QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

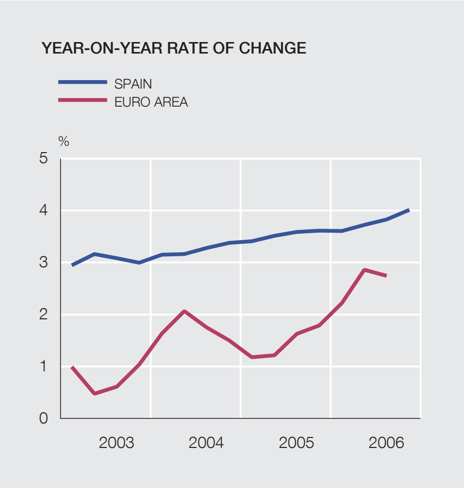
During the first three quarters of 2006, growth in the Spanish economy was very dynamic and on a slightly rising course. Growth at a year-on-year rate of 3.8% was posted in Q3. On data for the closing months of the year, this momentum and acceleration continued in Q4. Accordingly, a year-on-year rise in GDP of 4% is estimated for this quarter, corresponding to a quarter-on-quarter rate of 1.1%, 0.2 pp up on Q3 (see Chart 1). Behind this upturn lie the acceleration in national demand and an improved contribution of net external demand, which stood at –0.9 pp.

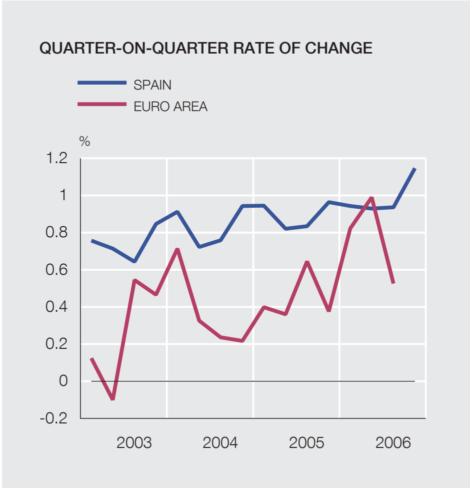
Estimates for Q4 place GDP growth for 2006 as a whole at 3.8%, up from 3.5% in 2005. This is the result of lower growth in national demand and of a significant correction in the negative contribution of net external demand, which would be standing at –1.1 pp. As to the reasons underlying this strong dynamism, it should be recalled that the slackening of some of the factors at play in recent years, namely the change in monetary policy stance and the minor moderation in increases in wealth, has been offset by the buoyancy of the external sector, and in particular by the recovery in the euro area. Nonetheless, in the second half of the year the rebalancing of the contribution of national demand and of exports to GDP growth would have lost momentum. Employment generation remained high in 2006 (the number of jobs created increased by over 3%), in a demographic setting in which, for yet another year, there were appreciable increases in the labour force, and the unemployment rate fell to 8.3% at year-end. The sizeable employment component in the current growth phase meant that aggregate productivity gains were once again low in 2006, and only slightly higher than in 2005. As to inflation, the growth rate of the CPI for the year on average was 3.5%, 0.1 pp up on 2005. That said, it trended unevenly during the year as a result of oil price developments. In July, the CPI began to slow from the rate of 4% at which it had held in the first half of 2006, ending the year at a rate of 2.7% and with an inflation differential vis-à-vis the euro area of 0.8 pp.

The sound behaviour of the world economy in 2006 as a whole was confirmed in the closing months of the year when, broadly, there was some improvement in relation to the previous quarter. Oil prices continued to decline from their August peak (at slightly over $78 per barrel), standing at $51 per barrel in late January, while stock markets posted fresh gains and prices remained high and risk premiums low on bond markets. The fall in oil prices prompted an across-the-board decline in inflation rates in the main developed economies where, moreover, economic growth remained high, though somewhat more balanced, owing to the slowdown in the US economy brought about by the adjustment in the real estate market. The monetary policy stance became tighter in some countries.

In the United States, the scale of the slowdown in activity was relatively moderate owing both to the limited magnitude of the adjustment in the sectors most affected – residential construction and industry – and to the scant knock-on effect to other branches of activity. The ability of the US economy to maintain high growth rates largely reflects the continuing buoyancy of household spending. Contributing principally to this was the favourable labour market situation, particularly employment in services. Despite the decline in the rate of increase of the consumer price index, which ended the year at 2.5%, underlying inflation held at somewhat above this level and the trade deficit showed a minor improvement. Against this background, the risk of inflation continued to be the main cause for concern of the Federal Reserve, which held its federal funds target rate at 5.25%. The dollar depreciated notably against the main currencies, in particular the euro and sterling, though not against the yen.

GROSS DOMESTIC PRODUCT (a) CHART 1





SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

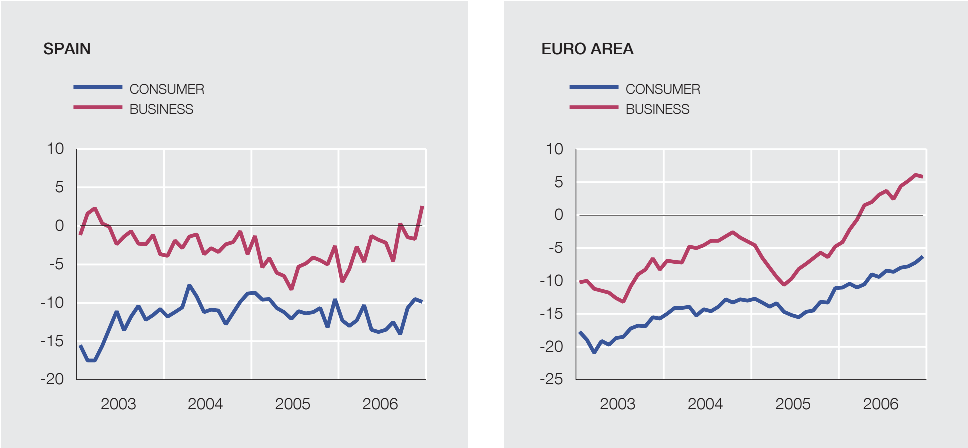
Economic activity in Japan was in better shape in the final quarter, after having fallen off in Q3. And in the United Kingdom, the indicators for the final months confirmed the continuing buoyancy of the economy, manifest in an acceleration in the inflation rate which hit a high in December, posting year-on-year growth of 3%. The Bank of England, following the rise approved in November, raised its official interest rate at its January meeting to 5.25%. Economic activity in the principal emerging regions, namely Asia, the new EU members and Latin America, remained very buoyant and the favourable developments seen on the financial markets in the previous months, particularly the equity markets, continued apace.

Growth prospects for the world economy in 2007 are favourable, although the outlook is for somewhat lower growth than in 2006, at slightly below 5%. However, the main uncertainties clouding international economic developments last year persist. These are mainly doubts over future developments in the oil market and the level of oil prices in the medium-term; the intensity of the slowdown in the US economy and the possible pass-through to other regions; and, finally, the effect on financial markets of a potential disorderly correction of global external imbalances, which continue to widen.

The economic recovery in the euro area that began in 2005 continued, albeit less sharply in the second half of the year. Euro area GDP in Q3 grew at a year-on-year rate of 2.7% (0.5% in quarter-on-quarter terms), 0.2 pp down on Q2; and the information available for Q4 points to continuing economic dynamism based, as in the previous quarters, on internal demand and on the sound behaviour of exports.

Inflation in the euro area continued to reflect the impact of energy price movements, whereby the year-on-year growth rate in December stood at 1.9%. Nonetheless, underlying inflation continued at 1.6% and wages held at a moderate rate of increase, as witnessed by the 0.8% growth in unit labour costs, which provided for a fresh widening of business margins. Yet as the ECB stated at its latest meetings, there remain risks to continuing price stability in the medium-term, largely relating to the possibility of greater demand pressures and employment growth bringing the current climate of wage restraint to a halt. Against this backdrop, the ECB continued with its withdrawal of monetary stimulus and twice (in October and December) raised official rates by 25 basis points, to 3.5%. These monetary policy measures were ac-

CONFIDENCE INDICATORS CHART 2



SOURCE: European Commission.

companied by a small increase in long-term rates on the government debt markets, a narrowing of the yield spread with the United States and a rise in the euro, whose nominal effective exchange rate appreciated by 1.3% in Q4. This movement was, however, partly reversed in the opening days of January.

The budgetary position of the euro area countries improved during 2006. Contributing decisively to this were the increases in revenue, which exceeded budgetary projections in most countries. On the information provided in the latest wave of stability programmes, the euro area deficit declined to 1.9% of GDP from 2.5% the previous year, and the fiscal policy stance was only marginally contractionary. Of particular note was the reduction in the Greek and German deficits, which will most probably be below 3% in 2006 already. Into 2007, if the public expenditure-containment and revenue-bolstering budgetary plans of Germany, France and Italy are realised, fiscal policy in the euro area might take on a contractionary stance.

Spain, with estimated growth of 4% in 2006 Q4 and of 3.8% for the year as a whole, is once again among the most dynamic euro area economies. As a result, Spanish GDP should outpace potential, meaning that the output gap would hold at positive levels for the sixth year running, denoting the persistence of a cyclical upturn.

As part of this overall picture, there were some characteristics worth commenting in Q4. The estimated growth rate for GDP in this period indicates the second half of the year was more dynamic than the first, while a slight acceleration in national demand and a slowdown in the improvement in the contribution of net external demand to GDP growth were discernible. All the components of domestic demand, with the sole exception of investment in other products, contributed to this buoyancy in the final quarter, despite the mild tightening of financing conditions for households and firms. Household consumption and investment in capital goods posted similar rates of increase to those of the preceding quarter, while investment in construction continued on the rising path marking its course throughout 2006, underpinned both by residential investment and by civil engineering works and non-residential investment.

To explain the stability of household consumption in Q4, we must look at the dynamism of disposable income, driven by resilient employment and by the decline in inflation in the closing months of the year, and also by a wealth effect that remained significant. In this respect, although the rise in real estate wealth was somewhat lower than in the previous quarters (house prices showed an increase of 9.1% at year-end, compared with 12.8% in 2005), stock market prices rose strongly, in step with the expansionary behaviour of business earnings and with the favourable economic outlook. The pace of household spending, in both its consumption and residential investment components, was largely financed by bank lending, which also held at a high rate in Q4; however, a mild downturn began to be apparent, possibly in response to the tightening of financing conditions. Overall, the year 2006 closed with a fresh decline in saving by households, a significant widening of their financing requirements and an additional increase in their debt ratio, which may have risen to 125% of gross disposable income at the close of the year.

Corporate investment continued to increase at a sound pace in Q4, as can be seen in the expansionary course of spending on capital goods (which remains the most dynamic component of domestic demand) and in non-residential construction. In 2006 as a whole, the sizeable increase in corporate investment, for the second year running, came about due to the expansion of demand and, in particular, to greater export activity, the healthy position of firms and favourable corporate earnings expectations. As in the case of households, business activity was financed in 2006 by a growing resort to borrowed funds, which moved on a slightly accelerating path throughout the year, reaching a rate of 27% in November. The sharp growth in funds raised by companies (especially by those engaged in real estate services and construction, immersed in some cases in specific corporate operations) and the rise in the cost of financing heightened the degree of financial pressure borne by these companies when taking contracting and investment decisions, although the favourable course of business earnings acted in the opposite direction.

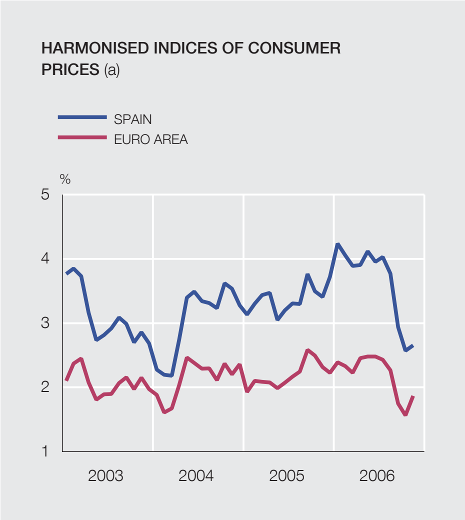
The general government sector also contributed in 2006 to expanding expenditure, mainly through the investment component and, in particular, through civil engineering works, the related rates of increase in which exceeded those for 2005, since the behaviour of government consumption was somewhat more moderate. The buoyancy of economic activity was also reflected in a most appreciable increase in tax revenue during the year. As a result, the general government financial balance in 2006 showed, on the latest official figures, a surplus of 1.4%, far above budget. And the fiscal policy stance, having regard to the course of the primary structural balance, was ultimately moderately contractionary. The government's budgetary plans, set out in the latest update of the Stability Programme approved in late 2006, project fiscal surpluses over the entire forecasting horizon (2006-2009), albeit with a diminishing profile.

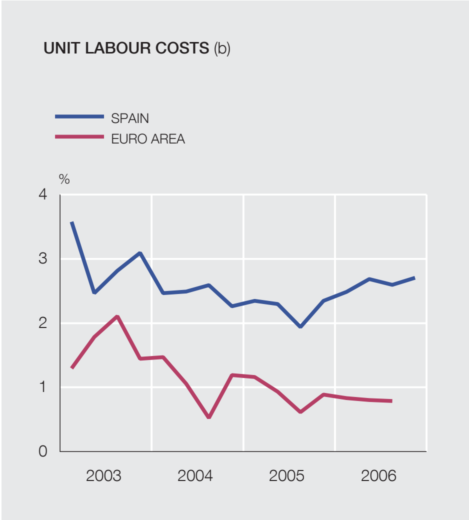
Foreign trade flows during 2006 reflected the more expansionary behaviour of foreign markets and of final demand, against a background in which price-competitiveness, according to movements in the habitual indices of competitiveness, deteriorated once more, albeit less sharply so than in previous years. Overall, exports picked up in 2006, performing in a way more in keeping with our export markets. At the same time, there was a very sharp increase in imports, higher than that of the previous year.

The pick-up in exports during 2006, which was in any event sharper in the first half of the year, was relatively widespread in terms of regions and products. Mention may nevertheless be made of the expansion in sales of capital goods and consumer goods, except cars, whose output is being affected by growing competitive pressures from third countries that are altering the structure of world trade in this type of good. The tourism indicators in 2006 showed little expansion, although in the last two quarters tourism receipts recovered somewhat. Real imports evidenced high growth throughout 2006 in response to the momentum of final demand, the high import content of capital goods exports and the favourable trend of import prices in euro. As regards products, purchases abroad of non-energy inputs were notably buoyant. The

PRICES AND COSTS

CHART 3





SOURCES: Eurostat, ECB and INE.

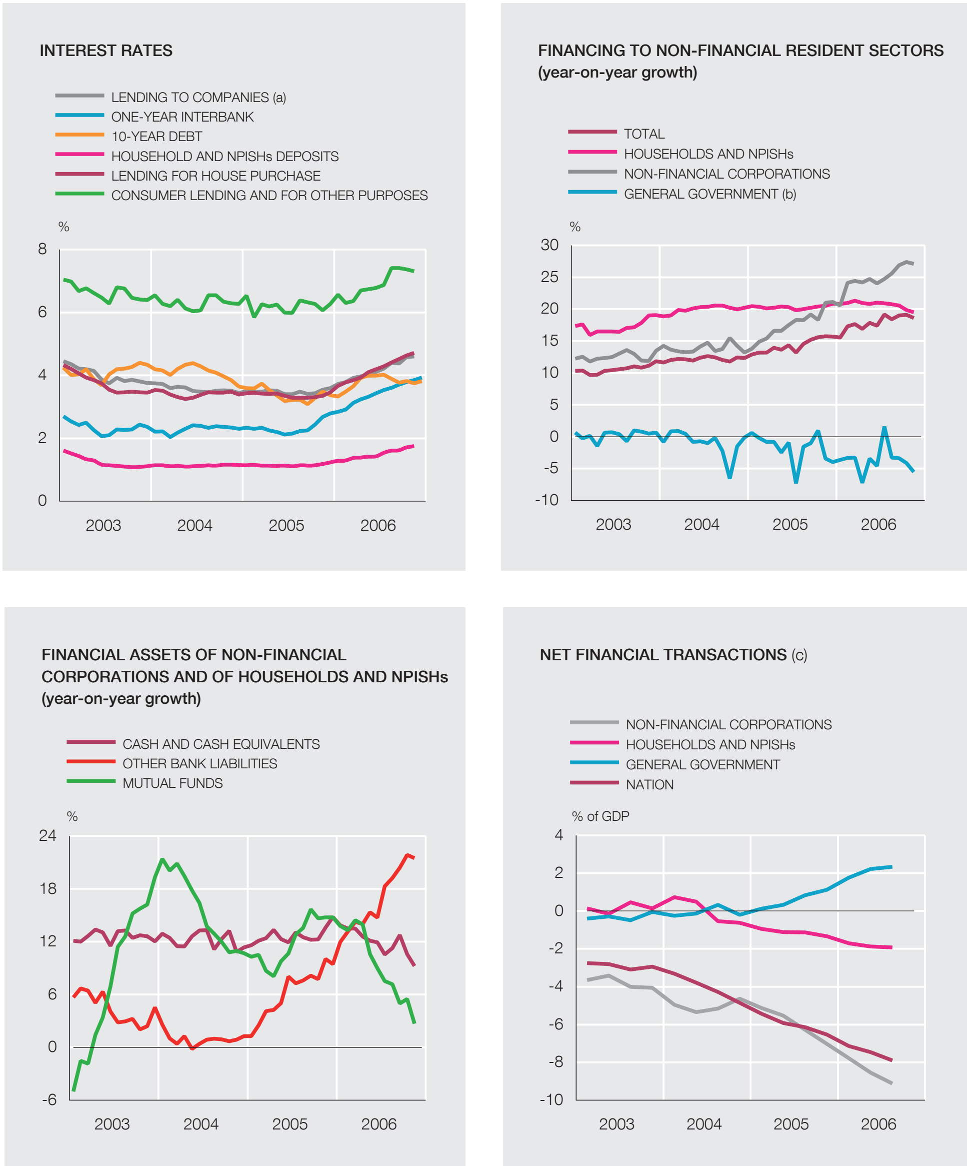
a. Year-on-year rate of change.
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

behaviour of foreign trade flows has translated into a fresh widening of the nation's net borrowing, which stood at 7.9% of GDP in the period to Q3.

In step with the dynamism of demand, activity in the non-farm productive branches was most robust. The buoyancy of the construction sector in particular was most notable, posting growth in value added of over 5% during the year. Industrial activity also picked up appreciably, ending 2006 at a rate of increase which was also close to 5%. The industrial recovery is proving very broad-based, though the strong increase in output earmarked for export markets and, under output intended for the domestic market, that aimed at meeting the demand for capital goods and intermediate goods linked to the construction and energy sectors, are both noteworthy. Market services retained high growth rates in 2006, with a slight rise in the second half of the year. At year-end they were growing at a rate of 4%. The intensity of the employment generation process was most marked in 2006 and followed a similar pattern to that of value added, meaning that apparent labour productivity gains were, overall, moderate. Regarding the productive branches, there was continuing divergence in the intensity of job creation in construction and services, on one hand, and industry, on the other, where employment only began to rise in the second half of the year. This behaviour was naturally reflected in different growth in apparent productivity across the various productive branches.

The course of labour costs led to a slight rise in market-economy compensation per employee, which moved on a quickening profile throughout the year, growing at a rate of 2.8% in 2006 compared with 2.1% in 2005. As in the past three years, the increase in compensation per employee was lower than that for collectively bargained wages, which rose to 4%: 3.2% for the agreed increase for the year, and 0.9 pp more due to the application of the indexation clauses. This gap may denote the presence of factors that are making the labour market more flexible and promoting wage moderation, factors attributable to the changes in the composition of labour supply in the light of the intensity of migratory flows and the strong increase in female participation. The acceleration in compensation per employee, driven above all by the rise in market services and, to a lesser extent, by industry, have passed through, in a setting of very low productivity gains, to unit labour costs in the market economy. This latter variable

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.

rose to 2.6% in 2006 (2.1% in 2005), outgrowing costs in the countries with which Spain competes internationally, as can be seen in Chart 3. However, unit costs in industry, the branch most exposed to foreign competition, have behaved relatively better owing to the strong increases in productivity arising in 2006. The persistence of high growth in costs, along with the ongoing widening of margins, meant first, that there was no appreciable correction in 2006 in underlying inflation, which held at an annual average rate of 2.9%; and further, that the inflation differential with the euro area countries continued to widen. That said, the figures for the closing months of the year portray a more favourable picture, which it should be sought to anchor in 2007 by taking such figures as the basis for the cost and price formation processes now being set in train.

At the close of 2006, then, growth in the Spanish economy is on a mildly accelerating path and contains sufficient elements of inertia for this to run into the opening months of 2007. The most favourable feature of 2006 has been the rebalancing of domestic and external demand in its contribution to output growth, although this process was seen to slow in the second half of the year. On the financial side, there was a mild slowdown in house prices and the rises in interest rates are contributing to slackening the rate of increase of household credit, but not that of corporate lending. This growing corporate debt is due, in some cases, to diversification strategies in the face of certain productive activities having reached their maturity, and such strategies are not exempt from the uncertainty that always accompanies the entry into new business areas.

2 The external environment of the euro area

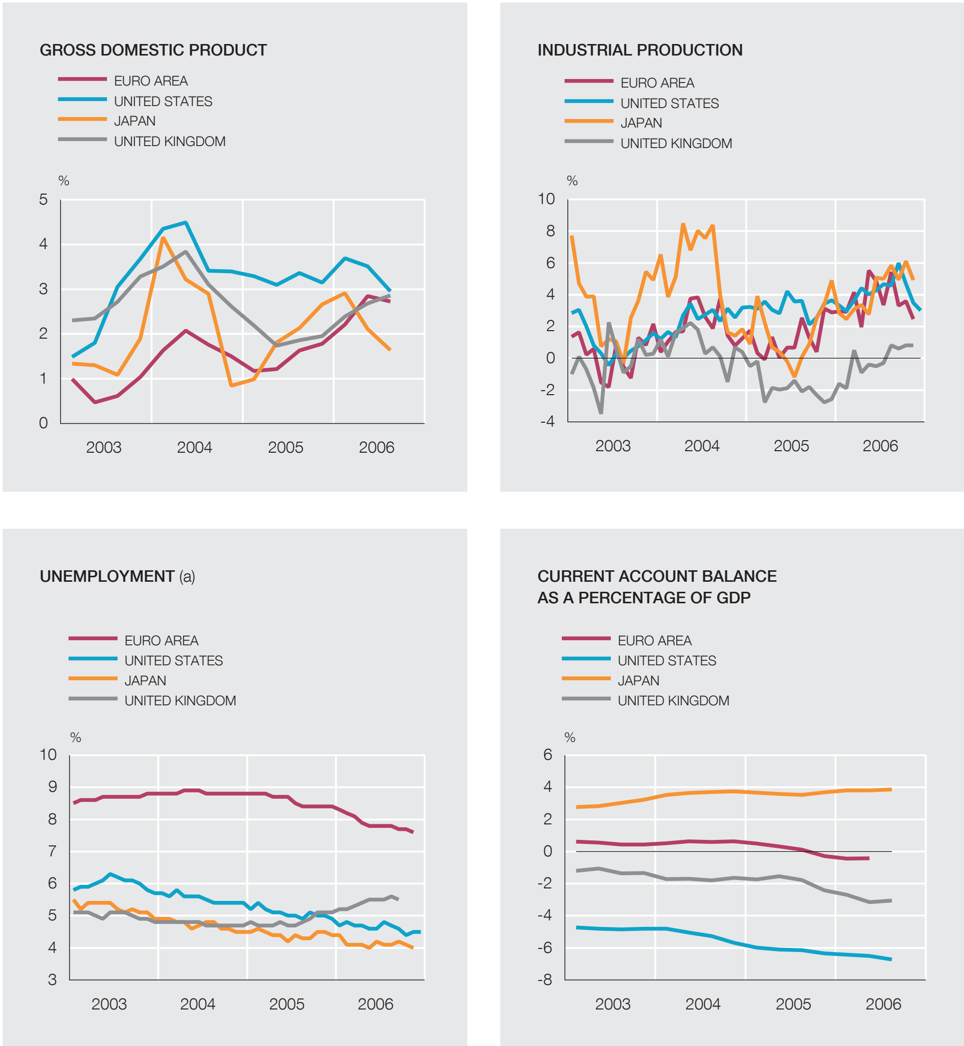
During the last quarter, developments in the external environment of the euro area were essentially marked by continuing high dynamism, aided by some check on the economic slowdown in the United States and a rebound in Japan. Meanwhile, in the other developed and emerging economies, the economic performance was generally expansionary. Influencing financial developments in the developed markets was the US business cycle, though its behaviour over the quarter as a whole was favourable. Of note was the fall in oil prices – and other industrial commodities – and the weakness of the yen. The emerging markets saw the favourable trend of recent months continue, with some bouts of tension on specific markets that did not have any relevant knock-on effects.

Early in the quarter, in the wake of the worsening conditions in the US housing market, expectations of early cuts in the Federal Reserve's official interest rates heightened. Long-term interest rates fell (albeit moderately) both in the United States and in other developed economies, and the dollar depreciated notably against certain currencies, in particular the euro and sterling. However, the behaviour of both the stock markets and corporate credit spreads remained positive. From early December, as favourable indicators in the United States were progressively released, directing the focus increasingly on inflationary risks, the expectations of lower official interest rates were corrected, long-term interest rates rose and the dollar stabilised at around 1.30 against the euro. In the emerging economies, equity markets continued to post gains and sovereign yields reached historical lows in all regions. Only one-off episodes of financial volatility in Thailand, Ecuador and Venezuela prevented the favourable developments from spreading to all markets. Brent oil fell in Q4 by around 15%, and its price dipped below $52 per barrel in early 2007, the lowest level since June 2005. This fall coincided with temporary factors, such as a mild winter in the northern hemisphere, favourable inventories data in the United States and downward revisions of the demand for oil in the year ahead. All these factors countered the adverse news on the supply side, which in another setting would have pushed oil prices upwards, such as the OPEC agreement to withdraw 500,000 barrels per day from February and the unrest in certain producer countries.

In the United States, many of the indicators released during Q4 were more favourable than in the previous quarter and reinforced the impression that the sluggishness of specific sectors – such as residential construction and manufacturing – has not spread to other productive branches. The continuing high rate of growth outside these sectors largely reflects the ongoing buoyancy of household spending. Contributing to underpinning this has been the benign trend of petrol prices and the continuity of a favourable labour market situation, which enabled significant growth in the labour force to be assimilated and allowed the unemployment rate to hold constant at 4.5%. The total level of employment fell in construction and manufacturing, but the creation of new jobs in services was exceptionally dynamic. Investment developments during the quarter were not, however, as favourable either in the case of capital goods, as substantiated by the business spending figures, or construction. Nonetheless, the latest real estate sector indicators have shown signs consistent with residential investment stabilising, although at least part of this relatively sound behaviour would be attributable to the exceptionally high temperatures recorded during the winter. As to the external sector, the trade balance figures showed a significant easing in the deficit, as a result of cheaper oil and the moderation of the volume imported. The inflation rate dipped, though more markedly so in the overall index. The CPI grew at a year-on-year rate of 2.5% in December, significantly down on the average for Q3 (3.3%). The underlying rate stood at 2.6% year-on-year, 0.2 pp below the average

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

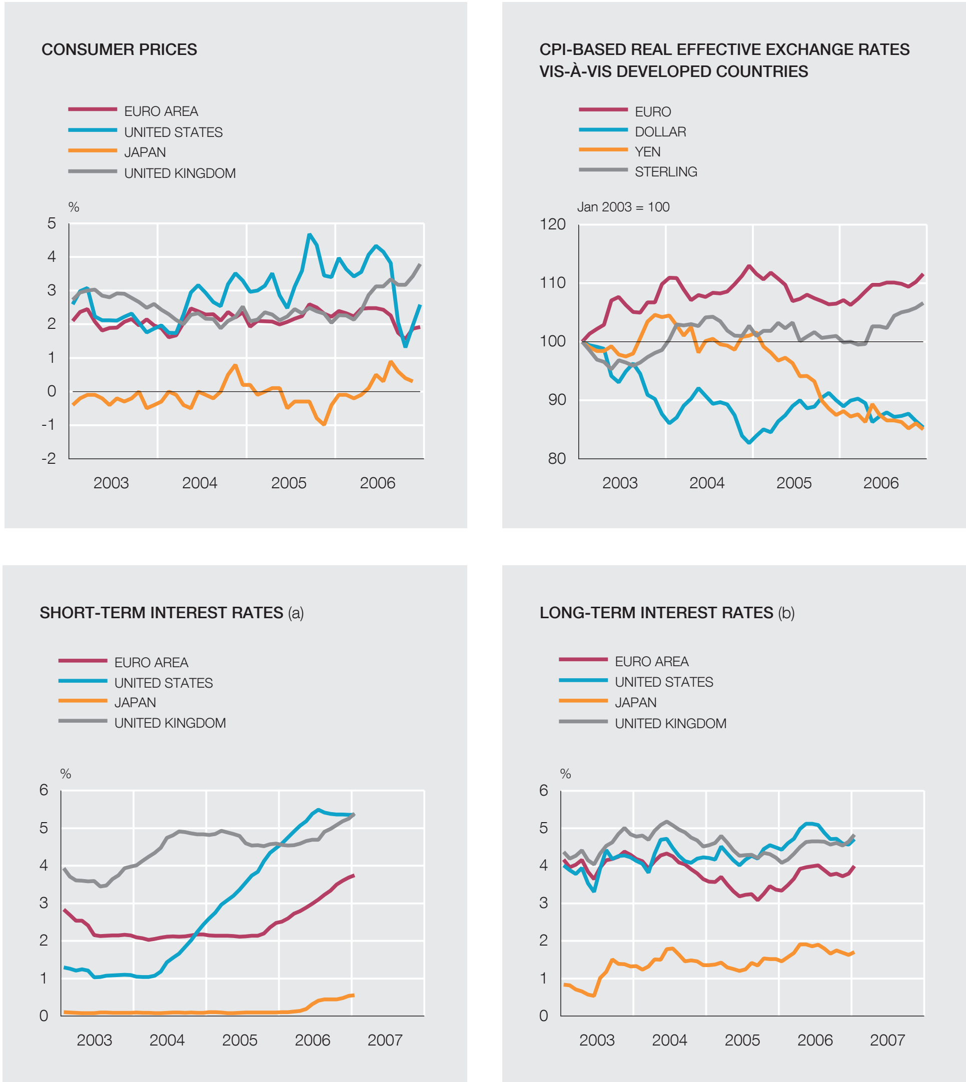
a. Percentage of labour force.

for the previous quarter. Nonetheless, the Federal Reserve, despite acknowledging somewhat greater concern over the possible sluggishness of growth, confirmed that the inflation risk is still its chief preoccupation.

Following the slackness in Q3, economic activity in Japan appears to have regained some momentum in Q4, as attested by the main supply-side indicators. There was also a rebound in private consumption, after the notable decline in Q3. This was underpinned by the rise in consumer confidence, the easiness of financial conditions and the buoyancy of the labour market, where the unemployment rate for November stood at 4%. This was the lowest level since April 1998, although wages remained flat. On the minus side, the manufacturing PMI for December posted its lowest level in over 18 months, which might augur lower rates of increase in industrial production in the coming months. On the external front, the trade surplus widened in November. Exports continued to hold at a notable rate of expansion and imports slowed markedly, owing to the impact of the fall in fuel prices. Turning to the inflation indicators, consumer prices and wholesale prices decelerated during the quarter, due in both cases to the moderation of fuel prices. Lastly, running against prior expectations, the

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.

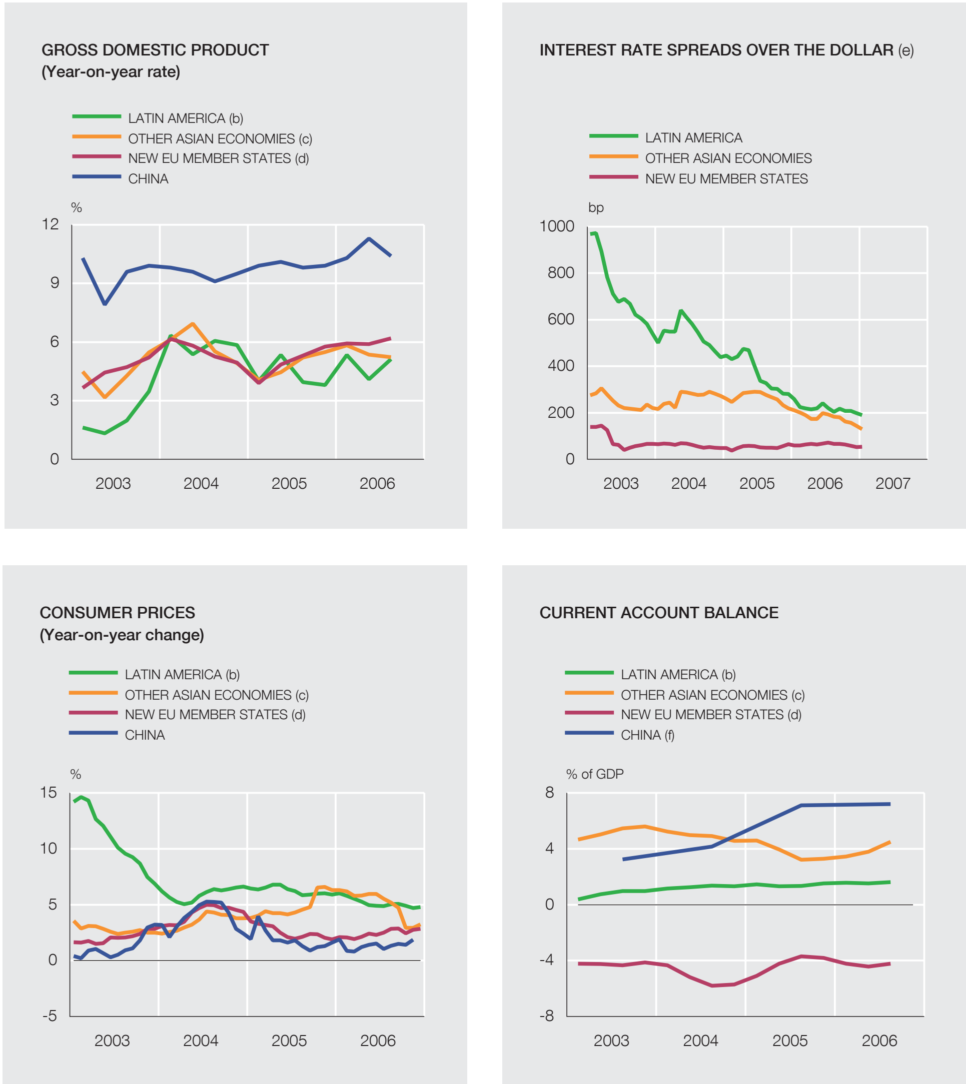
Bank of Japan decided to hold its official interest rates unchanged at 0.25% at its January meeting.

In the United Kingdom, preliminary Q4 figures for GDP placed growth at a quarterly rate of 0.8% (0.1 pp up on the preceding quarters) and at 3% in year-on-year terms. This confirmed the continuity of the favourable economic climate, although manufacturing figures remained sluggish. On the demand side, the indicators pointed to robust growth in private consumption and in business investment. The unemployment rate stood at 5.5% in the three months ending in November, and employment continued to grow forcefully. Inflation moved on a significant rising trend, and the December CPI stood at the upper limit of the Bank of England's target range (3%). The monetary authority raised its official interest rate by 25 bp at its November and January meetings (earlier than expected in the latter case), taking it to 5.25%.

In the new EU Member States, GDP quickened in Q3, posting on average a year-on-year rate of 6.1%, compared with 5.8% the previous quarter. This expansion was broadly underpinned

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.

by the strength of domestic demand, both in private consumption and, especially, in investment. Of note was the buoyancy of Slovakia, whose currency has progressively appreciated, drawing close to the upper limit of its ERM-II fluctuation band. Against this background of strong dynamism in Q4, inflation rose across the board, although inflation rates varied notably from country to country. The rate was noteworthy in Hungary, ending the year at 6.6%. Thus, while official interest rates held unchanged during the quarter in most countries, they increased by 25 bp in Hungary in October to 8%. In Turkey, GDP to decelerated notably from 7.8% to 3.4%, owing to the slowdown in private consumption, the result of the tightening of the monetary policy stance following the financial turbulence in May and June. In the political realm, the European Council decided to suspend negotiations for Turkish EU membership in various areas. Finally, Bulgaria and Rumania became EU Members on 1 January, and Slovenia joined the euro area.

Real GDP in China grew at a year-on-year rate of 10.4% in Q4, 0.2 pp down on Q3. As a result, growth in 2006 was 10.7%, the biggest figure for the last decade. Chinese growth over the past two years was, moreover, revised upwards by 0.2 pp on average. Against this background, investment in fixed assets and industrial production slowed in December after having risen in November. The money supply once again outgrew the official target, leaving the central bank to raise its reserve requirement on two occasions (in November and in January). The exchange rate of the renminbi continued to appreciate against the dollar (1.7% since end-September), but that did not prevent foreign reserves from exceeding a total of $1 billion in December. The trade surplus posted a new all-time high in Q4, and was 74% bigger in 2006 as a whole than in 2005. Foreign direct investment ended the year on accelerating past, and totalled $69.5 billion over the course of 2006. As regards prices, CPI inflation increased progressively during the quarter, reaching a year-on-year rate of 2.8% in December, up from 1.3% on average in Q3. As established under China's agreement with the World Trade Organisation, the activities of foreign banks in the country were liberalised in December. Regarding the main countries in the rest of Asia, most saw their economic growth continue on a moderately slowing path in 2006 Q3, held back by smaller increases in exports. The main exception here was India, whose GDP quickened to 9.2%. The Q4 figures point to the continuation of positive momentum in the area. Inflation held stable or dipped slightly, as a result of the favourable behaviour of energy prices. Finally, there were scarcely any significant changes in official interest rates, although these continued to fall in Indonesia and there was a cut in Thailand in January, following the financial turbulence of the previous weeks in this country, relating to the application of capital controls.

GDP growth in Latin America as a whole in Q3 increased to a year-on-year rate of 5.2%. The Q4 indicators of activity suggest a slight acceleration in Argentina, Brazil and Chile, and continuing dynamism in Colombia, Mexico and Peru. Inflation for the region as a whole reached a historical low in 2006, standing on average at 5.3%. Turning to official interest rates, in addition to the fresh rises in Argentina and Colombia and to the cuts in Brazil, the first downward movement in Chile in this monetary cycle was of note. Uruguay's sovereign debt rating was revised upwards in December, following this country's early repayment of all of its outstanding debt with the IMF. In contrast, proposed debt restructuring and re-nationalisations in Ecuador and Venezuela, respectively, prompted a downgrading of their credit standing and gave rise to bouts of financial volatility in the two countries. The Argentine Supreme Court ruled, at end-December, that the "pesification" in early 2002 was not unconstitutional. Although this imposes costs that are difficult to quantify on banks, the ruling dispels a substantial factor of uncertainty that was hanging over the financial system.

Despite the slowdown in GDP in Q3, the trend in economic activity in the euro area is one of sustained momentum. In fact, according to the most recent estimates of certain international institutions, growth reached a rate of more than 2.5% in 2006 as a whole and will continue to display high rates throughout 2007. In any event, analysis of the developments in the economic situation at around the turn of the year is hampered by the temporary impact of the rise in the main rate of VAT in Germany at the beginning of 2007, although the favourable signs emanating from the labour market, and in particular employment, may give a further boost to private consumption over the coming quarters. More in the medium term, however, the external risks of a macro-financial nature that have been highlighted in previous issues of this bulletin persist.

With regard to inflation, developments in the final quarter of 2006 were driven by its most volatile components, and in particular by the oil price. In any event, underlying inflation remained stable at 1.6%, against a background of wage moderation in the area as a whole. After the expected rise in the HICP in the first few months of 2007 due to the increase in VAT in Germany, the main risk factor for medium-term price stability relates to possible interruption of the current pattern of wage moderation, against a background characterised by buoyant domestic demand and a pick-up in the labour market. The recent fall in oil prices and the appreciation of the exchange rate in 2006 are factors that, if sustained, will tend to mitigate these risks.

In 2006, there was a tightening of monetary and budgetary conditions (see Box 1). In Q4, the ECB Governing Council continued to withdraw the monetary policy stimulus, with further 25 bp interest rate increases at each of its October and December meetings, since it considered that there were upside risks to price stability. As regards fiscal policy, the aggregate general government deficit was reduced in 2006 by 0.5 pp, to 1.9%, according to the deficit figures contained in the updated stability programmes presented in late 2006 and early 2007. Moreover, only Italy and Portugal are estimated to have had budget deficits of more than 3% in 2006.

On 1 January 2007, Slovenia became part of the Monetary Union. The adoption of the euro in place of the tolar, organised by the Slovenian authorities, was completed successfully during the first two weeks of the year.

3.1 Economic developments

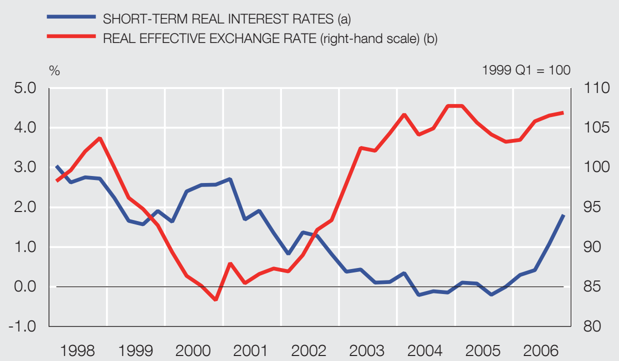
According to the second National Accounts estimate, euro area GDP grew by 0.5% quarter-on-quarter in 2006 Q3, well below the average growth of close to 1% seen in the first half of the year. However, this slowdown in activity was prompted by the loss of momentum in changes in inventories and the net external balance, since domestic demand sustained its buoyancy, with a contribution of 0.6 pp to output, only slightly down from that in the first half of the year (see Chart 8). By component, while private and government consumption displayed greater momentum than in previous months, gross fixed capital formation decelerated as a result of the slowdown in investment in both capital goods and construction, following its exceptional performance in Q2. The contributions to GDP growth of changes in inventories and net external demand fell by 0.2 pp, to 0.1 pp and -0.2 pp, respectively. The deceleration in the latter component arose from the fact that imports accelerated more than exports. In year-on-year terms, euro area GDP rose by 2.7% in Q3, 0.2 pp less than in the previous quarter (see Table 1).

In 2006, the monetary and budgetary conditions of the euro area economy tightened, with the consequent restrictive effect on aggregate demand. First, from December 2005 and during 2006 the Eurosystem's monetary policy became gradually less accommodative, as the recovery in activity in the euro area firmed and inflationary risks increased. During this period the ECB gradually raised the official interest rate by 150 bp, to 3.5% in December 2006. Also the euro tended to appreciate last year, both against the dollar and against the set of currencies of its main trading partners. In particular, the nominal effective euro exchange rate appreciated by 5% during the year, and the real effective rate by 4.7% (see Chart 1). Meanwhile, fiscal policy reflected not only the positive effect that higher economic growth has in terms of reducing the budget deficit (which, according to the estimates in the stability programmes recently presented by the euro area countries, was 1.9% in 2006 for the euro area as a whole, as against 2.4% in 2005), but also a certain structural correction of the fiscal imbalance in a large number of the member countries, as indicated by the increase (of 0.2 pp) in the cyclically adjusted primary balance (see Chart 2).

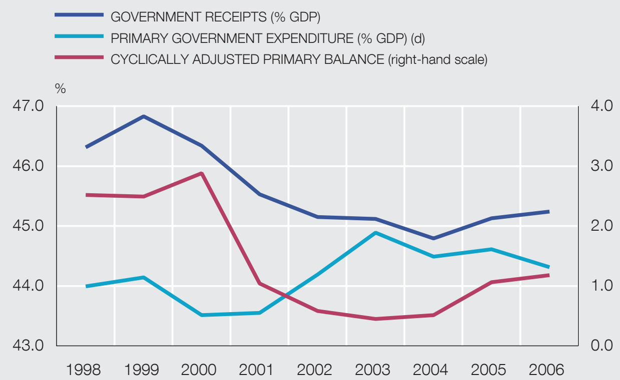
One way of analysing and assessing the overall stance of such monetary and fiscal conditions is to obtain a synthetic indicator reflecting the orientation of the policy mix prevailing in a country. This indicator cannot be expected to condense all the complex information relating to the effects of public policies on economic activity, but may be indicative of their general stance.

This index of monetary and budgetary conditions (IMBC) is calculated as the weighted sum of the changes (with respect to a base period) in the variables that enable the stance of monetary and fiscal policy to be characterised, the weights being estimates of the effects on economic activity of separate shocks to each of these variables, which were

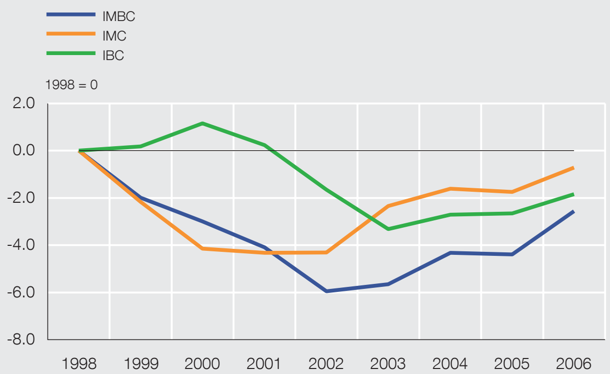
1 MONETARY CONDITIONS IN THE EURO AREA



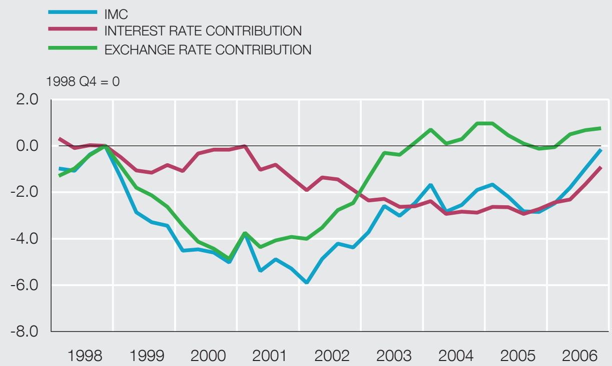
2 BUDGETARY CONDITIONS IN THE EURO AREA (c)



3 CONTRIBUTIONS TO IMBC (e)



4 CONTRIBUTIONS TO IMC (e)



SOURCES: European Central Bank, European Commisssion and Banco de España.

a. Three-month interbank interest rate less current inflation rate.
b. Calculated using the consumer price index as the deflator.
c. The 2006 figure is the European Commission's autumn forecast
d. Adjusted for the UMTS receipts in 2000 (which were treated as a reduction in expenditure).
e. IM(B)C: Index of monetary (and/or budgetary) conditions. An increase (reduction) in the index denotes a higher (lower) degree of restriction of the monetary (and/or bugetary) conditions.

obtained for the euro area from a number of simulations using the NiGEM model[1]. The variables used to calculate the index are the real short-term interest rate and the real effective exchange rate (to characterise the developments in monetary conditions) and government receipts and primary public spending (as a percentage of GDP).

Chart 3 shows the path of the IMBC for the euro area since 1998, while Chart 4 shows the contribution to the changes in monetary conditions of their two components: the real interest rate and the real effective exchange rate. As can be seen, during an initial phase (to 2002) the euro area policy mix became looser, as a consequence of the relaxing of monetary conditions and, to a greater extent, of the behaviour of fiscal policy. The latter was a result of the loose fiscal policies implemented by a large number of European governments in the early years of Stage Three of EMU, which subsequently led to the Stability and Growth Pact crisis. From 2002, the IMBC displays a progressively more restrictive economic policy mix for the euro area, especially in 2006, when all the components (fiscal policy, interest rate and exchange rate) contributed to this stance. However, both monetary and budgetary conditions are still more relaxed than they were at the start of Stage Three of EMU.

1. NiGEM is a global macroeconometric model built by the NIESR (National Institute of Economic and Social Research). For a more detailed analysis of how the index is compiled, see the article "Un índice de condiciones monetarias y presupuestarias" published in the *Boletín Económico* of July-August 2006, Banco de España.

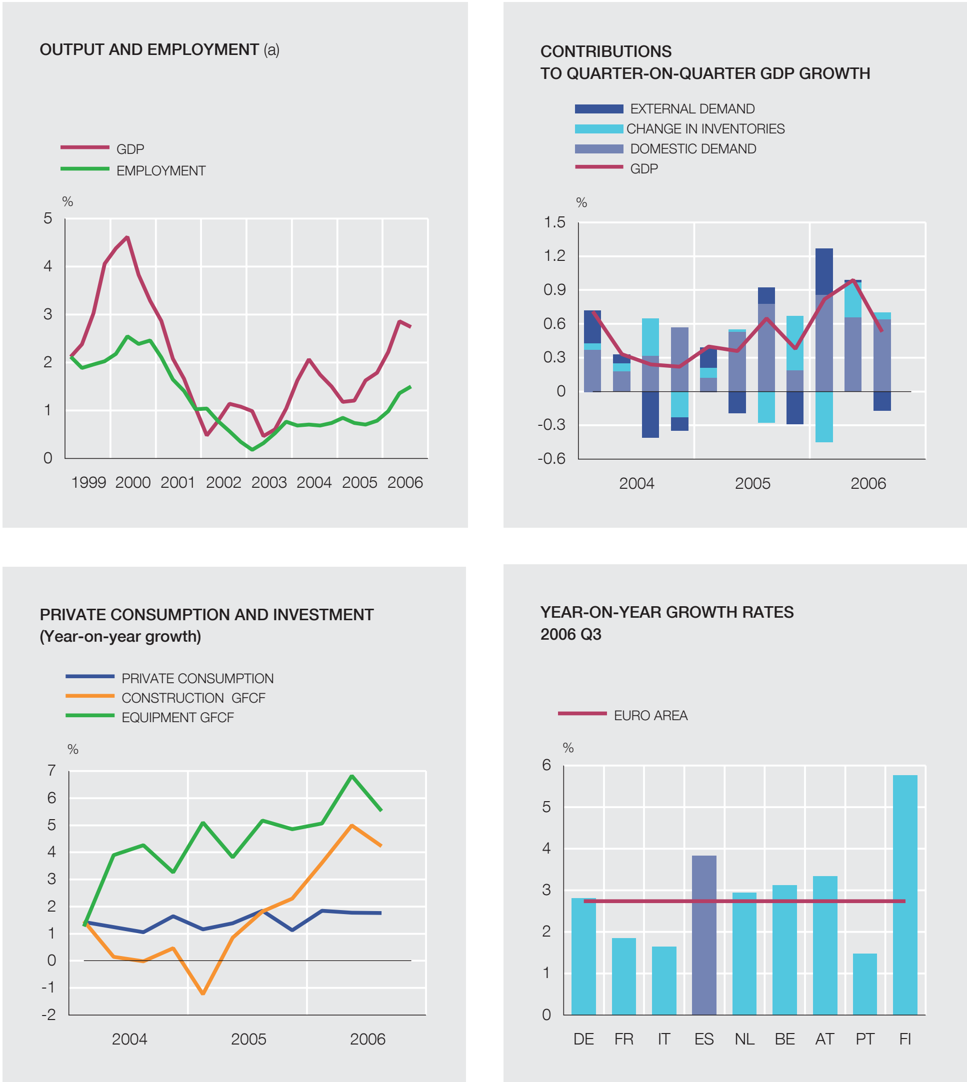
Almost all the branches of activity contributed to the slowdown in value added in Q3, although agriculture and construction did so particularly strongly. By country, the National Accounts data also show that the slowdown in euro area activity in Q3 was experienced by all the members, with the exception of Spain and Austria, which continued to grow at 0.9%. By component, while the strength of consumption was a feature common to most countries, investment developments were more varied. Among the largest economies, France and Germany recorded a notable slowdown, their GDP growing at nil and 0.6% rates, respectively, well below the 1.1% rate recorded in both countries in the previous quarter. The sharp slowdown was prompted in both cases by the reduction in the contribution to growth of changes in inventories, compounded in the French case by more muted investment growth, since the contribution of external demand improved. In Italy, however, the fall in the contributions of the net external balance and domestic demand were only partly offset by the larger contribution from changes in inventories, so that GDP recorded quarter-on-quarter growth of 0.3%, down 0.3 pp from the previous quarter.

With regard to labour, the latest information available is consistent with a gradual improvement in conditions in euro area labour markets. In 2006 Q3 employment again grew at a quarter-on-quarter rate of 0.4%, which entailed a slight improvement in year-on-year terms, to 1.5%. This smooth acceleration, together with the moderation in the rhythm of economic activity in the area during the same period, caused productivity growth to slow to 1.2% year-on-year. According to a recent study by the European Commission, however, this one-off decline in productivity took place within a process of smooth recovery in the trend component, with notable gains in the services sector. Meanwhile, wage moderation continued to prevail in Q3, with compensation per employee growing by 2%, 0.3 pp below the rate in Q2, which meant that the rate of change of unit labour costs held at 0.8% (see Chart 9). The moderate growth in costs in the euro area continued to be explained by their decline in Germany and the Netherlands, which offset the growth seen in the rest of the countries for which information is available. Finally, the increase in the GDP deflator (1.8%) in Q3 again exceeded that in unit labour costs, which caused business margins to widen further.

In general, the most recent conjunctural information for 2006 Q4 indicates that the rate of activity in the euro area was either sustained or improved slightly (see Chart 10). Among the supply indicators, industrial production decelerated in October and November, although the IPI continued to increase at an average rate of close to 3% year-on-year. The qualitative indica-

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

a. Year-on-year rates of change.

tors, for their part, held at high levels in Q4. On one hand, the European Commission's confidence indicators were on average in Q4 above their Q3 levels in the industrial and services sectors, while they held steady in construction. On the other hand, the surveys of purchasing managers in the manufacturing and services sectors showed a slight decline on average in Q4, although they remained at levels consistent with robust activity growth. Employment expectations according to both business surveys improved in all sectors (industrial, services and construction) in 2006 Q4. In addition, the November unemployment rate fell by 0.1 pp to 7.6% (the lowest level since the start of Stage Three of EMU), which extended the progressive reduction in unemployment that commenced in mid-2004.

On the demand side, the indicators also anticipate strong output in 2006 Q4, although the behaviour of some of them is distorted by the bringing forward of consumption prompted by the rise in VAT in Germany at the beginning of 2007. Thus, new car registrations rose notably in November (basically because of the strong increase in Germany) and the indicators of a qualitative nature on consumers and the retail trade compiled by the European Commission increased in the final quarter of last year. Retail sales behaved differently, rising only slightly in

EURO AREA ECONOMIC INDICATORS

TABLE 1

	2005			2006				2007
	Q2	Q3	Q4	Q1	Q2	Q3	Q4 (a)	Q1 (b)
GDP								
Year-on-year growth	1.2	1.6	1.8	2.2	2.9	2.7		
Quarter-on-quarter growth	0.4	0.6	0.4	0.8	1.0	0.5		
European Commission forecasts (c)							(0.3 ; 0.7)	(0.4 ; 0.8)
IPI (d)	0.7	1.5	2.1	3.4	4.1	4.0	*3.0*	
Economic sentiment	96.2	98.0	100.6	103.0	107.2	108.6	110.3	
Industrial confidence	-10.0	-7.3	-5.7	-2.3	2.3	3.3	5.7	
Manufacturing PMI	49.3	51.0	53.0	54.7	57.1	56.9	56.7	
Services confidence	8.7	10.7	14.0	14.7	18.7	19.0	19.7	
Services PMI	53.1	53.8	55.6	57.8	59.2	57.3	57.1	
Unemployment rate	8.7	8.5	8.5	8.2	7.9	7.8	*7.7*	
Consumer confidence	-14.3	-15.3	-12.3	-10.7	-9.7	-8.3	-7.0	
HICP (d) (e)	2.1	2.6	2.2	2.2	2.5	1.7	1.9	
PPI (d) (e)	4.0	4.4	4.7	5.1	5.8	4.6	*4.3*	
Oil price in USD (e)	54.0	62.6	56.5	61.6	68.1	61.2	62.8	*52.7*
Loans to the private sector (d) (e)	8.1	8.8	9.2	10.9	11.0	11.5	*11.2*	
Euro area ten-year bond yield	3.4	3.3	3.4	3.6	4.0	4.0	3.9	*4.1*
US-euro area ten-year bond spread	0.80	0.98	1.12	1.06	1.08	1.00	0.82	*0.66*
Dollar/euro exchange rate (e)	1.209	1.204	1.180	1.210	1.271	1.266	1.317	*1.304*
Appreciation/ depreciation of the dollar against the euro (e)	-11.2	-11.6	-13.4	2.6	7.8	7.3	11.6	*-1.0*
Dow Jones EURO STOXX Broad index (e)	8.9	17.7	23.0	10.3	4.2	11.9	20.3	*1.2*

SOURCES: Eurostat, ECB and Banco de España.

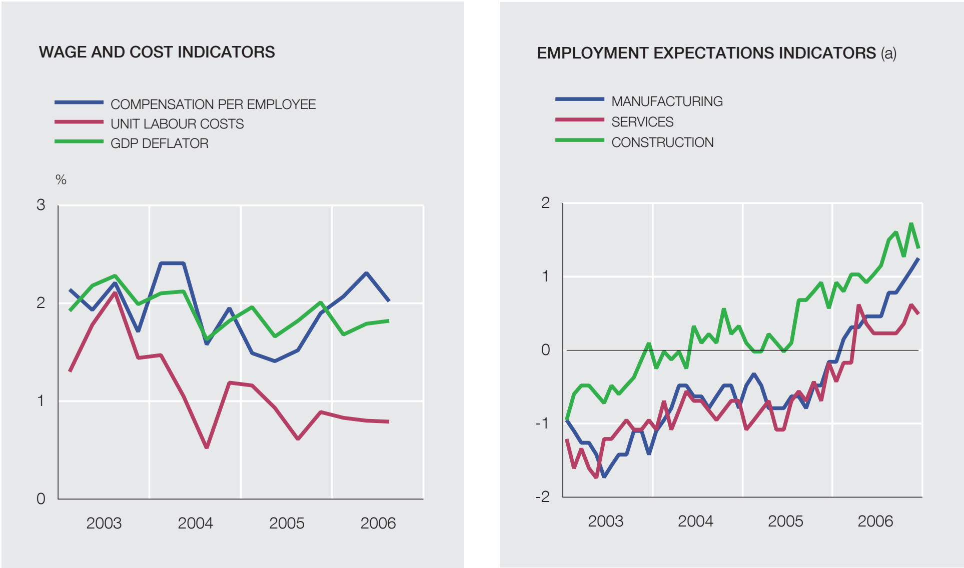
a. The information in italics does not cover a full quarter.
b. Information available up to 20 October 2006.
c. Quarter-on-quarter growth forecasts.
d. Year-on-year growth.
e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

October and November. With respect to capital goods investment, the improvements in Q4 in the capacity utilisation and order book indicators mean that good prospects can be discerned for this component of GDP. Finally, in relation to external demand, the assessment of external order books by industry improved notably in 2006 Q4, while export expectations according to the European Commission's quarterly survey held unchanged in the same period. Lastly, the data for euro area external trade in nominal terms for October and November show a high rate of growth of exports and, to a lesser degree, of imports.

As a result of the foregoing, in 2006 Q4 GDP growth in the euro area is likely to have been sustained or to have increased slightly, and may therefore be in the upper half of the range proposed by the European Commission (0.3-0.7%). In 2006 as a whole, therefore, output growth for the area may exceed 2.5%, in line with the most recent forecasts by certain international agencies. In 2007 Q1, the rhythm of activity is not expected to change significantly and the increase in GDP is expected to come within the range offered by the Commission (0.4-0.8%). However, this scenario is subject to a number of uncertainties. On one hand, while buoyant employment and decelerating oil prices may result in stronger consumption, the magnitude of the impact on spending of the tax reforms that came into force at the beginning of 2007 in Germany and Italy is not clear. In the longer term, the risk continues to exist of a disorderly unwinding of world imbalances.

With respect to inflation, the last two months of 2006 saw a halt in the downward trend in prices that commenced in the middle of the year, owing to the behaviour of the energy

EURO AREA. WAGE AND EMPLOYMENT INDICATORS CHART 9
Year-on-year percentage changes



SOURCES: Eurostat and European Central Bank.

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

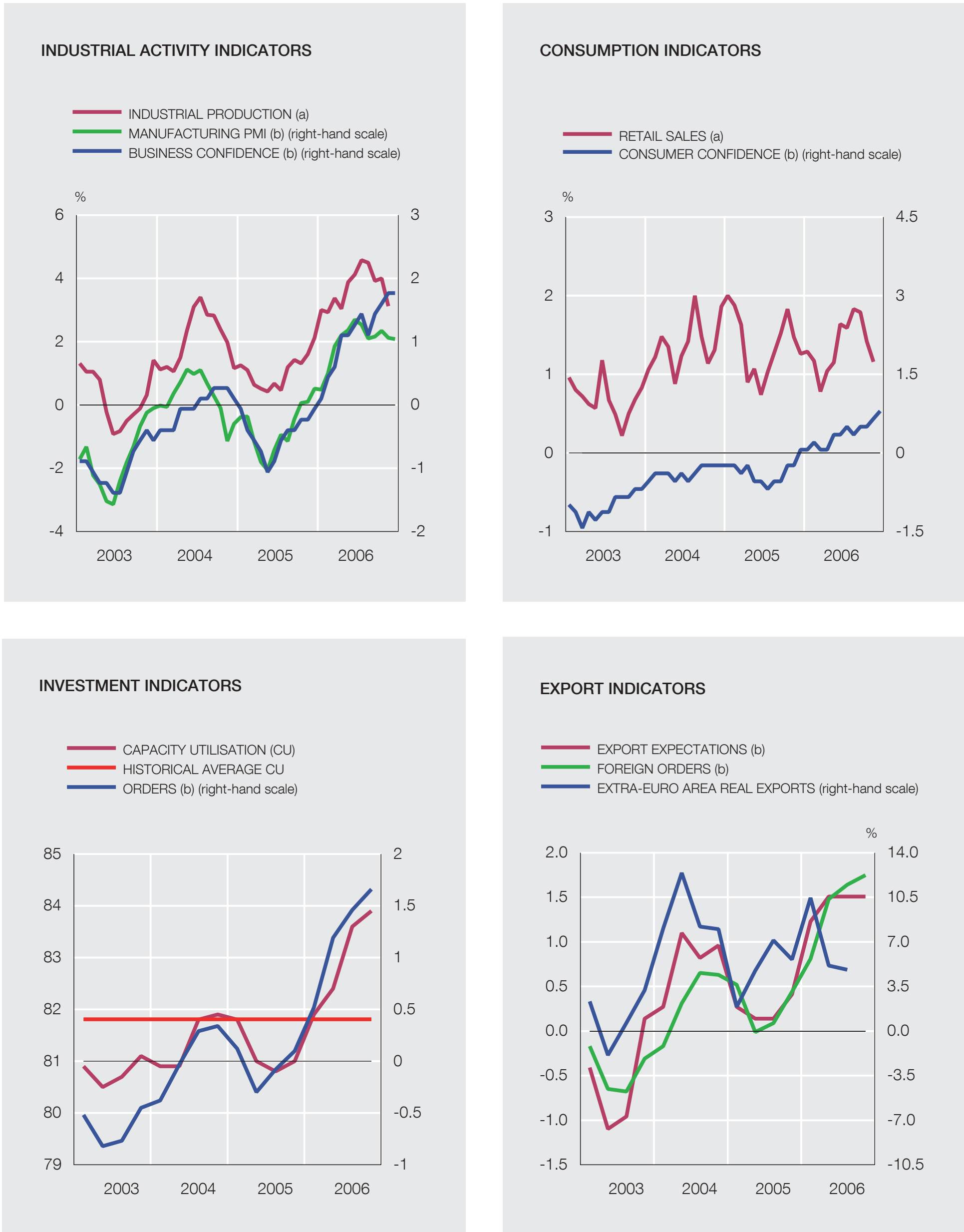
component (and, to a lesser extent, of unprocessed food), which was the result of a positive base effect related to the favourable behaviour of this group in the same period of 2005. Thus, the growth in the overall HICP was 1.9% in December, up 0.3 pp from the low for the year of 1.6% recorded in October (see Chart 11). Meanwhile, the HICP excluding unprocessed food and energy, its most volatile components, held steady during the quarter at 1.6%, only 0.1 pp higher than in September. In 2006 as a whole, therefore, inflation stood at 2.2%, the same rate as in 2005, so that it again exceeded the 2% reference used in the definition of the Eurosystem's price stability objective. The rise in energy prices in Q4 also influenced the behaviour of producer prices. Thus, the acceleration in energy prices and, to a lesser extent, in capital goods prices led to a rise in November in the overall index, while the rate of growth of the rest of the components either moderated or remained unchanged.

In general terms, despite the acceleration in prices in the last months of 2006, short-run inflationary risks were reduced slightly owing to the moderateness of wage growth and underlying inflation, the recent fall in oil prices and the past appreciation of the exchange rate. At a longer horizon, however, buoyant domestic demand and the pick-up in the labour market may prompt intensified wage demands. In any event, over the coming months, the biggest uncertainties relate to oil prices and the impact of tax reform in Germany.

On ECB estimates, the current-account deficit for the period January-October was €20 bn, well above the €6.3 bn deficit recorded in the same period of 2005. This worsening was a consequence of the decline in the goods surplus and, to a lesser extent, of the increase in the transfers deficit, which offset the reduction in the income deficit. Meanwhile, the basic balance, which combines the current-account balance with net direct and portfolio investment, recorded a surplus of €52.9 bn in the first ten months of 2006, up from €18.7 bn in the same period a year earlier. This improvement was based on the reduction in the direct investment deficit, with net capital outflows falling from €178.7 bn in 2005 to €94.7 bn to October 2006.

EURO AREA. REAL INDICATORS

CHART 10



SOURCES: Eurostat and European Commission.

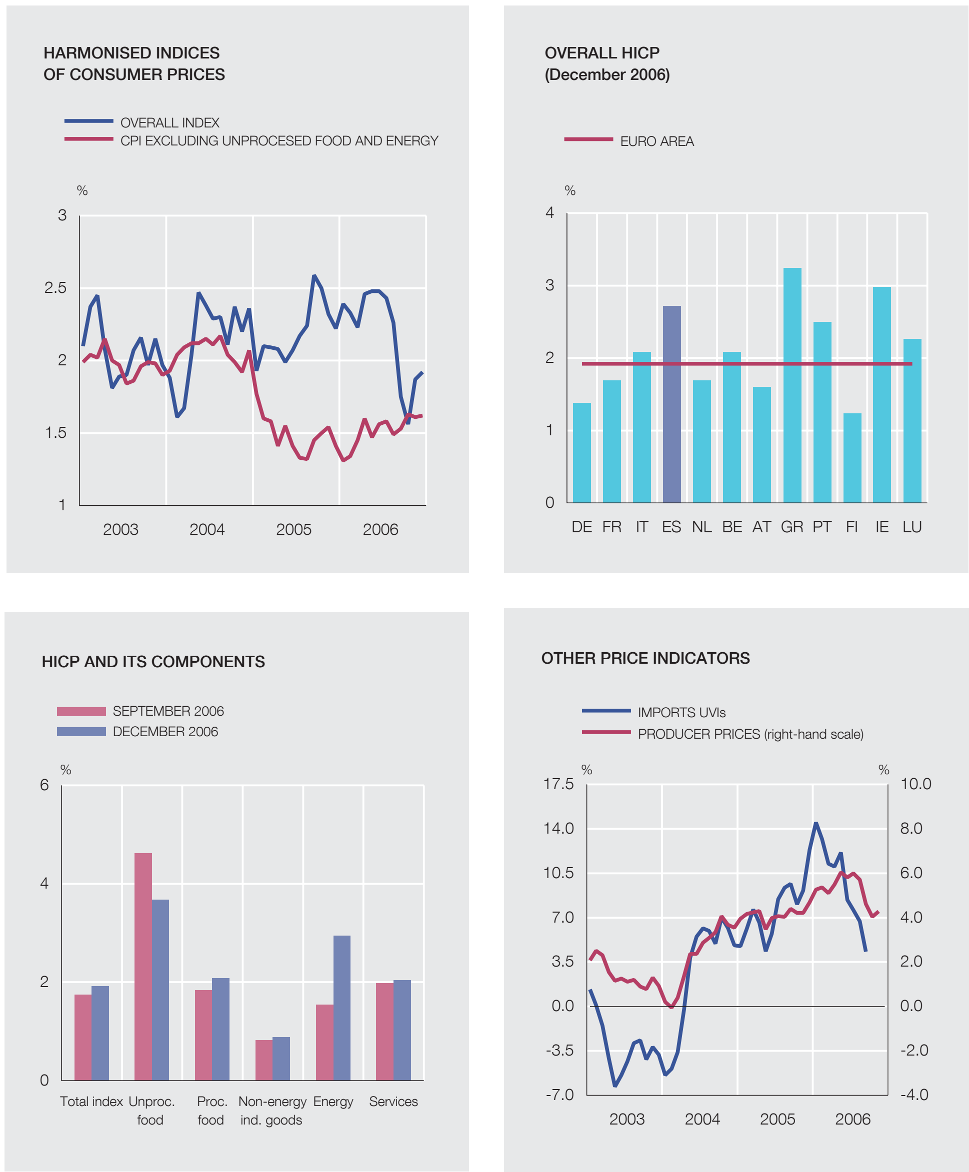
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.

By contrast, net portfolio investment contracted with respect to the same period of the previous year by €36.1 bn, to €167.6 bn.

With regard to fiscal policies, most of the countries presented their updated stability programmes to the European Commission in late 2006 and early 2007 (see Table 2). On aggregate, the general government deficit in the euro area was reduced to 1.9% in 2006, from 2.4% a year earlier, basically as a result of higher-than-expected revenues. This estimate is only 0.1 pp lower than that considered by the European Commission in its autumn report. By country, the budget balance projections for 2006 in the European Commission's autumn report also generally coincide with those presented more recently in the stability programmes. According to the latter, only Italy and Portugal had a budget deficit of more than 3% in 2006 (4.8% and

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

CHART 11



SOURCES: Eurostat and European Central Bank.

4.6%, as against 4.1% and 6% in 2005, respectively). The deterioration in the Italian public finances was basically a result of the refund of VAT revenues on certain products that the State was obliged to make. By contrast, the measures taken by Greece and Germany during 2006 led to a notable reduction in their deficits, to 2.6% and 2.1% respectively (5.2% and 3.2% in 2005). As a result, the European Council determined in October that, in line with the views of the European Commission and in accordance with the deficit-correction measures taken by the German authorities, no further measures would be needed in the context of the excessive deficit procedure. Finally, the French and Spanish programmes project a reduction in the deficit and an increase in the surplus in 2006, respectively.

Overall, the scant improvement in the cyclically adjusted primary balance estimated in accordance with the results of the European Commission's autumn forecasts suggests that the stance of public finances in 2006 was only slightly contractionary. However, fiscal policy is expected to be more clearly contractionary this year. Specifically, the euro area deficit will be

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2005	2006 (b)	2006 (c)	2007(d)	2007(c)
Belgium	-2.3	0.0	0.0	-0.5	0.3
Germany	-3.2	-3.3	-2.1	-1.6	-1.5
Greece	-5.2	-2.6	-2.6	-2.6	-2.4
Spain	1.1	0.9	1.4	1.1	1.0
France	-2.9	-2.9	-2.7	-2.6	-2.5
Ireland	1.1	-0.6	2.3	0.9	1.2
Italy	-4.1	-3.5	-4.8	-2.9	-2.8
Luxembourg	-1.0	-1.8	-1.5	-0.5	-0.9
Netherlands	-0.3	-1.5	0.1	0.1	0.2
Austria	-1.5	-1.7		-1.2	
Portugal	-6.0	-4.6	-4.6	-4.0	-3.7
Slovenia	-1.4	-1.7	-1.6	-1.6	-1.5
Finland	2.7	1.6	2.9	2.9	2.8
MEMORANDUM ITEMS: euro area (including Slovenia)					
Primary balance	0.5	0.7		1.4	
Total balance	-2.4	-2.3	-1.9	-1.5	-1.4
Public debt	70.6	70.6	69.6	68.0	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. Targets of the stability programmes presented in late 2005 and early 2006.
c. Stability programmes presented in late 2006 and early 2007: estimates for end-2006/targets for 2007.
d. European Commission forecasts (autumn 2006)

reduced in 2007 to 1.5%, according to the Commission's autumn report, or to 1.4%, according to the aggregate updated stability programmes. This would largely be the result of the public expenditure containment measures in Germany, France and Italy, and also of the permanent discretionary measures on the revenue side in the form of a rise in tax rates in Germany and an increase in direct taxes and social contributions in Italy. In 2007, both the Commission and the stability reports predict that only Portugal will be in an excessive deficit situation.

3.2 Monetary and financial developments

In 2006 Q4, the ECB Governing Council again moderated the expansionary nature of monetary conditions with 25 bp increases in its official interest rates at its October and December meetings. It considered that there were upside risks to the maintenance of price stability related to the rise in oil prices, the possible introduction of new fiscal measures and higher wage demands. At its first meeting of the year, the ECB decided to keep interest rates unchanged, but confirmed the existence of the same risks to price stability and assured that it would monitor economic developments very closely, in order to avoid such risks materialising. As a result of these decisions, the interest rate on main refinancing operations stood at 3.5%, and those on the deposit and marginal lending facilities at 2.5% and 4.5% respectively (see Chart 12). Despite the more restrictive monetary policy stance, the latter was still accommodative.

The interbank yield curve shifted gradually upwards in Q4, in step with the expectations of rising official rates. On government debt markets, long-term yields also rose in the last two

EURO AREA INTEREST RATES

CHART 12

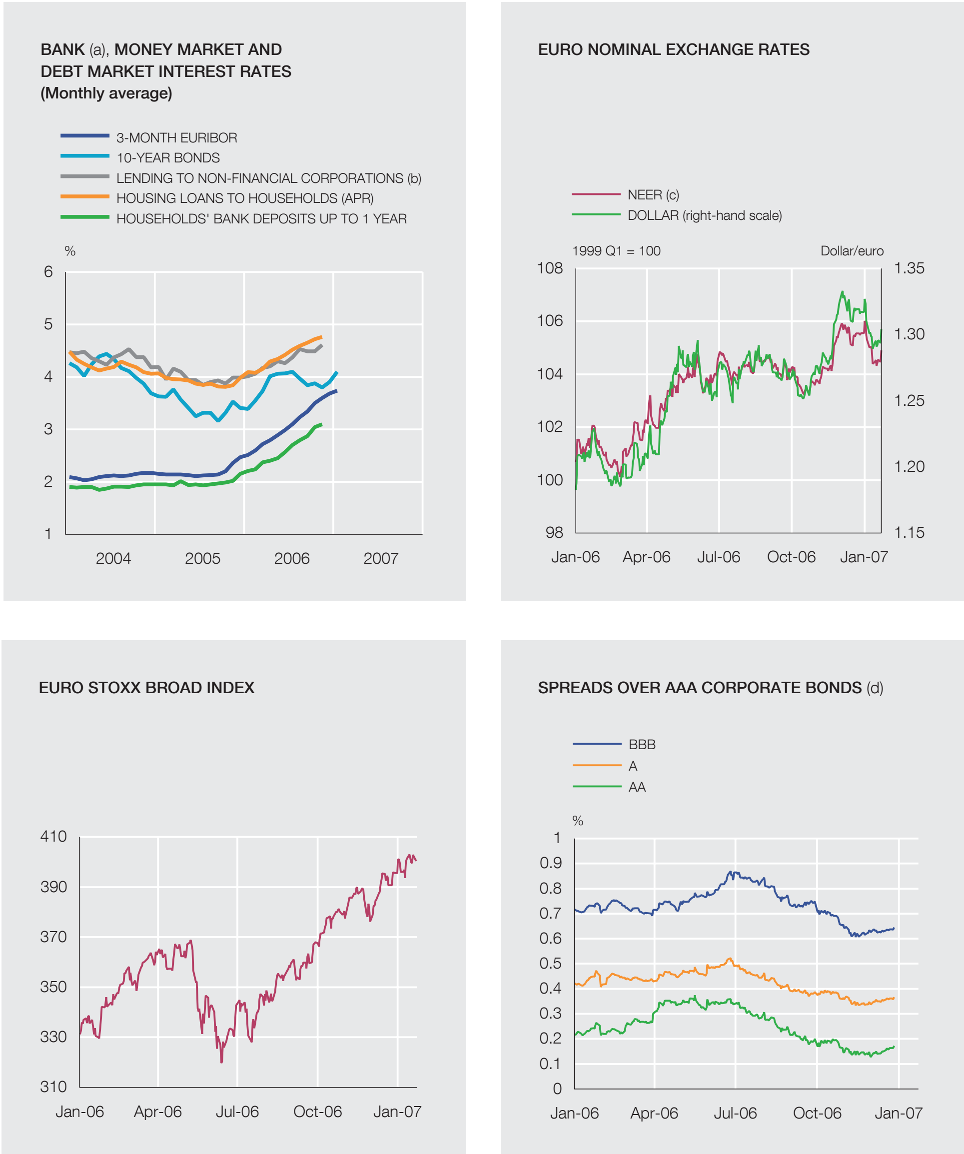
SOURCES:European Central Bank and Banco de España.

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

months of the year, following erratic behaviour in October and November. These developments, combined with the smaller decline in bond rates in the United States, meant that the yield spread narrowed constantly, to stand at 0.7 pp in January. Also, the rise in official rates drove up the rates applied by credit institutions to their loans and deposits (see Chart 13).

In the final quarter, the nominal effective euro exchange rate appreciated by 1.4% relative to September, as a result of the nominal appreciation with respect to the dollar and the Japanese yen, which was only partly offset by the weakening of the single currency against the pound sterling and other European currencies. In the first few weeks of 2007, however, the euro changed direction and depreciated on average by around 0.6% in nominal effective terms and about 1% with respect to the dollar. On equity markets, the favourable corporate earnings outlook, along with certain merger and acquisition transactions, boosted stock market indices in 2006 Q4. The EURO STOXX index rose by 7% in 2006 Q4, and by 20.3% in 2006 as a whole. During the first few weeks of January the index rose by about 1%.

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

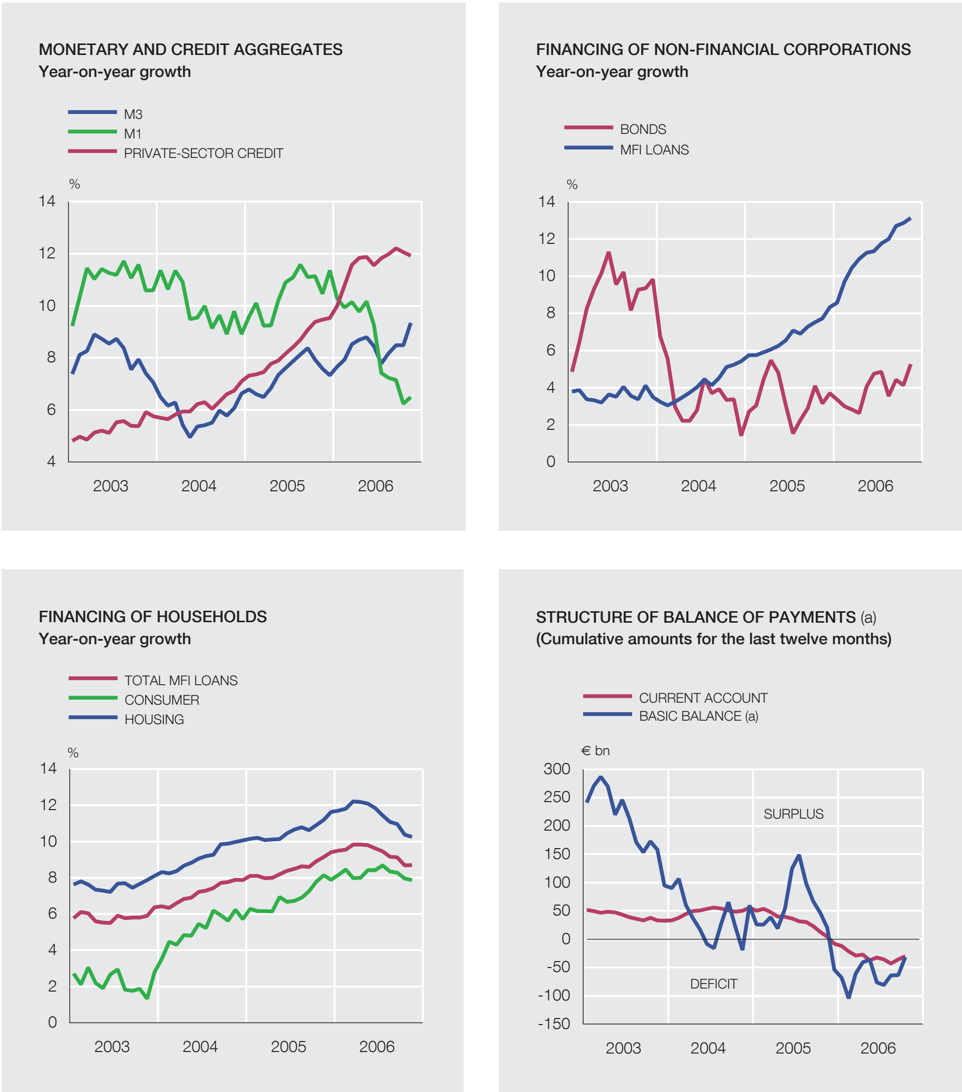


SOURCES: Banco de España and European Central Bank.

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

With regard to monetary aggregates, M3 grew by 9.3% in November, up 0.8 pp from the previous two months (see Chart 14). The strength of activity, the low levels of euro area interest rates and the flattening of the yield curve drove the growth of this aggregate to levels not seen since 1990. By component, while the rate of growth of cash fell, deposits (both overnight and other) and negotiable instruments accelerated. As for bank assets, the buoyancy of MFI loans to the private sector was sustained in Q4, with a rate of change of 11.2% in November. By agent, the high rate of growth of loans to non-financial corporations, which stood in November at 13.1%, was attributable, according to the Q3 Bank Lending Survey, to the strength of inventory and fixed capital investment, mergers and acquisitions and debt restructuring, against a background of favourable financing conditions. Meanwhile, loans to households continued to rise at a rate of 8.7%, since those for consumption and housing only suffered a slight loss of buoyancy, to 7.9% and

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.

10.2% respectively. The latter developments are in line with the expectations for Q4 according to the Bank Lending Survey, which envisage a gradual slowing of the demand for loans for house purchase, in step with expectations of a deceleration in prices and activity in the property sector. Finally, private sector credit continued to behave differently across countries. In Spain very high rates of growth (almost twice the euro area average) were recorded, while in Germany the rate was well below the European average. By contrast, loans in France and Italy grew more closely in line with the euro area as a whole.

On QNA estimates, year-on-year GDP growth in Q3 was 3.8%, 0.1 pp up on the previous quarter. This was due to the continuing expansion in national demand and to a slight improvement in the contribution of net external demand to output. In quarter-on-quarter terms, GDP increased at a rate of 0.9%, matching that of the first two quarters in 2006. The information available for Q4 suggests that the GDP growth rate has once again risen, to 4% year-on-year (1.1% in quarter-on-quarter terms), the result of the acceleration in national demand to 4.7% and of the 0.1 pp improvement in the contribution of net external demand to –0.9 pp (see Chart 15). The greater momentum of national demand was underpinned by the dynamism of investment both in capital goods and in construction.

On this estimate for Q4, GDP growth for 2006 as a whole would be 3.8%, 0.3 pp more than in 2005. The most favourable feature of this expansion is that it has proven compatible with the rebalancing of the contributions of national demand and of net external demand to growth. Indeed, national demand slowed by 0.4 pp in 2006, although it is still running at a fairly brisk year-on-year rate of 4.6%, while the contribution of net external demand to the expansion in output improved by 0.6 pp. Under national demand, the component where the slowdown was most patent was private consumption, while investment in construction retained its buoyancy from the previous year and investment in capital goods gathered even greater momentum in relation to its growth rate in 2005. Turning to the external sector, goods exports picked up significantly after having been flat in 2005, though they continued to grow at a lower rate than that of Spanish export markets.

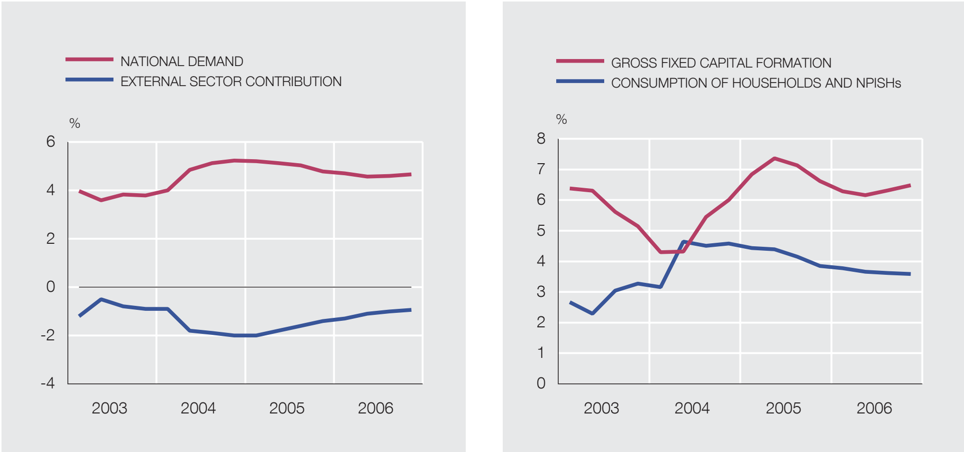
The disaggregated data for the different branches of activity show that the rise in GDP in Q4 was across the board. As in Q3, the most pronounced acceleration was in manufacturing industry, though the rate of increase in both construction and market services was significant and somewhat higher than the estimate for the previous quarter.

The Q4 indicators suggest that employment has continued to grow at a high rate in excess of 3%, whereby apparent labour productivity for the whole economy rose only slightly in this period. As a result, unit labour costs stabilised in Q4, offsetting the marginal acceleration in compensation per employee. The inflation rate continued to decline in Q4 from an average of 3.5% in Q3 in the case of the CPI, to 2.7% in December. Behind this to a large extent is the fall in oil prices since the summer, although some decline can also be seen in underlying inflation, as the growth rate of the CPI excluding unprocessed food and energy dipped from 3% on average in Q3 to 2.5% in December.

4.1 Demand

In 2006 Q3, Spanish household final consumption spending grew by 3.6% in year-on-year terms, 0.1 pp less than the previous quarter. The latest conjunctural information suggests that private consumption will post a similar rate in Q4. Specifically, the synthetic indicator of private consumption points to a slight acceleration in the consumption of goods in the closing months of the year, which includes the rise in new car registrations that took place in this period. That said, drawing on data from the tax authorities on large corporations, the consumption of services might hold up or lose some momentum in Q4 (see Chart 16). Finally, the consumer confidence indicator improved significantly in the last three months of the year, while retail trade confidence moved in the opposite direction, worsening in relation to the previous quarter.

MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

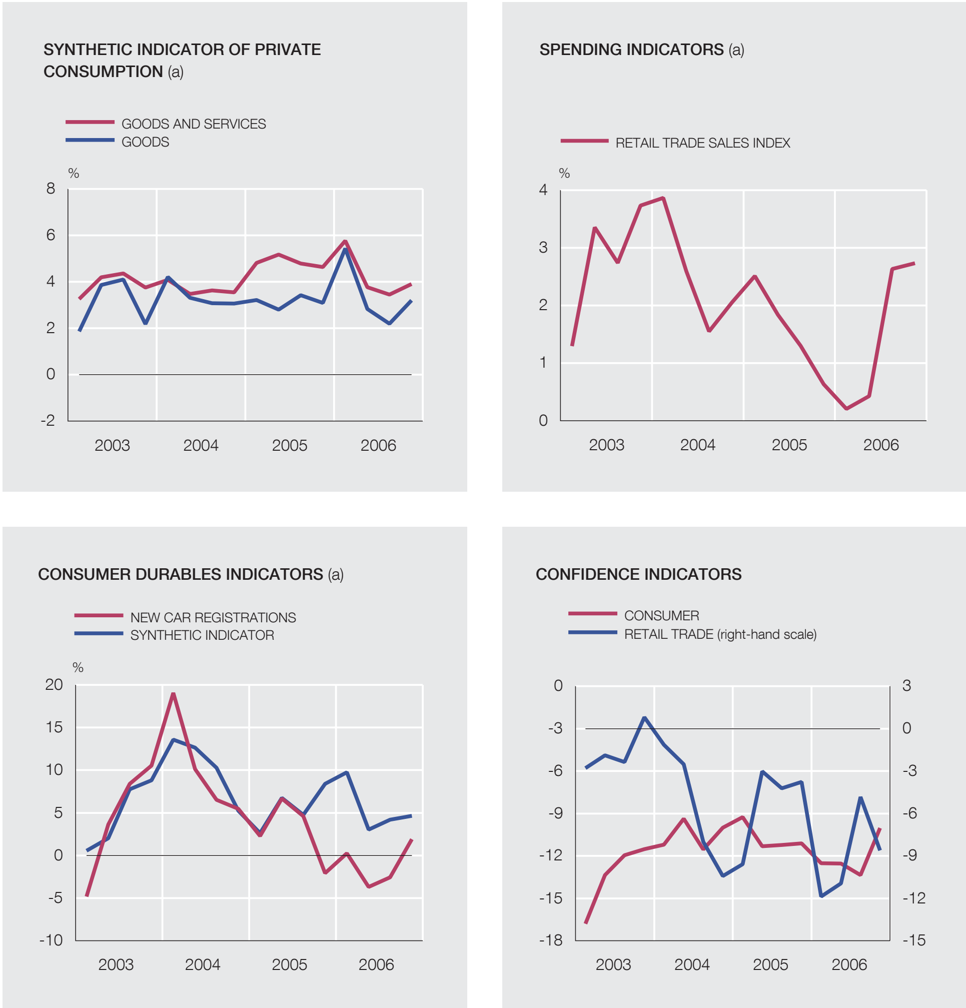
Private consumption is estimated to have grown by 3.7% over the year as a whole. That is still a sharp rate, albeit 0.5 pp below the 2005 figure. In any event, household consumption continued to grow in 2006 at a brisker pace than that of household disposable income. As a result, the saving ratio continued to decline, as shown by the non-financial accounts of the institutional sectors, which are available to Q3. And this despite the rise in interest rates, which should have boosted saving. One of the explanatory factors here might be the fact that household wealth continued to increase at a high rate in 2006, owing to the notable rise in stock market prices (the Madrid Stock Exchange General Index grew by almost 35% over the year as a whole) and the increase in real estate wealth, although house prices continued to slow gradually. The fact that employment generation held at a relatively high rate, which further led to employee compensation remaining buoyant, may also have improved future expectations of household income, thereby encouraging consumption.

In 2006 Q3, general government final consumption posted an increase of 4.2%, unchanged on Q2. The information available points to some quickening in this aggregate in Q4, based on the data on goods and services drawn from the State budget outturn and on employee compensation, chiefly in the territorial governments.

Gross fixed capital formation moved at a brisk rate of increase in Q3 (6.8% year-on-year), 0.2 pp above the rate for Q2. Behind this acceleration was the higher growth both in investment in capital goods and investment in construction, which rose by 9.5% and 6.1% respectively, 0.4 pp and 0.3 pp up on the previous quarter. In contrast, investment in other products slowed somewhat from 3.3% to 2.9%. On the information provided by the Q4 indicators, gross fixed capital formation continued to expand at a sharp rate in this period, the result of the continuing considerable strength of both spending on capital goods (which is still the most dynamic component of domestic demand) and investment in construction (see Chart 17).

In fact, the indicators relating to investment in capital goods reveal that the favourable trend recorded throughout the year is continuing. The indicator of apparent investment in capital goods, calculated with incomplete data for 2006 Q4, points to a fresh rise in capital goods purchases, based principally on the strength of the domestic output of these goods. Further, both the business climate indicator for the capital goods industry and the business confidence

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.

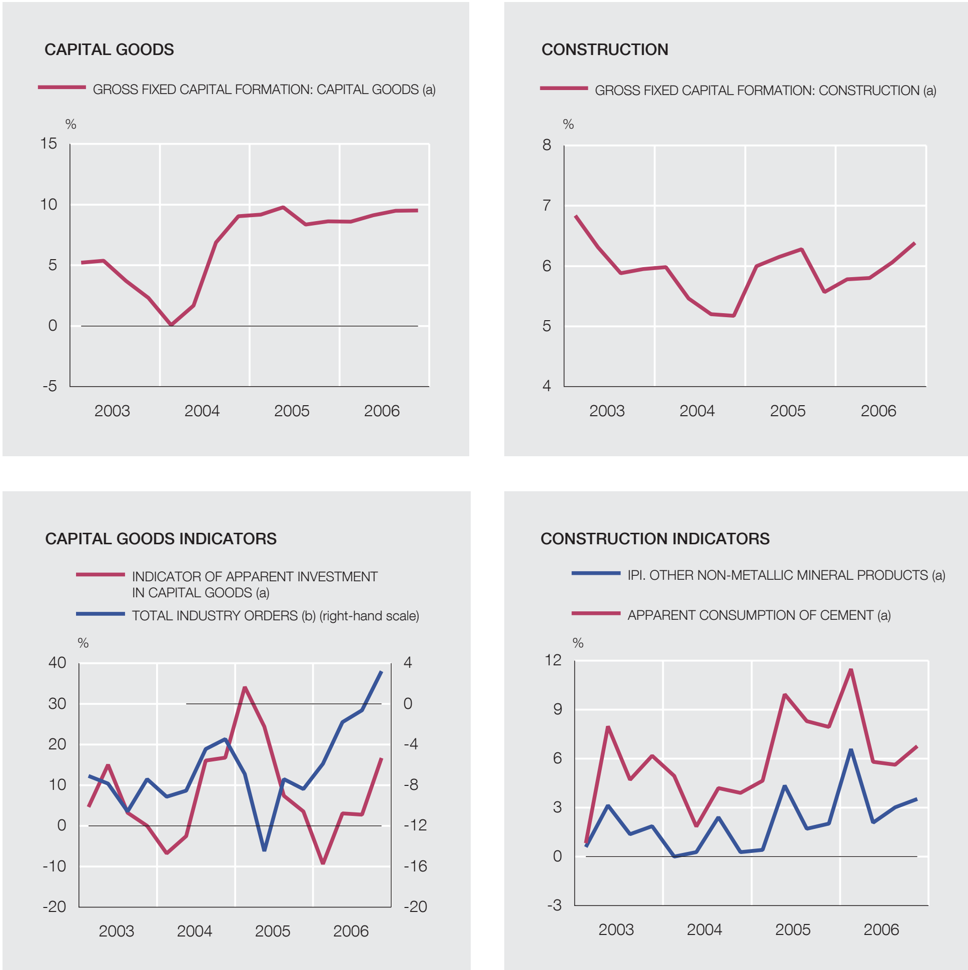
indicator improved considerably in Q4, accompanied by the favourable trend of orders and by an increase in the level of capacity utilisation.

Investment in construction climbed by 6.1% in 2006 Q3, in line with the high growth rate recorded in the previous quarters. Judging by the latest conjunctural information, this dynamism might continue into Q4. In this respect, among the coincident indicators, the apparent consumption of cement quickened considerably during the months of October and November, as did the manufacture of industrial products for construction. The number of Social Security registrations in this branch has lost some momentum in Q4, although they continue to grow at a high rate.

By type of work, investment in housing increased by 6.6% in Q3, meaning its growth in the first nine months of the year exceeded that of the related periods in previous years. According to the leading information provided by the Ministerio de Fomento's work approvals statistic, allocated in time according to a project execution schedule, residential construction might maintain this strength in the final quarter of 2006. Investment in the other construction segments – non-residential building and civil engineering works – grew by 5.5% in Q3, up on the rate estimated for the first six months. Although the conjunctural information is scanter and more

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.

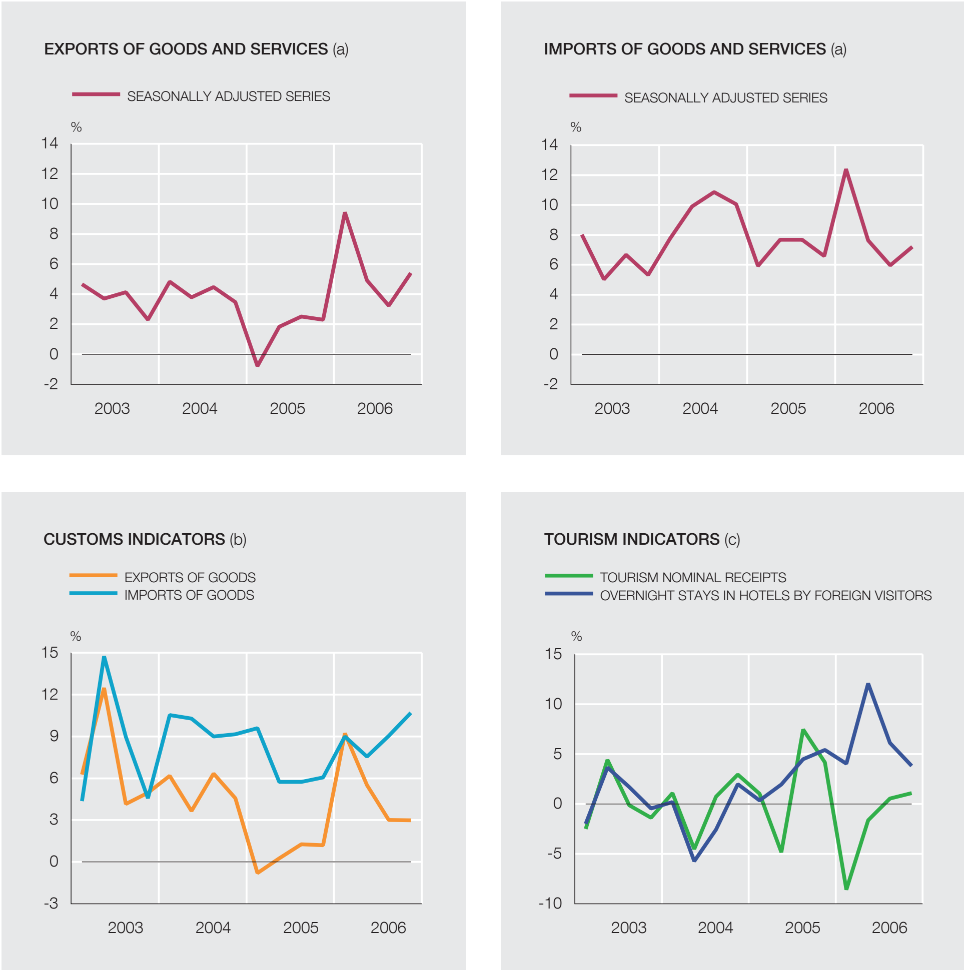
uncertain for this type of work, non-residential building continues to be sustained by the strong growth of works executed by general government. Civil engineering works, in the absence of full information on private sector-promoted works, also appear to be more robust in late 2006, in keeping with the period-adjusted data on government procurement.

The information on non-financial corporations for the first nine months of 2006, compiled by the Banco de España Central Balance Sheet Data Office, shows notable growth in activity and a firming of the job creation process, thanks to the strength of domestic demand and the improvement in external demand. The momentum of business activity has offset the increase in the interest burden, whereby the ordinary return on net assets has continued to trend favourably. This, combined with the still relatively moderate levels of interest rates, means that new investments continue to look attractive.

On the latest QNA figures, the contribution of net external demand to GDP growth improved by 0.1 pp in 2006 Q3 to –1.0 pp, whereby the gradual correction in this variable seen since 2005 Q2 continued. Set against the slackness of exports and the slowdown in imports observed in 2005, foreign trade flows in the first three quarters of 2006 were on the whole more dynamic. Exports picked up appreciably and imports rose, although in both cases the profile

FOREIGN TRADE
Percentage change on year ago

CHART 18



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

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

within the year 2006 was a slowing one. This recovery in exports has come about against a more expansionary international backdrop than that seen in 2005, and one in which the key-note is the greater buoyancy the euro area has acquired.

The as yet incomplete information for 2006 Q4 suggests that the rate of increase in exports rose slightly, in line with the firming of the recovery in the euro area countries (see Chart 18). For 2006 as a whole, however, the rise in exports is lower than that of the related markets, meaning that the share of sales abroad continued to diminish. Real imports of goods and services appear to have strengthened in the closing months of the year, underpinned by the dynamism of final demand, improved exports, the momentum of industrial activity and the lower prices in euro of such imports. Accordingly, the contribution of net external demand growth is estimated to have improved by 0.1 pp in Q4.

On QNA figures, the year-on-rate of increase of real goods exports continued to slow, falling in 2006 Q3 to 3% from 4.7% in Q2 and 13% in Q1. For Q4, information drawn from the customs authorities for October and November shows a slight rise on the rate estimated the previous quarter. In the first eleven months of the year real goods exports have increased by 5.7%, with capital goods exports performing most dynamically and increasing by 14.6% in this period. In terms of geographical areas, real goods exports to the euro area, which had fallen by 1.3% in 2005, rose by 3.5% in the first eleven months of 2006, while exports to the rest of the world maintained their momentum with a rate of increase of 11.1% in this period.

Real exports of tourist services posted a marginally positive rate of 0.6% in 2006 Q3 according to QNA data, above the rates in the first half of 2006. The latest indicators available on overnight stays by foreign visitors in hotels and on the number of foreign tourists suggest some moderation in Q4. The nominal indicators of tourist spending have also worsened in recent months, with a decline in total tourist spending in October and zero growth in November. In any event, overnight stays by foreign visitors in hotels in 2006 as a whole grew at a notable rate of 6.5%, more than twice that recorded in 2005, while the number of tourists climbed by 4.5%, in line with the WTO's projected growth for world tourism. However, according to EGATUR, total tourist spending continued to show signs of sluggishness, as average spending per tourist did not cease to fall. This was a result of the shortening of their average stay in Spain although, as indicated in the previous quarterly report, the figures in this survey may be somewhat downward biased in 2006.

Real exports of non-tourist services grew by 7% in 2006 Q3 according to QNA figures, prolonging the moderating profile of the previous quarter. Foreign sales of transport services slowed in this period, while other lesser items, such as IT services and insurance, fell. Nonetheless, business services, one of the main items, moved on an expanding course.

QNA figures show that the year-on-year growth rate of real goods imports stabilised in 2006 Q3 at 7.3%. Customs data for October and November indicate that imports will also remain strong over the course of Q4, at a slightly higher rate than in the July-September period. In the first eleven months of the year, the growth of imports in real terms climbed to 9.3%, with a rate of increase of around 11% for both purchases of non-energy intermediate goods and non-food consumer goods.

Finally, again on QNA figures, real services imports were virtually flat in Q3, posting a year-on-year rate of 0.6% compared with 9% the previous quarter, interrupting the expansionary path on which they had held in 2005 and early 2006. This was the outcome of the lesser momentum both of tourism and non-tourist services (the slowdown was more marked in the latter item).

4.2 Output and employment

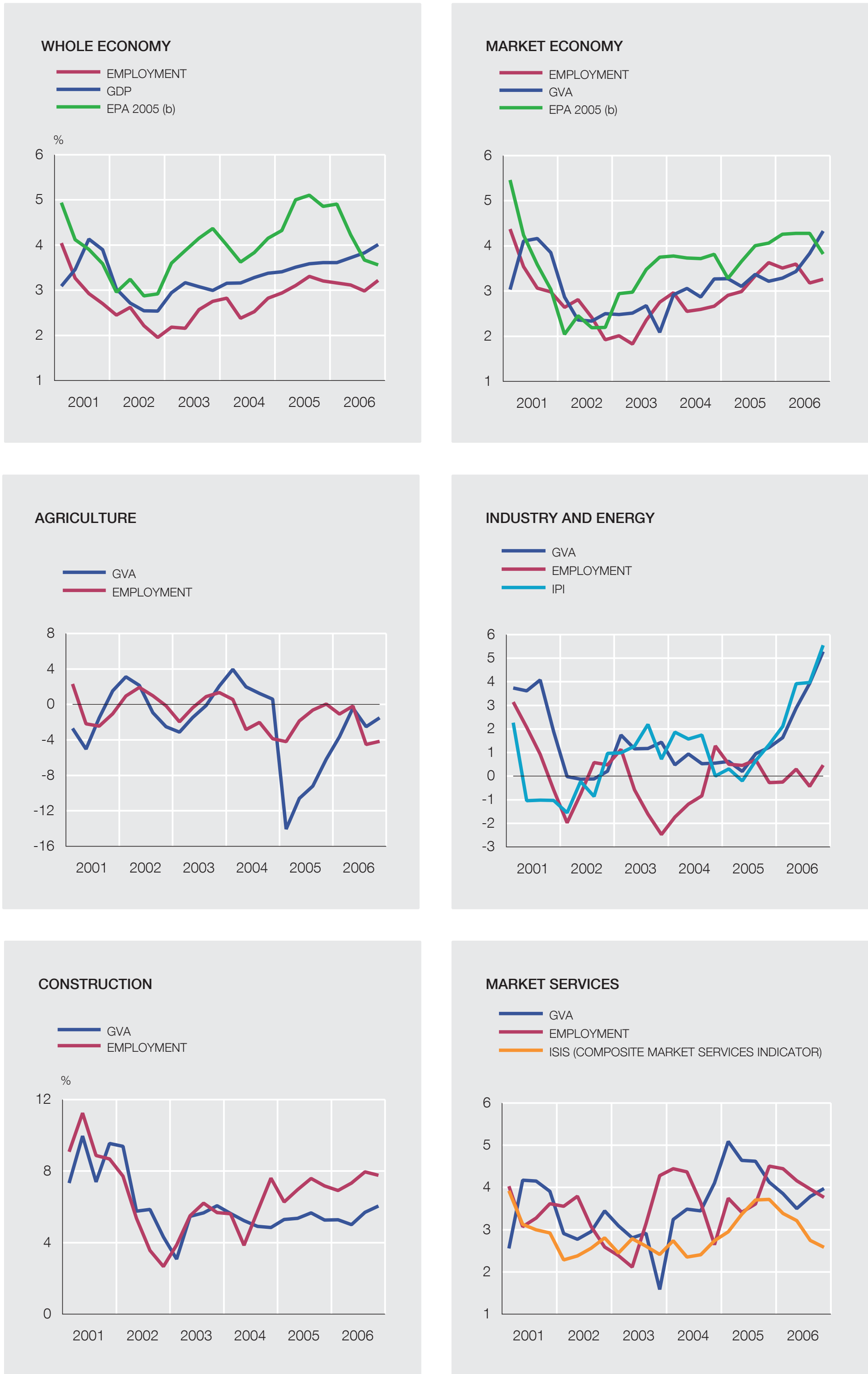
The dynamism seen in the market economy in the first half of the year gathered momentum in 2006 Q3 according to QNA figures, posting year-on-year growth in value added in these branches of 3.8%, 0.4 pp up on the previous quarter. This acceleration was across the board, with the exception of the agriculture and fisheries branches. The indicators available suggest that this robustness has run into Q4 whereby, for 2006 as a whole, annual growth in value added in these branches would be 0.5 pp higher than that of the previous year, with the related rates of increase improving in all branches except that of market services (see Chart 19).

Activity in the agricultural and fisheries branches contracted more sharply in 2006 Q3 than in the previous quarters. On QNA data, GVA in this branch fell off by 2.5 pp, compared with a decline of 0.4 pp in Q2. Nonetheless, this decline in activity came about in parallel with strong increases in the output of certain crops such as cereals, pulses and olives.

The energy and industrial branches remained, in the period from July to September, on the accelerating path initiated a year earlier. The momentum added in Q3 was of the order of 1 pp,

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 the EPA, when they are based on gross series. Employment in terms of full-time equivalent jobs. EPA figures refer to numbers of persons . For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b. Series linked at the Banco de España on the basis of the control survey conducted using the methodology applied until 2004 Q4.

taking the related growth rate to 3.9% on QNA figures. The main increase was in the industrial branch, which grew at a rate 1.2 pp up on Q2, rising to 4%, a rate not recorded since 2001. Exports, inputs in the construction branch and, above all, investment in capital goods were the factors behind the greater dynamism in Q3. The conjunctural information available for the final quarter of the year shows that industrial activity has continued to quicken. The industrial production index rose by 5.7% in year-on-year and calendar-adjusted terms in the October-November period, 1.5 pp above the growth in Q3; and the business turnover indices improved in October and November on the results obtained in the previous quarter. Finally, the opinion-based indicators also trended favourably: the European Commission's confidence indicator increased by a couple of points, emerging from the negative values of previous quarters, and the manufacturing PMI was up by 3.5 points on Q3.

Following a slight loss of steam in 2006 Q2, construction activity once again gathered momentum in the summer months, posting a rate of change of 5.7%. This saw an extension of the relatively stable growth phase in construction since 2003 Q2 which, in the light of the conjunctural information available, will continue into the final quarter of the year.

Services were also part of the general expansionary climate in the Spanish economy in 2006 Q3. On QNA figures, services grew by 3.8%, 0.3 pp up on the previous quarter. This momentum in services activity was extensive to market and to other services, with a similar rate of expansion in both cases. In 2006 Q4, market services held on an expansionary course, according to the conjunctural information available. On data to November, both sales by large services corporations and the turnover figures from the indicators of activity in the sector quickened in the second half of the year in real and calendar-adjusted terms. In turn, the index of trading activity drawn from the PMI ended Q4 on a clearly expanding course. In contrast, both the European Commission's confidence indicator and the number of Social Security registrations for the sector showed a more moderate trend in the final months of 2006. Among the activities making up market services, the most dynamic appear to be wholesale and retail distribution and, above all, transport and communications, bearing in mind the employment indicators and the passenger transport statistics with information to November. Set against this, the activities with the most modest growth were hotels and restaurants, with diminished momentum in overnight stays and in Social Security registrations, and real estate and business services, for which the Social Security registration figures also slowed in Q4.

In 2006 Q3, according to QNA figures, the pace of employment creation in the whole economy once again eased slightly: its year-on-year rate of increase dipped by 0.1 pp to 3%. Given the dynamism observed in GDP, which quickened by 0.1 pp during this quarter, economy-wide apparent labour productivity picked up slightly, standing at 0.8% compared with 0.6% the previous quarter. The main employment indicators paint a favourable picture for the final quarter of the year, in which employment might expand at a rate at least as robust as that in Q3. The year-on-year growth of Social Security registrations, stripping out the effect of immigrant regularisation, held in the final quarter of 3.3%, a similar rate to that in Q3. New hires also showed sustained growth in Q4 of 7.3%, meaning that the number of employment contracts increased by almost 8% in 2006, up on the 5% increase in 2005. Finally, EPA (Labour Force Survey) Q4 figures indicated the maintenance of the growth rate of employment, with a year-on-year growth rate of 3.6%, only 0.1 pp below that observed a quarter earlier.

The slight loss of momentum in employment in Q3 was the result of the slowdown in agriculture, industry and market services combined with the improved figures in construction and in non-market services. The slowing profile of employment in the market branches as a whole was, therefore, rather more marked than in the whole economy, posting a year-on-year growth rate of 3.2%, 0.4 pp less than the previous quarter. Consequently, the recovery in apparent labour productivity was on a greater scale for the market economy, with a gain of 0.6%, allowing the declining path of previous quarters to be left behind. In Q4, according to the EPA, employment would have continued on a declining path in agriculture but picked up in the industrial branches, with year-on-year growth of 1% following the losses in employment in Q3. The rate of employment creation once again rose in construction to 8.3%, while in the services branches employment slowed to 4.3%, compared with 4.9% in Q3.

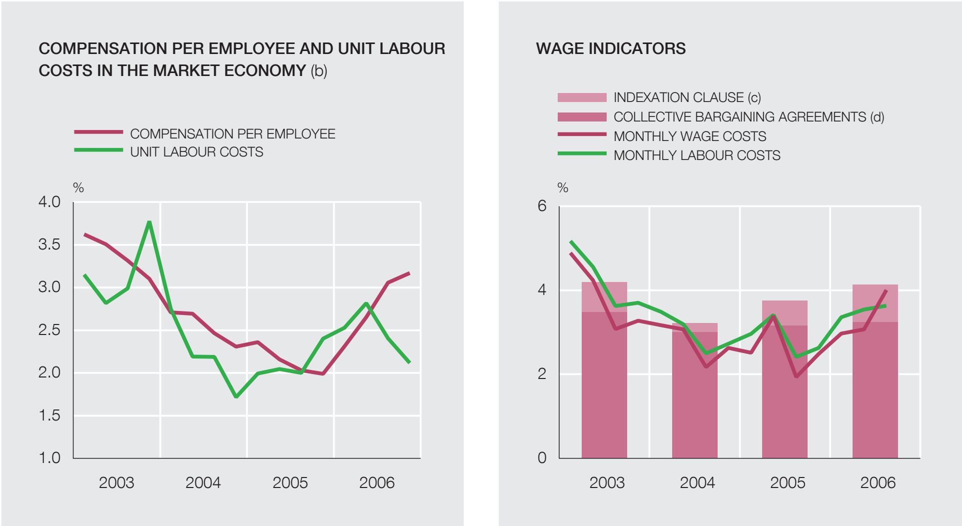
As regards the growth of dependent employment, the National Accounts data show some deceleration, with year-on-year growth for Q3 of 3% in the whole economy and of 3.3% in the market economy, 0.1 and 0.4 pp less, respectively, than in the previous quarter. The EPA Q4 figures point to stability in the growth of dependent employees, at 3.9%, while self-employment slowed somewhat, posting year-on-year growth of 2.3%. This meant that dependent employees as a proportion of total numbers employed stood at 82.3%, 0.3 pp up on the related level a year ago. The information drawn from Social Security registrations indicates that the easing in self-employment creation continued in the closing months of the year, once the effects of the immigrant regularisation process had run their course. As a result, in the last three months the numbers of self-employed registered with the Social Security system grew at a year-on-year rate of 0.4%, against 1.7% in Q3. In contrast, registrations remained buoyant in the case of dependent employees, with a growth rate of 4% in 2006 Q4.

On EPA data, the number of foreign employees increased in annual terms by 18.7%, somewhat above the related rise in the previous period (17.4%). The number of national employees grew by 1.6%, 0.3 pp down on Q3. With regard to contract duration, the year-on-year growth in numbers of dependent employees with a temporary contract remained slightly higher than that for permanent contracts. Nonetheless, the year-on-year growth rate of employees with a temporary contract eased to 4.1%, compared with 4.5% the previous quarter, while permanent employment quickened by 0.3 pp to year-on-year growth of 3.9%. These developments meant a quarterly decline in the ratio of temporary to total employees of only 0.8 pp to 33.8%, the level one year earlier, despite the exceptional process involving rebates for the conversion of temporary contracts into permanent ones which concluded on 31 December last year. According to INEM hiring statistics, this process prompted a strong rise in permanent hires in 2006 Q4, which raised the proportion of permanent contracts to 14.7%, more than 5 pp above the related 2005 level. Also contributing to this rise were permanent hires not as a result of contract conversions, especially in the case of employment-promoting contracts.

As regards full- and part-time employment, the former – as in the rest of the year – remained more buoyant than the latter in Q4. That said, the growth in full-time workers slowed slightly to 3.7% (4% in Q3). The year-on-year growth in part-time employees rose in Q4 to 2.5%, against 1.1% in Q3. Overall, the proportion of part-time to total workers rose to 11.9%, 0.6 pp up on Q3, but 0.1 pp below the related level a year earlier.

The labour force continued to be notably dynamic in Q4, although there was a slight slowdown in its growth to 3.1% year-on-year, 0.3 pp less than in the previous quarter. These developments in labour supply are attributable to the ongoing increase in the participation rate (which stood at 58.6%, 0.9 pp up on the same quarter in 2005) and to the sustained increase in the population, which once again grew by 1.6%, as in the previous quarters. 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 Q4 by around 45,000 in relation to Q3, although compared with the same period a year earlier it fell by some 30,000 (1.7%), following the stability recorded in Q3. The INEM registered un-

WAGES AND LABOUR COSTS (a) CHART 20



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

a. Percentage change on same quarter a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information on collective bargaining agreements to December 2006.
d. Previous year's indexation clause.
e. ETCL.

employment figures also show a sharper year-on-year rate of decline in unemployment, with a fall of 3.4% in Q4. In the final quarter of the year the unemployment rate stood at 8.3%, 0.4 pp down on a year earlier, although 0.2 pp higher than in Q3.

4.3 Costs and prices

On National Accounts estimates, compensation per employee continued to move in Q3 on the accelerating path seen since late 2005. Its rate of increase economy-wide rose by 0.1 pp to 3.4%. This was due to the acceleration in industry and market services, with a rise in both of 0.4 pp, taking the respective year-on-year growth rates to 3.3% and 2.6%. Also of note was the fact that compensation in non-market services continued to post a high year-on-year growth rate (4.8% in Q3). The Quarterly Labour Costs Survey is along the same lines, since it points to an acceleration in Q3 to 3.6%. That is attributable to the buoyancy of wage costs, which climbed from 3.1% in Q2 to 4% in Q3, the result of the strong rise in the wage component, since the rate of increase in non-wage costs slowed by over 2 pp to 2.6%. Compensation per employee is expected to continue quickening in Q4, which might take the wage increase for 2006 as a whole up to a level 0.7 pp higher than that of the previous year, both for the whole economy and for the market economy (see Chart 20).

The information drawn from collective bargaining agreements registered in 2006 showed an increase in wage rates, before including the impact of the indexation clauses, of 3.2%, 0.1 pp higher than in 2005. In revised agreements, with data to November, the increase recorded was also 3.2%, while the agreed rise in newly signed agreements was somewhat higher at 3.4%. This latter figure is some way off the wage guidelines implicit in the Interconfederal Agreement for Collective Bargaining, owing probably to the fact that the high inflation in the first half of the year may be reflected in a lesser degree of adherence to such guidelines. Almost 9 million workers were subject to a registered agreement to December, almost 79% of which (on figures to November) had a revised agreement. It is estimated that the indexation clause for 2005, which was paid in 2006, entails a wage increase of 0.9 pp, 0.3 pp more than in the previous year. The presence of these clauses was once again significant for collective bargaining in

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.

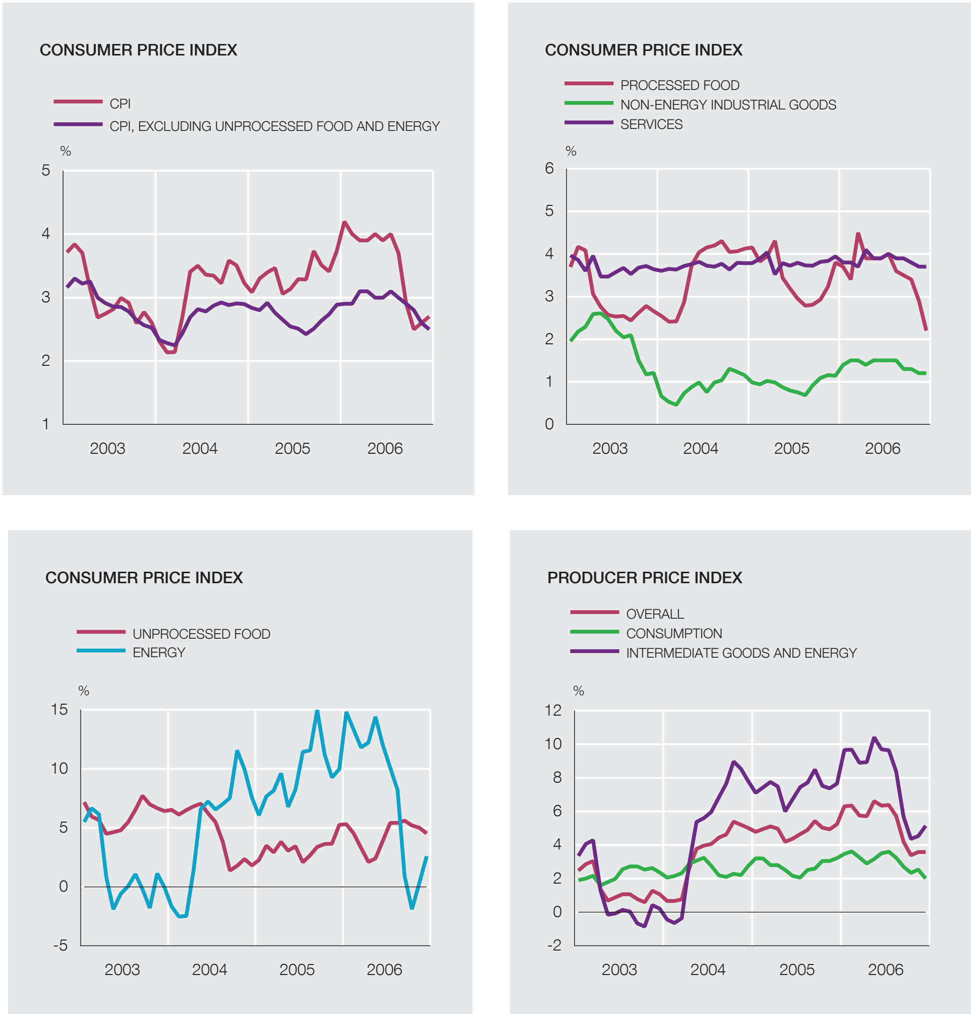
2006, since it affected 78.6% of employees in the agreements registered to November. Given that the growth rate of the CPI has progressively declined in the second half of 2006, to 2.7% in December (a substantially lower rate than a year earlier), the clauses will foreseeably impact labour costs in 2007 to a lesser extent than last year.

Despite the slight rise in compensation per employee in 2006 Q3, the greater acceleration in apparent labour productivity enabled the rate of increase in economy-wide unit labour costs to be cut slightly. In contrast, the growth of the value added deflator held at the levels of the previous quarter, whereby unit margins widened. A similar pattern was observable in the case of the market economy.

The rise in the growth of compensation per employee in Q3 was greater – by 0.4 pp – than in the market economy as a whole, where the year-on-year growth rate was 3.1%. However, the increase in productivity was also more significant in these branches, as a result of which unit labour costs in 2006 Q3 held stable in some cases, such as in construction or market services, or fell substantially, as in industry, where there was a particularly sharp improvement in apparent labour productivity (see Chart 21). A fresh rise in compensation per employee is estimated for Q4. That would be offset by a similar increase in productivity, as a result of which unit labour costs would continue to grow at the same rate. In the market economy, the expected bigger increase in productivity would, by contrast, allow unit labour costs to slow, which would mean an improvement in unit margins.

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

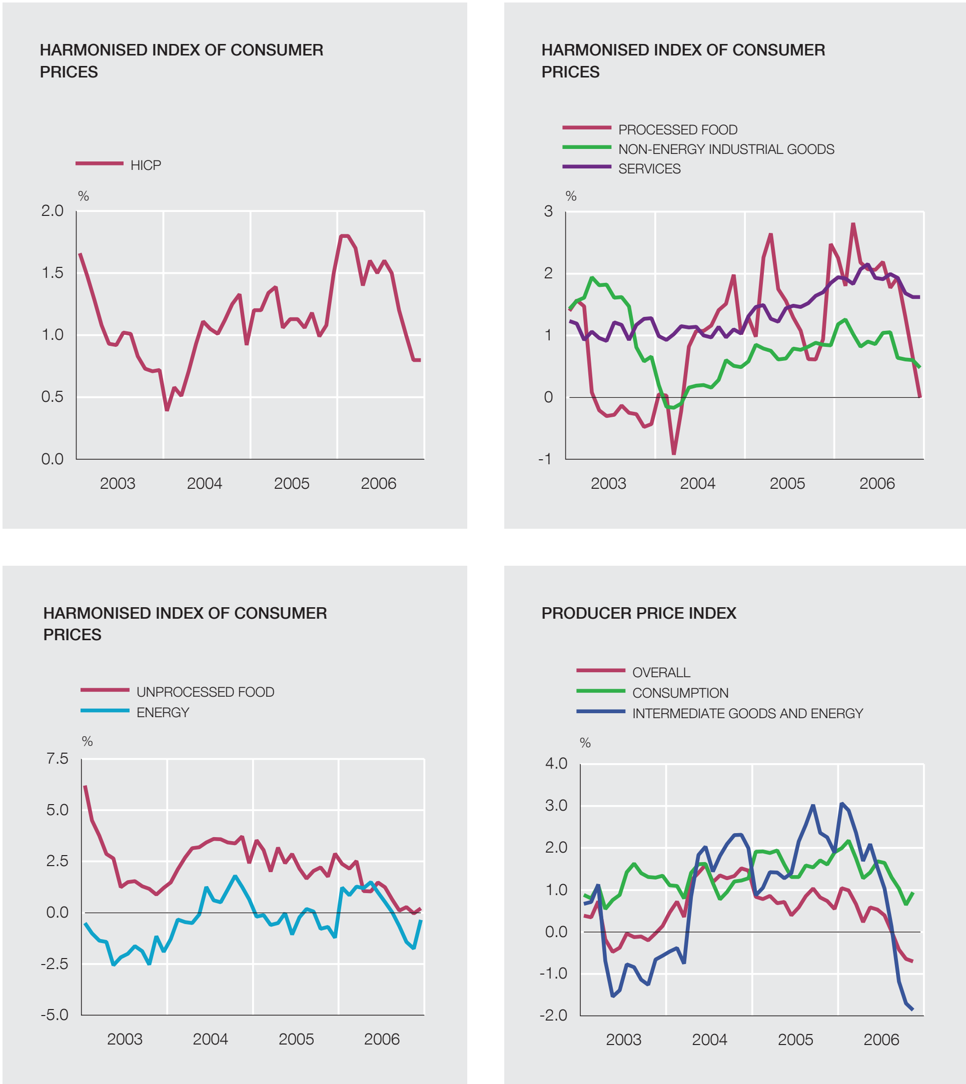
a. Twelve-month percentage change based on the original series.

In Q3, the year-on-year rate of increase in the final demand deflator fell by 0.3 pp to 3.8% as a result of the slowdown in both the imports deflator (down to 3.6% year-on-year from 4.4% the previous quarter) and the GDP deflator (also down 0.2 pp to 3.8%). On the expenditure side, the year-on-year growth rate of the private consumption deflator, like that of the CPI, fell by 0.4 pp to 3.5%. The year-on-year growth rate of the gross fixed capital formation deflator declined to 4.6%, after holding at 5% in the previous quarters, while the growth rate of the exports deflator stood at 4.3%, 0.1 pp lower than the previous quarter.

The CPI posted average growth of 3.5% in 2006, 0.1 pp up on 2005. However, this figure is the outcome of a mixed performance, with the rate of around 4% in the first half of the year falling to 2.6% in Q4, a figure not seen since 2004 Q1 (see Chart 22). In December, the year-on-year rate was 2.7%. The pace of the main CPI components fell off in Q4 in relation to the same quarter a year earlier, albeit with differing intensity. The most notable slowdown was that in energy prices, whose year-on-year growth rate declined by 6 pp between Q3 and Q4 last year from 6.3% to 0.3%. Oil prices fell notably from August, leading the average price per barrel to stand in Q4 at $10 below the related level the previous quarter, while the appreciation of the euro against the dollar in the two final months of 2006 also contributed to lower growth in

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

CHART 23



SOURCES: Eurostat and Banco de España.

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

the energy bill. Unprocessed food prices slowed in Q4 to 4.9%, 0.6 pp down on the rate the previous quarter.

The rate of change of the CPI excluding unprocessed food and energy fell to 2.6% in Q4, compared with 3% in the three previous quarters. The year-on-year growth of non-energy industrial goods prices declined by 0.2 pp in Q4 to 1.2%, while services prices grew at a rate of 3.7%, also slowing by 0.2 pp, thanks to the behaviour of tourism-related and air transport prices. Processed food prices, at 2.8%, posted a lower rate of increase in Q4 compared with Q3 (3.7%). This was thanks in particular to olive oil prices, which have slowed notably from a year-on-year rate of over 30% in the summer months to growth of less than 10% at year-end.

The growth of the HICP in Spain declined by 1 pp between Q3 and Q4 to a rate of 2.6%, while in the euro area as a whole there was a 0.3 pp fall to 1.8%. As a result, the differential with the euro area narrowed, for the first time since 2004 Q2, to less than 1 pp (see Chart 23). In terms of components, the improvement in the inflation differential was across the board, either be-

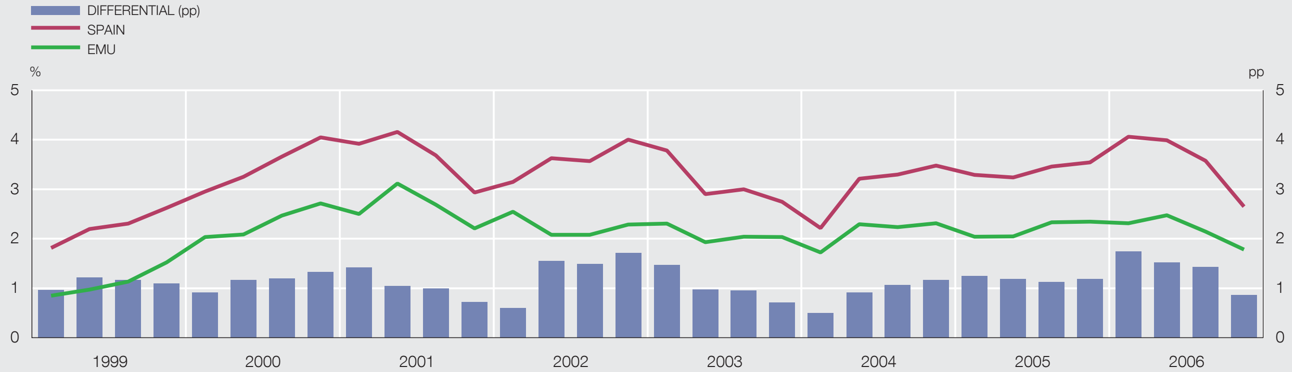
Since the outset of the monetary union, the Spanish economy's inflation rate, in terms of the harmonised index of consumer prices (HICP), has persistently outpaced that of the euro area as a whole. It posted a differential of 1.1 pp on average for the period 1999-2006 (see Chart 1). In 2006 as a whole, the Spanish HICP outgrew that of the euro area by 1.4 pp. Nonetheless, the annual average masks a favourable trend over the year as a whole. In December 2005 there was a notable widening of the inflation differential, which became more acute in 2006 Q1 when Spanish inflation exceeded that of the euro area by 1.7 pp. Since then, there has been a gradual reduction in the Spanish inflation rate, and in 2006 Q4 (the latest figure available) the differential narrowed to 0.9 pp (see adjoining table).

The deterioration in the inflation differential in the opening months of 2006 was closely connected with the course of energy and food prices, although the other components were also affected (see Chart 2). Similarly, the subsequent reduction has been concentrated in the more volatile components of the HICP and in processed food, while the cuts in services have been very limited.

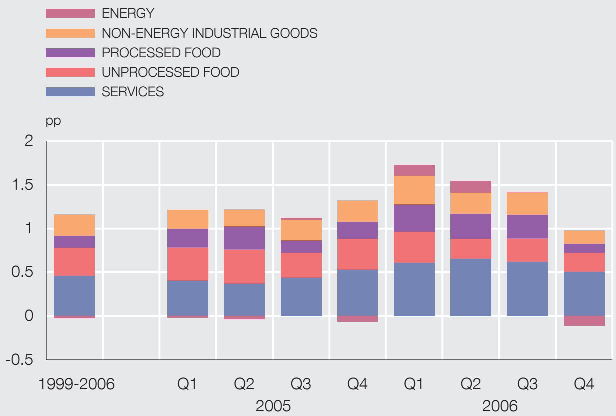
The widening of the differential in respect of energy products in early 2006 was essentially in response to changes in the regulated prices of gas and electricity in Spain, although there were also increases in charges on a similar scale in the euro area as the year progressed. The narrowing of the differential for unprocessed food during 2006 was largely due to the upward trend of these prices in the euro area. As a result, unprocessed food as a whole posted a differential of 0.2 pp in 2006 Q4, compared with 2.4 pp in 2006 Q1.

Some reduction in the differential of the three most stable HICP components with the euro area has also been apparent, although the scale of this narrowing is notably different. For instance, processed food prices increased in 2006 Q1 in Spain by 2.3 pp more than in the euro area, while in Q4 this differential narrowed to 0.6 pp. This trajectory was largely linked to dearer olive oil, whose consumer price increased in Spain by more than 30% year-on-year. Over the course of the year, these prices progressively eased and in December their year-on-year growth turned negative. The non-energy industrial goods differential stood at 0.6 pp in 2006 Q4, compared with 1.2 pp in the opening months of the year. This largely reflects how the growth rates of clothing and footwear prices in Spain have drawn closer to those in the euro area, against a background of growing penetration by Asian products.

1 SPAIN'S INFLATION DIFFERENTIAL WITH THE EURO AREA
Year-on-year rates



2 CONTRIBUTIONS TO THE INFLATION DIFFERENTIAL



3 DIFFERENTIAL WITH THE EURO AREA IN 2006

	DIFFERENTIAL		CONTRIBUTIONS	
	Q1	Q4	Q1	Q4
OVERALL INDEX	1.7	0.9	1.7	0.9
UNPROCESSED FOOD	2.4	0.2	0.4	0.2
PROCESSED FOOD	2.3	0.6	0.3	0.1
NON-ENERGY INDUSTRIAL GOODS	1.2	0.6	0.3	0.2
ENERGY	1.1	-1.2	0.1	-0.1
SERVICES	1.9	1.6	0.6	0.5
MEMORANDUM ITEM				
CPI EXCLUDING UNPROCESSED FOOD AND ENERGY	1.7	1.1	1.2	0.8

SOURCES: Eurostat and Banco de España.

In 2006 as a whole, the inflation differential in services amounted to 1.9 pp, a figure not recorded since the start of the monetary union. Over the course of the year the reduction was very small, and was concentrated in the final quarter. Indeed, the differential in 2006 Q4 (1.6 pp) was only 0.3 pp below that for Q1 and was largely linked to the trend of tourist package prices. Notable among the services components for its contribution was the item *restaurants, bars and cafeterias*. In 2006 as a whole, this item accounted for almost two-thirds of the services differential. The high relative significance of this component reflects two types of effects of similar magnitude. On one hand, there is the composition effect, arising from the fact that the share of these services in our country's expenditure is higher than in the euro area. Thus, spending on the services item in 2006, in accordance with the HICP weights, accounted for almost 40% of the consumption of services in Spain, compared with less than 20% in the euro area. On the other hand is the fact that restaurant and bar prices in Spain increased by 4.5% in 2006, 1.8 pp above the rate in the euro area. The greater dynamism of these prices in Spain might reflect the different cyclical situation in our country, which would be conducive to the widening of margins, and a more expansionary trend in the wages for these activities in Spain. Other items also contribute to the services inflation differential, albeit to a lesser extent. The differential observed in house rentals and services would be linked, on one hand, with the buoyancy of the construction sector in Spain, which has a bearing on the prices of specific services, and, on the other hand, with the high growth rate of house prices, which carries rentals in tow to some extent. Finally, there were lower declines in communications prices in Spain in 2006 than in the euro area as a whole, which may be attributable to the rises in the subscription charge made by the dominant operator.

Spain's inflation differential relative to the euro area has trended favourably during 2006, with an appreciable reduction in its magnitude and one which, moreover, has been extensive to all the attendant components. However, the scale of the differential in December 2006 remains high (0.8 pp) and, furthermore, the cumulative differential since the outset of monetary union is almost 10 pp. Additional reductions are expected in this differential in the coming months, given the foreseeable impact of the increase in the VAT rate in Germany on inflation in this country and, consequently, in the euro area as a whole. Nonetheless, certain factors of uncertainty about the future course of the differential persist. Firstly, vigilance will be necessary to ascertain whether the significant narrowing of the price differential in some components - such as unprocessed food - is sustainable, since it may simply reflect a particularly negative performance in the euro area. Secondly, the differential in respect of services price increases has remained most sizeable and persistent, which hampers any lasting approximation of the Spanish inflation rate to that of the euro area. Indeed, expert forecasts compiled by *Consensus Forecasts* assume that the consumer price differential between Spain and the euro area will hold at the relatively high figure of 0.7 pp over the course of 2008.

cause the slowdown was greater in Spain than in the euro area (as with energy, where the differential proved in fact favourable to Spain in Q4, and services), or because price growth in the euro area held stable (as with processed food) or rose (as with unprocessed food and non-energy industrial goods) (see Box 2).

Finally, the producer price index continued slowing to October, but rose slightly in November and December. It posted a year-on-year growth rate in this latter month of 3.6%, compared with 4.2% in September. In the euro area as a whole, producer prices climbed by 4.3% in November year-on-year, 0.3 pp down on September. The slowdown in the producer price index in Spain is largely due to the lesser dynamism of energy production prices, the year-on-year growth rate of which declined by 3 pp from September to November. The growth rate of producer prices in the consumer goods segment also diminished, though only by 0.2 pp, to 2.5% in November. In the case of capital goods and intermediate goods, producer prices are maintaining a stable growth rate of 2.5% and 6.8%, respectively. Prices received by farmers slowed sharply in July and August, to rise subsequently. Lastly, hotel prices held at a very moderate year-on-year growth rate and rose slightly in November, to 2.4%.

4.4 The State budget

In late December 2006, the government presented the eighth Stability Programme update, with estimates and macroeconomic and fiscal projections for the period 2006-2009. The update revised real estimated GDP for 2006 significantly upwards, to 3.8%, compared with 3.3% for the previous update. There has also been an upward revision – albeit a somewhat more moderate one, to 3.4% – of the forecast for 2007, in relation to the growth scenario (3.2%) on which the State budget for 2007 was based. The general government financial balances have likewise been revised, significantly so for 2006, and a general government surplus of 1.4% of GDP is now anticipated, while in 2007 the surplus is projected to fall to 1% of GDP. In the following years, against a background of stabilising growth in the economy, the general government surplus is also expected to hold at around 0.9% of GDP until the end of the period covered by the update. By sub-sector, the surplus for 2006 will principally be determined by that of the Social Security system, which is expected to amount to 1.1% of GDP, and, to a lesser extent, by the central government surplus (0.6% of GDP). It is estimated that the regional and local governments will end the year with deficits of 0.1% and 0.2% of GDP, respectively. The reduction in the projected general government surplus in 2007 is due to the central government sub-sector, whose surplus will be halved, and the Social Security system, whose forecast surplus is 0.9% of GDP, while the local government deficit will fall to 0.1% of GDP and the regional governments will post a similar deficit to that of the previous year.

According to National Accounts methodology, the State accounts recorded a surplus of 2.2% of GDP in the 11 months to end-November 2006, notably higher than the surplus of 1.6% of GDP obtained a year earlier (see Table 3). Despite the fact that the State balance is subject to a high degree of seasonality, and that December is a clearly deficit month, which means a substantial reduction in the surplus to November is foreseeable, this result might suggest that the surplus at the end of the year for central government will be somewhat higher than initially estimated.

In cash-basis terms, the State posted a surplus of €17,070 million to November, compared with the figure of €11,209 million the previous year. The discrepancies between the National Accounts and cash-basis balances are mainly due, as usual, to the adjustments for the different interest imputation criterion and for the change in receivables and payables.

Likewise in cash-basis terms, State revenue grew more than forecast in the outturn projection, while expenditure growth was somewhat more moderate than the projection indicated. Higher revenue was due both to indirect and, above all, to direct taxes, while on the expenditure side there was some containment in most items, with the exception of current transfers and interest payments, which posted declines lower than forecast in the outturn projection.

For the analysis of revenue, information is available on total takings relating to the main taxes, both the portion assigned to the State and that corresponding to the ordinary-regime regional governments, although Table 3 only includes the State figures. According to total takings, revenue quickened overall in the closing months of the year despite the easing by certain items. Specifically, the growth of personal income tax revenue intensified to 14.4%, underpinned by the favourable course of withholdings on income from work and those on movable capital. In contrast, corporate income tax slowed slightly following the October prepayment, but it continues to reflect the sound trend of corporate earnings, posting growth of 17%. Turning to indirect taxes, the growth of VAT increased sharply in the final months to 9.7%, while the increase in excise duties stabilised at 2.6%, below the outturn projection for the year as a whole. This was largely due to the easing back of tobacco consumption and to price movements in the case of the tax on hydrocarbons. Finally, the rate of decline of the items grouped under the heading *Other revenue* continued to slow, with a reduction of 9.9% to November.

As to State expenditure, there was a fairly generalised acceleration in the closing months. Of note in terms of scale were the increases in current transfers and the easing in the path of reduction of interest payments, while wages and salaries posted more moderate increases, significantly below those foreseen in the outturn projection. As regards capital expenditure

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2005	Percentage change 2005/2004	Outturn projection 2006	Percentage change 2006/2005	Outturn JAN-SEP Percentage change 2006/2005	Outturn 2005 JAN-NOV	Outturn 2006 JAN-NOV	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	128,777	12.2	138,167	7.3	8.2	119,770	132,362	10.5
Direct taxes	70,665	20.4	78,482	11.1	14.7	64,940	75,132	15.7
Personal income tax	*35,953*	*18.2*	*38,445*	*6.9*	*12.5*	*34,115*	*39,156*	*14.8*
Corporate income tax	*32,496*	*24.9*	*37,478*	*15.3*	*18.0*	*28,808*	*33,710*	*17.0*
Other (a)	*2,215*	*-1.3*	*2,559*	*15.5*	*14.2*	*2,017*	*2,266*	*12.3*
Indirect taxes	44,618	7.9	47,427	6.3	5.3	43,159	46,719	8.2
VAT	*32,009*	*10.0*	*34,452*	*7.6*	*7.5*	*31,566*	*34,944*	*10.7*
Excise duties	*9,795*	*0.5*	*9,932*	*1.4*	*-2.8*	*9,020*	*9,012*	*-0.1*
Other (b)	*2,813*	*12.9*	*3,043*	*8.2*	*7.8*	*2,574*	*2,763*	*7.4*
Other net revenue	13,494	-8.7	12,258	-9.2	-13.6	11,671	10,511	-9.9
2 EXPENDITURE	122,755	7.0	130,951	6.7	4.8	108,561	115,292	6.2
Wages and salaries	20,677	6.1	22,439	8.5	7.1	17,969	19,293	7.4
Goods and services	3,388	-3.5	3,834	13.2	7.3	2,754	3,045	10.6
Interest payments	17,831	6.4	15,520	-13.0	-14.8	17,569	15,470	-11.9
Current transfers	64,541	5.8	71,661	11.0	11.9	56,971	64,779	13.7
Contingency fund	…	…	…	…	…	…	…	…
Investment	8,978	26.4	9,258	3.1	0.4	7,117	7,228	1.6
Capital transfers	7,341	6.8	8,238	12.2	-3.6	6,182	5,477	-11.4
3 CASH-BASIS BALANCE (3 = 1 – 2)	6,022	…	7,216	…	…	11,209	17,070	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	130,419	11.9	143,587	10.1	11.5	120,619	136,734	13.4
Uses	126,719	0.6	140,933	11.2	8.4	105,910	114,783	8.4
NET LENDING (+) OR BORROWING (–)	3,700	…	2,654	…	…	14,709	21,951	…
(as a percentage of GDP)	0.4		0.3			1.6	2.2	

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.

there was a marked reduction in capital transfers, caused by the notable decline in payments to regional governments and those intended for the private sector.

Box 3 details the main aspects of the Social Security budgetary outturn to October.

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

In the first ten months of 2006, the overall balance on current and capital account was a deficit of €68,999 million, 40.3% up on the same period in 2005 (see Table 4). During this ten-month period the current account deficit widened considerably (32%), rising to €72,524 million, while the surplus on capital transactions declined (–38.6%) to €3,525 million. Under current transactions, there was a generalised deterioration in the balances of the main items, proving especially acute in the case of the trade deficit, the surplus on services, the income deficit and, to a lesser extent, net current transfers.

The trade balance deficit increased by €10,893 million in the January-October period compared with the same period a year earlier, up to a figure of €66,918 million. In year-on-year terms, the deficit increased by 19.4%, prolonging the deterioration of the two previ-

The Social Security system posted a surplus of €15,361 million in the ten months to end-October 2006, €2,223 million up (16.9%) on the same period a year earlier, making for a more favourable outturn than to end-July (see accompanying table). The growth rate of revenue remained virtually unchanged, standing at 9.4% in October, while the growth rate of expenditure quickened slightly in recent months to 7.9%, which would account for the deterioration in the balance.

Revenue from Social Security contributions has been posting a growth rate of around 9% in recent months, including October, despite the slowdown observed in the number of Social Security registrations since Q3, once the effects of the immigrant regularisation process petered out.

Turning to expenditure, that earmarked for contributory pensions held at a growth rate of 7.8% to October, higher than budgeted for the year as a whole. The number of contributory pensions has begun to slow mildly in the closing months of the year, posting a growth rate of 2.3% to December compared with 2.6% in July. The hitherto high growth rate of expenditure on sickness benefits fell to a rate of 8.3% to October, far below the budgeted figure.

As regards the SPEE (State Employment Public Service), the information on which is not shown in the accompanying table, contributions received held at a growth rate of 9.9% to July, above budget. Rebates on contributions in respect of employment-promoting contracts, meanwhile, increased by 14.1% in the same period, also above the initial budget projection.

Expenditure on unemployment benefits rose by 7.5% to November (a growth rate higher than the 6.7% increase recorded in 2005 as a whole), and the number of beneficiaries grew by 2.9% in November (against 3.3% in 2005). This was due to the decline in registered unemployment, which fell by 1.7% in November (compared with the decline of 1.6% over the whole of 2005), and despite the acceleration in the eligibility rate, which stood at 63.3% to November 2006 (above the end-2005 level of 60.7%).

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

EUR m and %

	Outturn	Budget		Outturn JAN-JUL	Outturn JAN-OCT		
	2005	2006	% change	% change	2005	2006	% change
	1	2	3 = 2/1	4	5	6	7 = 6/5
1 REVENUE	95,476	97,547	2.2	9.5	78,571	85,992	9.4
1.1 Social security contributions (c)	89,110	90,625	1.7	9.0	73,352	80,017	9.1
1.2 Current transfers	4,896	5,295	8.2	9.3	4,057	4,403	8.5
Other (d)	1,470	1,628	10.7	58.1	1,162	1,572	35.3
2 EXPENDITURE	84,598	90,562	7.0	7.7	65,433	70,631	7.9
2.1 Wages and salaries	2,016	2,165	7.4	4.7	1,641	1,730	5.5
2.2 Goods and services	1,655	1,733	4.7	15.1	1,192	1,381	15.8
2.3 Current transfers	80,529	86,133	7.0	7.6	62,463	67,286	7.7
Benefits	80,527	86,131	7.0	7.6	62,463	67,285	7.7
Contributory pensions	*68,905*	*73,832*	*7.2*	*7.8*	*53,343*	*57,511*	*7.8*
Sickness	*5,925*	*6,656*	*12.3*	*10.2*	*4,928*	*5,338*	*8.3*
Other	*5,697*	*5,644*	*-0.9*	*1.2*	*4,191*	*4,435*	*5.8*
2.4 Other (e)	399	530	33.0	49.2	138	234	70.3
3 BALANCE	10,877	6,986	-35.8	21.0	13,138	15,361	16.9

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

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

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 4

EUR m

		JANUARY-OCTOBER	
		2005	2006
CREDITS	Current account	227,708	250,846
	Goods	127,996	142,122
	Services	64,239	68,945
	Tourism	34,084	34,201
	Other services	30,156	34,744
	Income	24,973	27,861
	Current transfers	10,499	11,919
	Capital account	6,473	4,792
	Current + capital accounts	234,181	255,638
DEBITS	Current account	282,636	323,370
	Goods	184,021	209,040
	Services	43,329	51,116
	Tourism	10,133	11,164
	Other services	33,196	39,952
	Income	39,905	45,705
	Current transfers	15,381	17,509
	Capital account	731	1,267
	Current + capital accounts	283,367	324,637
BALANCES	Current account	-54,928	-72,524
	Goods	-56,025	-66,918
	Services	20,911	17,829
	Tourism	23,951	23,037
	Other services	-3,040	-5,208
	Income	-14,932	-17,844
	Current transfers	-4,882	-5,590
	Capital account	5,742	3,525
	Current + capital accounts	-49,187	-68,999

SOURCE: Banco de España.

a. Provisional data.

ous years. Despite the pick-up in real export flows in this period, the rise in real imports and the strong increase in the energy bill – owing to the hike in oil prices recorded to August – prompted the unfavourable course of the trade deficit. Nonetheless, the rate of increase in the trade deficit has slackened since 2006 Q2 thanks to the more moderate growth of the deficit on the non-energy trade balance and to the fact that, owing to the fall in oil price prices from September, the rate of deterioration of the energy deficit began to lessen in Q3.

The services balance posted a surplus of €17,829 million in the first ten months of 2006, €3,082 million down on the figure recorded in the same period a year earlier. This deterioration was due both to the €914 million decline in the tourist surplus and to the €2,168 million increase in the deficit on the non-tourist services balance. Tourist revenue rose by scarcely 0.3% in the January-October period, in nominal terms, although it has shown some improvement following the highly negative performance in Q1. Tourist expenditure increased by 10.2% to October, although the strong rate of increase marking it in the two previous years has slowed from Q2. As a result of these revenue and expenditure developments, the tourist surplus declined by 3.8%.

The deficit on the income balance widened by 19.5% over the course of the first ten months of 2006 to a negative figure of €17,844 million. Revenue grew at a very high rate in this period (11.6%), with a notable rise in that relating to the financial sector, while expenditure posted an even bigger increase (14.5%), reflecting the dynamism of expenditure by the financial and non-financial private sector, while general government expenditure increased but moderately. Sector by sector, there was a slight improvement in the general government deficit, while the private-sector deficits, especially that of the non-financial sector, widened notably. In terms of instruments, the deficit on the portfolio investment and other investment (essentially loans, deposits and repos) income balances worsened, while the direct investment income balance improved.

In the ten months to October, the current transfers deficit totalled €5,590 million, €708 million up on the deficit recorded in the same period in 2005. Revenue increased by 13.5%, owing to the favourable course of flows from the EU under EAGGF-Guarantee (one of the main items), while Community transfers from the European Social Fund fell off. Expenditure, meanwhile, grew at a similar rate (13.8%), once again with a strong increase in emigrants' remittances (34.7%), and with a rise in expenditure earmarked for Community coffers under the GNP Resource, VAT resource and Traditional own resources.

Finally, the capital account surplus amounted to €3,525 million over the course of the first ten months of 2006, a decline of €2,216 million on the same period a year earlier. This deterioration was partly due to the decline in various structural funds, especially from the ERDF, although transfers from the EAGGF-Guarantee and from the Cohesion Fund also fell. Furthermore, expenditure increased most notably, especially in connection with disposals of intangible assets and capital transfers by the private sector.

5 Financial developments

5.1 Overview

In 2006 Q4, money market interest rates continued to rise, albeit at a slower rate than in the preceding quarters. In December, twelve-month EURIBOR reached an average level of 3.9%, up 20 bp from September. In line with these developments, the cost of bank loans to households and corporations continued to increase. Spanish long-term government bond values were, by contrast, more stable, the ten-year bond yield rising barely 6 bp during the same period to 3.8%. This, together with the fact that Spanish firms' credit default swap premia were unchanged, explains the absence of significant changes in firms' average price of financing through the issuance of long-term fixed-income securities.

Spanish stock markets remained on an upward course in 2006 Q4, in step with the growth in corporate earnings and the favourable outlook for 2007. Also, indices continued to benefit from mergers and acquisitions activity. The Madrid stock exchange general index rose by 34.5% during 2006 as a whole, outperforming the main international markets (the EURO STOXX broad index rose by 20.2% during this period and the S&P 500 by 13.6%). Volatility, meanwhile, remained low (see Chart 24).

On the property market, according to the latest data published by the Ministry of Housing, the progressive trend slowdown observed since the beginning of last year continued in 2006 Q4. Accordingly, the year-on-year growth rate of the price of appraised unsubsidised housing stood at 9.1% in December, down 0.7 bp from September and 3.7 bp from December 2005. The likelihood of a smooth landing for property prices thus continues to strengthen.

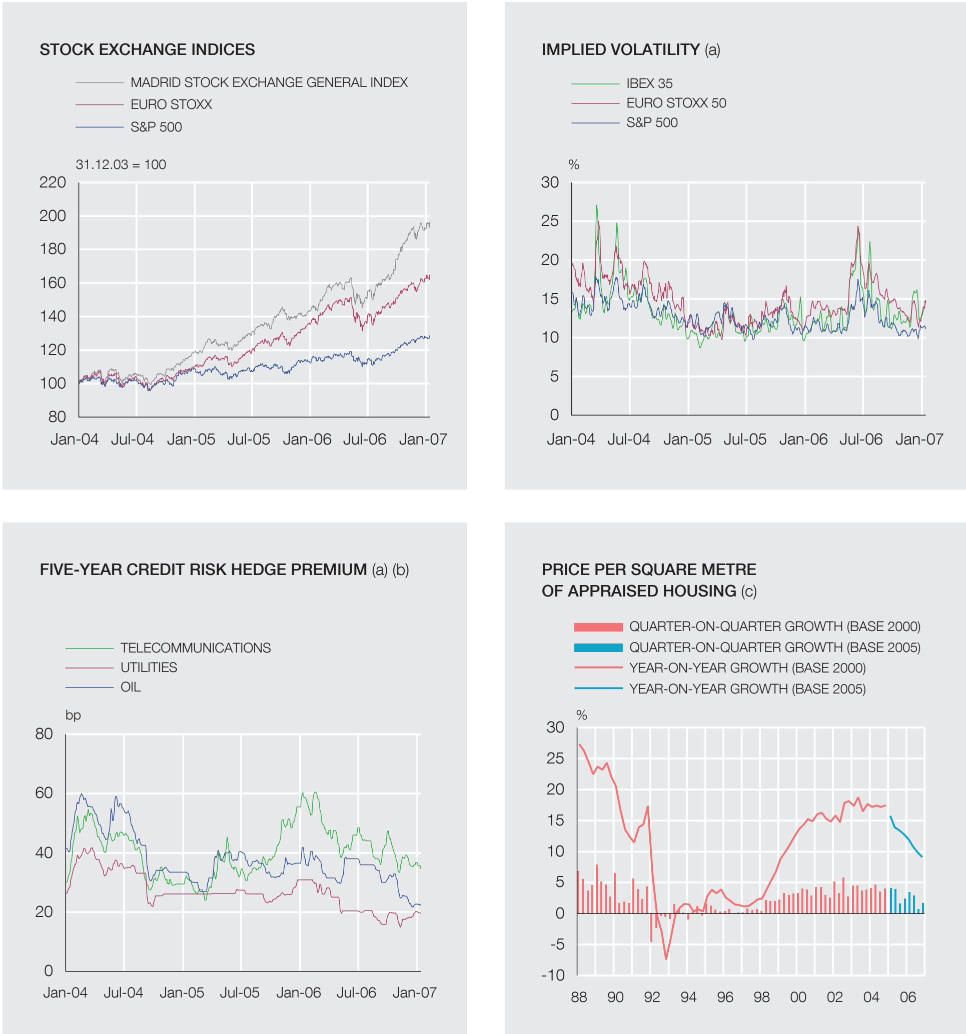
Despite the rising interest rates, private-sector debt continued to grow rapidly in 2006 Q3. In the case of households, the year-on-year increase remained above 20%, barely 0.5 pp down from June. To reduce the probability of these liabilities reaching levels that may have a negative impact on the spending decisions of these agents, their growth needs to be reduced significantly, in line with the more acceptable behaviour of their explanatory variables (see Box 4). By component, the smooth slowdown in funds for house purchase continued, although their rate of change stood at around 22% in year-on-year terms (down somewhat more than 2 pp from end-2005). By contrast, the rate of growth of financing for consumption and other purposes increased again to over 17%. The provisional information on lending to households during 2006 Q4 shows that these same trends continued to prevail.

Meanwhile, the year-on-year growth rate of corporate debt increased again to 27%. The investment boom and the pick-up in mergers and acquisitions both contributed to this growth. According to the breakdown of bank loans by productive activity, in Q3 there was a notable increase in the buoyancy of funds raised by construction, the sector primarily responsible for the acquisition of shareholdings, which reached a high for recent years. These data also show that lending to property services companies continued to grow at a high rate, which was even above that in June. In other sectors, by contrast, although these liabilities accelerated somewhat, they grew more moderately. The provisional information available for 2006 Q4 suggests that the intense growth in the financing of corporations was sustained during that period.

The notable buoyancy of the funds raised by households and the rise in the cost of financing led to a further increase in the degree of financial pressure on households in Q3, a trend that, according to the provisional information available, continued during Q4. Thus, in 2006 Q3, the debt and debt burden ratios continued to rise, while net saving after debt service fell once

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



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

a. Five-day moving averages.
b. Average asset-weighted premia.
c. New statistic from 2005.

again. However, according to the Financial Accounts, the sector's net borrowing held steady relative to GDP (see Table 5). In any event, the financial position of households continued to be bolstered by the increase in their net wealth, although the slowdown in house prices is tending to moderate its rate of growth.

In the case of non-financial corporations, the aggregate debt and debt burden ratios also continued to rise in 2006 Q3 and, in the light of the provisional information available, appeared to do so during Q4 too, while the return on equity was not significantly different from its June level. Meanwhile, according to the Financial Accounts, the sector's net borrowing rose again in Q3. The information for the same period from the companies reporting to the quarterly survey of the Central Balance Sheet Data Office (CBQ), among which larger companies have a particularly high weight, offers a more benign view. Thus, although interest payments again increased for these companies relative to profits, this development was offset by a slight reduction in their borrowing relative to their profits and by their favourable results, so that synthetic indicators of financial pressure displayed a modest improvement.

Over the last 10 years the financing raised by households has been expanding at a high rate (of close to 17% per annum on average), well above that of their income. It is important to understand what factors explain these developments, since the empirical evidence indicates that when debt is above the level implied by its fundamental determinants, the sector's spending may eventually be adversely affected[1].

The statistical analyses carried out by the Banco de España show that the behaviour of household credit may be explained by changes in variables such as wealth, spending on consumption and residential investment, financing conditions (loan interest rates and maturities) and the rate of unemployment[2]. As the left-hand chart shows, the liabilities of Spanish households have grown in the last few years in parallel with their estimated long-term equilibrium path to stand, at end-2006, slightly above such path.

As the right-hand chart shows, in general, all the explanatory variables have, since 1996, moved in the direction of favouring greater buoyancy, although the relative importance of each has varied. The increase in household wealth, basically as a consequence of the rise in house prices, has made a very significant and increasing contribution to the rise in debt, reflecting property's important role as loan collateral.

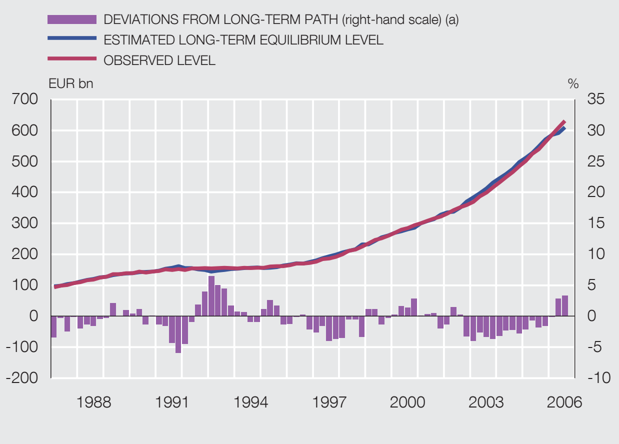
The buoyancy of the sector's spending has also contributed to the growth in credit, as have the more favourable financing conditions in the form of lower loan interest rates and longer loan maturities during most of the period analysed, although the expansionary effect of this latter factor has been reduced recently, especially following the change in the stance of monetary policy from end-2005. Finally, another factor that has also had a positive impact on the growth of household liabilities is the decline in the unemployment rate, which has increased the proportion of the population with access to the loan market.

These results suggest that the current level of debt should not be having a significant contractionary effect on household spending decisions. However, this does not mean that this sector is not more exposed to adverse shocks to its wealth, its income and interest rates, especially if the predominance of variable rate loans is taken into account.

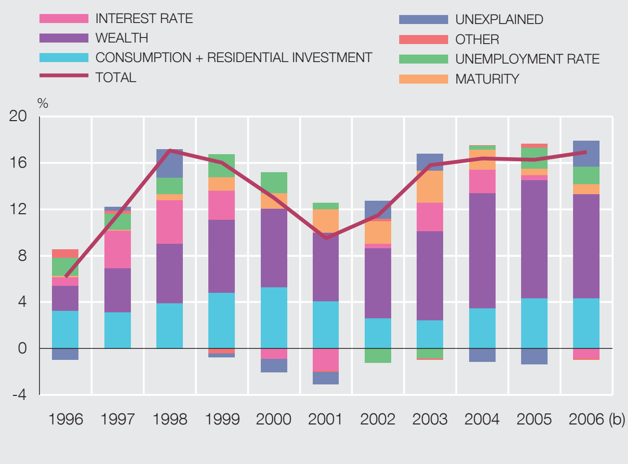
Over the coming quarters, the long-term equilibrium level of credit will foreseeably tend to decelerate, in line with the most likely behaviour of its explanatory variables. Accordingly, the rate of growth of household liabilities will have to moderate considerably if they are not to end up reaching levels that may have a contractionary effect on the buoyancy of consumption and residential investment.

1. For further details on the effects that an excessive level of debt may have on spending, see Martínez-Carrascal and del Río (2004), *Households borrowing and consumption in Spain: a VECM approach,* Working Paper No. 0421, Banco de España,. **2.** The analysis of this box is based on the results of the updated and revised credit equation presented in Nieto (2003), «Determinantes del crecimiento del crédito a los hogares en España», *Boletín Económico,* April, Banco de España.

HOUSEHOLD CREDIT: OBSERVED LEVEL, LONG-TERM PATH AND DEVIATIONS



CONTRIBUTIONS TO THE ANNUAL GROWTH IN HOUSEHOLD CREDIT IN REAL TERMS



SOURCE: Banco de España.

a. Standarised to obtain an average of zero over the sample period.
b. Data to 2006 Q3.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP (a)	2001	2002	2003	2004	2005		2006		
					Q3	Q4	Q1	Q2	Q3
National economy	-3.5	-2.7	-2.9	-4.8	-6.1	-6.5	-7.1	-7.5	-7.9
Non-financial corporations and households and NPISHs	-4.2	-3.5	-3.9	-5.3	-7.4	-8.4	-9.5	-10.4	-11.1
Non-financial corporations	*-5.2*	*-4.2*	*-4.1*	*-4.6*	*-6.3*	*-7.0*	*-7.8*	*-8.5*	*-9.1*
Households and NPISHs	*1.1*	*0.7*	*0.1*	*-0.6*	*-1.1*	*-1.3*	*-1.7*	*-1.9*	*-1.9*
Financial institutions	1.2	1.2	1.0	0.6	0.4	0.7	0.6	0.7	0.8
General government	-0.5	-0.3	0.0	-0.2	0.8	1.1	1.8	2.2	2.3
MEMORANDUM ITEM:									
Financing gap (b)	-9.9	-8.6	-8.3	-8.9	-11.0	-11.2	-14.1	-14.8	-15.5

SOURCE: Banco de España.

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

The continued decline in the financial saving of corporations led to a further increase in the nation's net borrowing, to 7.9% of GDP in cumulative twelve-month terms in September 2006, as against 7.5% in the previous quarter. The funds raised from the rest of the world continued to be channelled mainly through financial institutions, in particular those that are not credit institutions.

In short, although the financial position of households and companies remained solid, rising debt and interest rates continued to increase the degree of financial pressure to which they are subject and their exposure to adverse economic shocks. Moreover, in the case of companies, although the recent acquisitions of shareholdings by certain firms (especially in the construction industry) in other productive sectors, diversifies their businesses, it also introduces an element of uncertainty associated with entry into new areas of activity and the resulting increase in borrowing. Accordingly, in the light of the new information available, the risks of a financial nature to the medium-term macroeconomic outlook, mentioned in previous reports, have not been reduced in recent months.

5.2 Households

In 2006 Q4, financing conditions for households continued to tighten. During October and November, the average interest rate applied by institutions to new lending business rose by 12 bp. By type of lending, the cost of funds for house purchase increased by 19 bp, while the cost of those for consumption and other purposes, which tends to be more variable, fell by 10 bp. Following these movements, the total change since November 2005 was 140 bp and 120 bp, respectively. As regards credit standards, according to the bank lending survey (BLS), financial institutions forecast a further modest relaxation in those for consumption in Q4, without any change in those applied to debt for house purchase.

Despite the upward trend in the cost of financing, the year-on-year rate of growth of household debt declined only modestly, and was still over 20% in September, barely 0.5 bp below its end-Q2 level. With regard to the breakdown by component, the pattern remained the same as it had been since the beginning of the year. Thus, the rate of growth of funds for consumption and other purposes rose to more than 17%, while the mild slowdown in loans for house purchase continued, although their year-on-year growth remained close to 22%. The provisional information available for Q4 points to continuation of this same pattern.

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

TABLE 6

% GDP

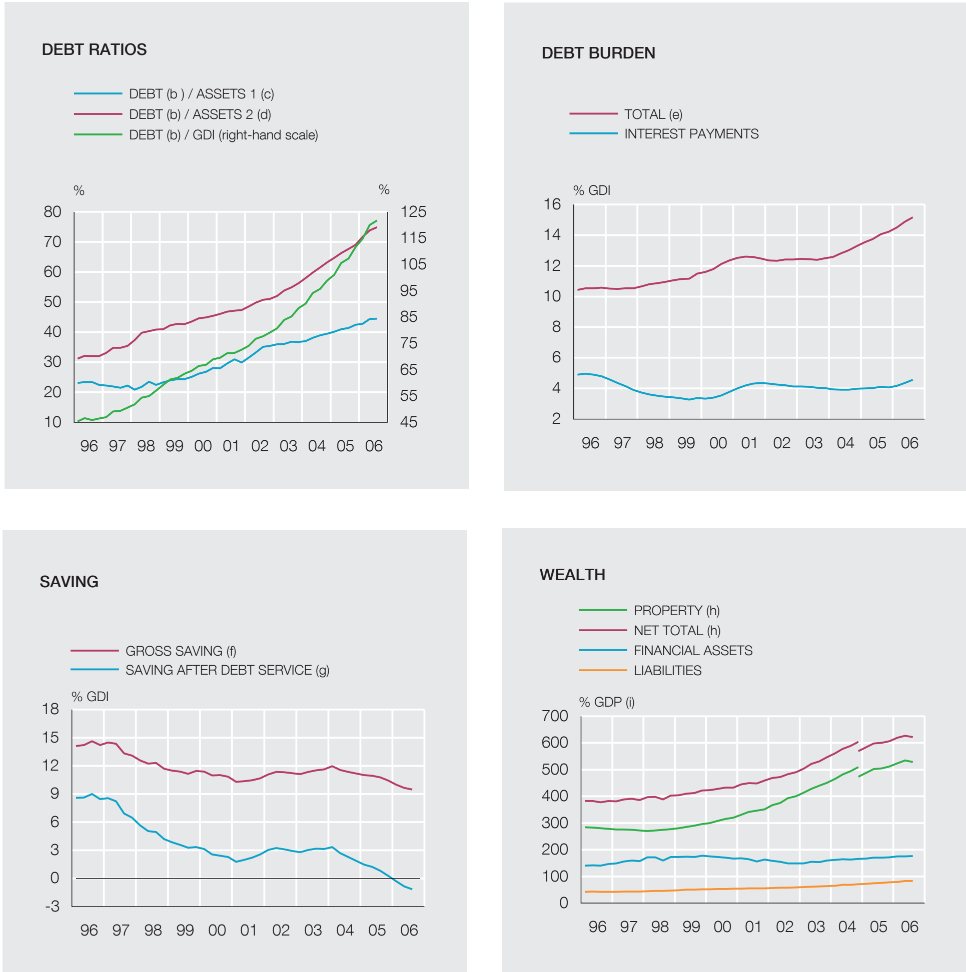
	2003	2004	2005	2006		
				Q1	Q2	Q3
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	9.0	9.6	10.6	10.3	10.4	10.5
Cash and cash equivalents	4.1	4.0	4.4	3.8	3.6	3.4
Other deposits and fixed-income securities (a)	-0.3	1.2	1.9	3.2	3.5	4.6
Shares and other equity (b)	0.6	0.5	0.0	-0.3	-0.3	-0.4
Mutual funds	2.3	1.5	1.9	1.8	1.6	0.8
Insurance technical reserves	1.8	1.8	1.9	1.7	1.5	1.5
Of which:						
Life assurance	*0.7*	*0.7*	*0.8*	*0.8*	*0.7*	*0.6*
Retirement	*0.9*	*0.8*	*0.9*	*0.8*	*0.7*	*0.7*
Other	0.5	0.7	0.5	0.1	0.4	0.5
Financial transactions (liabilities)	8.8	10.3	11.9	12.0	12.3	12.4
Credit from resident financial institutions (c)	9.2	10.8	12.3	12.9	13.2	13.2
House purchase credit (c)	*7.0*	*8.7*	*10.3*	*10.5*	*10.5*	*10.2*
Consumer and other credit (c)	*2.2*	*2.1*	*2.2*	*2.4*	*2.8*	*3.0*
Other	-0.4	-0.6	-0.4	-0.9	-1.0	-0.8
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	15.9	15.6	18.8	20.1	19.3	22.2
Cash and cash equivalents	0.9	1.0	2.1	2.1	2.0	2.4
Other deposits and fixed-income securities (a)	1.2	0.3	1.3	1.6	1.0	2.5
Shares and other equity	7.4	6.4	6.8	8.9	9.1	9.3
Of which:						
Vis-à-vis the rest of the world	*4.5*	*3.8*	*3.8*	*6.1*	*5.7*	*6.0*
Other	6.4	7.9	8.6	7.5	7.2	8.0
Financial transactions (liabilities)	20.0	20.2	25.8	27.9	27.8	31.3
Credit from resident financial institutions (c)	6.1	8.3	13.0	13.5	14.4	16.6
Foreign loans	2.7	0.7	2.0	3.7	3.0	3.2
Fixed-income securities (d)	-0.2	0.0	0.3	0.9	1.3	1.6
Shares and other equity	5.1	4.6	3.2	3.2	3.2	3.3
Other	6.2	6.6	7.4	6.6	5.9	6.7
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.9	16.3	21.0	23.0	22.7	24.0
Households and NPISHs	19.1	20.2	20.9	21.3	21.0	20.5
Non-financial corporations	13.5	13.2	21.1	24.4	24.0	26.9

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 securitisation special purpose entities.

In September, investment in financial assets was equivalent to 10.5% of GDP in cumulative four-quarter terms, scarcely 0.1 bp higher than in June (see Table 6). By instrument, the lower risk ones (cash and deposits) were the main component of financial investment. Among these, cash and cash equivalents continued to decelerate slightly, while time deposits, included under the heading other deposits and fixed-income securities, grew notably, in parallel with a sharp contraction in mutual fund shares, to just 0.8% of GDP, in cumulative twelve-month terms. Households' lower preference for mutual fund shares than for other deposits and fixed-income securities may have been at least partly attributable to changes in the taxation of savings that have come into force in 2007. For their part, net equity purchases were again nega-

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 25



Source: Banco de España.

a. From 1999, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Includes bank credit and securitisation.
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. There is a new house price statistic for 2005.
i. CNE base 2000.

tive (–0.4% of GDP), while flows in the form of insurance technical reserves were at the same level as in the previous quarter (1.5% of GDP).

The continuation of the strong growth in financing obtained by households led to a further increase in the ratio of debt to gross disposable income (GDI), which was already over 120% in September (see Chart 25). This development, along with the rise in the cost of credit, explains why the associated debt burden continued to increase, to reach more than 15% of GDI in September. Also, both gross saving and saving after debt service declined further. However, according to the Financial Accounts, household net borrowing held steady at around 1.9% of GDP in cumulative twelve-month terms. As in previous quarters, the rise in the value of financial and real assets meant that the sector’s net wealth continued to increase, albeit at declining rates, thus alleviating the higher degree of financial pressure arising from the trend in the aforementioned indicators.

5.3 Non-financial corporations

In the case of corporations, the cost of bank financing also continued to rise during 2006 Q4. The interest rate on loans of up to €1 million rose in October and November by 24 bp, a similar increase to that recorded in the case of larger loans (25 bp), making a total increase since November 2005 of around 120 bp and 110 bp, respectively. According to the BLS, institutions did not foresee any significant changes in credit standards between October and December. In contrast, the cost of long-term debt issuance hardly changed, owing to the stability of the yield on public debt and credit default swap premia, while the terms for obtaining funds on equity markets improved, as a consequence of the upward path of share prices.

Despite the upward trend in the cost of bank debt, the volume of external funds received by corporations accelerated in 2006 Q3, to reach a year-on-year rate of close to 27% at the end of the quarter, up almost 3 pp from June. The breakdown by instrument shows that credit from resident institutions continued to contribute most to the increase in these funds, although the issuance of fixed income securities, which still have a low weight in company liabilities, was highly buoyant. Meanwhile, foreign loans picked up slightly, so that the funds raised through this channel represented 3.2% of GDP in September, in cumulative twelve-month terms (see Table 6).

The breakdown of credit by purpose shows that the most buoyant sectors were again property services and construction, the loans to these companies growing in September by 49% and 35%, respectively, relative to the same month of 2005, both these rates being higher than in June (by 2.5 pp and 5.5 pp, respectively). In the latter case, this growth was partly a consequence of the financing of certain transactions to acquire shareholdings. In other productive activities the changes were more moderate, the most notable being the increase, for the second consecutive quarter, in the rate of growth of funds raised by other services branches, and the pick-up in the growth of those to industry, following the declines recorded since late 2005. Finally, according to CBQ data, the debt of large groups decelerated slightly during the same period, although the year-on-year rate remained around 25%.

In contrast to the buoyancy of external financing, corporations did not significantly increase their issuance of shares and other equity, which in September represented 3.3% of GDP in cumulative twelve-month terms, barely 0.1 pp more than in June.

Unlike in the preceding quarter, the volume of company assets-side transactions picked up notably to reach 22.2% of GDP in September, in cumulative twelve-month terms, almost 3 pp more than in June. By instrument, the most notable development was the growth in flows in the form of liquid assets and fixed-income securities, to 4.9% of GDP (from 3% in June).

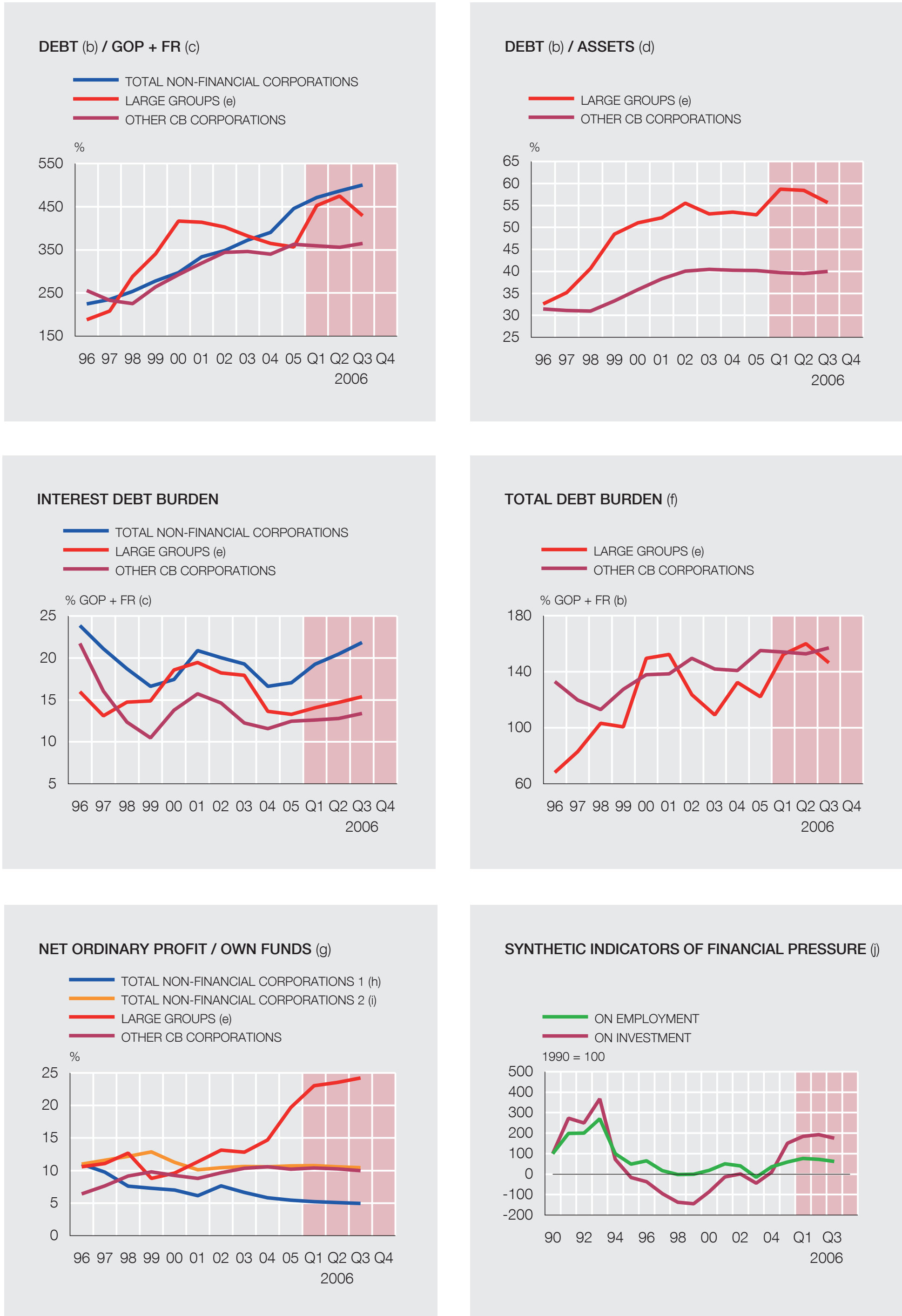
Despite the increase in asset flows, the notable buoyancy of the liability ones led to a further increase in the net borrowing of corporations in Q3, to 9.1% of GDP in cumulative twelve-month terms. Meanwhile, the financing gap, which approximates the funds needed to undertake real investment and permanent foreign financial investment, increased by a similar amount, to 15.5% of GDP (see Table 5).

The strong growth in the funds raised by corporations led to a further increase in the sector's debt-to-profit ratio (see Chart 26). This, along with the increase in the cost of funds, explains the upward path in the ratio of interest payments to profits, which stood at close to 22% in September. The increase in financial expenses was, however, offset by the rise in income, so that the return on capital held unchanged.

The information on companies reporting to the CBQ, among which large corporations predominate, also shows an increase in the debt burden in Q3. However, this development was

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

CHART 26

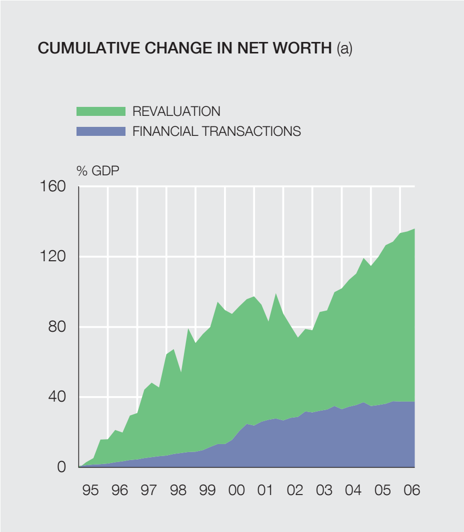


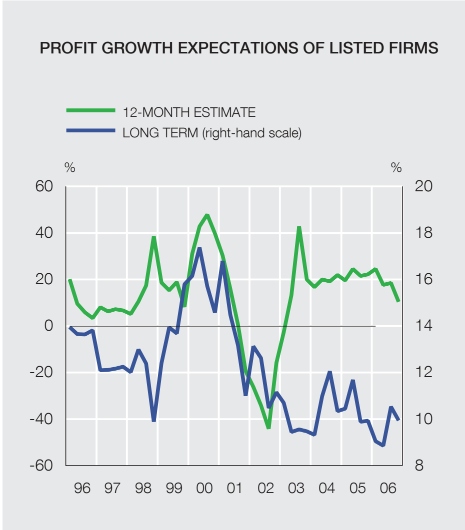
SOURCE: Banco de España.

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 Telefónica groups. Adjusted for intra-group financing to avoid double counting.
f. Includes interest plus interest-bearing short-term debt.
g. For total non-financial corporations, NOP=GOS +interest and dividends received - interest paid - fixed capital consumption.
h. Own funds valued at market prices.
i. Own funds calculated by accumulating flows from the 1996 stock onwards.
j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 27





SOURCES: I/B/E/S and Banco de España.

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

offset by a contraction in the debt ratio, basically as a result of the behaviour of large groups, and by the favourable performance of earnings, so that the synthetic indicators of financial pressure on investment and employment fell slightly during this period.

Finally, analysts expectations regarding the growth of the profits of quoted non-financial firms, among which larger ones also predominate, were revised downwards in Q4 both at the longer and, especially, at the shortest horizons. However, expected earnings growth at both horizons remains at significant levels, of around 10% (see Chart 27).

5.4 General government

In 2006 Q3, general government net lending continued to grow, albeit moderately, to stand, in cumulative twelve-month terms, at 2.3% of GDP (see Chart 28). By instrument, general government increased its net issuance of long-term securities, while continuing to make net redemptions of short-term securities. Also, there was an increase in deposits and a decline in loans, which led to significant growth (1.8% of GDP) in the heading that reflects the net balance of these two items. At the same time, despite the increase in the cost of funds, interest payments continued to fall relative to GDP, thanks to the decline in the debt ratio, to stand at around 1.7%.

5.5 The rest of the world

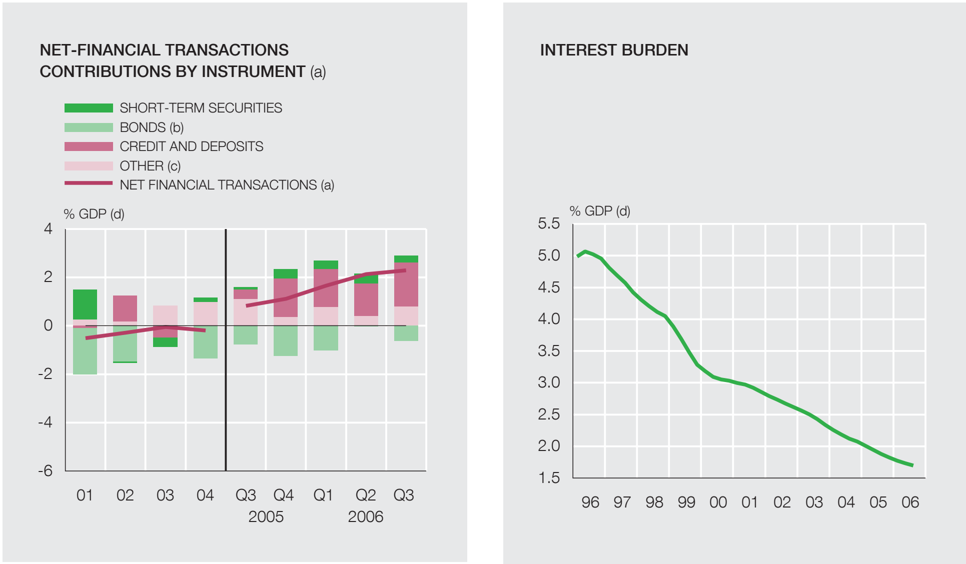
Between July and September 2006, the net debit balance of the nation's financial transactions expanded again to represent, in cumulative four-quarter terms, 7.9% of GDP. This was a result of the greater need for funds on the part of corporations, which was not fully offset by the slight increase in the net lending of financial institutions and general government.

Non-monetary financial intermediaries continued to contribute more than any other subsector to the financing of the external deficit. In September, the debit balance of their net transactions with respect to non-residents represented, in cumulative twelve-month terms, 11.7% of GDP, up 0.3 pp from June (see Chart 29).

Investment in foreign assets by resident sectors was 18.2% of GDP in September 2006, in cumulative twelve-month terms, down 1.4 pp from June (see Table 7). By instrument, the pat-

GENERAL GOVERNMENT
Four-quarter data

CHART 28

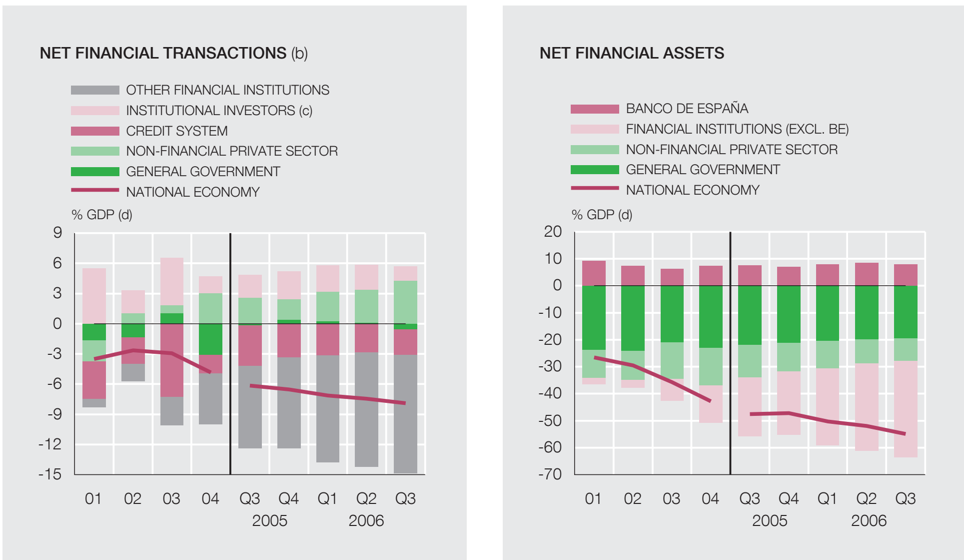


SOURCE: Banco de España.

a. A postive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
b. Includes only liabilities transactions.
c. Unpaid accrued interest on bonds and net investment of Social Security funds in assets issued by the rest of general government.
d. CNE base 2000.

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

CHART 29



SOURCE: Banco de España.

a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.
b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.
c. Insurance companies and portfolio investment institutions.
d. CNE, base 2000.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3
NET FINANCIAL TRANSACTIONS	-2.9	-4.8	-6.5	-7.1	-7.5	-7.9
FINANCIAL TRANSACTIONS (ASSETS)	13.5	13.7	18.2	23.0	19.6	18.2
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	0.7	3.2	2.4	3.3	4.3	4.8
Of which:						
Interbank (a)	*0.5*	*0.7*	*3.2*	*2.3*	*2.6*	*3.5*
Securities other than shares	6.5	1.8	8.7	8.5	3.4	0.8
Of which:						
Credit institutions	*3.5*	*1.0*	*6.6*	*6.2*	*1.9*	*-0.2*
Institutional investors (b)	*3.5*	*0.3*	*2.1*	*2.0*	*1.5*	*0.8*
Shares and other equity	4.7	6.8	4.9	8.1	8.6	8.7
Of which:						
Non-financial corporations	*4.5*	*3.8*	*3.8*	*6.1*	*5.7*	*6.0*
Institutional investors (b)	*1.1*	*0.8*	*0.8*	*1.6*	*1.7*	*1.6*
Loans	0.3	0.8	1.1	1.8	2.0	2.2
FINANCIAL TRANSACTIONS (LIABILITIES)	16.4	18.5	24.7	30.1	27.1	26.1
Deposits	6.9	1.7	5.7	6.2	2.6	0.8
Of which:						
Interbank (a)	*5.3*	*5.0*	*7.2*	*7.5*	*2.8*	*1.3*
Securities other than shares	5.3	12.4	15.6	18.9	19.7	21.4
Of which:						
General government	*-1.0*	*2.7*	*0.1*	*1.0*	*0.8*	*1.6*
Credit institutions	*3.5*	*4.6*	*6.3*	*7.1*	*7.5*	*8.1*
Other non-monetary financial institutions	*2.8*	*5.1*	*9.3*	*10.8*	*11.4*	*11.7*
Shares and other equity	1.1	2.7	0.8	0.9	1.2	0.0
Of which:						
Non-financial corporations	*1.3*	*1.7*	*1.0*	*0.8*	*1.0*	*0.1*
Loans	2.8	1.3	2.0	3.6	3.1	3.3
Other, net (c)	-0.8	-0.6	-0.6	-0.8	-0.9	-1.2
MEMORANDUM ITEMS						
Spanish direct investment abroad	3.3	5.8	3.4	5.5	5.9	6.3
Foreign direct investment in Spain	2.9	2.4	2.0	1.8	1.9	1.9

SOURCE: Banco de España.

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

terns were the same as in the previous quarter. The most notable development was the decline in net purchases of fixed-income securities (in particular, in those made by credit institutions) and the main destination of the flows to the rest of the world continued to be the acquisition of shares and other equity (primarily in the form of direct investment).

Net capital inflows also fell slightly in Q3, to 26.1% of GDP in cumulative twelve-month terms, down 1 pp from the volume recorded in June. In line with the pattern observed during the year, the funds raised through securities other than shares continued to increase in importance, to the point that they exceeded 21% of GDP. Thus, the issuance of these instruments, especially by financial institutions, continued to play a crucial role in the financing of the external deficit. Conversely, the flows in the form of interbank deposits fell in net terms, so that for the first time since 2001, they recorded a credit balance. The funds channelled through variable income assets also fell, to reach zero.

In 2006 Q3, the inflows of direct investment held steady, with respect to June, at around 1.9% of GDP in cumulative twelve-month terms, while outflows continued to grow and, in the same period, represented 6.3% of GDP, up 0.4 pp from the preceding quarter and almost 3 pp from December 2005.

As a result of the behaviour of the financial flows to and from the rest of the world and the changes in asset prices and the exchange rate, the debit position of the economy continued to grow, to stand in September 2006 at close to 55% of GDP (see Chart 29). By sector, the slight improvements in the net financial position of general government and the non-financial private sector were not sufficient to cancel out the notable increase in the debit balance of financial institutions (excluding the Banco de España), to almost 36% of GDP, more than 3 pp higher than in June.

26.1.2007.