.9	28,715	30,898	7.6
NET LENDING (+) OR BORROWING (–)							
	7,070	…	2,176	…	4,621	6,857	…
(as a percentage of GDP)	0.8		0.2		0.5	0.7	

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.

level of 63.6% at end-2006), and despite the fall in registered unemployment, which declined by 4.4% in February (set against the 1.9% decline in 2006 as a whole).

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

In January 2007, the overall balance on current and capital account was a deficit of €7,320 million, 24% up on the same month in 2006 (see Table 4). During this month the current account deficit widened by 37% to €8,622 million, while the surplus on capital transactions improved notably to €1,301 million. The balances of the main current account items worsened in January, with the exception of the deficit on non-tourist services, which was significantly corrected.

The trade balance deficit increased by €572 million in January 2007 compared with the same month a year earlier, up to a figure of €6,452 million. In year-on-year terms, the deficit increased by 9.7%, prolonging the deterioration in recent years. The energy bill continued to slow in January, in step with the easing of crude oil prices on international markets and the appreciation of the euro against the dollar; however, the pace at which the non-energy trade deficit is widening increased.

BALANCE OF PAYMENTS: SUMMARY (a) TABLE 4

EUR m

		JANUARY	
		2005	2006
CREDITS	Current account	23,230	25,436
	Goods	*12,957*	*14,205*
	Services	*5,628*	*6,434*
	— Tourism	2,539	2,673
	— Other services	3,089	3,761
	Income	*3,786*	*3,808*
	Current transfers	*858*	*988*
	Capital account	490	1,444
	Current + capital accounts	23,720	26,880
DEBITS	Current account	29,516	34,058
	Goods	*18,837*	*20,657*
	Services	*4,853*	*5,483*
	— Tourism	967	1,114
	— Other services	3,887	4,369
	Income	*4,350*	*5,757*
	Current transfers	*1,477*	*2,160*
	Capital account	124	143
	Current + capital accounts	29,640	34,201
BALANCES	Current account	-6,286	-8,622
	Goods	*-5,879*	*-6,452*
	Services	*775*	*952*
	— Tourism	1,573	1,560
	— Other services	-798	-608
	Income	*-563*	*-1,949*
	Current transfers	*-618*	*-1,172*
	Capital account	366	1,301
	Current + capital accounts	-5,920	-7,320

SOURCE: Banco de España.

a. Provisional data.

The services balance posted a surplus of €952 million in January 2007, €177 million up on the same month a year earlier. The improvement was due to the decline in the non-tourist services deficit, while the tourist surplus showed a slight deterioration, standing at €1,560 million. Tourist revenue increased by 5.3% in January, in nominal terms, slightly above the increase observed in the closing months of the previous year. Tourist expenditure rose by 15.2% in the first month of 2007, exceeding the average increase seen in 2006. Both the revenue and, to a lesser extent, the expenditure relating to other services remained very buoyant in January (with respective growth rates of 22% and 12%). The deficit on the income balance widened notably in January to €~1,949 million, while the current transfers deficit was €1,172 million in January 2007, double that recorded in the same month a year earlier. Finally, the capital account surplus stood at €1,301 million in January, far higher than the same month in 2006. This improvement was essentially due to the expansionary behaviour of structural funds from the ERDF which, however, are usually very erratic in the opening months of the year.

5.1 Overview

Financing conditions for households and firms tightened somewhat further in the early months of 2007. The cost of bank credit increased, reflecting the interest rate rises in the money markets (1-year Euribor stood at 4.11% in March, up 18 bp on December 2006). Also more expensive (up 16 bp) was the cost of financing through the issuance of corporate fixed-income securities. By contrast, the cost of equity financing for firms remained relatively steady (see Chart 24).

Developments in the Spanish and international stock markets were marked by a bout of instability which began in late February and interrupted the hitherto upward path of market prices in the previous months. This period brought sharp falls in market prices accompanied by rising volatility. These developments mainly seemed to reflect heightened uncertainty as to the macroeconomic outlook of the United States, against a background characterised in that country by increased delinquency of the higher-risk mortgage loans. Hence the Madrid Stock Exchange General Index lost 9% in just a few days, but it subsequently recovered and, at the cut-off date for this report, was 6.8% higher than at end-2006. This performance was similar to that of the euro area EURO STOXX index (7.7%) and somewhat better than that of the US S&P 500, which in the same period gained 3.8%. Subsequently, a further bout of turbulence in the Spanish stock market in April was associated with the market price movements of certain firms linked to the property sector.

According to the latest data published by the Ministry of Housing, the slowdown in house prices continued in 2007 Q1. Year-on-year growth stood at 7.2%, down nearly 2 pp on December 2006. The process of gradual normalisation of the situation in this market is thus still underway.

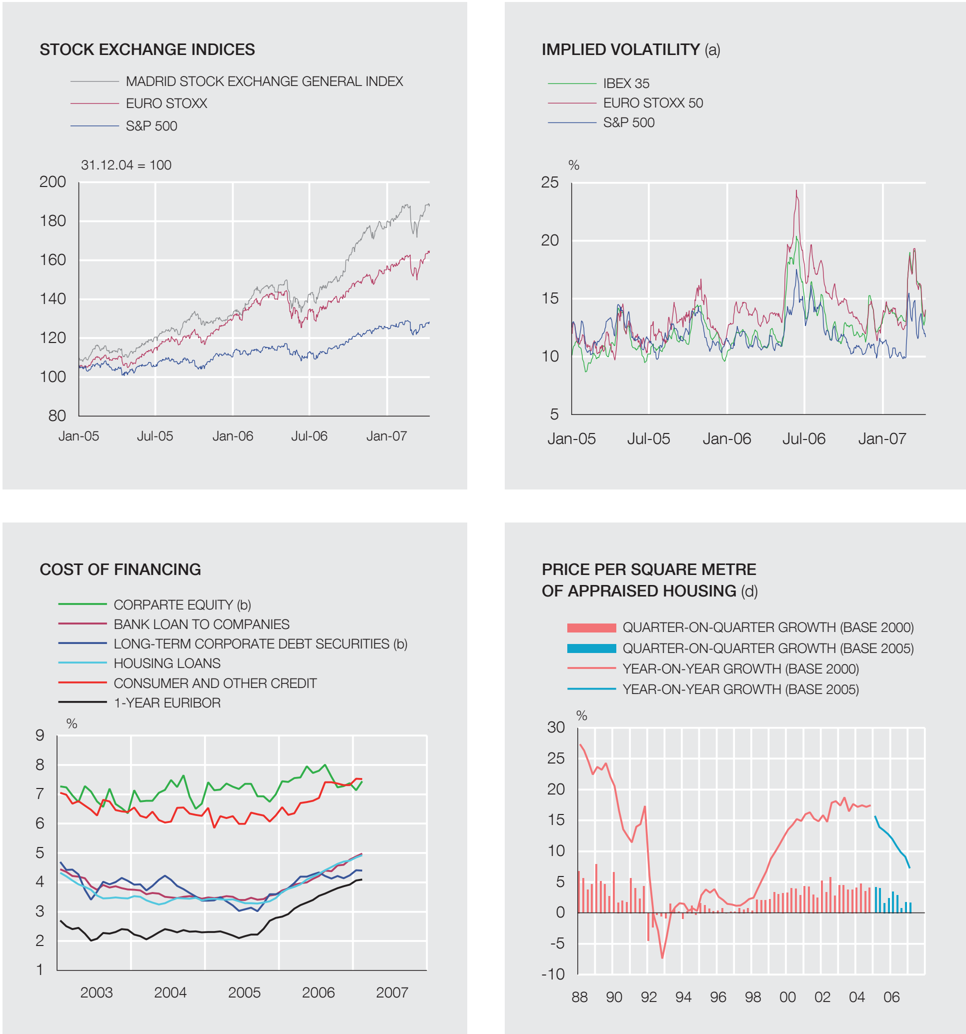
The slowdown in house prices and the rise in financing costs helped to moderate the increase in household debt, although it continues to grow at a high rate. Hence in 2006 Q4 the rate of expansion of liabilities fell by somewhat more than 1 pp to around 19%, and, according to the provisional information available, this trend has continued in 2007 to date. The breakdown by component shows that the slowdown in house purchase lending has continued in recent months, whereas the growth rate of funds for consumption and other purposes has not varied significantly. Box 5 analyses the contribution of the foreign resident population to the behaviour of household debt in recent years, which, although growing, has done so less vigorously than the relative weight of this segment in the total population.

Corporate debt, by contrast, continued to accelerate in 2006 Q4, the growth rate exceeding 28% in year-on-year terms. The provisional data for the opening months of 2007 point to a significant decrease in this rate. This mainly reflects a base effect, although the funding granted by financial institutions, which is not affected by this phenomenon, also showed signs of moderation. The latest information on the breakdown of bank lending by productive activity, which relates to December 2006, indicates that lending to property services and construction companies continued to lead the expansion of corporate debt, although greater buoyancy was shown by the funds borrowed by industry and by other services.

The still-high rate of expansion of lending to households led to further increases in that debt and financial burden ratios in late 2006 and early 2007, while saving after debt service remained negative. Nevertheless, on Financial Accounts data, in 2006 Q4 their net borrowing

FINANCING CONDITIONS AND ASSET PRICES

CHART 24



SOURCES: Bloomberg, Credit Trade, MSCI Blue Book, Datastream, Ministerio de la Vivienda and Banco de España.

a. Five-day moving averages.
b. The cost of equity is based on the three-stage Gordon dividend discount model.
c. The cost of market-based long-term debt is aproximated as the sum of the average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.
d. New statistic from 2005.

decreased with respect to GDP in cumulative annual terms. In addition, the growth in household net wealth continued to help lessen the impact that the changes in the aforementioned indicators had on the sector's financial position, although the latest data, relating to December 2006, showed more moderate growth of this variable in line with the slowing house prices.

The aggregate debt and financial burden ratios of non-financial corporations also held on an upward path in 2006 Q4 and 2007 Q1. Furthermore, the upward march of interest payments is detracting from the buoyancy of corporate earnings, and this is reflected in a certain fall-off in return on equity. The quarterly Central Balance Sheet Data Office (CBQ) data also show that between September and December 2006 the proportion of profits used to meet financial expenses increased. However, the debt ratio for this sample decreased slightly, a development that was due to the behaviour of the large groups, since other corporations recorded an increase in this variable. This behaviour, along with the profitability of these corporations, which remained high, resulted in a slight decrease in the synthetic indicators of financial pressure on investment and employment.

In the last 10 years the immigrant flow into Spain has grown rapidly. According to the Spanish Labour Force Survey, the number of foreign residents aged 16 or above increased tenfold in this period, and by the end of 2006 immigrants made up 10.3% of the population of Spain in this age range. This Box analyses the role of this phenomenon in lending by financial institutions to individuals. The data are drawn from the central credit register (CCR) of the Banco de España, a register containing information at individual level on all outstanding loans exceeding €6,000[1].

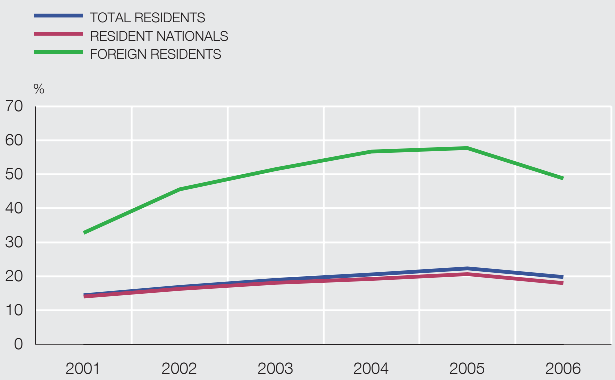
Chart 1 shows that the debt of foreign residents has grown rapidly in recent years (at more than 40% since 2002), in line with the notable growth of this population group. It also shows that the path of this rate over time is similar to that for Spanish-born residents. Thus between 2001 and 2005 there was an accelerating trend, while in 2006 the rate of expansion of these liabilities decreased. This notable buoyancy of the funds received led to a sustained rise in their contribution to lending growth (see Chart 2), which was nearly 3 pp last year.

1. Given this characteristic, the credit data in this box do not coincide exactly with the regular information published by Banco de España, although the discrepancy between the two sources is small.

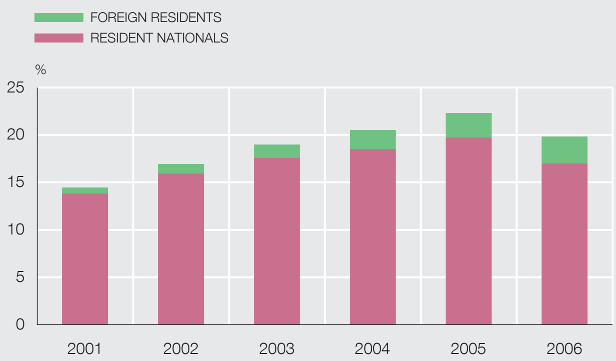
Nevertheless, the proportion of foreign residents who resort to borrowing, although it has increased in recent years, is still much lower than that of Spanish nationals (see Chart 3). The average balance of their outstanding debt, however, is somewhat higher, which undoubtedly reflects the fact that mortgage loans have a greater relative importance among the population of foreign origen.

In terms of outstanding debt, in December 2006 foreign residents accounted for 7.1% of the total debt of the Spanish population and 7.4% of that backed by mortgage collateral. In any event, it should be taken into account that these figures include the liabilities associated with two separate types of loans with different features: they include not only the loans requested by immigrant workers, but also those used to acquire houses on the coast, linked to the residential tourism of basically Northern European citizens. Although, on the available information, these two types of loans cannot be separated, the geographical distribution of the proportion of outstanding loans held by foreign individuals may be useful in approximating the relative importance of each. In this respect, Chart 4 illustrates how the highest percentages of this indicator are obtained on the Mediterranean coast and the islands, suggesting that

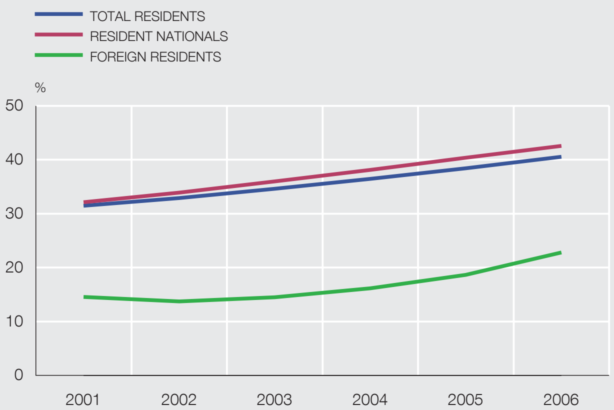
1 ANNUAL GROWTH OF LOANS TO INDIVIDUALS



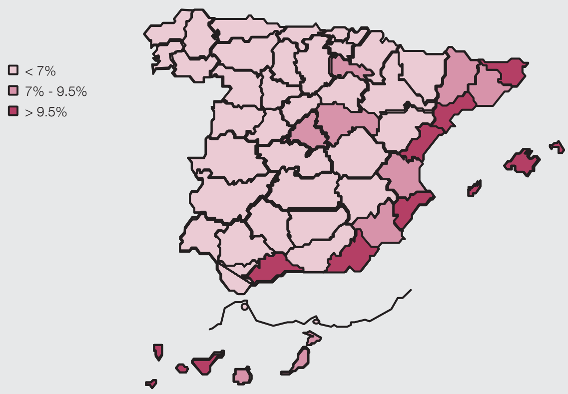
2 CONTRIBUTION TO GROWTH OF LOANS TO INDIVIDUALS



3 PROPORTION OF INDIVIDUALS WITH DEBT (a)



4 LOANS TO FOREIGN RESIDENTS AS A PROPORTION OF LOANS TO INDIVIDUALS (2006)



SOURCES: Banco de España (Central Credit Register) and INE (Spanish Labour Force Survey).

a. Population aged 16 or above.

the second type of loan has a not insignificant impact on the aggregate data.

In short, foreign residents are playing a growing role in the buoyancy of household lending, as might be expected from the ongoing expansion of this population group. Its propensity to take on debt, however, is lower than that of Spanish households, its liabilities are, comparatively, more fully backed by collateral, and a significant part of them are linked to the acquisition of property, foreseeably associated with residential tourism, in coastal provinces.

On Financial Accounts data, the nation's net borrowing increased further in 2006 Q4 to stand at 7.8% of GDP in cumulative twelve-month terms. This resulted in a fresh rise in the shortfall of funds of corporations and a decrease in the general government financial surplus, which were not offset by the recovery of household saving (see Table 5). Financial institutions continued to channel the bulk of funds received from the rest of the world, basically through the issuance of fixed-income securities. These funds were used to cover both the difference between the expenditure and receipts of the Spanish economy and the investment abroad of other resident sectors.

In short, the still-high buoyancy of debt and the increase in interest rates are tending to moderate the rise in income, particularly in the case of firms, and have continued to heighten the private sector's exposure to adverse changes in the macroeconomic environment or in the cost of borrowing. Therefore, although neither firms nor households are in a situation of financial weakness, the past quarter has not seen significant progress in containing the financial risks mentioned in previous reports that threaten the outlook for medium-term economic growth.

5.2 Households

In 2007 Q1 financing conditions for households continued to become less generous. Thus between December and February the interest rates applied by institutions in new transactions increased by 18 bp in the case of housing loans and by 20 bp in the case of consumer and other loans, the cumulative rise from the low levels of October 2005 being 161 pp and 124 bp, respectively. Further, according to the latest bank lending survey (BLS), the institutions anticipated for the opening months of the current year a slight tightening of the general conditions offered by lenders.

These changes, together with the slowdown in house prices, are tending to rein in the increase in the growth rate of household debt, which fell back by more than one percentage point between September and December 2006. According to the provisional information available, this pattern continued during the early months of 2007. However, the pace at which these liabilities are expanding continues to be elevated (above 18%). The breakdown by loan purpose shows that during this period the growth rate of house purchase loans continued to decline, standing at 19% in February, while that of consumer and other loans showed a certain tendency to stabilise, after having followed an upward path until the end of summer.

In 2006 Q4 purchases of financial assets reached the equivalent of 11.4% of GDP in cumulative twelve-month terms, up 0.7 pp on September (see Table 6). The main components of financial investment were again the less risky instruments (cash and deposits). Of these, the most noteworthy were time deposits (included under the heading other deposits and fixed-income securities), which accelerated further, boosting the flows associated with them to 5.2%

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP

	2001	2002	2003	2004	2005	2006			
					Q4	Q1	Q2	Q3	Q4
National economy	-3.5	-2.7	-2.9	-4.8	-6.5	-7.0	-7.2	-7.6	-7.8
Non-financial corporations and households and NPISHs	-4.2	-3.5	-3.9	-5.3	-8.4	-9.3	-10.0	-10.6	-10.4
Non-financial corporations	-5.2	-4.2	-4.1	-4.6	-7.0	-7.7	-7.8	-8.5	-8.9
Households and NPISHs	1.1	0.7	0.1	-0.6	-1.3	-1.6	-2.2	-2.0	-1.5
Financial institutions	1.2	1.2	1.0	0.6	0.7	0.6	0.7	0.7	0.7
General government	-0.5	-0.3	0.0	-0.2	1.1	1.7	2.1	2.2	1.8
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-9.9	-8.6	-8.3	-8.9	-11.3	-14.0	-14.7	-15.8	-15.9

SOURCE: Banco de España.

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

of GDP. Once again, this development seems to reflect a greater preference for these products, at the expense of mutual funds, the net subscriptions of which continued to decline, and in 2006 amounted to only 0.2% of GDP. Meanwhile, households continued to record net sales of shares, while saving in the form of insurance technical reserves was at levels similar to those three months earlier.

The high buoyancy of credit, along with the rise in financing costs, continued to spur the upward course of households' debt and financial burden ratios, which at end-2006 stood at around 125% and 16% of the sector's GDI, respectively (see Chart 25). According to the provisional information available, this trend was prolonged to the beginning of 2007. However, the recovery of gross saving in 2006 Q4 meant that, despite the expansion of liabilities, the sector's saving capacity net of financial obligations remained unchanged. Also, on Financial Accounts data, in the same period net borrowing by households decreased to 1.5% of GDP in cumulative annual terms. Furthermore, the increase in net wealth continued to contribute to the solidness of their financial position, although the gains of this variable are moderating in line with the slowdown in house prices.

5.3 Non-financial corporations

The financing conditions of corporations also tightened somewhat in 2007 Q1. Thus the synthetic indicator proxying the marginal cost of new funds received[1] increased by 25 bp up to February (latest available figure). This increase basically resulted from a rise in bank interest rates of 21 bp (156 bp above the lows of September 2005). This increase probably reflects not only the course of market returns, but also a certain widening of margins, as evidenced by the BLS. In the case of fixed-income securities, there was also an increase at both long and short maturities (around 16 bp), while the cost of own funds grew more moderately (6 bp).

The increase in the cost of borrowing did not prevent a notable buoyancy of debt, which between September and December accelerated further to a growth rate above 28%. The provi-

1. For the method used to calculate this synthetic indicator, see the article "*Un indicador del coste de financiación de las sociedades no financieras*" (An indicator of the financing cost of Spanish non-financial corporations) in the December 2006 *Boletín Económico.*

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

% GDP	2003	2004	2005	2006 Q2	2006 Q3	2006 Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.7	9.6	10.2	10.2	10.7	11.4
Cash and cash equivalents	4.1	3.9	4.0	3.4	3.2	3.2
Other deposits and fixed-income securities (a)	-0.3	1.2	1.9	3.4	4.7	6.0
Shares and other equity (b)	0.6	0.5	0.0	-0.3	-0.4	-0.8
Mutual funds	2.3	1.5	1.9	1.7	0.8	0.2
Insurance technical reserves	1.8	1.8	1.9	1.5	1.5	1.6
Of which:						
Life assurance	0.7	0.7	0.8	0.6	0.6	0.6
Retirement	0.9	0.8	1.0	0.8	0.7	0.8
Other	0.2	0.6	0.4	0.4	0.8	1.1
Financial transactions (liabilities)	8.5	10.2	11.6	12.3	12.7	12.9
Credit from resident financial institutions (c)	9.2	10.8	12.3	13.3	13.2	12.9
House purchase credit (c)	7.0	8.7	10.3	10.5	10.2	9.7
Consumer and other credit (c)	2.2	2.1	2.2	2.8	3.0	3.2
Other	-0.7	-0.7	-0.8	-0.9	-0.5	0.0
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	12.1	12.3	17.0	18.4	21.8	22.9
Cash and cash equivalents	0.9	1.0	2.3	2.1	2.5	2.2
Other deposits and fixed-income securities (a)	1.2	0.3	1.0	1.1	2.6	3.3
Shares and other equity	7.4	6.4	7.1	10.3	10.7	10.2
Of which:						
Vis-à-vis the rest of the world	4.5	3.8	3.9	6.8	7.4	6.9
Other	2.6	4.6	6.6	5.0	6.0	7.2
Financial transactions (liabilities)	16.2	16.9	24.0	26.2	30.4	31.8
Credit from resident financial institutions (c)	6.1	8.3	12.9	14.4	16.5	18.0
Foreign loans	2.6	0.7	2.1	3.2	3.5	3.3
Fixed-income securities (d)	-0.2	0.0	0.3	1.3	1.6	1.8
Shares and other equity	5.1	4.6	3.2	3.2	3.3	2.3
Other	2.5	3.3	5.5	4.1	5.5	6.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.8	16.3	21.2	22.9	24.3	24.2
Households and NPISHs	19.1	20.2	20.9	21.0	20.6	19.3
Non-financial corporations	13.4	13.2	21.4	24.4	27.4	28.2

SOURCE: Banco de España.

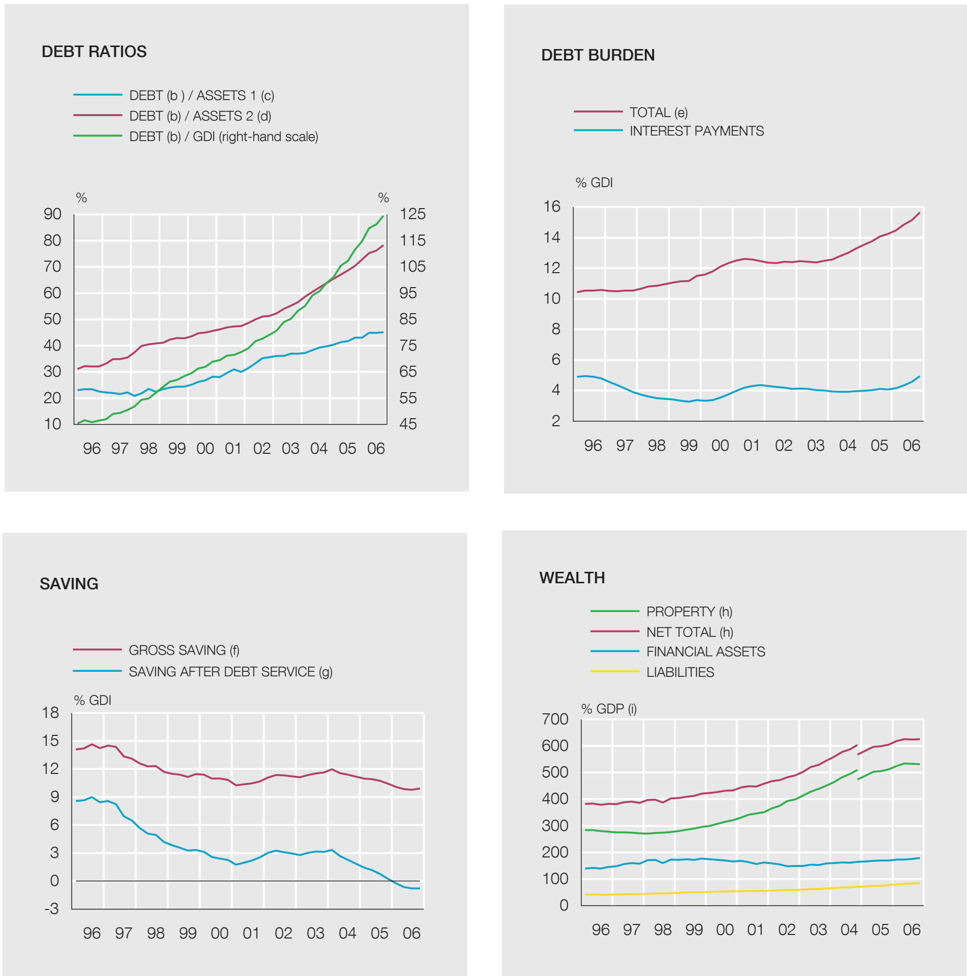
a. Not including unpaid accrued interest, which is included under "other".
b. Excluding mutual funds.
c. Including derecognised securitised loans.
d. Includes the issues of resident financial subsidiaries.
e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income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

sional data for the early months of 2007 point to a decrease of more than 4 bp in this rate, basically reflecting a base effect linked to an exceptionally high flow in the same period of the preceding year (associated with the financing of a large corporate acquisition). In any event, the credit granted by financial institutions, which is not affected by this phenomenon, also showed signs of a slight moderation.

The most recent information on the breakdown of credit by productive activity, relating to December 2006, shows that the most expansionary sectors in the demand for funds were again real estate services and construction, with growth rates of 50% and 33%, respectively. The

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 25



SOURCE: Banco de España.

a. From 1999, the sectoral National Accounts data corrrespond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Includes bank credit and off-balance-sheet securitised loans.
c. Assets 1 = Total financial assets - "other".
d. Assets 2 = Assets 1 - shares (excluding mutual fund shares) - shares in FIM.
e. Estimated interest payments plus debt repayments.
f. Balance of households' 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. This is a new house price statistic from 2005.
i. CNE, base 2000.

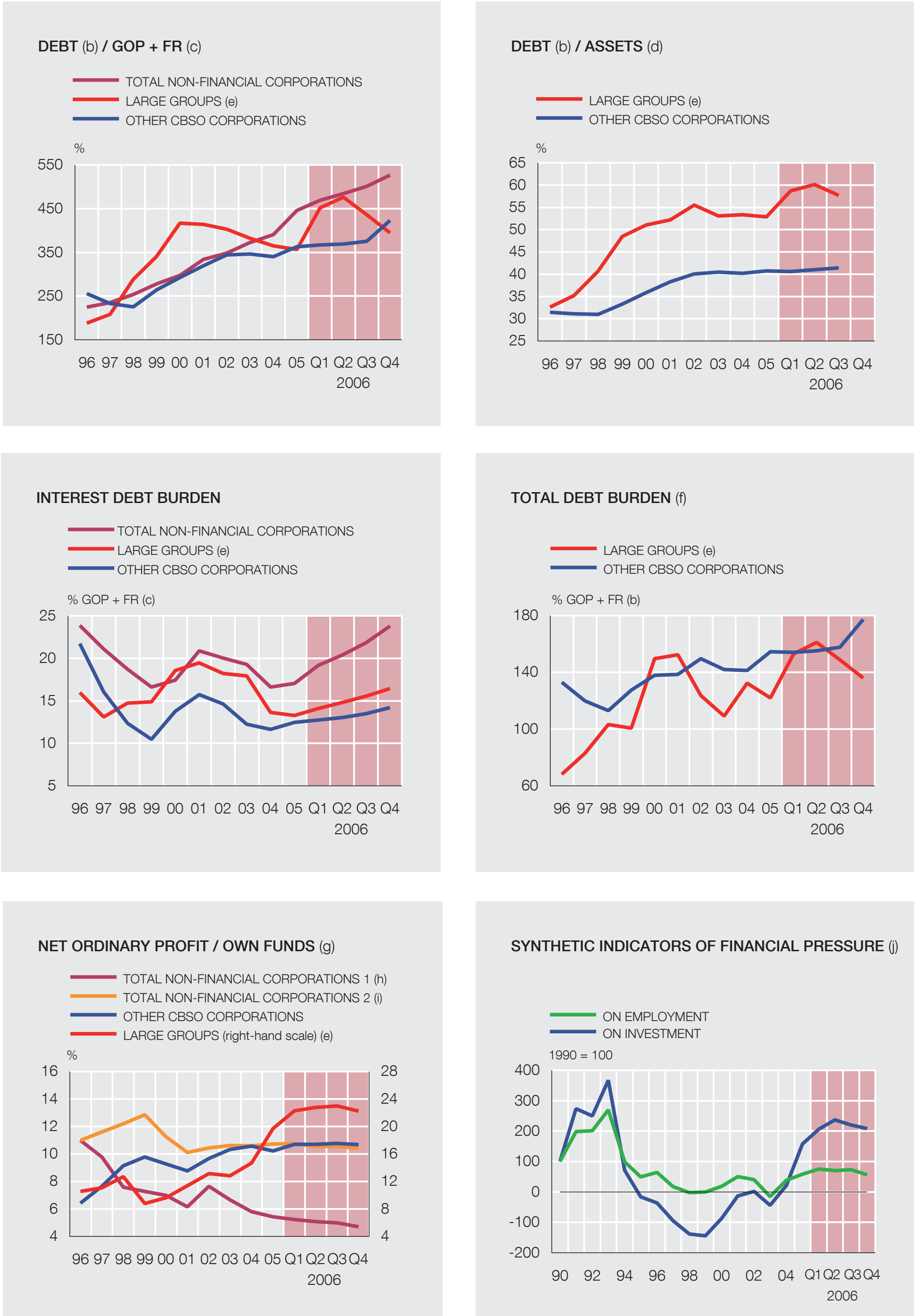
funds raised by industry and by other services companies picked up to a growth rate of 14% and 21%, respectively.

In contrast with the expansion of external funds, corporations reduced the issuance of shares and other equity, so that in December they represented 2.3% of GDP in cumulative annual terms, down 1 pp from the preceding quarter.

The volume of company assets-side transactions again grew, amounting in December 2006 to nearly 23% of GDP (1 pp more than in the preceding quarter). Analysis by instrument shows that equity securities continued to account for the bulk of acquisitions, although the relative importance of net investments held in the form of cash and debt continued to rise.

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

CHART 26

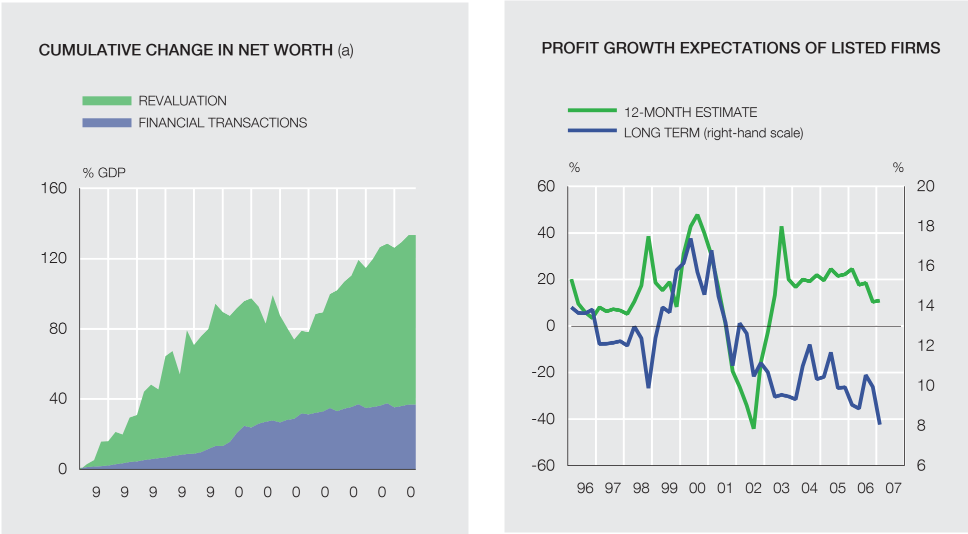


SOURCE: Banco de España.

a. Based on CBSO annual and quarterly survey data, except in the case of the "total non-financial corporations" series, which is based on the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
e. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica 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.

The most recent Financial Accounts information, relating to 2006 Q4, shows a fresh increase in corporations' net borrowing to nearly 9% of GDP in cumulative twelve-month terms. Meanwhile, the financing gap, which approximates the funds needed to undertake real investment and permanent foreign financial investment, also increased, albeit to a lesser extent, practically reaching 16% of GDP (see Table 5).

The increase in recourse to external funds and their higher cost further raised the debt-to-profit and financial-burden-to-profit ratios, and this trend seems to have extended into early 2007 (see Chart 26). The higher interest payments constrained the growth of ordinary net profit, which in fact remained in 2006 at the same level as in the previous year, resulting in a slight decrease in return on equity.

For the companies reporting to the CBQ, among which large corporations have a considerable weight, the latest available information, relating to 2006 Q4, also shows an increase in the proportion of income used for interest payments. By contrast, the debt ratio for this set of corporations decreased as a result of the behaviour of large groups, because for other companies this variable increased appreciably. Return on equity remained high (14%). The industrial sector recorded the largest increase in profits, which helped to reduce its debt ratio. The overall result of all these changes was a slight decrease in the synthetic indicators of financial pressure on investment and employment.

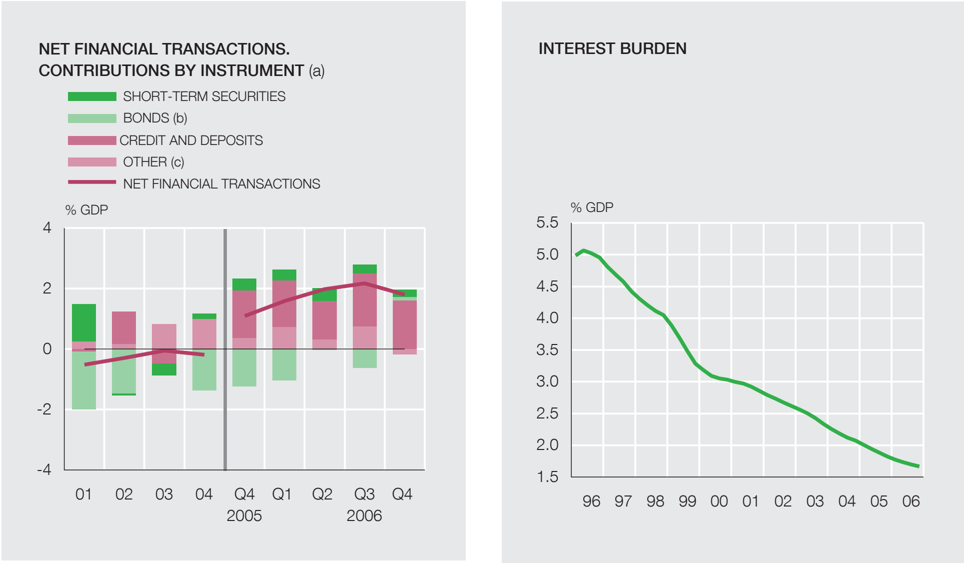
Finally, analysts' forecasts for long-term growth of the profits of quoted non-financial corporations decreased to 8% in 2007 Q1 (10% at the end of 2006), while the expectations of short-term growth underwent little change and stood around 10% (see Chart 27).

5.4 General government

At the end of 2006 general government net lending stood at 1.8% of GDP in cumulative twelve-month terms, a figure which, however, is below the 2.2% recorded in 2006 Q3 (see Chart 28). By instrument, the sector made net redemptions of both short-term securities and, unlike in the first half of the year, long-term ones, although for a low amount, so the stock of deposits, net of loans, continued to increase. The decrease in the debt ratio meant that,

GENERAL GOVERNMENT
Four-quarter data

CHART 28

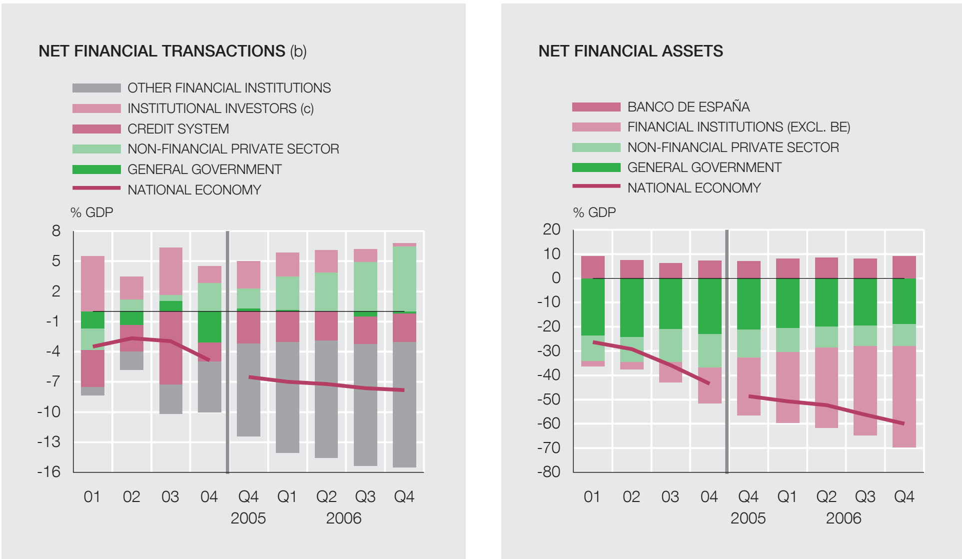


SOURCE: Banco de España.

a. A postive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilites.
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.

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 collective investment institutions.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2003	2004	2005	2006 Q2	2006 Q3	2006 Q4
NET FINANCIAL TRANSACTIONS	-2.9	-4.8	-6.5	-7.2	-7.6	-7.8
FINANCIAL TRANSACTIONS (ASSETS)	13.1	13.3	18.2	20.2	19.0	16.8
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	0.7	3.2	2.2	4.3	4.8	5.6
Of which:						
Interbank (a)	0.5	0.7	3.2	2.6	3.5	3.4
Securities other than shares	6.5	1.8	8.8	3.5	0.8	-1.2
Of which:						
Credit institutions	3.5	1.0	6.6	1.9	-0.3	-2.0
Institutional investors (b)	3.5	0.3	2.0	1.3	0.7	0.4
Shares and other equity	4.7	6.8	5.2	9.7	10.2	9.4
Of which:						
Non-financial corporations	4.5	3.8	3.9	6.8	7.4	6.9
Institutional investors (b)	1.1	0.8	0.9	1.8	1.7	1.2
Loans	0.3	0.8	1.1	1.6	1.7	2.1
FINANCIAL TRANSACTIONS (LIABILITIES)	16.0	18.2	24.8	27.4	26.6	24.6
Deposits	6.9	1.7	5.7	2.6	0.8	0.3
Of which:						
Interbank (a)	5.3	5.0	7.2	2.8	1.3	0.6
Securities other than shares	5.3	12.4	15.8	20.0	21.7	21.5
Of which:						
General government	-1.0	2.7	0.2	0.8	1.6	1.3
Credit institutions	3.5	4.6	6.3	7.5	8.1	7.8
Other non-monetary financial institutions	2.8	5.1	9.3	11.7	12.0	12.4
Shares and other equity	1.1	2.7	0.7	1.2	0.2	-0.9
Of which:						
Non-financial corporations	1.3	1.7	0.8	1.0	0.2	-1.3
Loans	2.8	1.3	2.3	3.4	3.7	3.5
Other, net (c)	-0.9	-0.6	-0.7	-1.0	-1.3	-0.8
MEMORANDUM ITEMS:						
Spanish direct investment abroad	3.3	5.8	3.4	5.9	6.3	6.3
Foreign direct investment in Spain	2.9	2.4	2.0	1.9	1.8	1.4

SOURCE: Banco de España.

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

against a background of rises in the cost of funds, interest payments as a proportion of GDP decreased further to 1.7%.

5.5 The rest of the world

In the closing months of 2006, the net debit balance of the nation's financial transactions increased again to stand, in cumulative four-quarter terms, at 7.8% of GDP, compared with 7.6% in September. By sector, the greater need for funds stemmed from the increase in the shortfall of firms and from the decrease in the financial surplus of general government, which were not offset by the recovery of household spending.

Financial institutions (excluding institutional investors), particularly those other than credit institutions (FVCs and the subsidiaries of financial and non-financial firms specialised in securities issuance) continued to channel most funds received from abroad. In all, the fresh net liabilities attracted by this sector amounted to 17% of GDP, up 2.1 pp on September 2006 (see Chart 29).

Despite this, capital inflows decreased for the second quarter running, and at end-2006 stood at 24.6% of GDP (in cumulative twelve-month terms, see Table 7). The bulk of these funds continued to be invested in securities other than shares, so these securities and, more specifically, those issued by financial institutions, remained the principal vehicle channelling the foreign saving needed to cover the Spanish economy's borrowing requirements. The most notable change was the fall in acquisitions of shares and other equity by non-residents, the flow of which turned slightly negative, partly as a result of the decrease in foreign direct investment in Spain. Furthermore, the financing raised through the interbank market contracted, so a net credit balance was sustained.

The acquisition of foreign assets also decreased, albeit to a lesser extent, accounting for 16.8% of GDP in cumulative twelve-month terms. By instrument, the most significant changes were the declines in the amounts associated with the net purchases of fixed-income securities, the flow of which was negative, and of shares and other equity. This development did not, however, prevent the volume of funds held in the form of foreign direct investment in the rest of the world from remaining at the same level as in the previous quarter.

As a result of the developments in financial inflows and outflows and of the changes in asset prices and the exchange rate, the economy continued to accumulate net liabilities vis-à-vis the external sector (see Chart 29). By sector, this was basically a result of the increase in the debit balance of financial institutions (excluding institutional investors), which in the past year went from 24% to 42% of GDP, thereby confirming the growing importance of this sector in the channelling of saving from the rest of the world to the Spanish economy.

27.4.2007.