QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

The Spanish economy remained notably dynamic in the first half of 2007 and made further headway in re-balancing its sources of growth. GDP continued to quicken in 2007 Q1, posting a year-on-year rate of change of 4.1%, the result of the 0.2 pp improvement (to –0.7 pp) in the contribution of net external demand to growth, given that domestic demand slowed mildly. The information for 2007 Q2 indicates that this pattern will have continued, though possibly with somewhat diminished buoyancy, since most of the indicators available suggest that domestic spending will have continued easing and that the contribution of net external demand will have held at a similar level to that of the previous quarter. Accordingly, a year-on-year rise in real GDP of 4% is estimated for Q2, 0.1 pp down on Q1. In quarter-on-quarter terms, the estimated rate of increase in GDP in this period is 0.8% (see Chart 1).

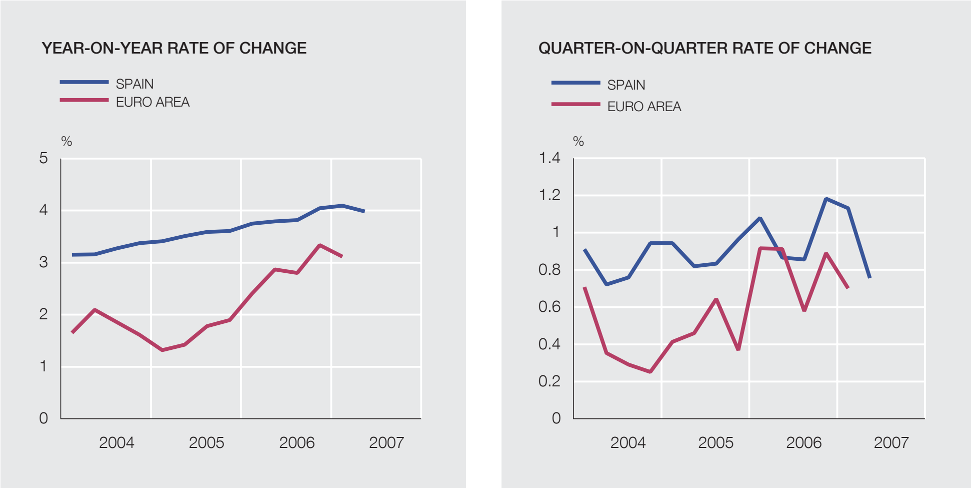
The pace of all the components of national demand, except investment in other products, eased. Notable in this broad pattern, along with the mild moderation in private consumption, was the strength of investment in capital goods, for which a rate of over 11% is estimated. The buoyancy of investment in construction showed signs of easing off, with a rate of increase of around 5%. As to net external demand, the rate of expansion of both exports and imports of goods and services quickened in 2007 Q2, although the increase in imports is proving less than that a year earlier. On the supply side, the restructuring of growth has chiefly been manifest in the ongoing momentum of industrial activity, offsetting the moderate deceleration in value added in the construction sector. Overall, employment held at a sustained rate of increase in Q2 and the improvement in apparent labour productivity seen in the previous quarter became firmer. The CPI has moved on a fairly stable path in the year to date, running at a rate of around 2.4%, although component by component its trend has been very mixed; the prices of non-energy industrial goods slowed significantly, driven in part by the appreciation of the euro, while services prices remained very dynamic. Over the quarter as a whole, the CPI excluding unprocessed food and energy slowed by 0.2 pp to 2.5%, and the inflation differential with the euro area held stable at 0.6 pp.

The external environment was marked by a fresh bout of oil price rises in Q2. The oil price hit an annual high in mid-July, standing at over $77 per barrel and thus drawing close to the all-time high recorded in August 2006. As regards international financial developments, there was a trend towards the normalisation of financial conditions during the quarter, the key feature of which was the rise in long-term interest rates. Nonetheless, the continuing difficulties in the US mortgage markets in recent weeks partially corrected this rise and prompted a widening of credit risk spreads, although they remain at relatively low levels. On most international equity markets, the upward trend in previous quarters continued, despite which there was a moderate increase in volatility. And on the foreign exchange markets the ongoing depreciation of the dollar continued, particularly against the euro and sterling, and the yen also depreciated against the main currencies.

The world economy remained highly dynamic in Q2, driven mainly by the momentum of the emerging economies and by the sound headway of the European economies taking root. That said, in the year as a whole there has been some easing off in international trade flows compared with the exceptional figures recorded a year earlier. In the United States, the data for 2007 Q2, though somewhat more favourable than those for Q1, continue to point to a moderate growth phase. This means that it is not possible to dispel fully the doubts over the duration and scope of the current phase of lower growth. Such doubts are closely linked to the horizon

GROSS DOMESTIC PRODUCT (a)

CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

for the completion of the adjustment in the real estate sector, to its possible spread to other sectors and to the consequences for the subprime segment of the mortgage market. Nonetheless, the manufacturing sector has picked up notably and investment is trending somewhat more favourably, underpinned by the continuing strength of corporate earnings and by the external sector, which augur a more dynamic second half of the year.

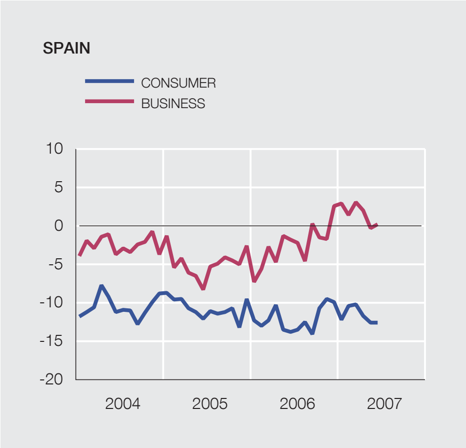
Inflation rates in the developed economies turned slightly downwards during the quarter. That did not prevent the predominant perception among central banks being that of the presence of upside risks to inflation in the short and medium term. In the United States, where the CPI stood at 2.7% in June, the Federal Reserve held its federal funds target interest rate unchanged at 5.25%. In the United Kingdom, although the 12-month growth rate of the CPI eased significantly during the quarter, the Bank of England raised its official interest rate by 25 bp at its May and July meetings, taking it up to 5.75%. Finally, the Bank of Japan held its official interest rate unchanged at 0.50%, in a setting in which underlying inflation posted negative figures.

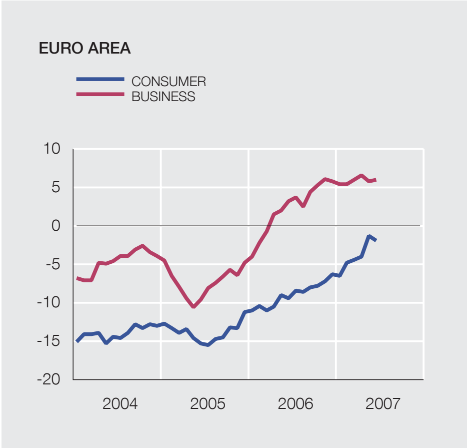
During the first half of 2007, the euro area economy continued to grow soundly. Largely behind this economic dynamism was the strength of investment and also of exports. However, private consumption showed some slackness in Q1 (affected in part by the VAT increase in Germany), though it might begin to pick up in the second half of the year judging by the sound behaviour of employment. The forecasts of various international agencies point to the continuity of these trends over the rest of the year whereby, according to the European Commission, GDP in the euro area might grow by 2.6% in 2007, a figure that matches the 0.5 pp range estimated by the ESCB (between 2.3% and 2.9%) in its last joint forecasting exercise.

This favourable economic situation has made itself felt in public finances, which improved significantly on 2006. This was thanks to the fiscal consolidation drive undertaken in some countries, but above all to high growth, which resulted in higher-than-expected tax revenue. Regarding fiscal results for 2007, the European Commission's Spring report envisages further reductions – albeit moderate ones in some countries – in budget deficits, that might prove insufficient to meet the commitments made under the Stability and Growth Pact. In keeping with this relative normalisation of the fiscal situation in the EU, the ECOFIN Council decided to repeal the Excessive Deficit Procedure still in force for Germany and Greece since January 2003

CONFIDENCE INDICATORS

CHART 2





SOURCE: European Commission.

and May 2004, respectively. Further, it adopted the decision on 1 July to enlarge the euro area to 15 members, taking in Cyprus and Malta from January 2008.

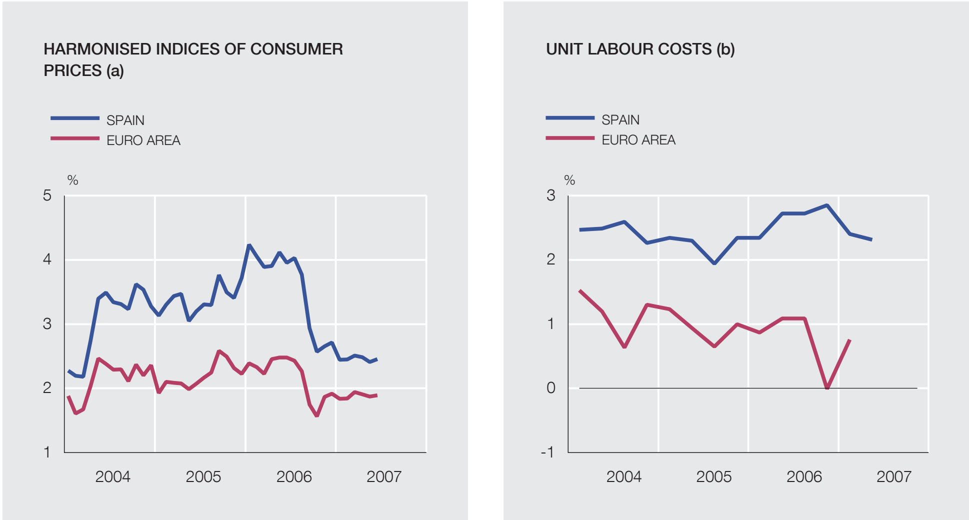
Turning to inflation developments in the euro area, the year-on-year rate of change of the HICP held stable during the quarter at 1.9%, still affected by the rise in the price of the energy component in the first half of 2006 (see Chart 3). The disappearance of this base effect as from next September and the upward course oil prices have resumed will most likely entail a rise in inflation in the short run. Into the medium term, the inflation forecasts for the euro area are compatible with price stability, although the ECB considers that they remain upwardly biased. That stems not only from the uncertainty surrounding the future course of oil prices, but also from the potential effect of a more mature business cycle on wage negotiations (although the indicators available show no signs that this risk is materialising) and from the increases in business margins in certain industries.

It was precisely this assessment of risks to price stability that led the ECB to adjust the monetary conditions in the euro area once again at its June meeting, raising its official interest rates by 25 bp to 4% in the case of the main refinancing operations, to 3% in that of the deposit facility and to 5% in that of the marginal lending facility. Following this rise, the euro area monetary policy stance remains accommodative, bearing in mind the current cyclical phase of the economy. In response to these movements, interbank market yields continued to rise during the quarter and, as earlier indicated, the euro appreciated further against the dollar and the yen, taking the appreciation since the beginning of the year to somewhat over 3% vis-à-vis the dollar and to 1.7% in terms of the nominal effective exchange rate.

The external environment of the Spanish economy thus continued to be supportive of the expansion in activity, chiefly through the dynamism of Spanish export markets, although the pace was somewhat slacker than the previous year. The tightening of monetary conditions by the ECB made for a fresh increase in the cost of financing, the effect of which on agents' spending decisions continued to be limited, although it made itself felt with greater intensity in household debt decisions (see Chart 4). Property market prices held on the slowing trajectory of the previous quarters (with year-on-year growth of 5.8% in the April-June period). The stock markets, despite holding on an uptrend throughout the period, experienced bouts of instability associated with greater uncertainty over the valuation of certain real estate companies. The outcome was that household wealth slowed over the quarter as a whole, contributing to greater moderation in domestic demand.

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.

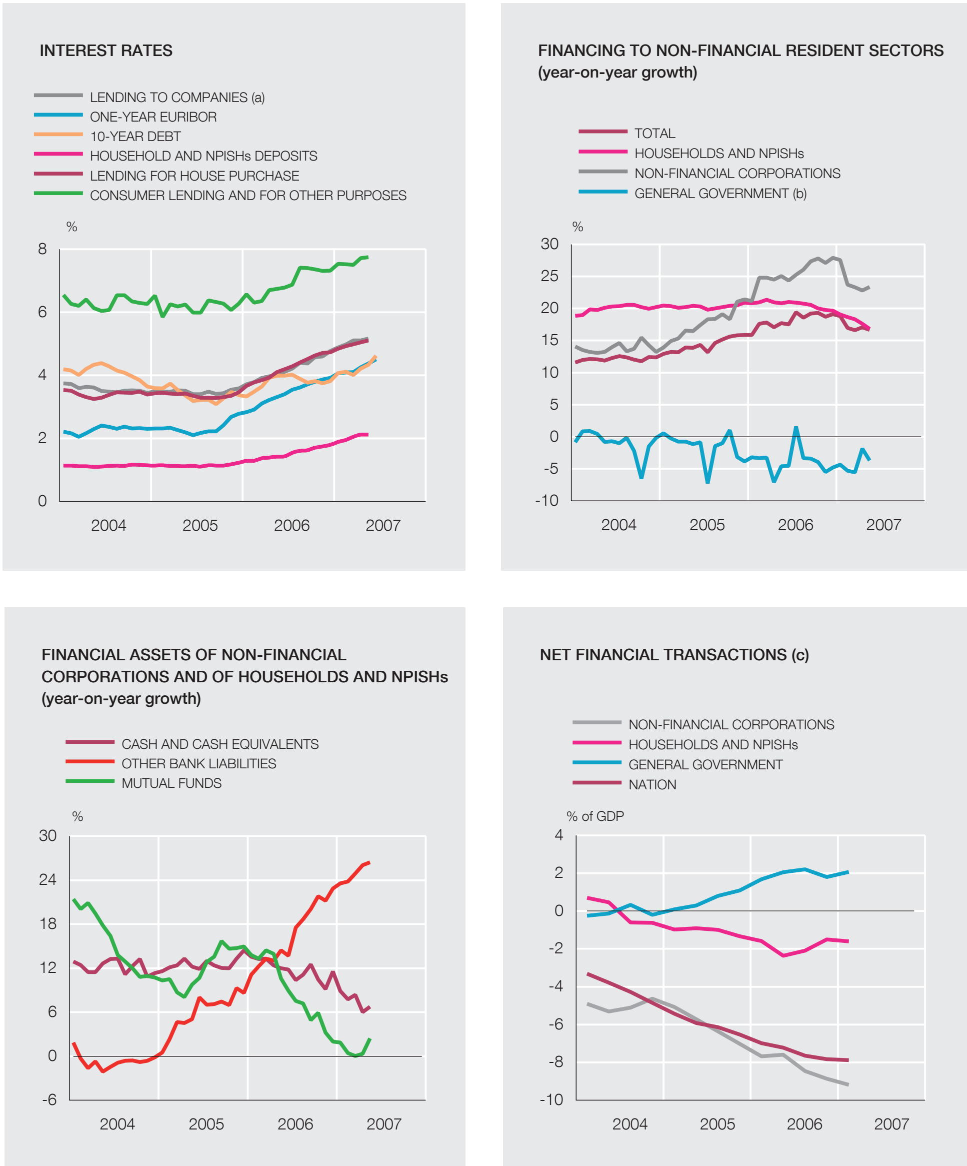
Nonetheless, household consumption remained notably buoyant (while moving on a mildly slowing path), underpinned by the strength of job creation, by the decline in inflation and by lower tax payments following the personal income tax reform, since the increase in net interest payments, as a result of the rise in interbank market rates, had a counteracting effect. The smaller increase in wealth also checked consumption, bringing it closer to the growth of real household income. Residential investment evidenced a more marked - though in any event moderate – slowdown, in response to the diminished expectations of rising house price values and to the increase in the cost of financing. From the standpoint of the household financial position, the diminished momentum of spending, along with the less benign financing conditions, led to a fresh reduction in the rate of household debt. As a result, the increase in lending to households and NPISHs stood in June at slightly below 16%, 2.5 pp down on the end of the previous quarter.

Corporate investment continued to be highly dynamic, based on a favourable international environment, high corporate earnings and a bright outlook for domestic activity. Further, no significant effects of the higher cost of financing on firms' investment and hiring plans have been discerned. The momentum of investment in capital goods has been particularly notable, and this was once again the most dynamic demand component during the quarter. In step with this, the debt of non-financial corporations continued to increase, posting a year-on-year growth rate of 23%, only slightly lower than the previous quarter. However, there are incipient signs of a change in the composition of corporate debt by end-use, with funds for financing property and construction activities slowing, and those earmarked for industrial corporations stepping up.

General government spending eased somewhat in Q2. This affected government consumption and, above all, gross capital formation. It also bore particularly on construction, following the high increases the previous quarter, largely linked to the local and regional government elections held in May. Nonetheless, general government gross capital formation is expected to hold at a sustained pace in the coming months as a result of meeting the commitments made under the PEIT (infrastructure and transport strategic plan), among other investment plans. It

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCE: Banco de España.

a. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
b. Consolidated financing: net of securities and loans that are general government assets.
c. Cumulative four-quarter data.

is against this background that the continuing strength of non-financial corporations' non-residential investment should be viewed. Tax revenue continued growing forcefully, especially in relation to direct taxes, in a setting in which the effect of the personal and corporate income tax reform introduced at the start of the year was cushioned by the dynamism of the taxation of returns on financial assets. As a result of these developments, it is foreseen that the growth rate of public revenue will, by the end of the year, be far higher than budgeted, even if direct tax revenue were to slow in the second half of the year. The resulting financial headroom should not be used to take spending off its budgeted path but to further fiscal consolidation and to increase the room for manoeuvre in less favourable circumstances than those currently prevailing. Should these forecasts hold, the fiscal balance in 2007 should result in a surplus exceeding the figure of 1% established in the last Updated Stability Programme. The budgetary stability targets for the period 2008-2010, approved by the government at the end of May, nevertheless maintain a general government surplus target for 2008 of 0.9% of GDP (the same as that set in the last Updated Stability Programme), which is slightly lower than that programmed for the current year.

Foreign trade flows slowed significantly in 2007 Q1. The deceleration was sharper in the case of imports and, as indicated, this provided for a 0.2 pp improvement in the contribution of net external demand to output growth, to 0.7 pp of GDP. The still-incomplete information for Q2 points to a mild acceleration in both exports and imports of goods and services, which are expected to have grown at respective rates of 5% and 6% in this period.

The moderate increase in exports in the first half of the year is consistent with developments in world trade, the expansion in which was somewhat slacker in this period following its dynamism the previous year. In the case of imports, the strength of final demand (in particular the estimated dynamism for investment in equipment) and the virtually zero change in import prices, owing to the appreciation of the euro, would justify this recovery in Q2. However, the increase in the share of imports in final demand has been checked in the first half of the year, after rising notably in the three previous years. As to exports, although extra-Community sales showed – as has become habitual – comparatively greater momentum, their growth rates were once again far lower than those of the previous year, especially in the case of exports to the United States and to Japan, and that might also reflect the effect of a stronger euro. Real services exports also expanded somewhat more in Q2, despite the notable moderation in real tourism receipts. And this was broadly extensive to services imports. It is expected that the joint effect of these movements will mean that the contribution of net external demand will remain stable at the level of the previous quarter, subtracting 0.7 pp from the increase in output. Nonetheless, the external deficit has continued widening, albeit at a slowing rate. The nation's net borrowing stood at 7.9% of GDP in 2007 Q1, in cumulative four-quarter terms, 0.1 pp up on end-2006.

On the supply side, it is estimated there were minor changes in the contribution of the various productive branches to growth in Q2. These included most notably the strength of industrial activity, although perhaps with a slightly more moderate rate of increase, and the mild slowdown in activity in the construction sector. Employment began incipiently to reflect this structural change, although the construction branch remained the most dynamic in terms of jobs. Overall, employment increases remained sustained and the improvement in labour productivity dating back to the previous period firmed. The EPA (Labour Force Survey) data for Q2 confirmed the buoyancy of employment, against the backdrop of the somewhat more contained growth of the population of working age. Numbers employed increased at a year-on-year rate of 3.4% in Q2, and there was a slight fall in the ratio of temporary to total employees to 31.8%.

Turning to labour costs, the growth rate of wages is expected to have stabilised at a similar level to that of the previous quarter, when compensation per employee in the market economy stood at 3.1%. The increase in compensation would thus be close to the average wage settlements in collective bargaining agreements (2.9% in the first five months of the year), and no significant deviations from this rate are envisaged over the rest of the year. This is because, first, the effect of the activation of the indexation clauses in 2007 will be far less than was the case in 2006; and further, the tendency towards the rebalancing of activity, which is beginning to be discernible, may lessen the scale of wage drift which, as is known, has been strongly negative in recent years. The rise in actual productivity has, in turn, enabled the rate of change of unit labour costs to stabilise at comparatively lower levels and, in the case of manufacturing, to scarcely change over the course of the quarter, checking a further deterioration in our price-competitiveness. This development, combined with what might be somewhat less expansionary margins than in previous periods and with the temporary downturn in oil prices in the opening months of the year, has contributed to shaping a more contained inflation scenario. Indeed, the inflation rate has held below 2.5% to June and the differential with the euro area is close to its all-time low. Significantly, however, core inflation is holding stable at a relatively high rate (due partly to the high increases in services prices), and oil prices have resumed an upward course, which will intensify the adverse base effect of the reductions in energy prices in late 2006. Against this background, it is highly likely that inflation will rise again in the coming months, attaining levels similar to those at the close of the previous year.

Throughout this quarter the Spanish economy has remained strongly dynamic and continuing headway has been made towards a more balanced composition of spending. At the same time, financial conditions have become progressively less benign and the property market has moved on to a more normal footing, with a very gradual slowdown in prices in the sector, which is prompting some containment in the rates of household spending and indebtedness. In the case of corporations, however, there is still no significant reaction to the new financial setting, which requires moderation in the rate of indebtedness, in line with a gradual slowdown in real estate development activities that may pave the way for other productive activities and other forms of investment to replace them. This replacement is a necessary condition not only for ensuring the continuation of an orderly rebalancing of the Spanish economy's growth sources, but also for entrenching higher increases in productivity. To see this process through, fresh momentum must be given to structural reforms. On the supply side, such reforms may allow industry and services to assume the leading role of construction, once the exceptional impulse exerted by this productive branch over the past decade progressively peters out, and employment to be reallocated without friction across sectors. The greater flexibility of the economy and the greater innovatory dynamism of corporations that may be expected from the deepening of these reforms will ultimately help improve the Spanish economy's competitiveness and see the external sector contribute to increases in GDP and in income.

2 The external environment of the euro area

In the last quarter, a key development on the international financial scene was the rise in long-term interest rates, particularly in the United States, where ten-year rates rose by 60 bp between early May and mid-June to reach levels above 5.25%. Subsequently, they fell back in July to around 4.8% on concerns about subprime lending in the US mortgage market. Credit spreads – both emerging-country sovereign spreads and, more especially, the corporate spreads of the companies with the lowest credit ratings in the United States – also increased considerably, although they still remain at relatively low levels. Developments on both emerging and developed stock markets were positive, with most indices recording gains despite a moderate increase in volatility. On the foreign exchange markets, the dominant feature was the strength of the euro against the US dollar – whose exchange rate fell to record lows of below 1.38 per euro – and, in particular, against the yen. Another notable feature in the last quarter was the rebound in oil prices, which rose by 14%, pushing the price of a barrel of Brent above $77, slightly below its all-time high in August 2006. This increase coincided with political tensions in Nigeria and Iran, and with petrol supply problems in the United States.

In the United States, advance data on GDP for Q2 indicated a substantial acceleration in economic activity, with an annualised quarterly growth rate of 3.4%, compared with 0.6% in Q1. The composition of this growth, however, maintains the uncertainty concerning the duration and depth of the low-growth phase and its transmission to other economies (see Box 1). On the negative side, private consumption, the key driver of growth in recent quarters, slowed considerably. It grew at an annualised quarterly rate of 1.3%, 2.4 pp down on the previous quarter. Additionally, there are no clear signs of a possible stabilisation in the real estate market. The negative contribution of residential investment to growth was still very substantial (over half a percentage point). The number of house sales has continued to slide and, despite the adjustment in residential investment, the stock of new houses for sale has remained at historically high levels, contributing to the slowdown in house prices. On the positive side, it is worth mentioning developments in investment and the recovery of both the manufacturing and external sectors. Non-residential investment performed more favourably than in the previous quarter, with strong growth in infrastructure investment and an increase in expenditure on capital goods and software, albeit at still-moderate rates. The ISM manufacturing index recovered, reaching levels that would suggest a sustained expansion of industrial activity in the months to come. In the external sector, exports were more buoyant and imports fell, with the result that external demand contributed 1.2 pp to annualised quarterly growth. Turning to prices, the year-on-year rate of the personal consumption expenditure deflator remained roughly stable during the quarter at 2.3%, though underlying inflation turned downwards to 1.9% in May, from 2.4% in February 2007. In June, underlying inflation as measured by the CPI picked up slightly in monthly terms (0.2%, 0.1 pp up on May), but the year-on-year rate remained at 2.2%. In this context, the Federal Reserve held its official interest rate unchanged at 5.25%.

In Japan, the indicators for Q2 point to some moderation in activity, despite continued dynamism in private consumption and exports. The main factor behind this slowdown has been the overall sluggishness of the industrial sector, which is currently undergoing a period of inventory adjustment, following a strong expansion in the second half of 2006. Industrial production thus contracted for the third consecutive month in May and the PMI index fell in June to a four-year low. However, some recent indicators, such as the positive June figure of the Tankan confidence index for large manufacturers and the pick-up in machinery orders in May, suggest that the adjustment in the manufacturing sector will not intensify in the coming months. As for

THE RESILIENCE OF THE WORLD ECONOMY TO THE ECONOMIC SLOWDOWN IN THE UNITED STATES

BOX 1

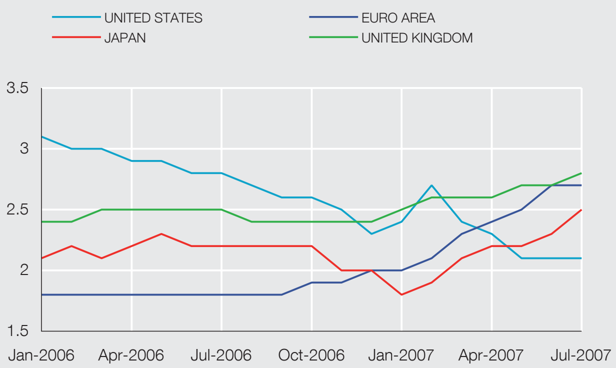
Since mid-2006 the US economy has been undergoing a period of slow growth, weighed down mainly by a sizeable downward correction in residential investment. During this period, other economies have maintained historically high rates of growth. Despite the optimistic assessment that could be made of recent developments, the continuation of the adjustment in the US real estate sector, borne out by the indicators published during the quarter, may prolong – and even worsen – the phase of slow growth in this country. For this reason, the possible transmission to other economic areas of developments in the United States is one of the main factors of uncertainty clouding the international economic outlook.

The experience of the last thirty years is corroboration that periods of recession in the United States usually coincide with phases of lower growth in the world economy. However, this is not necessarily proof of a high degree of transmission between the United States and the rest of the world: much of the synchronisation observed between the US economic cycle and that of the rest of the world is attributable to common shocks that have simultaneously affected, albeit to varying degrees, several economies. The oil crises of the 1970s and the sharp stock market correction associated with falling technology stocks at the beginning of the millennium are prime examples of this type of shock.

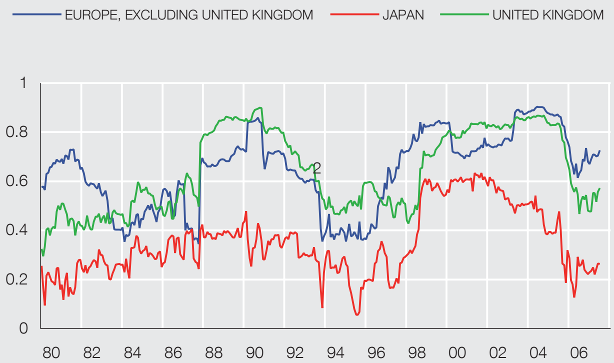
The current slowdown in the US real estate sector cannot, however, be compared to this type of simultaneous shock, since it is an idiosyncratic phenomenon. Consequently, its negative impact on growth in other economic areas is expected to be less than in past episodes.

Most economists expect a moderation in US growth in 2007, compared with 2006, compatible with a recovery in the pace of activity from the low at the start of 2007. The composition of growth is also likely to reduce the extent of the transmission of this slowdown to other areas. On one hand, residential investment is forecast to remain depressed, although housing is a non-tradable sector, with a relatively low demand for imports. On the other, indicators released during the quarter point to a recovery in the manufacturing sector, which is more import-intensive. The consensus scenario also foresees an im-

1 CONSENSUS FORECASTS FOR GROWTH IN 2007



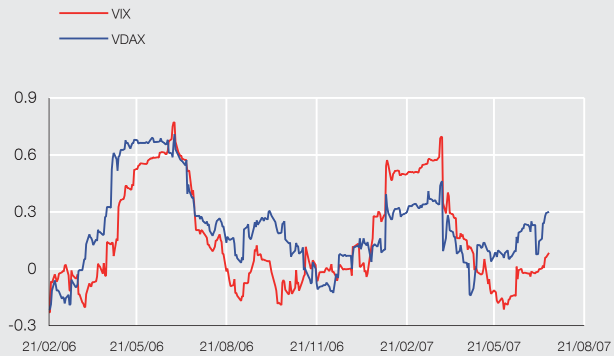
2 EQUITY MARKETS. CORRELATION WITH THE US STOCK MARKET



3 EQUITY MARKETS. CORRELATION WITH THE US STOCK MARKET

	Months of positive return	Months of negative return
Europe (c)	0.32	0.62
United Kingdom	0.42	0.56
Japan	0.11	0.32
Global (d)	0.41	0.60

4 CORRELATION IN IMPLIED VOLATILITIES OF STOCK MARKETS AND MORTGAGE-BACKED ASSETS (b)



SOURCES: Consensus Forecast, Datastream and JP Morgan.

a. Year-on-year rate of change.
b. Three-week correlation between the changes in the ABX.HE BBB- index and the changes in the VIX (United States) and VDAX (Germany) indices.
c. Excluding the United Kingdom.
d. Excluding the United States.

provement in non-residential investment, whose influence on imports from the rest of the world is greater than that of housing expenditure. The latest consensus forecasts have tended to raise growth expectations for the rest of the world, notwithstanding the progressive scaling back of prospects for the United States (see Chart 1). That suggests economic agents expect the world economy to show considerable resilience to the loss of dynamism in the United States.

It would be hasty, however, to consider that the far-reaching structural changes in a number of economies over recent decades will ensure a greater degree of autonomy between the economic cycles of the different regions. In particular, there is no evidence that the two transmission channels – trade and finance – have lost their relevance.

From a trade perspective, worldwide growth in foreign trade has been accompanied by greater external openness, which tends to provide a counterweight to the lesser relative importance of the United States as the origin or destination of these trade flows. According to recently published IMF data[1], the percentage of exports intended for the United States has been on a downward trend in most regions. However, since total exports have grown over-proportionately, exports to the United States currently account for a larger share of the GDP of most of the other countries. Taking the euro area as an example, in the period 1986-90 exports to the United States accounted for 8% of total exports and 1.5% of GDP. In the period 2001-05, although sales to the United States were equivalent to 7% of total exports, their weight in terms of GDP had practically doubled to 2.4%. Taking into account indirect exposure through exports to third countries that, in turn, have trade ties with the United States[2], this figure would rise about 2.5 pp more. The trend seems to suggest that the transmission, via the trade channel, of US slowdowns may have strengthened in recent decades. Nevertheless, simulations based on macroeconometric models tend to confirm the view that the attendant magnitude in the event of a correction in the US real estate sector would still be relatively limited.

Measurement of a possible transmission via the financial channel is more complicated, both conceptually and because of a lack of accurate data. The financial exposure of most economies to the rest of the world has increased continuously in recent decades; consequently, in terms of GDP, the weight of their claims on and liabilities to the United States has also risen. In the case of the euro area, according to the Coordinated Portfolio Investment Survey, while US portfolio assets accounted for only 3.1% of GDP in 1997, in 2004 they amounted to 14.1%. Over the same period, euro area liabilities vis-à-vis the United States rose from 7.4% of GDP to 9.9%. This situation is repeated in most geographical areas, suggesting greater exposure to developments in US financial markets.

Correlations between financial markets do not point to a significant reduction in the risk of cross-regional contagion. In equity markets, the correlation became smaller during the last upturn, although it still remains significant (see Chart 2). Moreover, were the historical pattern to repeat itself, these correlations would foreseeably be stronger in the context of falls on the US stock exchange (see Table 1). However, the fact that the adverse developments have been confined to the US real estate sector does not necessarily guarantee there will be no contagion to other financial instruments and areas. The strong growth in mortgage securitisation could contribute to such contagion, since it implies that securities of this type are becoming increasingly weightier in the portfolios of a large number of investors. Accordingly, evidence from the most recent bouts of financial turbulence (May 2006 and March 2007) indicates that the implied volatilities of stock markets, both in the United States and in the euro area, have tended to increase in synchrony with the fall in value of higher-risk mortgage-backed assets (see Chart 3). This highlights the risk that the sharp increase in defaults in the subprime mortgage market may lead to a revision of risk premia in other markets and other areas, which in turn could have significant macroeconomic consequences.

In conclusion, given its magnitude and composition, the US slowdown is expected to have a limited impact on other economies, especially if it is confined to the real sector and the trade channel. Nevertheless, concerns remain that the slowdown may possibly be transmitted with greater intensity via the financial channel, giving rise to a deterioration in global financial conditions that could have more significant negative consequences for growth rates in other areas.

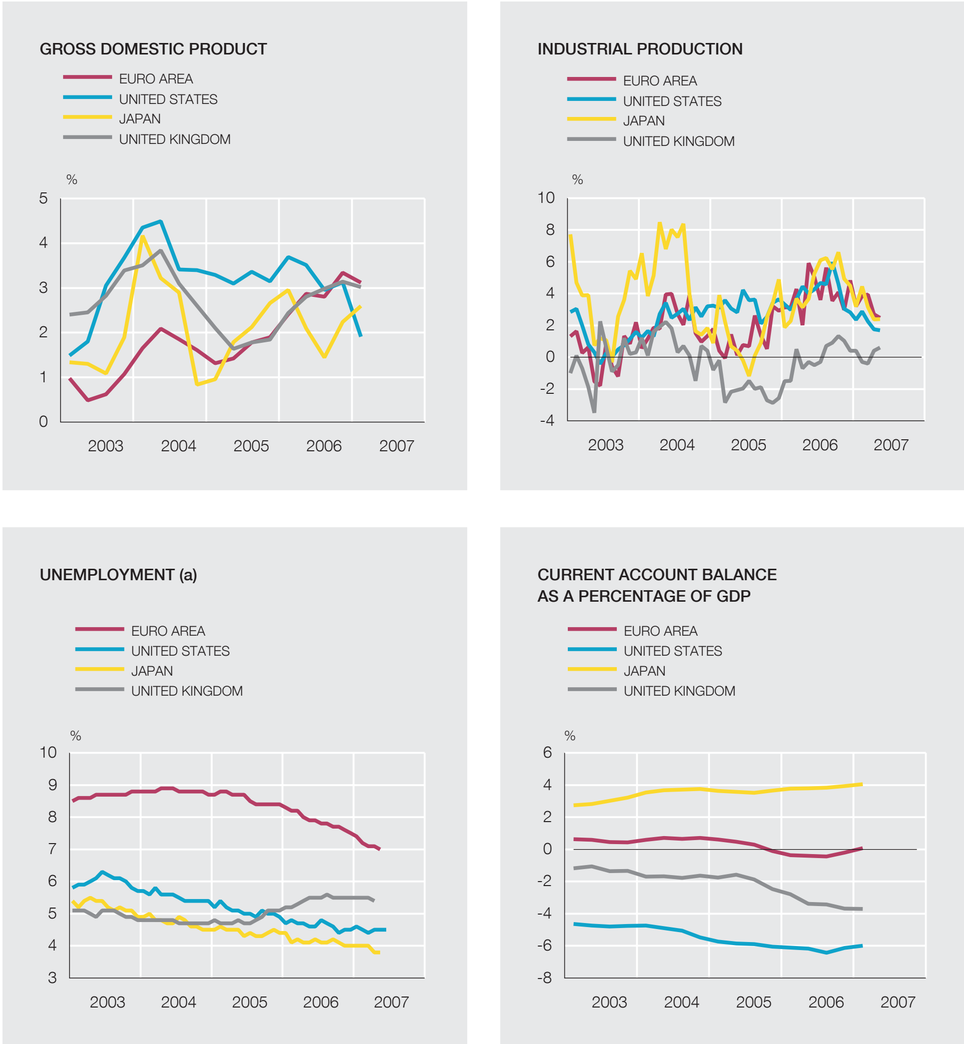
1. See Chapter 4 of the *World Economic Outlook*, April 2007. **2.** See the *Annual Report*, 2006-07 of the Bank for International Settlements.

inflation indicators, the data for May showed a year-on-year rate for the overall index of 0%, while the underlying rate turned negative. Against this background, the Bank of Japan held the official interest rate at 0.50%, unchanged since February 2007.

In the United Kingdom, the preliminary estimate of GDP for Q2 pointed to quarterly growth of 0.8% – 0.1 pp more than in Q1 – with the year-on-year rate holding at 3%. Although the biggest contribution to growth was from services, construction and manufacturing were more dynamic than in previous quarters. With regard to inflation, the year-on-year rate of change in the CPI eased significantly during the quarter, standing at 2.5% in May, although the prospects

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



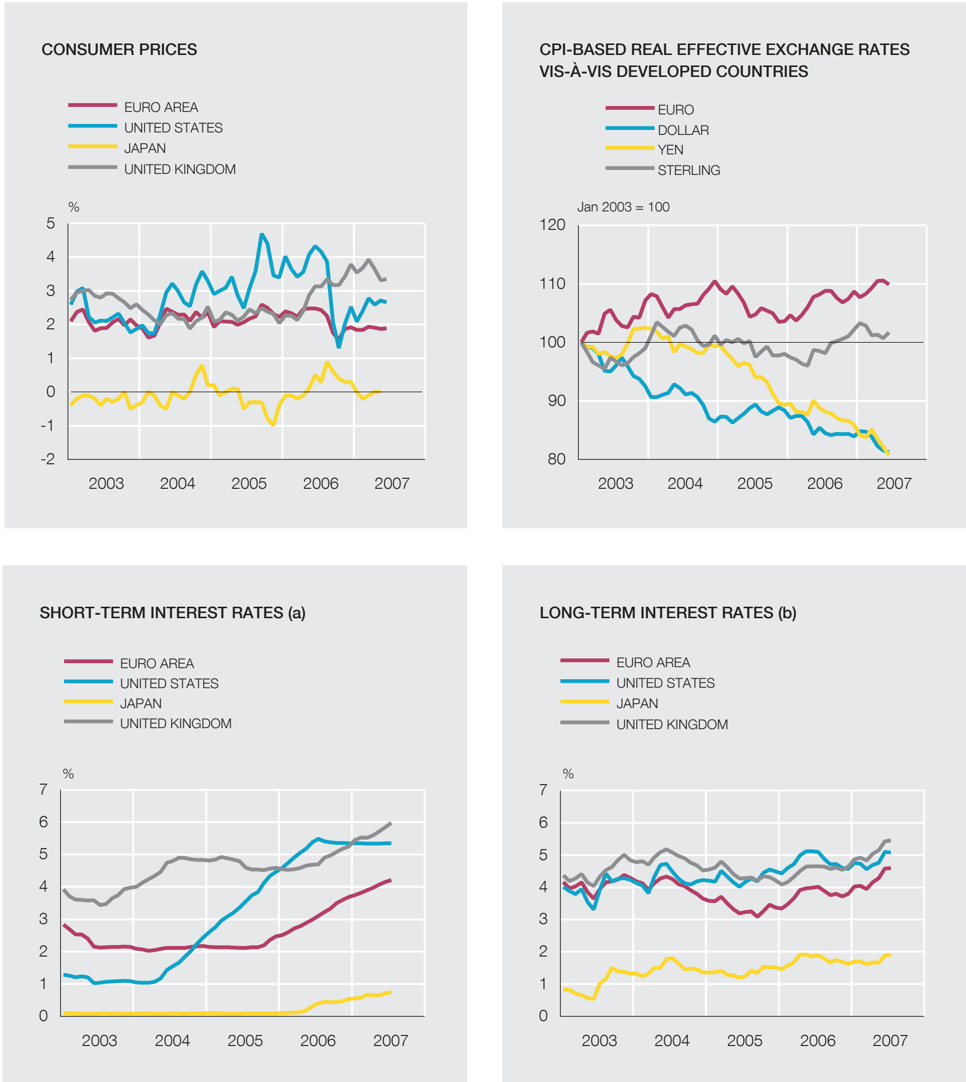
SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

of upward pressures remain. House prices continued to rise at a rate slightly above 10% year-on-year during Q2. In this context, the Bank of England raised its official interest rate by 25 bp on two occasions (May and June), taking it to 5.75%. In the new EU Member States, the strength of domestic demand pushed GDP growth in 2007 Q1 to 6.5% year-on-year, compared with 6.6% in 2006 Q4, in spite of the expected deceleration in Hungary. Nevertheless, the most recent indicators of activity and demand show signs of a slight deceleration in Q2. Inflation in June rose across the board, although rates varied considerably from country to country. On the monetary policy front, the official interest rate in Poland rose by 25 bp to 4.5%, while in Hungary there was an unexpected cut of 25 bp, leaving the rate at 7.75%. Within ERM II, currencies remained at the central rate of their fluctuation band, with the exception of the Slovak koruna, which has resumed a gradually appreciating path since the end of June. On 10 July, ECOFIN formally approved the adoption of the euro by Cyprus and Malta on 1 January 2008.

In China, the already very dynamic growth rate increased further. GDP grew by 11.9% year-on-year in Q2, 0.8 pp up on Q1. Underpinning this was the expansion in industry and services,

PRICES, REAL EXCHANGE RATE AND INTEREST RATES CHART 6



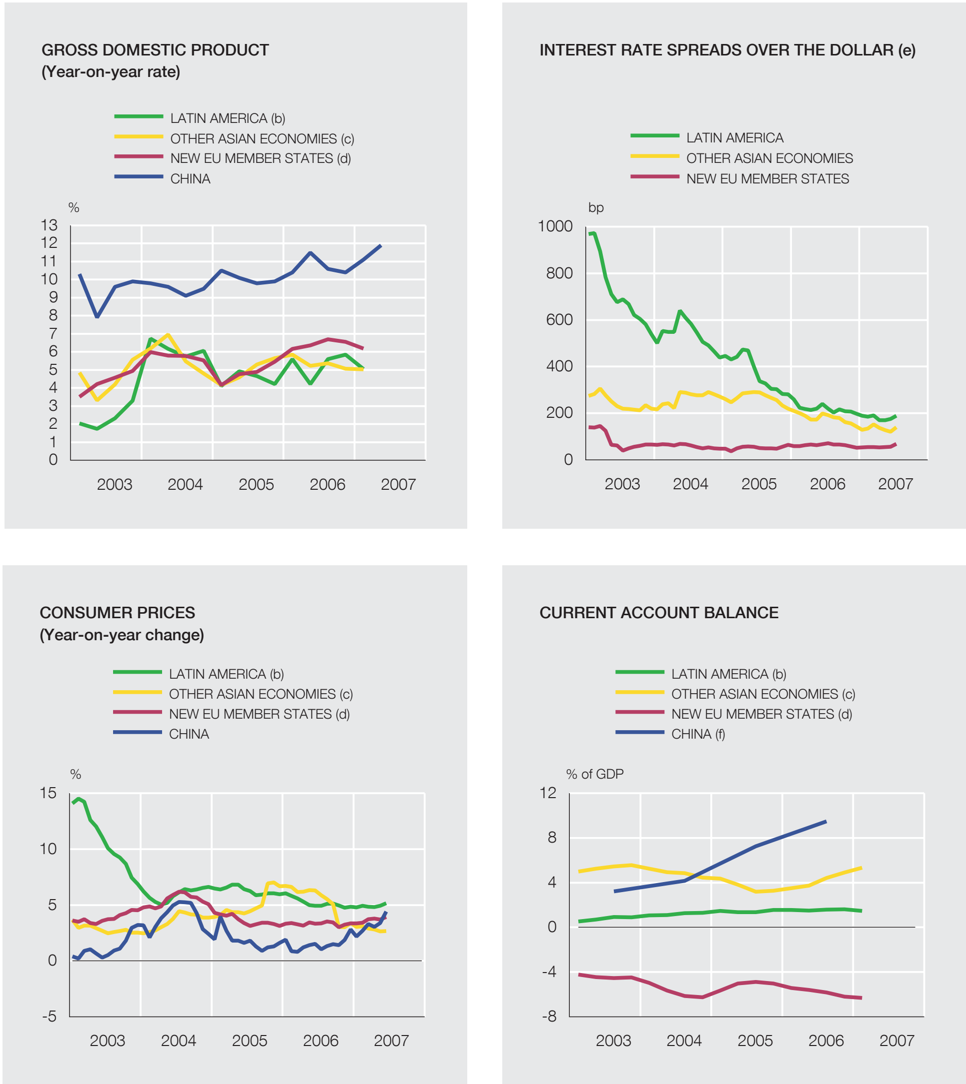
SOURCE: Banco de España.

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

leading to the likelihood of new tightening measures. Growth in industrial production was similar to that in the previous quarter and fixed asset investment quickened considerably, while retail sales continued to accelerate gradually. In the external sector, the trade surplus for Q2 grew by 43% over that of the previous quarter, reaching $66 billion, despite the slight acceleration in the rate of appreciation of the renminbi against the dollar. With a view to easing back the growth of financial variables, the central bank has raised the reserve ratio on four occasions (and reference rates for loans and deposits on three occasions), increased the taxes on equity trading (prompting the temporary correction in equity markets at the end of May) and adopted new measures to make investment in foreign markets easier for residents. Given the ample liquidity, inflation rose considerably. It posted a year-on-year rate of 4.4% in June, its highest level September 2004, heavily influenced by the upturn in food prices. Lastly, the first steps were taken towards the creation of the institution that will be responsible for the active management of a portion of international reserves. In the other Asian countries, the Q2 indicators of activity moved in positive territory, buoyed fundamentally by growth in exports. Furthermore, inflation in most of the economies in the region fell slightly. There were few changes in

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. Poland, Hungary, Czech Republic, Slovak Republic, Estonia, Latvia, Lithuania, Cyprus, Malta, Bulgaria and Romania.
e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
f. Annual data.

official interest rates in the region in Q2, with the exception of Indonesia, where they were cut by 50 bp.

GDP growth in Latin America in 2007 Q1 slowed slightly, from 5.8% in 2006 Q4 to 5.1% in 2007 Q1, as a result of the behaviour of domestic demand. This deceleration was driven by a fall in the growth of the main economies in the region, particularly in Mexico, although recent indicators of activity point to an acceleration during Q2 both in this economy and in Brazil. Inflation in the region as a whole rose slightly during the quarter, reaching 5.1% in June, compared with 4.9% in May. As for monetary policy, official interest rates rose more or less across the board, with the notable exception of Brazil, where they fell by a further 100 bp to 11.50%. Current account balances remained relatively stable in the region, except in Colombia, where it worsened considerably. Financial inflows increased significantly in Colombia and Brazil, the accumulation of reserves having gathered momentum in both countries. With regard to fiscal policy, general government balances improved, with the exception of Venezuela, where the budget deficit widened. Lastly, the sovereign debt rating of Peru, Colombia and Brazil improved, rising in the case of the latter two countries to one step below investment grade.

During the first half of 2007 the euro area economy continued growing soundly, as can be seen in the National Accounts figures for Q1 and in the indicators available for Q2. Economic dynamism has largely been underpinned by the strength of investment and exports. In contrast, private consumption remains somewhat slack, having been partly affected by the tax rises in Germany, although its fundamentals and the high level of household confidence auger greater momentum. That said, the economic outlook for the euro area for the current year is optimistic. According to the ESCB June forecasting exercise, GDP growth in 2007 will be in a range from 2.3%-2.9%, the mid-point of which (2.6%) is in line with the estimates provided by other international agencies. In the medium term some risks persist, stemming essentially from external factors relating to the rise in oil prices, uncertainty about the course of the US economy, the possibility of a disorderly adjustment of global imbalances and the potential change in the appetite for risk on financial markets.

Inflation in the euro area held stable at 1.9% in the period from February to June. However, the renewed upward path of oil prices may lead to a rise in the growth rate of the HICP in the short run. Into the medium term, the inflation outlook available is compatible with price stability, although there are upside risks relating essentially to the future course of commodities prices and to the maturity of the current upturn.

Against this background, the Governing Council of the ECB continued gradually to withdraw the monetary stimulus from the euro area and, in June, it once again raised official interest rates by 25 bp, to 4%. These conditions continue to be accommodative and propitious to the expansion of activity.

Turning to fiscal policy, public finances improved significantly in 2006 thanks to the fiscal consolidation drive, but especially to high economic growth, which resulted in higher tax revenue than expected. As regards 2007 and 2008, the European Commission, in its spring report, foresees further – albeit modest – reductions in the budget deficit. Moreover, the estimated trend of the structural deficit suggests that the adjustment in some countries will not suffice to meet the provisions of the reformed Stability Pact and the political commitment reaffirmed by the Eurogroup in April. Lastly, the Ecofin Council, in the light of progress made, decided to abrogate the Excessive Deficit Procedure in Germany and Greece.

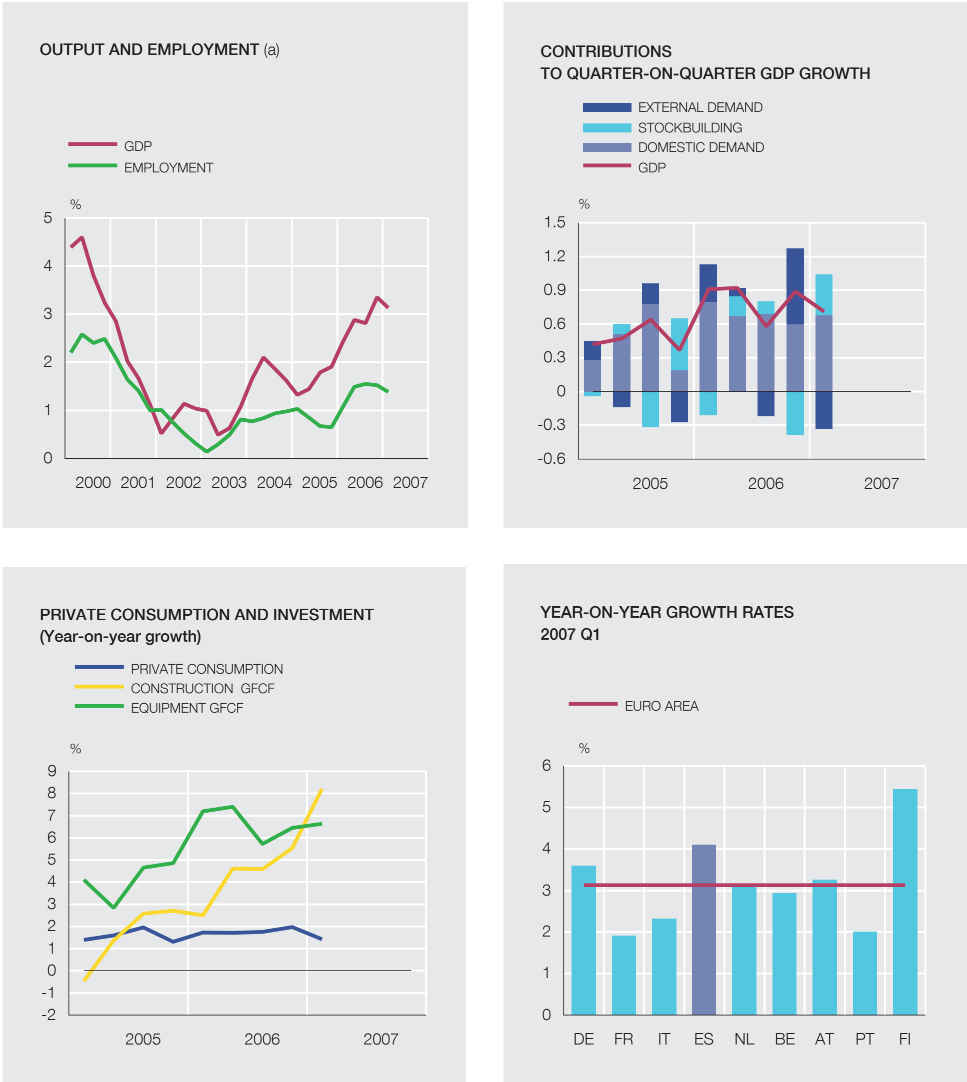
From 1 January 2008 the euro area will be enlarged, comprising 15 members following the incorporation of Cyprus and Malta. In May, the European Commission recommended the incorporation of these countries into the euro area, after noting their high degree of convergence and compliance with the necessary requirements. In July, the Ecofin adopted the final decision, announcing the irrevocable exchange rates of the Maltese lira and the Cyprus pound.

3.1 Economic developments

According to the second National Accounts estimate, GDP in the euro area remained highly dynamic in 2007 Q1, with growth of 0.7% on 2006 Q4. Although this rate is slightly lower than the exceptional increase in GDP in late 2006, domestic demand once again played a key role, and its contribution to the quarter-on-quarter change in output increased by 0.1 pp to 0.7 pp (see Chart 8). The firmness of domestic demand was largely due to the robustness of gross fixed capital formation, both in investment in capital goods and, above all, in construction, which was driven by very favourable weather. In contrast, private consumption posted a zero rate of change, having been affected by the increase in German VAT last January. Net external

EURO AREA NATIONAL ACCOUNTS

CHART 8



Sources: Eurostat and national statistics.

a. Year-on-year rates of change.

demand subtracted 0.3 pp from GDP growth owing to a marked slowdown in exports, after an abnormally high rise in late 2006, due to German statistics accounting factors. Lastly, the change in stockbuilding further contributed to underpinning the economic expansion and added 0.4 pp to the increase in output. In year-on-year terms, euro area GDP increased by 3.1% in Q1, 0.1 pp down on 2006 (see Table 1).

The breakdown of value added by branch of activity shows an across-the-board acceleration, except in agriculture and in retail and wholesale trade. Country by country, quarter-on-quarter GDP growth was relatively high in all the member states, in a range from 0.5% to 1.1%. The exception was Italy, where the increase was only 0.3%, following the strong expansion in late 2006. Turning to the area's four biggest countries, the momentum of domestic demand was notable in most of them. While private consumption quickened in France and Italy, the main driving force in the German economy was the momentum of investment, both in capital goods and in construction. Box 2 analyses in greater detail how temporary or permanent the pick-up in construction is, following the long period of stagnation dating back to the mid-90s.

EURO AREA ECONOMIC INDICATORS

TABLE 1

	2005	2006				2007		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
GDP								
Year-on-year growth	1.9	2.4	2.9	2.8	3.3	3.1		
Quarter-on-quarter growth	0.4	0.9	0.9	0.6	0.9	0.7		
European Commission forecasts (c)							(0,4 ; 0,8)	(0,4 ; 0,8)
IPI (d)	2.2	3.5	4.3	4.3	4.0	3.7	*2.5*	
Economic sentiment	100.1	102.6	106.8	108.2	109.9	110.0	111.6	
Industrial confidence	-5.7	-2.3	2.3	3.7	5.7	5.3	6.3	
Manufacturing PMI	53.0	54.7	57.1	56.9	56.7	55.5	55.3	*54.8*
Services confidence	14.0	14.7	18.7	19.0	19.7	20.7	22.3	
Services PMI	55.6	57.8	59.2	57.3	57.1	57.6	57.5	*58.1*
Unemployment rate	8.4	8.2	7.9	7.8	7.6	7.3	*7.0*	
Consumer confidence	-12.3	-10.7	-9.7	-8.3	-7.0	-5.3	-2.3	
HICP (d) (e)	2.2	2.2	2.5	1.7	1.9	1.9	*1.9*	
PPI (d) (e)	4.7	5.1	5.8	4.6	4.1	2.8	*2.3*	
Oil price in USD (e)	56.5	61.6	68.1	61.2	62.8	62.3	71.8	*78.0*
Loans to the private sector (d) (e)	9.2	10.8	11.0	11.4	10.8	10.5	*10.3*	
Euro area ten-year bond yield	3.4	3.6	4.0	4.0	3.9	4.1	4.4	*4.7*
US-euro area ten-year bond spread	1.12	1.06	1.08	1.00	0.82	0.67	0.47	*0.45*
Dollar/euro exchange rate (e)	1.180	1.210	1.271	1.266	1.317	1.332	1.351	*1.382*
Appreciation/ depreciation of the euro (e)	-13.4	2.6	7.8	7.3	11.6	1.1	2.5	*4.9*
Dow Jones EURO STOXX Broad index (e)	23.0	10.3	4.2	11.9	20.3	3.4	9.9	*9.8*

SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available up to 26 July 2007.
c. Quarter-on-quarter growth forecasts.
d. Year-on-year growth.
e. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

Significant progress continued to be made in the labour market. The pace of job creation held stable in Q1, with an increase of 0.4% on the three previous months, entailing a rise of 1.4% in year-on-year terms. This development, along with the trend in activity, did not give rise to significant changes in productivity growth, which stood at 1.7%. The improvement in the labour market has not yet translated into wage pressures. Hence, from the exceptionally low end-2006 levels, both compensation per employee and unit labour costs regained in 2007 Q1 their previous rates of increase, standing at moderate rates of 2.5% and 0.8%, respectively (see Chart 9). Conversely, business margins once again expanded notably (1.3% year-on-year in Q1, a similar rate to that of 2006).

For Q2, the indicators available depict a favourable scenario for activity (see Chart 10). On the supply side, and although the growth of industrial production eased in the April-May period, industrial orders for April and the qualitative indicators for Q2 point to a robust increase in production. According to the European Commission's surveys, confidence improved across-the-board in all branches, and the PMI indices, compiled on the basis of purchasing managers' opinions, stood in Q2 at high levels very similar to those for January-March in average terms, and consistent with an expansion in activity. Moreover, both the Commission and PMI surveys maintained a favourable outlook for job creation in all sectors, albeit to a lesser extent in construction. In this respect, the unemployment rate continued on its downward trend in May, standing at 7% of the labour force.

Following five years of sluggish growth, German GDP rose forcefully in 2006 to its highest rate since the start of the decade (3%). As in previous years, the positive behaviour of the external sector contributed to this favourable development. What was new was the improvement in the contribution of domestic demand, which added 2 pp to GDP growth, making it more balanced. As part of this recovery in domestic demand, construction played a key role, with its contribution amounting to 0.5 pp (see panel 1). This demand component had exhibited persistent weakness in the 1995-2005 period, weighing significantly on German GDP growth throughout this phase, in marked contrast to the trajectory seen in the rest of the euro area (see panels 2 and 3). Hence the relevance of the analysis of the temporary or structural nature of the improvement seen in 2006, for the purpose of evaluating whether it might entail an exit from this lengthy contractionary phase. This box focuses specifically on the residential component, in view of its weight in total construction demand.

To better understand the reasons behind the protracted downturn in residential investment, it is necessary to go back to previous periods characterised by significant surges in activity in the sector. In the specific case of what was then West Germany, the expansionary phase originated in the mid-80s, when there was a notable wave of immigrants of German origin resident in other Eastern European countries. These flows stepped up following reunification. In the former East Germany, the loss of population did not prevent a strong expansion in housing construction from taking place. This expansion came about, first, due to the expectations of rapid convergence towards the standards of living in place in the West; and, further, to the mismatch between the types of existing dwellings (old, dilapidated city-centre flats, along with other more recent prefabricated dwellings in the industrial complexes created during the period East Germany existed) and those potentially in demand (with similar features to those in West Germany). In both parts of Germany (although especially in the East), residential construction was boosted by substantial government incentives, which included subsidies, subsidised loans and tax breaks. The result was a 28.4% increase in residential construction between 1991 and 1994. In terms of the number of finished dwellings, the respective peaks were in 1994 in the western zone, and in 1997 in the east (see panels 4 and 5).

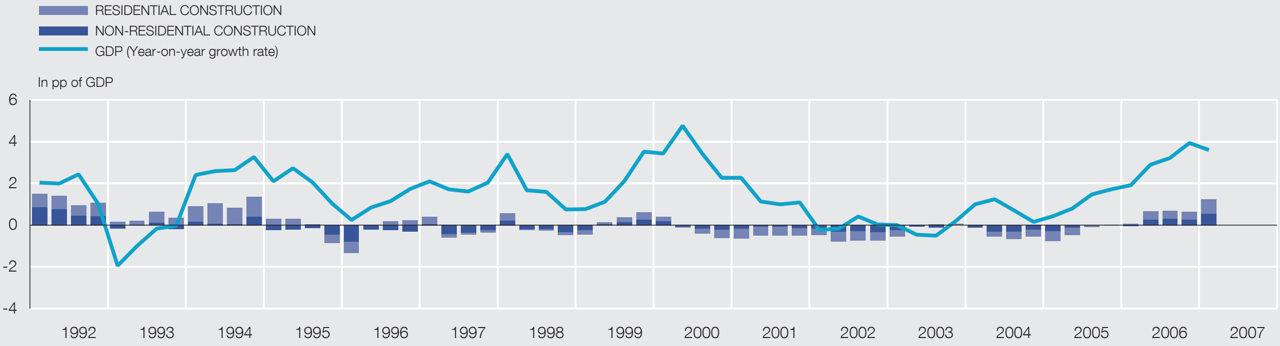
By the late 90s, excess supply began to be evident, much more acutely so in what was East Germany. Firstly, demographic developments led to a weakening in demand. In the West, the interruption of migratory flows led to a slowdown in the pace of household formation. In the East, the number of inhabitants has not ceased to fall to date, given emigration towards the western part of the country (most particularly by young, skilled individuals, the main potential demanders of housing). Further, housing construction in the first half of the decade had been excessive, propelled by the sizeable government assistance offered and by the expectations – later proven mistaken – of high returns on this asset.

In both parts of the country, excess supply was concentrated above all in rental housing. In Germany (the country with the lowest rate of house ownership in the euro area), the house rental and house ownership markets are two completely separate segments. The latter encompasses, above all, single-family dwellings promoted directly by their future owners and generally located in rural areas and in residential areas on the outskirts of cities. In contrast, housing for rent tends to be in city-centre apartment blocks. The property developers behind these latter buildings, encouraged by the generous fiscal depreciation rules, overestimated demand. This explains why the decline (19.2%) in residential investment between 1995 and 2005 was concentrated in buildings of three or more dwellings, and why the fall in the price of owner-occupied dwellings was comparatively less sharp (see panel 6).

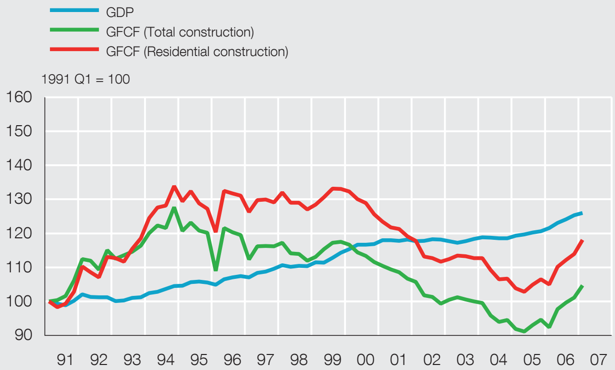
The residential market adjustment was far-reaching and slow. The structural characteristics of the problem are such that doubts have arisen over the possibility of the recovery observed in 2006 marking the end of this adjustment. Such uncertainty is heightened by the coexistence of several transitory factors. First, the increase in VAT, which came into force on 1 January 2007, might have led spending decisions to have been brought forward. Further, the elimination of the tax incentives relating to the purchase of the habitual principal dwelling from 1 January 2006 (incentives of which dwellings whose construction permits were approved prior to that date could avail themselves), even though the outlay was made later, may also have proven influential in this connection. Finally, in the opening months of 2007, the mild weather of last winter may have contributed to the favourable course of residential investment.

Beyond temporary factors, the trend of housing demand determinants appears to augur more favourable behaviour in the medium term. Pointing in this direction is housing affordability, measured as the ratio of house prices to gross disposable income, and the improvement in this latter variable. Aside from the residential component, the outlook also appears bright. For one thing, the recovery in investment in equipment also augurs an increase in investment in construction by companies. And for another, the improvement in the fiscal position might provide greater leeway for increasing public investment. In any event, the trend of the short-term indicators in 2007 to date has not been very propitious (see panel seven), although it should be pointed out that the level of confidence in construction stands above its long-term average.

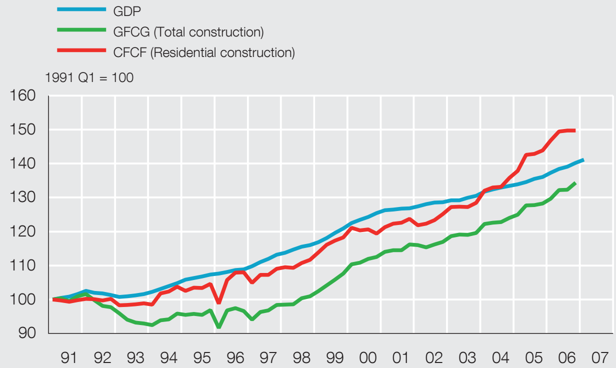
1 CONTRIBUTION OF GFCF IN CONSTRUCTION TO GDP GROWTH



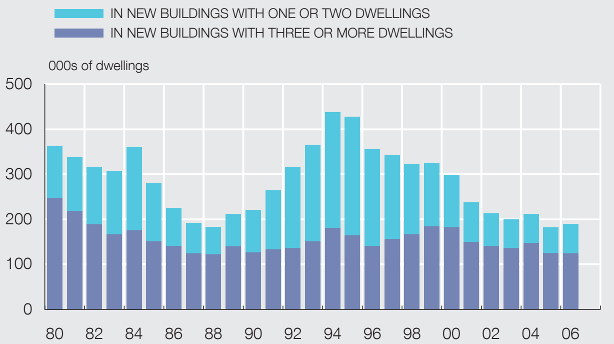
2 GDP AND GFCF IN CONSTRUCTION IN GERMANY



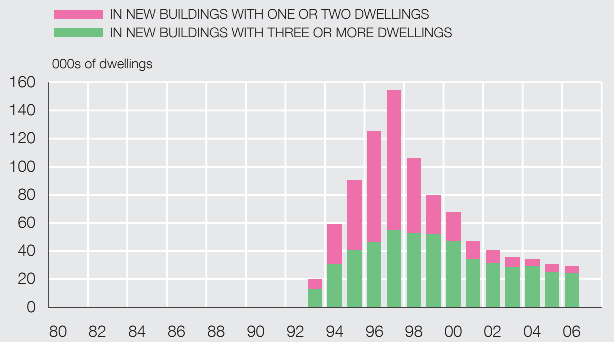
3 GDP AND GFCF IN CONSTRUCTION IN THE EURO AREA (excluding Germany)



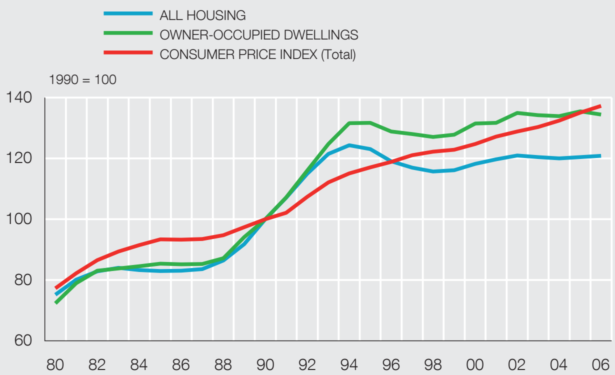
4 FINISHED HOUSING: WEST GERMANY



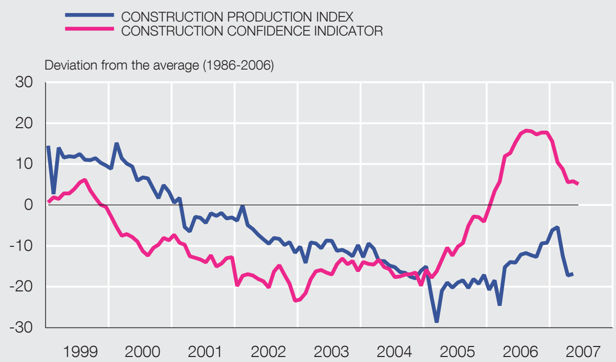
5 FINISHED HOUSING: EAST GERMANY



HOUSE PRICES



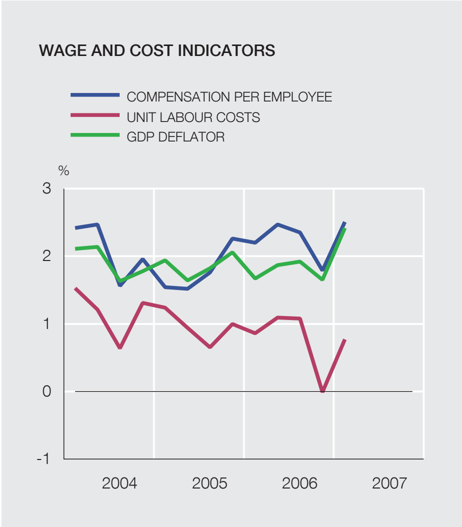
7 INDICATORS OF SHORT-TERM CONSTRUCTION ACTIVITY

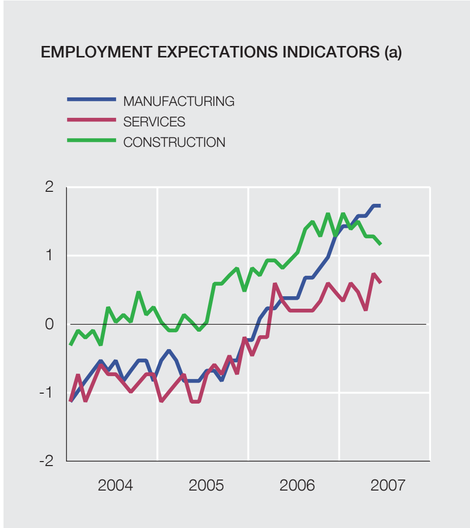


SOURCES: European Commission, Eurostat, German Federal Statistical Office and Bulweing AG.

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

CHART 9





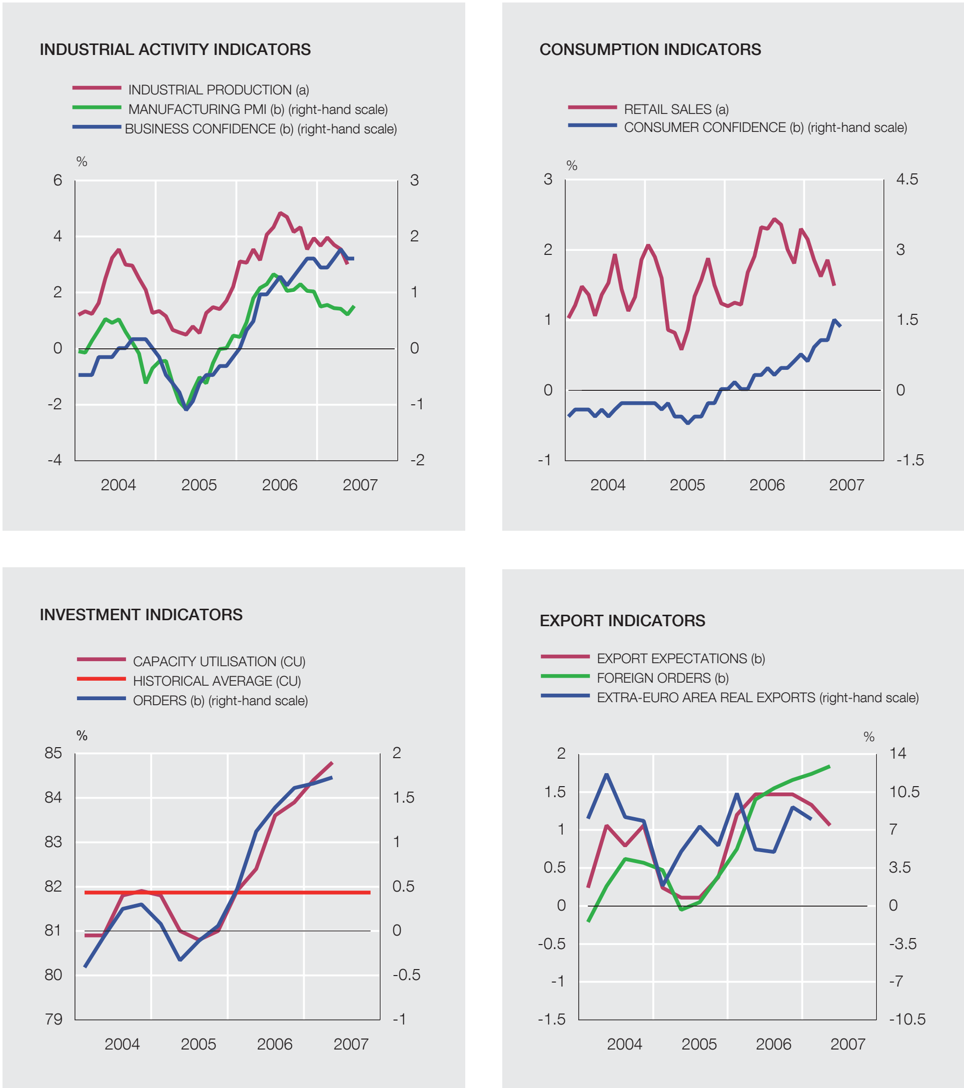
SOURCES: Eurostat and European Central Bank.

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

From the standpoint of demand, the picture is also encouraging. Regarding consumption there has not yet been a conclusive improvement in the quantitative indicators; but this nevertheless runs counter to the strength of opinion-based surveys. Both retail sales in April and May and new car registrations in Q2 were only slightly higher in volume terms than the previous quarter, when they were exposed to a fall-off due to the effect of German VAT. In contrast, consumer and business confidence in the retail trade and the readiness to buy durable goods stood, in June, at appreciably higher levels than those in March. This optimism and the favourable labour market outlook should make for a greater impulse to consumption. The investment indicators substantiate a firm increase in this aggregate for the year as a whole, although growth rates are likely to ease from the high figures recorded in Q1, especially in construction. The European Commission's half-yearly survey on industrial investment has revised the capital spending forecast for 2007 upwards. This variable should grow by 8%, 1 pp up on what was expected six months earlier. This assessment has been made in a setting in which capacity utilisation is very high, the confidence indicators are pointing to optimism and credit to non-financial corporations is quickening. Finally, as regards external demand, the growth of exports remains healthy and, although export expectations have slipped, they are holding at high levels and the assessment of foreign orders improved on average in Q2.

Accordingly, judging by the latest available information, the robustness of domestic demand will foreseeably continue against the background of propitious financial conditions, a sound corporate financial position and an improvement in the labour market. Moreover, the likely continued buoyancy of export markets will contribute to sustaining external demand. Consequently, the outlook for activity in the euro area is dynamic, as inferred from the latest European Commission forecasts which place euro area GDP growth at between 0.4% and 0.8% in the two coming quarters and at 2.6% for the year as a whole. These estimates are in line with those of other international agencies and, once adjusted for the calendar effect, are slightly above the mid-point of the range estimated in June by the ESCB, namely between 2.3% and 2.9%. In the medium term, the scenario is subject to certain risks related essentially to external factors. These include specifically the renewed upward course of commodities prices, uncertainty over the US economy, the possibility of a sharp adjust-

EURO AREA. REAL INDICATORS CHART 10



SOURCES: Eurostat and European Commission.

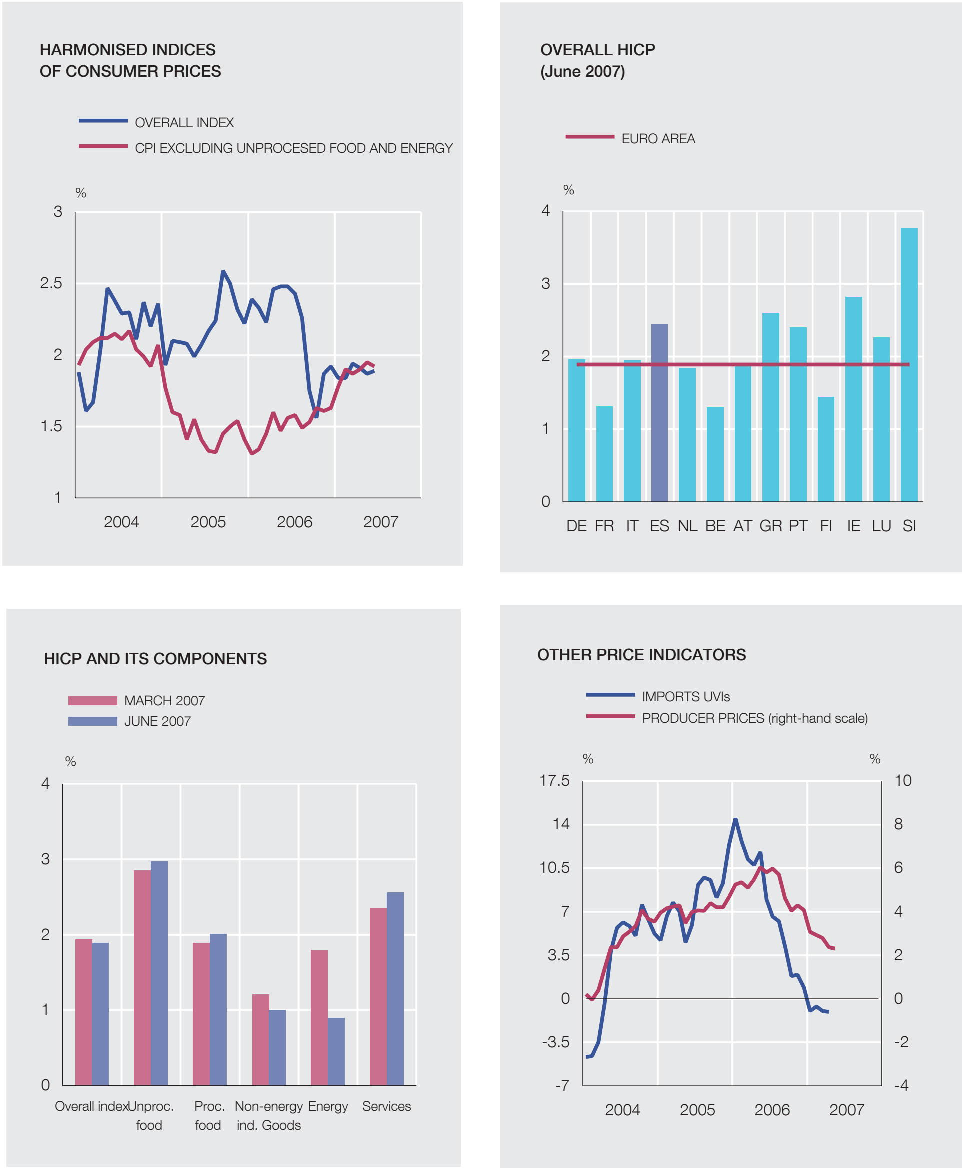
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.

ment in global imbalances and a potential change in financial market participants' attitude towards risk.

Inflation in the euro area held stable at 1.9% during Q2, a level below the limit set by the ECB as compatible with price stability (see Chart 11). Among the most volatile components, unprocessed food prices quickened slightly to 3% in June, while the energy component, despite the recent rise in crude oil prices, was dominated by a base effect which saw its year-on-year rate of increase dip to 0.9%, from 1.8% in March. As for the other components, services continued to be the most inflationary item, with year-on-year growth of 2.6% in June, 0.2 pp up on March. In contrast, the accelerating profile of non-energy industrial goods seen since mid-2006 was interrupted, and the related rate fell by 0.2 pp to 1%. As a result, underlying inflation in June held stable at 1.9%, its level at the beginning of the year, when the rise in VAT in Germany entailed an acceleration in this component (see Box 3). Turning to the other indicators, the year-on-year rate of expansion of producer prices eased to 2.3% in May, 0.6 pp down on the average for Q1. Although these developments were once again determined by the deceleration in energy prices, there was also some slowing in the prices of non-energy intermediate

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

CHART 11



SOURCES: Eurostat and European Central Bank.

goods and consumer durables. In May the growth of the producer price index, excluding energy, dipped by 0.2 pp to 3.2%, its lowest level since June 2006. Conversely, the prices of non-durable consumer goods have quickened in recent months.

In the coming months it is likely that the course of the energy component may lead inflation to stand temporarily above 2% after the summer. In the medium term, the forecasts available suggest that inflation will hold at relatively moderate levels, although the risks to price stability remain on the upside as a result of a sharper rise in crude oil and the maturation of the business cycle in the euro area. Regarding this latter aspect, high capacity utilisation and a tighter labour market might result in wage pressures outpacing improvements in productivity, although the latest indicators on negotiated wages do not yet provide evidence that this risk is materialising. This setting might also give rise to further increases in business margins, especially in the industries less exposed to competition. Furthermore, potential increases in administered prices and indirect taxes cannot be ruled out.

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2004	2005	2006	2007 (b)	2007 (c)
Belgium	0.0	-2.3	0.2	-0.1	0.3
Germany	-3.7	-3.2	-1.7	-0.6	-1.5
Greece	-7.9	-5.5	-2.6	-2.4	-2.4
Spain	-0.2	1.1	1.8	1.4	1.0
France	-3.6	-3.0	-2.5	-2.4	-2.5
Ireland	1.4	1.0	2.9	1.5	1.2
Italy	-3.5	-4.2	-4.4	-2.1	-2.8
Luxembourg	-1.2	-0.3	0.1	0.4	-0.9
Netherlands	-1.8	-0.3	0.6	-0.7	0.2
Austria	-1.2	-1.6	-1.1	-0.9	-0.8
Portugal	-3.3	-6.1	-3.9	-3.5	-3.7
Slovenia	-2.3	-1.5	-1.4	-1.5	-1.5
Finland	2.3	2.7	3.9	3.7	2.8
MEMORANDUM ITEMS: Euro area (including Slovenia)					
Primary balance	0.3	0.5	1.3	1.9	
Total balance	-2.8	-2.5	-1.6	-1.0	-1.4
Public debt	69.7	70.5	69.0	66.9	68.0

SOURCES:European Commission and national stability programmes.

a. As a percentage of GDP. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. European Commission forecasts (spring 2006).
c. Targets of the stability programmes presented between late 2006 and early 2007.

According to balance of payments figures, the current account posted a deficit of 0.6% of GDP in the January-May period, 0.3 pp down on the same period in 2006. This improvement is due to the bigger surplus on the merchandise balance, which stood at 0.4% of GDP, since imports slowed to a greater extent than exports, which respectively grew at year-on-year rates of 5.1% and 8.2% in the first five months of the year. As regards the financial account, net capital inflows in the form of portfolio investment, amounting to €145 billion, exceeded net outflows in the direct investment caption (€60 billion). Thus, in this period of 2007, the basic balance posted a positive balance of €63.8 billion compared with the negative figure (around €17 billion) recorded in the same period of 2006.

In the fiscal policy realm, and according to the European Commission's spring forecasts, public finances made significant and greater-than-expected progress in 2006 as a result of tax revenue proving higher than forecast and also of the fiscal consolidation drives in some countries. The budget deficit in the euro area declined by somewhat less than 1 pp (to 1.6% of GDP) and public debt also fell for the first time since 2002 (to 69.1% of GDP).

According to the estimates of the cyclically adjusted primary balance, which fell by 0.9 pp (to –1.1% of GDP), the fiscal policy stance in the euro area as a whole was contractionary in 2006. However, this improvement is not entirely a genuine one since it is due, in part, to the high elasticity of taxes to nominal GDP that is proper to expansionary phases. Indeed, and in particular, such elasticity is higher than the unit value normally assumed in calculations of the structural balance. Further, the estimation of the underlying fiscal position will still be subject to changes if, as has occurred in similar economic situations, the economy's growth potential is revised. This uncertainty therefore advises caution in the design and assessment of fiscal policy, and budgetary easing – as occurred in a similar situation at the start of the decade – should be avoided.

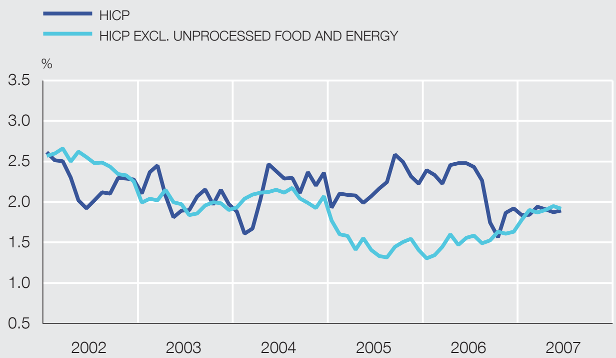
In the past two years, core inflation – measured by the year-on-year growth rate of the HICP, excluding energy and unprocessed food – has been very contained, with its annual average holding at close to 1.5%, significantly below the overall inflation rate. However, since 2006 Q4 it has moved on a rising trend, standing at present at 1.9%, coinciding with the overall inflation rate (see panel 1).

Panel 2 analyses the explanatory factors of core inflation in the period from 2002 to 2006, drawing on the estimation of a simple model for determining this variable[1]. As can be seen, the change in core inflation in the most recent period is essentially due to two factors. First, the changes in the most volatile elements of the HICP – whose influence is reflected by the term that measures the difference between overall inflation and core inflation – has had a positive effect on core inflation and, moreover, one that has grown in the final part of the period under analysis, characterised by successive rises in oil prices. Second, this effect has been partly offset by the negative contribution of the output gap since early 2005 which, nonetheless, has diminished in recent quarters as the economic recovery in the euro area has taken firmer hold. In any event, a negative though moderate residual can be seen from 2005 and, therefore, core inflation in these years has been less than what could be accounted for by its determinants. This may be linked to the presence of certain factors related to globalisation and greater worldwide competition, along with the significant wage moderation observed in recent years in the euro area. Such factors may have contributed to easing inflation and, in particular, to softening the indirect effects of past increases in the more volatile components (principally the price of energy) on final prices.

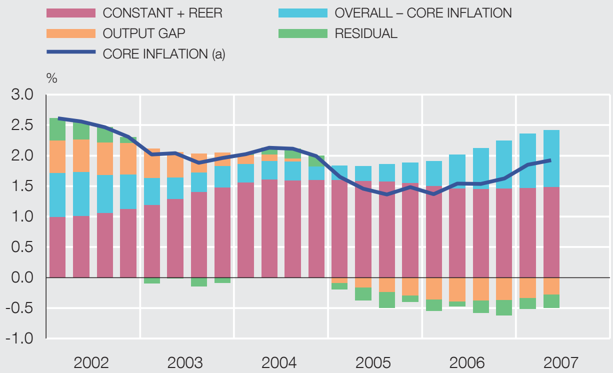
As regards the latest developments, the 3 pp rise in VAT in Germany – effective 1 January 2007 – has undoubtedly been one of the most significant factors behind the upward trend observed in core inflation, and in its main components (see panel 3). Firstly, before this tax measure came into force, tobacco prices rose significantly in Germany (standing

1. The estimated equation of core inflation determination replicates the methodology used by the OECD in box I.4 of the article entitled "Explaining Core Inflation", published in *Economic Outlook* no. 78.

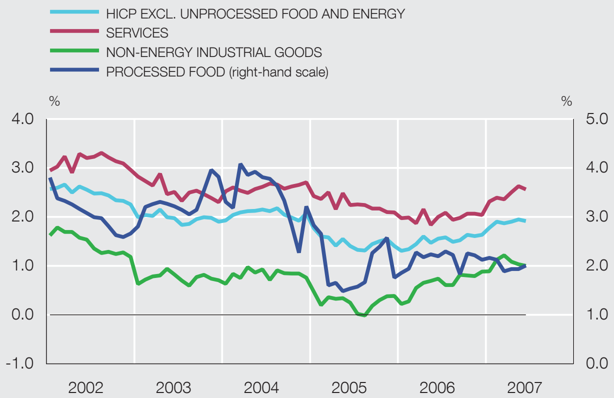
1 OVERALL INFLATION AND CORE INFLATION (a)



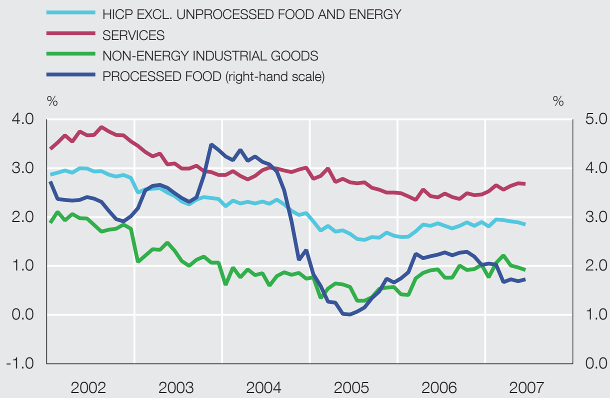
2 CONTRIBUTIONS TO CORE INFLATION (b)



3 MAIN COMPONENTS OF CORE INFLATION. EURO AREA (a)



4 MAIN COMPONENTS OF CORE INFLATION. EURO AREA EXCLUDING GERMANY (a)



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

a. Year-on-year rates of change.
b. Contributions to the year-on-year growth rate of core inflation obtained from an estimated equation for this variable using the differential between overall and core inflation, the output gap (difference between actual and potential GDP, as a percentage of potential GDP) and the real effective exchange rate as explanatory variables.

at close to 5% in October 2006) and certain items of the non-energy industrial goods component showed signs of an advance adjustment to the rise in VAT. But from January especially, the acceleration in the prices of non-energy industrial goods and of services has been clearly visible. On Bundesbank estimates[2], the rise in VAT may have contributed around 1 pp to the year-on-year growth rate of the German HICP in the opening months of 2007 (although part of this impact corresponds to the rises already anticipated in 2006 Q4). That entails adding approximately 0.3 pp to overall inflation in the euro area, and a significant portion of this increase to core inflation. However, the effect of the VAT rise on consumer prices, while notable, has been less than would have been the case with a full pass-through, which was estimated at 1.6 pp on top of the growth rate of the German HICP. This was largely possible thanks to the fact that the reduction in Social Security contributions paid by employers enabled the latter to absorb part of the tax effect, probably in an attempt to limit its negative impact on consumption by German households, the recovery in which is still incipient. Also, the possibility of certain lagged adjustments by consumer prices to this tax measure taking place over the rest of the year should not be ruled out. Elsewhere, the introduction of university charges in certain German regions prompted an increase in education prices of 25% last April, raising the year-on-year growth rate of services prices in Germany by 0.3 pp, and by 0.1 pp in the euro area as a whole.

Given Germany's importance in the behaviour shown by consumer prices and, in particular, by core inflation in the euro area as a whole, it is worth analysing how this variable trends if Germany is excluded from the aggregate (see panel 4). As can be seen, the rising trend observed in core inflation in the euro area from late 2006 proves less clear when price developments in Germany are not taken into account. In terms of components, although the prices of both services and non-energy industrial goods continue to show something of an accelerating profile (albeit milder than when Germany is included), this trend is partly offset by the slowdown in processed food prices.

In sum, wage moderation and heightening world competition may have contributed in recent years to maintaining core inflation at moderate levels, restricting the emergence of indirect effects associated with the continuing rises in oil prices. The very functioning of the Eurosystem's monetary policy, which has acted pre-emptively to ensure that the risks to price stability do not materialise, is proving conducive to such containment. However, in the current setting of robust economic expansion, growing capacity utilisation and diminishing labour market slack, there are risks that the still-incipient acceleration in the less volatile components of the HICP may begin to manifest itself more sharply.

2. See "Economic Conditions in Germany", *Deutsche Bundesbank Monthly Report*, May 2007, pp. 42-56.

The Commission's forecasts for the coming two years point to further cuts in the budget deficit, greater than those outlined in the latest updates of the stability programmes. The favourable economic situation and the drive to contain spending in some countries will enable the euro area budget deficit to settle at 1% and at 0.8% of GDP in 2007 and 2008, respectively. These estimates suggest that fiscal policy will adopt a slightly restrictive stance in 2007 and a neutral stance in 2008, but the budgetary plans of some member states will not be ambitious enough to comply with the Stability Pact. During "good times" (the wording adopted in the reformed text in 2005), then, a procyclical fiscal policy should be avoided; and, if the medium term objectives set in the stability programmes are not met, the improvement of the deficit should be expedited with a reduction of, at least, 0.5% of GDP in structural terms. These commitments were reaffirmed by the Eurogroup last spring, as part of its talks on the course of budgetary policies. However, the recent initiatives by the French and Italian governments, proposing tax cuts and the expansion of spending, entail a risk to compliance with this agreement, which might impair the credibility of the Pact following its reform.

As to countries with an excessive deficit, the European Commission forecasts that Italy will manage to reduce its deficit to below 3% of GDP in 2007, while further measures will be needed in Portugal to achieve this objective on schedule (in 2008). The procedure initiated against Greece and Germany was abrogated in June by the Ecofin Council.

3.2 Monetary and financial developments

The presence of risks to price stability, in a setting in which the economic expansion was firming, prompted a fresh adjustment of monetary conditions. At its meeting in June, the ECB Governing Council decided to increase its official interest rates by 25 bp, to 4% in the case of the main refinancing operations, to 3% for the deposit facility and to 5% for the marginal lending facility (see

EURO AREA INTEREST RATES CHART 12

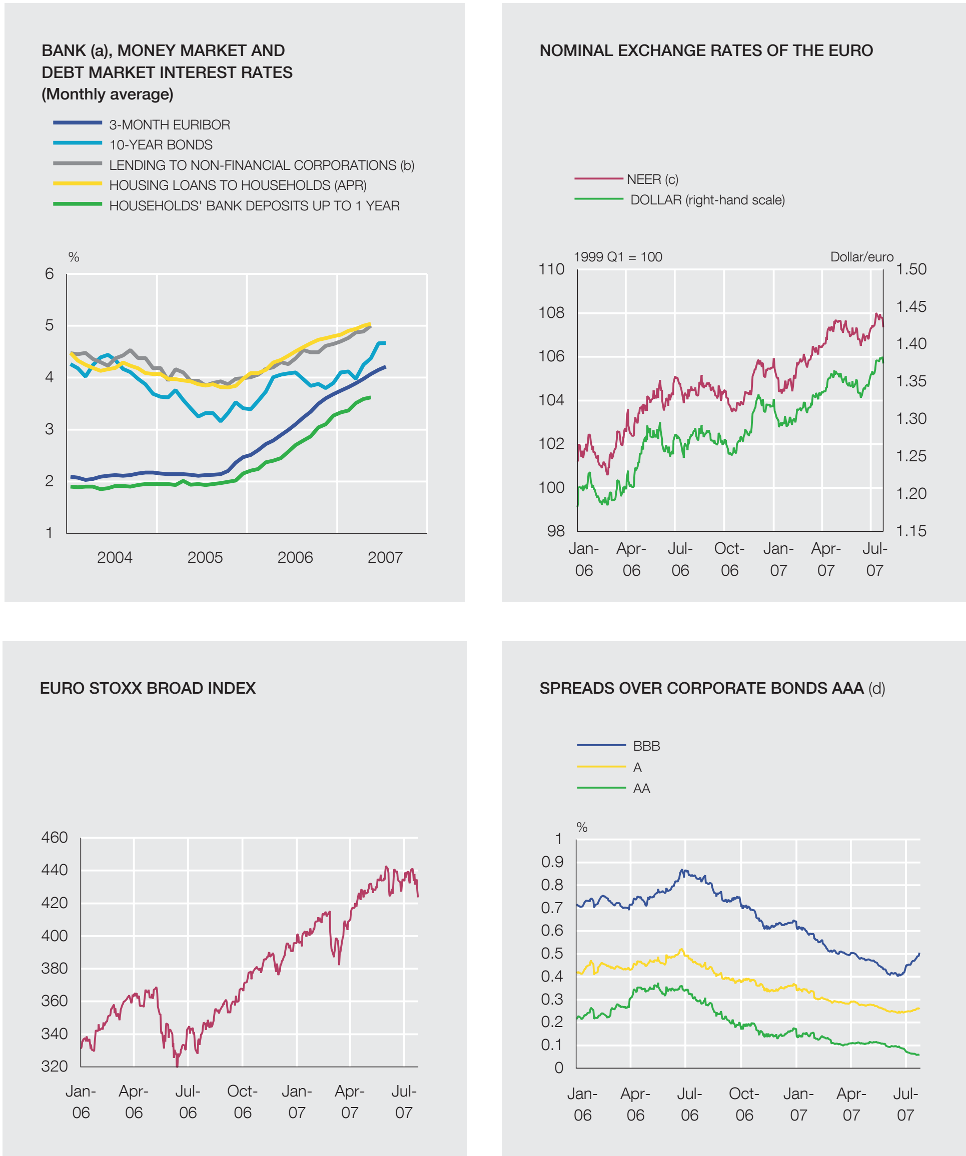
SOURCES:European Central Bank and Banco de España.

a. Estimated using Euribor data.

Chart 12). Following this increase, the second in 2007, the monetary policy stance in the euro area continues to be accommodative, bearing in mind the cyclical juncture of the economy.

The higher official rates and the expectations of further increases gave rise to an increase in interbank market yields, prompting an upward shift in the yield curve, with a slight recovery in the slope. From the end of March, the one-month and one-year Euribor rose by approximately 30 bp and 40 bp, to levels around 4.2% and 4.6%, respectively, in late July. Government bond market yields also moved on an upward path from late February, with that of the 10-year bond rising to around its current level of 4.7%. This rise was also seen in inflation-indexed bonds, suggesting that such developments are largely due to an adjustment by market participants of real rates to brighter economic prospects. The rise in the yield on 10-year bonds in the euro area, totalling more than half a percentage point, was somewhat more pronounced than that seen in the United States; accordingly, the spread has narrowed to a level around 45 bp. The developments in short- and long-term interest rates were accompanied in July by an increase in the spreads for corporate bonds at the lower end of the credit quality spectrum.

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



SOURCES: Banco de España and European Central Bank.

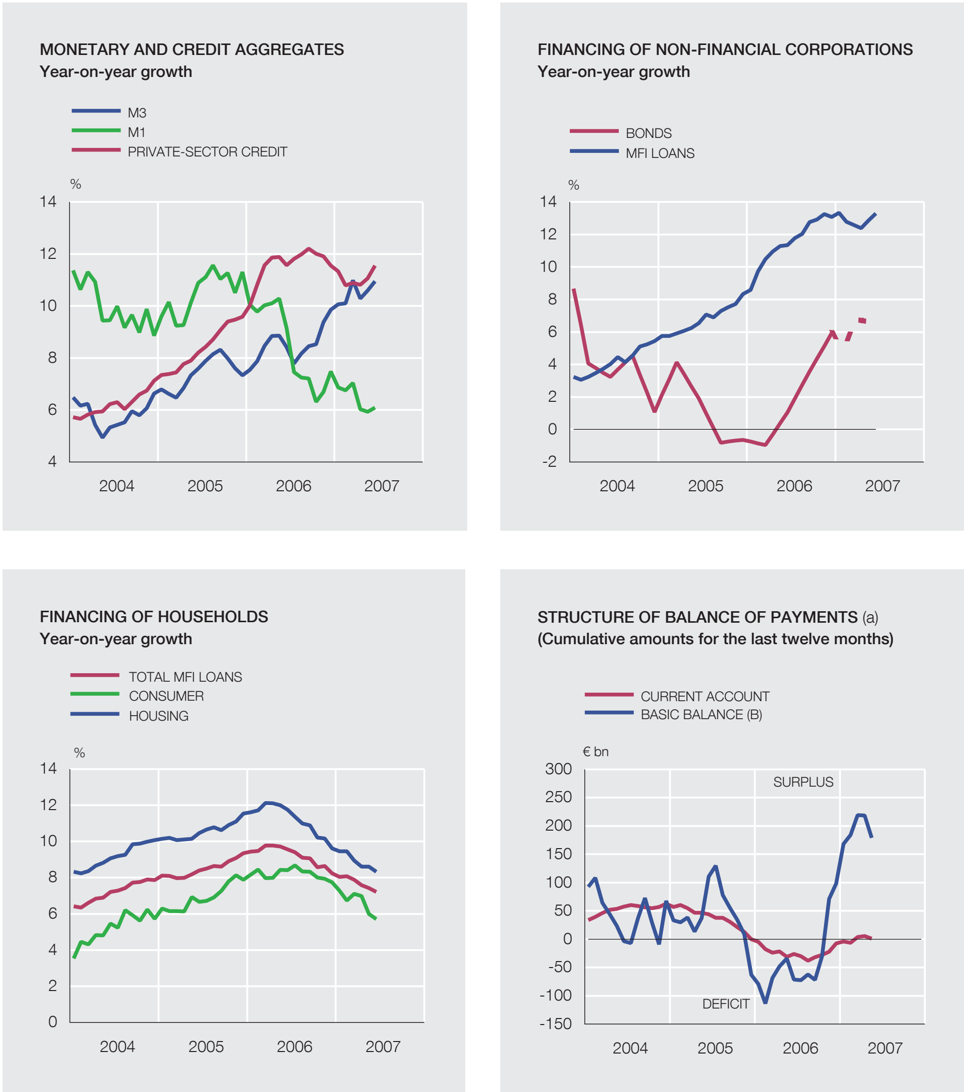
a. Data drawn from new statistics on interest rates compiled by the ECB for new operations.
b. Interest rates over five years.
c. Nominal effective exchange rate index (EER - 23). Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

Lastly, the interest rates set by banking institutions on their lending and deposit operations continued to be adjusted gradually upwards (see Chart 13).

As regards the exchange rate of the euro, the currency continued to appreciate during Q2, especially against the dollar and the yen; however, in nominal effective exchange rate terms the appreciation has been more moderate, totalling approximately 2% since the start of the year.

The equity markets posted rises over the course of Q2, underpinned by the growth of earnings and announcements of corporate operations. Since June, however, stock market indices have fluctuated frequently, accompanied by a rise in volatility. Further to these movements, the cumulative gains on the broad Dow Jones Euro Stoxx index are close to 7% for the year.

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS CHART 14



SOURCES: Banco de España and European Central Bank.

a. The dotted line is an estimate calculated using fixed income held by MFIs.
b. The basic balance is approximated by the sum of the balance on current account and direct and portfolio investment.

Economic strength and interest rates at moderate levels from a historical standpoint continued to make for marked dynamism in the monetary and credit aggregates. M3 showed year-on-year growth of 10.9% in June, 1.6 pp up on the end-2006 rate. That said, the most liquid components have actually slowed, consistent with the rises in interest rates. Regarding the counterparts, credit extended by the MFIs to the private sector and its most significant component – loans – sustained year-on-year growth rates of close to 11%. These developments were the result of an acceleration in loans extended to non-financial corporations, which posted growth in June of 13.3% year-on-year, 0.7 pp up on the end of Q1. In contrast, the increase in loans received by households eased slightly to a year-on-year rate of 7.2% in June, 0.7 pp down on the March figure.

On QNA estimates, in 2007 Q1 the growth rate of the Spanish economy continued to climb, to reach 4.1% in year-on-year terms, up from 4% in 2006 Q4 (see Chart 15). In quarter-on-quarter terms, growth was 1.1%. The restructuring of expenditure continued in that period since there was a slowdown in national demand and a further improvement in the contribution of net external demand to output against a backdrop of moderation in exports of goods and services and, to a greater extent, in imports. There were also changes in the composition of demand since the slowdown in private consumption which had begun in 2005 resumed, while investment became more buoyant, underpinned largely by its capital goods component since the pace of growth in construction slowed very slightly.

The information available for 2007 Q2 suggests that the Spanish economy remained expansive in that period and the estimate for year-on-year growth in GDP was approximately 4%, 0.1 pp lower than in Q1 (0.8%, in quarter-on-quarter terms). This result shows a slight moderation of national demand, both in terms of consumer spending and gross fixed capital formation. Investment in equipment seems to have held at around 11%, slightly lower than in 2007 Q1, whereas the slowdown in investment in construction seems to have been rather more pronounced with a real growth rate of approximately 5%. The contribution of net external demand (based on as yet incomplete data) seems to have stabilised at –0.7 pp, since both exports and imports of goods and services gained momentum following the small increases in Q1.

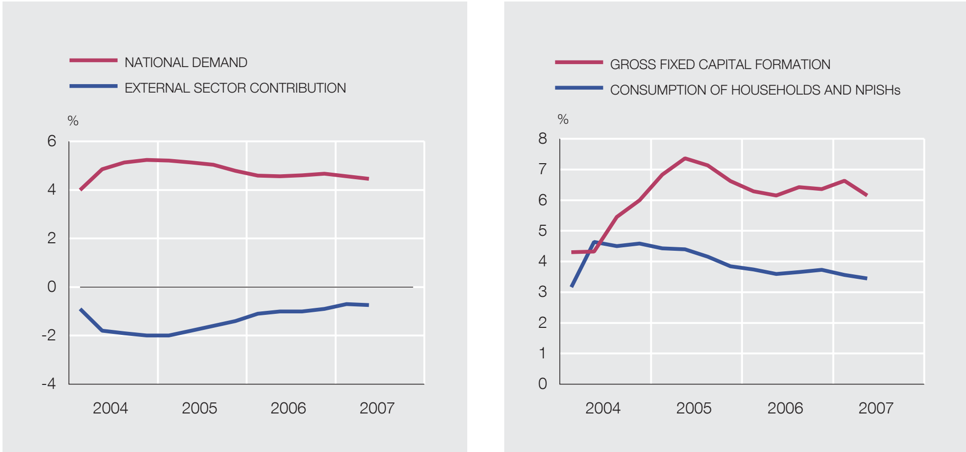
Highlights on the supply side include the buoyancy of the industry and services branches and the mild slowdown in activity in the construction sector. Information on the labour market indicates that employment began to reflect this change in composition. In this setting, there was sustained growth in employment and apparent labour productivity consolidated the previous quarter's improvement. Unit labour costs seem to have advanced at a similar pace as in Q1 and the year-on-year rate of change in the CPI ended 2007 Q2 at 2.4%, unchanged from the beginning of the year.

4.1 Demand

In 2007 Q1, the final consumption spending of Spanish households and NPISHs grew 3.6% year-on-year, 0.1 pp less than in the second half of 2006 (see Chart 16). The most recent conjunctural information points, in general, to a continuation of this mild slowdown in 2007 Q2. Specifically, the figures drawn from the tax authorities for large corporations' sales indicate a slight moderation in consumer goods and services in Q2. The retail sales index posted slightly lower growth in this period than in Q1, although confidence in the sector remained high. By component, the mild slowdown in consumer spending was felt more strongly in car sales, new car registrations in the April-June period fell for the second consecutive quarter. In contrast, purchases of other consumer durables retained some buoyancy.

The resilience of private consumption is increasingly underpinned by high growth in real household disposable income, driven by strong job creation, the moderation of inflation as compared with the rates posted in 2006 and lower taxes due to the personal income tax reform which came into force at the beginning of the year. Consequently, one would expect the slight drop in household confidence, against a backdrop of tighter financing conditions and slower growth in household real financial wealth, to be dampening their propensity to spend and triggering an upturn in the savings ratio, which has been on a downward track for several years. In fact, the non-financial accounts of institutional sectors available for 2007 Q1 reveal

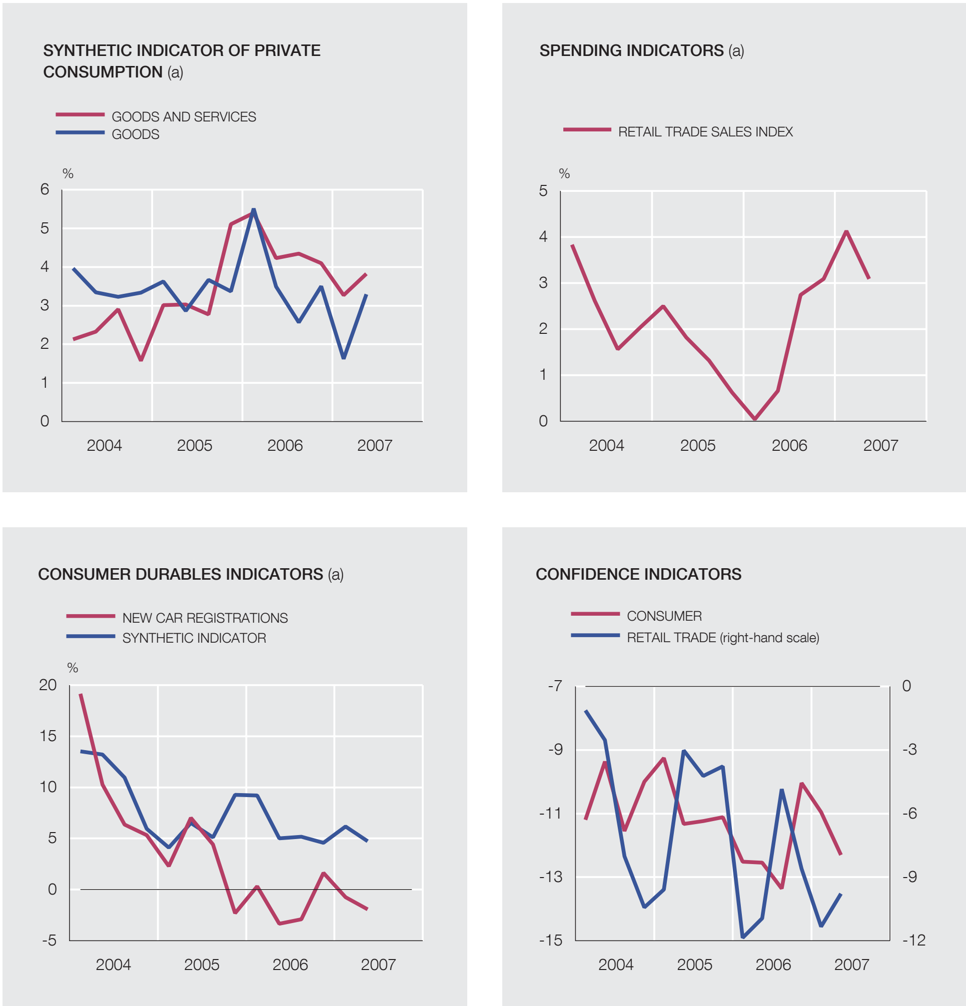
MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION INDICATORS CHART 16



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

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

GROSS FIXED CAPITAL FORMATION

CHART 17

SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.
b. Level of original series.

that the household saving ratio remained at 10.1% for the second consecutive quarter (in cumulative four quarter terms), stemming its uninterrupted slide since the beginning of 2004.

General government final consumption rose 0.3 pp in 2007 Q1 to 5.2%. This component is expected to slow in 2007 Q2 owing to a smaller increase in both employee compensation and net purchases of goods and services.

As mentioned above, gross fixed capital formation was notably buoyant in 2007 Q1 and grew 6.6% year-on-year, 0.2 pp more than at the end of 2006 (see Chart 17). This acceleration was based on higher growth in investment in capital goods and investment in other products, which climbed by 12.1% and 2.5%, respectively. Conversely, investment in construction slowed 0.1 pp, posting growth of 5.6%. The information provided by the indicators relating to the second quarter show that the rate of increase in gross fixed capital formation was high in 2007 Q2, although slightly lower than in 2007 Q1, as a result of milder growth in construction and capital goods expenditure, which, nevertheless remains the most dynamic component of domestic demand.

Indicators of investment in capital goods continue to emphasize the strength of the sector, although they are showing signs of easing slightly. Consequently, the rate of increase in the indicator of apparent investment in capital goods, calculated with as yet incomplete data for 2007 Q2, was lower due to the moderation of domestic production of this type of goods and weaker growth of imports following the extraordinary rise in 2007 Q1. Opinion indicators for this industry worsened slightly in Q2 yet remained high. The recent trend in investment in equipment continued to be underpinned by robust final demand, which pushed up the indicators of productive capacity utilization to record highs. This, in conjunction with high growth in business profits, underscores the existence of incentives to increase installed capital . However, the gradual rise in the financing requirements of non-financial corporations and the increase in the consequent financial burden in a setting of interest rate rises could curb their investment plans.

The pace of growth in investment in construction slackened slightly in 2007 Q1, as it did in the closing months of 2006, to 5.6% in year-on-year terms, 0.1 pp lower than the previous quarter. According to the latest conjunctural information, the slowdown in this investment component from mid-2006 seems to have continued in 2007 Q2. Intermediate consumption and employment indicators in the sector eased in Q2, maybe partly explained by highly adverse weather conditions in April and May. Industrial production of construction materials was lacklustre in those two months, whereas apparent cement consumption shrank in year-on-year terms for the quarter as a whole. The rate of increase of Social Security registrations fell 0.2 pp and registered unemployment increased, albeit it slightly, in year-on-year terms, following two years of continuous decline. In contrast, the business confidence index improved slightly in the same period.

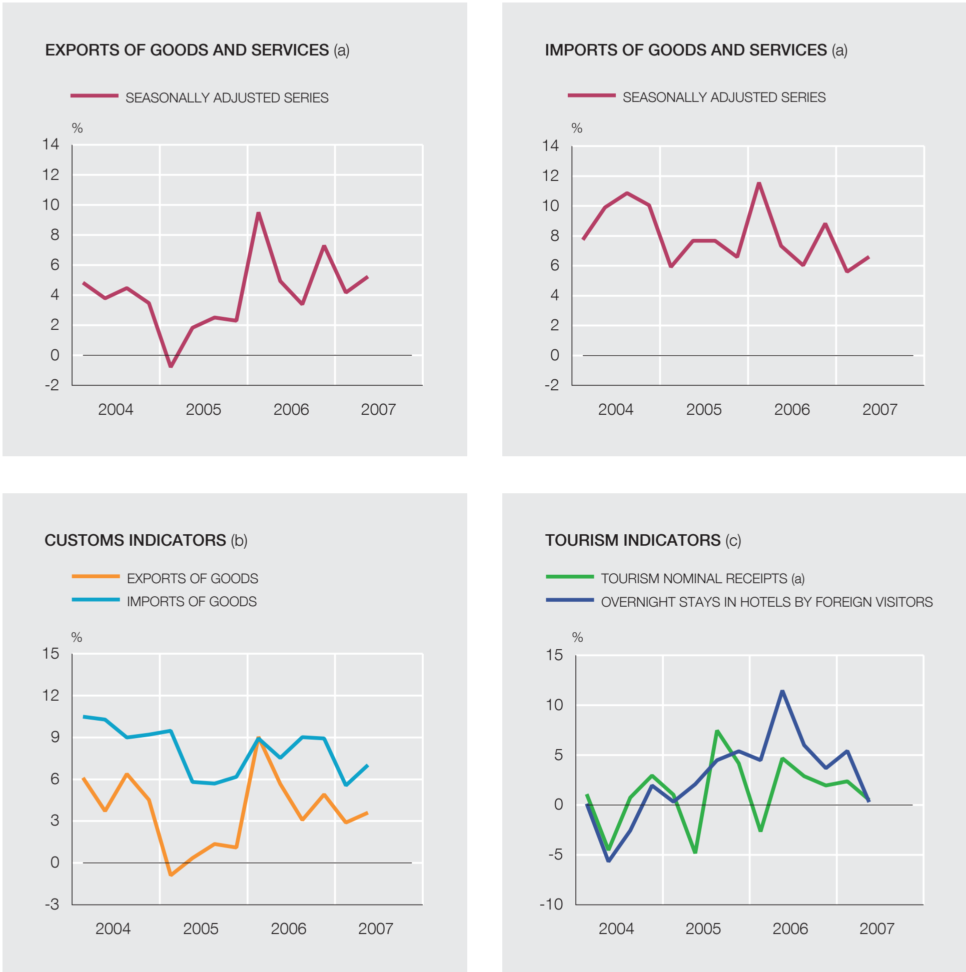
By type of work, estimated investment in housing was affected by the distortions introduced by the entry into force of the Technical Building Code with regard to work approved. However, the lack of momentum in demand which can be deduced from several indicators, such as the decrease in new home purchases, could give rise to a slowdown in the pace of completion of approved projects in line with the trend in the intermediate consumption and employment indicators for the same period. It is estimated that the rate of increase in other construction, although highly buoyant, eased due to the lower growth in civil construction following the high growth rates posted in previous quarters for projects whose target completion date was before the regional and local government elections held in May.

On the latest QNA data, the contribution of net external demand to GDP growth improved by 0.2 pp in 2007 Q1 to –0.7 pp, prolonging the correction that commenced in mid-2005 (see Chart 18). This took place in a setting of slowing exports and imports of goods and services whose year-on-year rates of change decreased by just over 3 pp (to 4.2% and 5.6%, respectively), partly due to the base effect resulting from comparison with the extraordinarily high levels posted in 2006 Q2. The as yet incomplete information for 2007 Q2 points to a mild slowdown in both exports and imports in that period, meaning that the contribution of net external demand seems to have held stable. According to estimates, exports posted real growth of nearly 5% in 2007 Q2, underpinned by the higher buoyancy of the goods component whereas tourist receipts were flat. The real growth rates of imports of goods and services seem to have remained slightly higher in the same period at above 6%, driven by the resilience of final demand and their lower prices in euro.

According to customs figures for foreign trade, after slowing in 2007 Q1, real goods exports picked up slightly in 2007 Q2, although their real rates of increase remained moderate at less than 5%. This is closely linked to the performance of world trade, which in the first half of 2007 posted growth of nearly 6%, in terms of volume, a lower rate than that recorded in the second half of 2006 (8%). By geographical area, the profile of exports to

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.

the euro area was relatively stable with moderate real growth rates of approximately 3%. The estimated share of Spanish products in this market, calculated on the basis of nominal foreign trade figures, seems to have stabilised following the decline in the three previous years. Outside the euro area the behaviour of exports was very uneven in the first five months of the year and included, most notably, flat exports to Japan and the US and high rates of increase in exports to China and Russia. By product group, the lack of dynamism spread to all components although worth noting is the drop in capital goods exports and, in particular, exports of shipbuilding material. Sales of non-energy intermediate goods remained the most dynamic item and car sales continued the expansion which began at end-2006.

Real exports of tourist services performed favourably in 2007 Q1 and increased by 2.4%, 0.4 pp up on end-2006. However, this expansion was discontinued in the second quarter as can be seen from the sector indicators. Accordingly, both the inflows of foreign tourists and their overnight stays in Spanish hotels remained practically flat in the second quarter. The Tourism Expenditure Survey (EGATUR) shows moderate rates of increase in total nominal expenditure and average spending per tourist in 2007 Q2. These results are influenced by comparison with the sound figures posted during the previous year's Easter holiday period and poor weather conditions in Spring 2007.

On QNA figures, real exports of non-tourist services grew 7.9% in 2007 Q1, a considerably lower rate than the 21.2% posted in the previous quarter. The scant information available for the second quarter is restricted to the nominal balance of payment figures for April. This component of external demand shows a highly expansive profile in this period with a strengthening of transport and business services.

In 2007 Q1, the year-on-year growth rate of real goods imports eased to 5.9%, down from 8.6% in 2006 Q4, thus ending the acceleration seen throughout the previous year. Customs data reveal that imports grew at higher rates in April and May, although the increase of their share in the supply of final demand seems to have fallen notably in comparison with 2006. Consequently, in the January-May period real imports grew by 7%, below the previous year's average increase of 8.6%. This essentially reflects flat consumer goods purchases in this period, influenced by the high concentration of textile imports in the early months of 2006, although car purchases also posted moderate rates of increase. Conversely, imports of capital goods and non-energy intermediate goods were notably vigorous in line with strong investment and industrial activity.

Lastly, real imports of services eased in 2007 Q1 and their year-on-year rate of increase stood at 4.4%, down from 9.8% in 2006 Q4, as a result of the slowdown in real imports of non-tourist services (to 3.5%), which, according to the latest balance of payment figures seems to have reversed in April. As for the main items of exports, there was a slight loss of momentum in transport and business services in the early months of the year whereas royalties slipped for the third consecutive quarter. Real imports of tourist services were stronger in the first quarter with a year-on-year growth rate of 9.2% in comparison with 7.3% in the previous quarter.

4.2 Output and employment

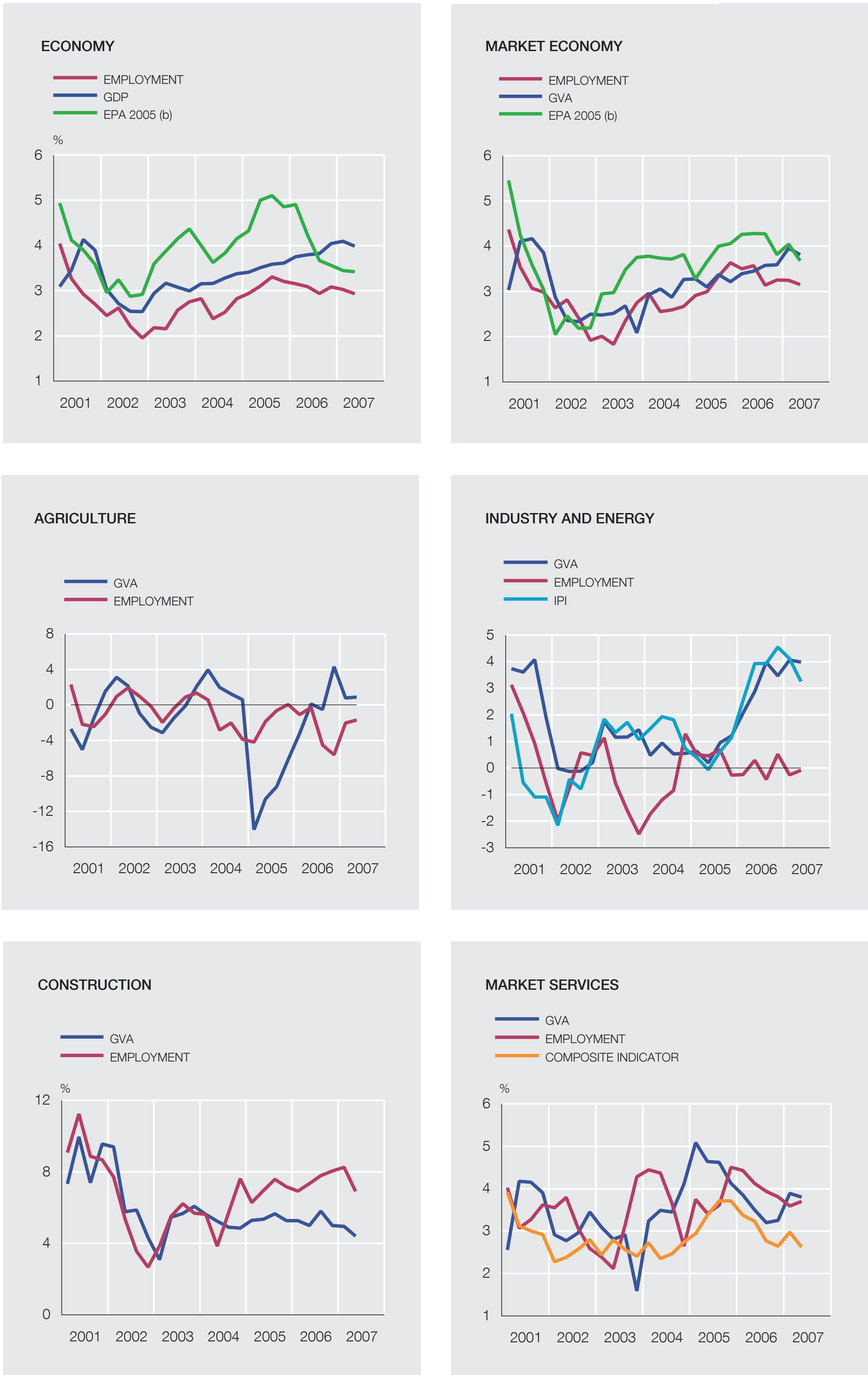
The market economy began 2007 with considerable momentum (see Chart 19). According to the QNA, its added value increased by 4% in year-on-year terms, 0.4 pp up on 2006 Q4. This rise was prompted by a stronger rate of increase in the industry, energy and market services branches, while the agriculture and fisheries branches and construction slowed down. Information available for Q2 reveals a moderation in the value added of the market branches in that period which was somewhat more pronounced in construction.

In 2007 Q1 the growth rates of value added in agriculture and fishing remained positive, albeit moderate, prompted by more favourable weather conditions for this activity. High rainfall last winter and spring pointed to a very favourable year for crops. However, these expectations were thwarted in May when flooding and other adverse weather conditions affected fruit and cereal output. Consequently, it is estimated that this branch maintained a moderate rate of increase in 2007 Q2.

The industry and energy branch quickened in 2007 Q1 and its rate of increase stood at 4.1%. The performance of the energy branch was affected by the relatively mild temperatures, as in 2006 Q4, which meant that energy requirements for heating fell with the consequent contraction in this branch's activity (–2.2% in 2007 Q1, 0.1 pp up on the previous quarter). In contrast, there was notable momentum in industrial activity which posted a growth rate of more than 5% for the first time since 2000. Contributing factors were the momentum of the production of goods destined for domestic consumption and construction, along with ongoing highly buoyant demand for domestic capital goods. Conjunctural information available for Q2 reveals slightly less expansive behaviour by industrial activity in line with other countries in the euro

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

CHART 19



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

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

area, although, in general, high growth rates prevailed. In particular, the non-energy component of the industrial production index slowed in April and May. Similarly, opinion-based indicators in the sector both in the case of the manufacturing PMI and the European Commission's industry confidence indicator show a slight decline in 2007 Q2.

The activity of the construction branch began the year with high growth rates (4.9% according to the QNA), although slightly down on previous quarters. As discussed in the previous section, according to the information available, this continued in 2007 Q2.

Services activity quickened in 2007 Q1 posting year-on-year growth of 4%, with market services, which grew 3.9%, being notably robust while non-market services slowed. As in industry, the momentum in market services in the early months of the year slackened slightly in Q2, as confirmed by several activity, employment and opinion-based indicators, although the Labour Force Survey data for 2007 Q2 showed a new rise in employment in this sector. The main factor behind this loss of momentum is the transport and communications sector which nonetheless continues to be the most expansive component of market services. The strength of the wholesale and retail trade and hotels and restaurants waned against a backdrop of slowing consumption by residents and non-residents. Finally, business services are the only sector to have grown stronger in the April-June period prompted, amongst other factors, by the sound performance of sales of services abroad.

In this expansive setting, employment was noticeably dynamic; in National Accounts terms in 2007 Q1 the rate of job creation[1] stood at 3% for the economy as a whole and at 3.2% for the market economy. In both cases, growth in employment was 0.1 pp lower than in the previous quarter, in contrast with the quickening of economic activity. This enabled apparent labour productivity to strengthen (it grew 1% in the economy as a whole and 0.7% in the market branches, slightly above the previous quarter's figures) as a result, among other factors, of the gradual refocusing of activity on industrial branches which in general have higher productivity levels. Also, in Q1, there was a mild moderation in the labour supply, since growth in the labour force stood at 2.8% which is lower than usual for recent years. As a result, the decline in unemployment increased (–4.1%), in spite of the slowdown in the pace of job creation. In any event, the rate of unemployment climbed to 8.5%, back in line with the average for 2006.

The information for 2007 Q2 shows a slight moderation in the rate of job creation in that period, albeit to levels similar to those at end-2006. In particular, year-on-year growth in Social Security registrations, both using month-end and average registrations, dropped slightly in Q2 to 3.3% in both cases. Hiring recorded by the INEM showed a slight fall of –0.1% in Q2, in comparison with the increase of 5.3% in Q1, so that the slowdown recorded at the beginning of the year, once the special period of exceptional rebates for permanent hires had ended, intensified. Finally, on EPA information for Q2, the rate of employment creation remained at 3.4%.

By productive branch, employment generating capacity continues to be concentrated in services and, in particular, construction, the already high buoyancy of this branch increasing once again in 2007 Q1. In more recent months, however, this branch has begun to show signs of a slowdown. Thus, on EPA figures, in 2007 Q2 employment in construction posted high growth of 7.7% which, nevertheless, represents a slowdown of 1.7 pp in comparison with 2007 Q1.

1. Measured by the number of full-time equivalent jobs.

Employment in the services branches quickened in this quarter and grew by 4.3%, as a result of the acceleration in the market and non-market branches. Conversely, EPA data do not confirm the recovery in industrial employment seen in Social Security registrations and employment dropped once again in year-on-year terms (by –1.3%). Lastly, in agriculture there was a sharp decline in employment of –3.8%, following the muted recovery in the preceding quarter.

As is usual in expansive phases, dependent employment was still more buoyant in the first half of the year than total employment, while growth in the self-employed segment remained notably flat. According to National Accounts data, in Q1 dependent employment increased by 3.4% in the economy as a whole and by 3.7% in the market economy, while growth in self-employment amounted to 0.9%. As a result, dependent employees as a proportion of total numbers employed stood at 82.3% in Q1, 0.4 pp up on the figure posted in the previous year. EPA information for Q2 once again shows higher growth in dependent employment (4.1%) than in total employment and very low growth in self-employment (0.4%).

Furthermore, the EPA data underscore certain changes in the structure of employment by contract duration and according to whether it is full-time or part-time. Consequently, in 2007 Q2 the number of dependent employees with a permanent contract grew by 8.2%, once again a higher rate than growth in temporary employment, which in fact decreased by 3.6% in year-on-year terms. Nevertheless, the ratio of temporary to total employees only dropped 0.2 pp from the Q1 figure, to 31.8%, although it stood at 2.6 pp below its level one year ago. This decrease in the ratio of temporary to total employment reflects the strong rise in permanent hires recorded by the INEM statistics on contracts in the closing months of 2006 given the special rebates available for converting temporary contracts into permanent ones until 31 December. In the first half of 2007, once these arrangements had ended, there was a slowdown in permanent hires which, nonetheless continued to show high rates of change in contrast to the fall in temporary contracts. Lastly, there was a high rate of change in the number of full-time employees (3.7%), while the number of part-time employees eased notably in the quarter and grew by 1.5%, pushing the ratio of part-time to total workers down to 12%, nearly 0.5 pp lower than in Q1.

Finally, the rate of increase in the labour force remained stable at 2.8% in 2007 Q2, which seems to confirm lower dynamism than in recent years. This is explained by a smaller increase of 0.6 pp in the participation rate, since the labour force quickened in the quarter and grew by 1.8%. in year-on-year terms. According to the breakdown by sex, the female labour force was more buoyant than the male one, although it eased in this quarter and grew at a notably lower rate than in recent years (3.4%). The female participation rate climbed to 48.8%, 0.8 pp up on one year ago, while the male participation rate increased 0.2 pp to 69.3%. By nationality, the growth rate in the foreign labour force remained stable in the quarter (15.9%), while the Spanish labour force grew by a modest 1.2%. Box 4 evaluates the contribution of the non-resident population to geographic labour mobility.

Lastly, in Q2 the number of unemployed fell 4.2%, a rate of decline similar to the previous quarter. The unemployment rate fell to 8%, 0.5 pp lower than that posted in Q1 and an historically low level. Registered unemployment behaved less favourably, its rate of decline falling progressively, and in June the year-on-year rate of change was positive again unlike during the whole of last year.

4.3 Costs and prices

In 2007 Q1 growth in compensation per employee, which had quickened in 2006, dipped to 3.5%, 0.3 pp down on the previous quarter (see Chart 20). The behaviour by branch of activity was very uneven, the rate of increase in compensation in non-market services was

Internal population mobility may be a highly important factor for reducing differentials in employment or unemployment rates between towns or regions. In the case of Spain, the findings of various studies[1] show, however, that internal migration of the Spanish population does not seem to have contributed in the past to reducing these differentials since, in addition to being small, population movements do not seem to have been linked to regional variables of the labour market.

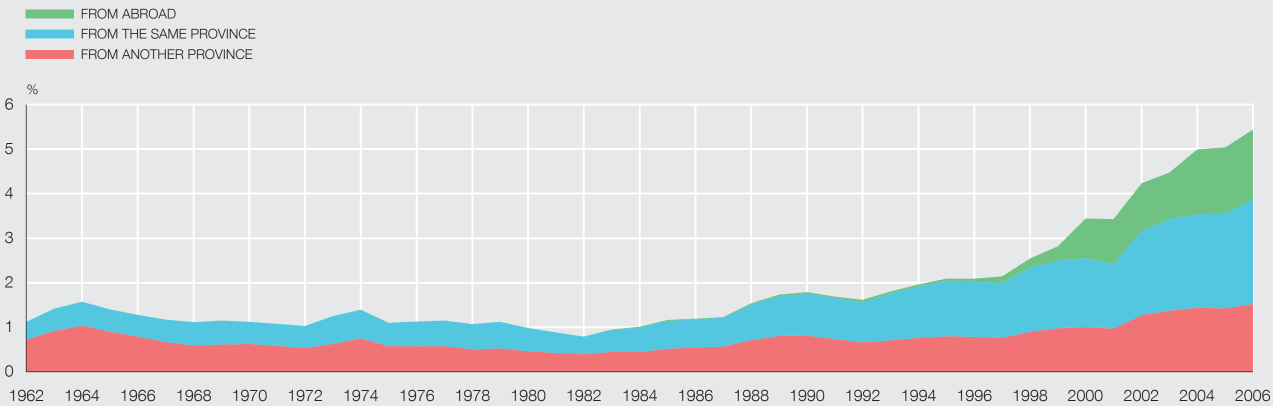
The phenomenon of immigration could, however, change these findings to the extent that this group might be more geographically mobile and might react more to regional labour market conditions. The immigrant population generally has a set of characteristics, at least during its initial years in Spain, which could make it more inclined to migrate internally. In these initial years, the immigrant population has, for example, fewer social or family constraints and lower employment stability which could favour greater geographic mobility. Similarly, the immigrant population's initial decision to reside in a given country might be expected to be strongly linked to the labour market situation to the extent that the initial motivation for immigration is mainly to find work. Subsequently, once settled in Spain, the immigrant population could also react more to changes in the relative labour conditions in its region of residence[2]. A preliminary analysis of this issue has been made in this box.

The Spanish population has traditionally been characterised by low levels of geographical mobility, which seem to have increased in recent years. Population movements between towns remained at slightly above 1% of the population between 1960 and 1985, posting a slight upward trend from the mid-eighties to reach 2% in 1996. This trend has quickened since then, the level reaching almost 4% in 2006 (see accompanying chart). The increase seen in internal population movements in the last decade has coincided with a large rise in the number of immigrants from abroad which could suggest that these phenomena are linked. The available data seem to confirm this hypothesis: whereas the internal mobility of the Spanish population does not exceed 3%, when both interprovincial and intraprovincial movements are included, that of the foreign population is nearly four times higher and stands at 11% (see lower right panel of accompanying chart), which implies that this group has contributed nearly 1 pp to the above-mentioned rise in internal mobility in Spain. The analysis of the breakdown of population movements, be they interprovincial or intraprovincial shows,

1. Bover and Velilla (1999), *Migrations in Spain: Historical background and current trends,* Working Document No. 9909, Banco de España or in Bentolila (2001), *Las migraciones interiores en España, Documento de Trabajo* 2001-07 FEDEA.

2. As a result, for example, of their lower employment stability, mentioned above, or the lower likelihood of them having access to the social benefit system due to their shorter working life.

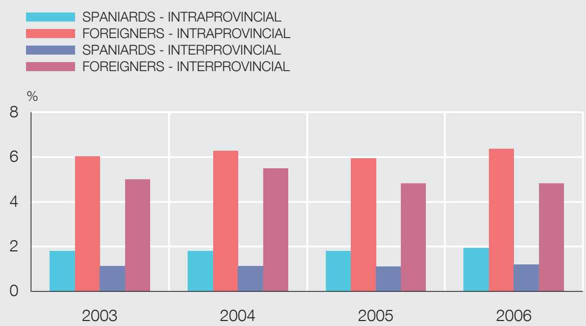
NET MIGRATORY BALANCE BY ORIGIN
% of population



THE RELATIONSHIP BETWEEN MIGRATION IN 2006 AND THE LABOUR MARKET IN 2005

	DISTRIBUTION BY PROVINCE OF INFLOWS OF			RATE BY PROVINCE OF OUTFLOWS OF	
	Foreigners		Spaniards	Foreigners	Spaniards
Correlation	From abroad	From other provinces	From other provinces	To other provinces	To other provinces
Participation rate	0.46	0.52	0.45	-0.68	-0.07
Employment rate	0.46	0.52	0.40	-0.61	-0.09
Unemployment rate	-0.19	-0.22	-0.06	0.14	0.06
Distribution of stock of foreigners in 1998	0.92	0.88		-0.51	

AVERAGE PROPENSITY TO MIGRATE WITHIN SPAIN BY NATIONALITY
As a percentage of the related population group



SOURCE: Banco de España.

however, that both for the Spanish and foreign population, the highest number of movements takes place within the same province.

As regards the relationship between these movements and the labour market situation, the accompanying table includes correlations of interprovincial inflows and outflows by nationality with certain labour variables at provincial level. There is a positive correlation between the participation rate and employment rate of a province and the amount of immigrants it attracts from abroad. This relationship is negative for the rate of unemployment, as expected, although the figure is considerably lower. As shown by the last row of the table, the factor which seems most important when choosing the initial province of residence is the number of immigrants already residing there[3]. Once immigrants reside in Spain, this factor is less important when explaining their internal migrations and employment variables tend to become more important. This is particularly true in the case of outflows of population at provincial level, which in the case of the foreign population are negatively correlated with the participation and employment rates of the province[4], whereas for the Spanish population this relationship is practically nil. The correlation of inflows of foreign population with employment variables is also higher, although the differences in behaviour in comparison with the national population are low.

In short, the internal mobility of the foreign population is almost four times higher than that of the Spanish population which has made a decisive contribution to explaining the rise in internal population mobility in Spain in the last 10 years. As for the relationship between this internal mobility and the differences observed in labour markets at provincial level, foreign workers seem to respond to a greater extent to the employment conditions of provincial markets, at least in the first few years they are in Spain, which could contribute to the reduction of the marked differentials in existing employment and unemployment rates. In any event, the results presented in this box are a preliminary analysis and in order to confirm them it would be necessary to undertake a more detailed empirical study of the determining factors of internal migrations and the impact of foreign immigration.

3. 1998 was the year chosen to calculate the initial stock of immigrants being the year prior to Spain's migratory boom. The high correlation still exists when different nationalities are taken into account.

4. The same result is found in more detailed articles such as De la Rica y Amuedo Dorantes (2005), *Immigrants' Responsiveness to Labour Market Conditions and Its Implications on Regional Disparities: Evidence from Spain,* IZA Discussion Paper 1557.

contained, while growth in compensation in the market economy held steady at above 3%, for the third consecutive quarter. Within the market economy the growth in compensation per employee eased in agriculture and industry to rates of 2.6% and 2.8%, respectively, while in construction and sales-related services the year-on-year rate of change rose to 4.1% and 3%.

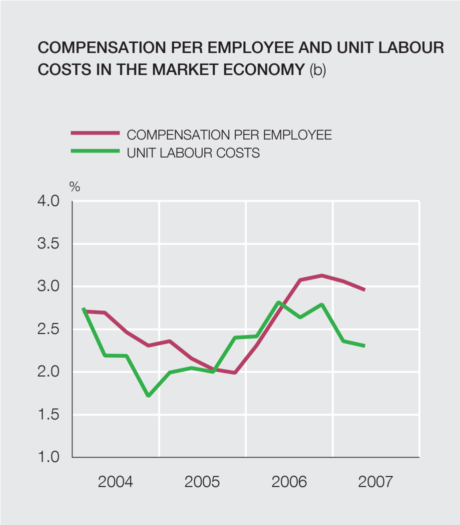
The information available for Q2 points to stable growth in compensation per employee in that period of approximately 3.5%, down on that posted in the second half of 2006. The collective bargaining agreements registered in the first five months of 2007 show high stability in the wage settlements which remained at approximately 2.9%. This is lower than in previous years but in line with the guidelines on wages of the Interconfederal Agreement for Collective Bargaining which was extended at the beginning of the year by the main social agents. This slowdown in wage settlements was common to all branches, except for construction. In addition there is the estimated effect of the 2006 indexation clause amounting to 0.3 pp, which is considerably lower than that of the previous year (0.9pp), mainly due to the lower inflation at end-2006 (2.7% in December, one point down on 2005)[2]. The incidence of these clauses continues to be significant in the current year; they affect 65.8% of employees with a collective bargaining agreement registered between January and May.

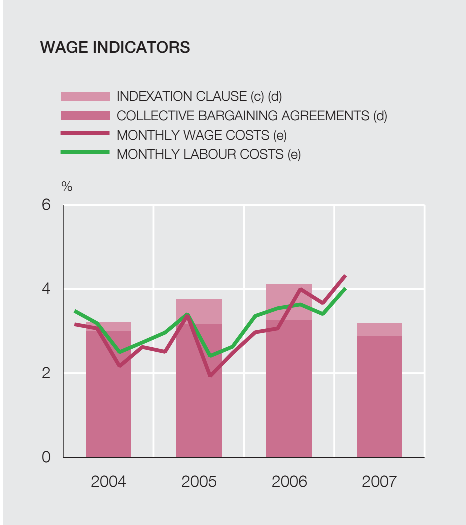
Lower growth in compensation per employee and the recovery of apparent productivity made it possible for unit labour costs in the first half of the year to abandon the upward path they had

2. It should be noted that the impact of these clauses will be reflected in other wage statistics in the year in which said payments are made, namely in 2007.

WAGES AND LABOUR COSTS (a)

CHART 20





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

a. Percentage change on same period a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information from collective bargaining agreements to May 2007.
d. Previous year's indexation clause.
e. ETCL (quarterly labour costs survey).

followed in the previous two years. Growth in unit labour costs stood at approximately 2.5% (see Chart 21). This easing of unit labour costs fed through to prices, although further widening of operating margins can also be seen. Growth in margins has only slowed down in construction against a backdrop of easing demand.

It is estimated that in 2007 Q2 almost all the components of the final demand deflator continued to move along the slowing path which had begun in the second half of 2006, although the decline in their year-on-year rates of change was more moderate than in Q1. For the first six months of the year the slowdown in inflation was sharper in the case of imports, influenced by the appreciation of the euro and base effects arising from lower oil prices posted throughout 2007 in comparison with a year earlier. Finally, the rate of increase in the GDP deflator slowed 0.3 pp in Q1 and subsequently held steady with year-on-year growth of approximately 3.3%.

In general, in Q2 all the price indicators tended to moderate the downward profile they have shown since the second half of 2006 (see Chart 22). Specifically, the year-on-year growth rate in the CPI fell 0.2 pp in Q1 to 2.4% and no additional improvements were seen in Q2 due to the rise in oil prices on international markets and the increase in unprocessed food price inflation (see Box 5). By component, energy products became more expensive in Q2, although their growth rate remained negative in year-on-year terms (–1.1%), similar to 2007 Q1. This is a result of the behaviour of oil prices on international markets, which began the year on a downward tack but climbed subsequently to approximately $73 per barrel in June and pushed even higher in July. This occurred even though the appreciation of the euro against the dollar partially offset growth in the energy bill. The upward trend in energy prices coincided with the quickening of unprocessed food prices, which in 2007 were the most inflationary component of the CPI, with an average year-on-year growth rate of 5.8% in Q2 in comparison with 4.1% in Q1. Services prices remained anchored at rates of slightly less than 4%, reflecting the continued high growth in the prices of services linked to tourism and hotels and restaurants and,

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.

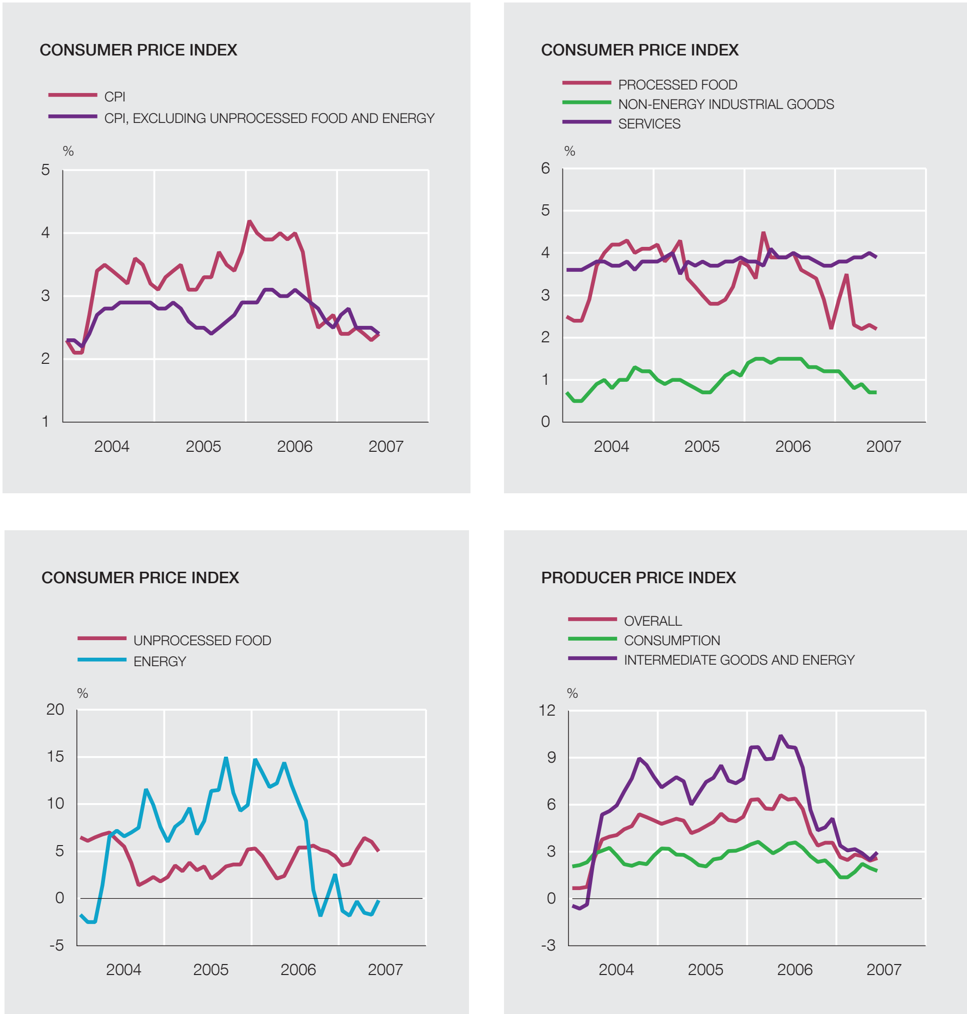
in recent months, the rise in the prices of telephone services, which abandoned the negative year-on-year growth rates of recent years. Conversely, other components performed more favourably: processed food prices slowed 0.7 pp in Q2 to a year-on-year average rate of 2.2%, while the year-on-year growth rate of non-energy industrial goods once again dipped by 0.2 pp in Q2 to 0.8% and there was a significant drop in the prices of electronic and computer goods.

Measured by the HICP, inflation in Spain remained stable at 2.5% in 2007 Q2, while for the euro area as a whole it held steady at 1.9% (see Chart 23). Consequently, the differential was unchanged at 0.6 pp, the lowest level of the last three years (see Chart 23). The stability of the inflation differential in the first half of the year is the result of an upturn in the energy price differential, although it remains negative, which was offset by the improvement of the relative prices of non-energy industrial goods, whose differential has been negative since March. Conversely, the services differential remains high, although slightly more moderate than the average for last year.

Lastly, the producer price index (PPI) slowed in Q2 and its year-on-year growth rate stood at 2.4% in June, in comparison with 2.8% at the end of Q1. The declining path followed by this indicator in the last twelve months is due largely to lower dynamism in energy production prices. Even so, the most notable feature of producer prices in recent months is the high

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

growth rates of nearly 6% in intermediate goods prices. This phenomenon is common to other developed countries and arises from the upward path in industrial raw materials prices on international markets in a setting of high growth in worldwide industrial activity. The increase in industrial export prices, albeit smaller than in 2006, remained at approximately 2% and is also underpinned by high growth in non-energy intermediate product prices since the growth rates of the other components of exports remained very moderate or even negative. By contrast, industrial imports prices seemed to maintain a very moderate rate of increase until May, with practically flat rates as a result of the appreciation of the euro and, in particular, the decrease posted by imported energy prices in that period.

4.4 The State budget

The figures published, in accordance with the methodology of the Excessive Deficit Procedure, on the State budget outturn to June 2007 show a surplus of €6,075 million (0.6% of GDP), notably higher than the €2,569 million surplus (0.3% of GDP) obtained in the first half of 2006. This was due to strong direct taxes which drove growth in revenue to 12.4%, while expenditure climbed 7% in line with GDP. The State's cash-basis balance improved notably in comparison with the same period in 2006 and posted a surplus of €4,168 million as against the surplus of €1,153 million to June 2006. Strong revenues, in comparison with budgeted

Since the beginning of monetary union, unprocessed food prices in Spain have tended to post substantially higher rates of change than the overall Consumer Price Index (CPI) which makes it difficult to reduce the latter. Average CPI growth of unprocessed food for the 1999-2007 period was 4.8%, 1.7 pp above the overall inflation rate and also above the other principal components of the CPI (see Chart 1). Similarly, increases in unprocessed food prices in the Spanish economy have persistently been higher than in the euro area as a whole contributing to the maintenance of a positive inflation differential in terms of the harmonised consumer price index (HCPI). In the common currency period, the average price differential for these products was 1.7 pp in comparison with 1.1 pp for the overall index. Logically, as a result of this greater increase in prices, Spanish prices levels are catching up with those of other EU countries (a process also seen across Europe), although prices in Spain continue to be lower. According to the results of the harmonised survey of prices levels conducted by National Statistics Institutes in 2006, food and non-alcoholic beverage prices were 8% lower in Spain than in the EU 27 and 13% lower than in the EU 15; in 2003 prices in Spain were 22% lower than in the EU 15 (see Table 1).

In the most recent period, the trend in unprocessed food prices was particularly unfavourable. While the overall CPI eased from 2006 Q2, when it increased by 3.9%, to 2.4% in 2007 Q2, unprocessed food prices climbed from 2.8% to 5.8%. Furthermore, this rise was higher than that posted against the euro area with the result that the differential of this component increased to 1.7 pp.

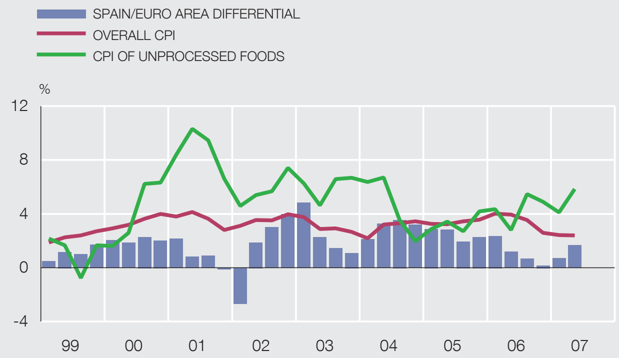
This cannot be explained by an acceleration in distribution margins in view of the latest indicator of the trend in commercial margins of fresh food products prepared by the Ministerio de Industria, Turismo y Comercio. This indicator approximates the trend in the gross retail margin obtained as the difference between the producer price and the retail sale price. In 2007 Q2 this index stood at 100.4, practically the same level as in 2006 Q2 (100.8).

The recent upward trend in unprocessed food prices does not seem to reflect higher salary increases in the agricultural branches since Quarterly Spanish National Accounts estimates show a slight slowdown in compensation per employee in recent quarters. Conversely, some pressure can be seen in certain non-wage costs such as livestock inputs. Consequently, food raw material indexes on international markets have shown notable growth as have domestic feed prices.

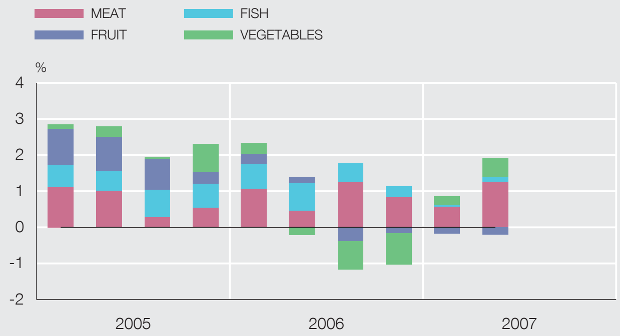
The price rises in cereal, feed and, indirectly, livestock products can be expected to be increasingly important in the future. The worldwide upward trend in bio-fuel production means greater demand for certain agricultural products such as cereals, sugar, oleaginous seeds and vegetable oils. Over the next few years, efforts to reduce greenhouse gases under the Kyoto Protocol will lead to the further replacement of fossil fuels by bio-fuels. According to estimates of the recently approved Action Plan of the Saving and Energy Efficiency Strategy for 2008-2012, penetration of bio-fuels may reach 8% of the total in 2012, as against current penetration of 1%.

Within unprocessed food, uneven price growth and trends can be seen in the recent period. Meat prices have tended to post increases of over 5% and represent the main factor which determines the unprocessed food price differential with the euro area (see Chart 2). Particularly notable is the rise in the price of chicken, which surged by nearly 20% in March 2007 and currently stands at 8% in year-on-year terms. Supply of this product seems to remain limited since certain producers delayed the start-up of production following the avian flu crisis and rising feed prices. Vegetable prices quickened markedly, which worsened the differential with the euro area as a whole, and the increase in potato prices was particularly noticeable and even exceeded 20%. Low European production due to the hot, dry climate last summer in central Europe seems to be the main reason for this. Likewise fruit prices have continued to follow an upward track, as in other euro area countries. Lastly, fish prices eased in the most recent period, to an even greater extent than in the euro area.

1 CONSUMER PRICES AND DIFFERENTIAL WITH THE EURO AREA



2 CONTRIBUTIONS TO THE DIFFERENTIAL



1 PRICE LEVELS

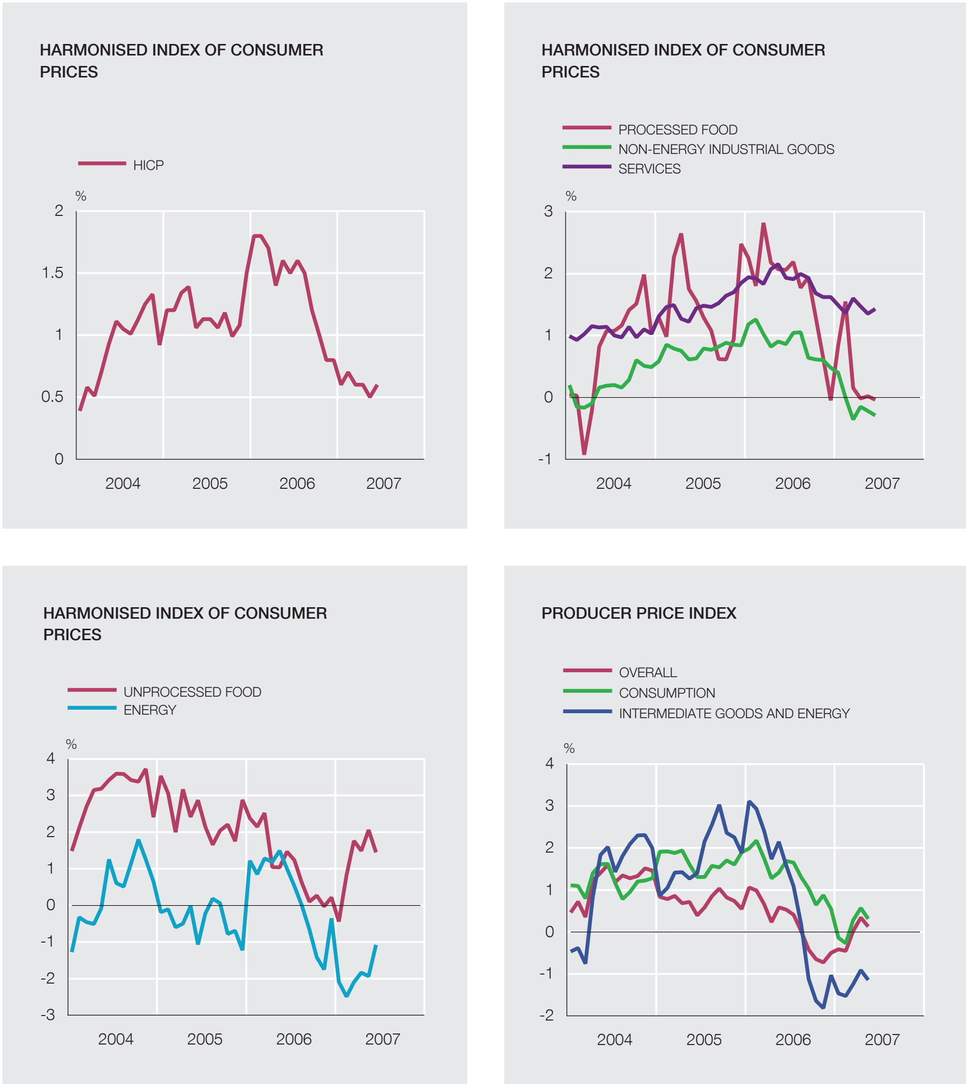
	EU15 = 100 (a)			EU27 = 100
	2001	2003	2006	2006
FOOD AND NON-ALCOHOLIC BEVERAGES	81	78	87	92
MEAT	69	67	76	81
FISH	90	70	84	89
FRUIT AND VEGETABLES (b)	83	82	90	95

SOURCES: Eurostat and Banco de España.

a. The indexes based on EU15 for 2001 and 2003 are in-house estimates.
b. The figure for fruit and vegetables for 2001 and 2003 was obtained as an average.

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.

rates, indicates a better-than-forecast outturn for the year as a whole, despite the probable slowdown in personal income tax and corporate income tax over the next few months due to the reform of both taxes introduced at the beginning of the year. In any event, the buoyancy of withholdings on investment income and leases (partly due to higher rates) in the case of both taxes is notably softening the impact of the lower rates on other withholdings and prepayments. There has also been a notable improvement in the Social Security budget outturn as shown in Box 6.

In cash-basis terms, State revenue climbed by 12.7% to June as a result of the dynamism of the main taxes, marking a clear difference from the budgeted increase of 3.3% for the year as a whole. Direct taxes in particular posted considerably higher-than-budgeted growth while indirect taxes were slightly more in keeping with budget projections, although their performance was also better than forecast. Personal income tax quickened slightly in Q2 to 15.3%, due to the acceleration posted in withholdings on investment income and leases which amply offset the slowdown in withholdings on income from work. Average growth in withholdings on

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2006	Percentage change 2006/2005	Initial Budget 2007	Percentage change 2007/2006	Outturn JAN-MAR Percentage change 2007/2006	Outturn 2006 JAN-JUN	Outturn 2007 JAN-JUN	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	141,846	10.1	146,547	3.3	13.6	61,315	69,126	12.7
Direct taxes	81,130	14.8	83,925	3.4	16.5	27,130	32,003	18.0
Personal income tax	*41,451*	*15.3*	*39,474*	*-4.8*	*14.4*	*18,593*	*21,445*	*15.3*
Corporate income tax	*37,207*	*14.5*	*41,641*	*11.9*	*40.3*	*7,293*	*8,937*	*22.5*
Other (a)	*2,472*	*11.5*	*2,810*	*13.7*	*21.9*	*1,244*	*1,621*	*30.3*
Indirect taxes	48,328	8.3	50,740	5.0	10.1	28,542	30,515	6.9
VAT	*35,424*	*10.7*	*36,538*	*3.1*	*10.0*	*22,334*	*23,567*	*5.5*
Excise duties	*9,895*	*1.0*	*10,961*	*10.8*	*11.9*	*4,710*	*5,386*	*14.4*
Other (b)	*3,009*	*7.0*	*3,241*	*7.7*	*6.0*	*1,498*	*1,561*	*4.2*
Other net revenue	12,388	-8.2	11,882	-4.1	21.6	5,643	6,608	17.1
2 EXPENDITURE	130,375	6.2	142,927	9.6	7.4	60,162	64,958	8.0
Wages and salaries	22,209	7.4	23,686	6.7	5.3	10,999	11,722	6.6
Goods and services	3,799	12.1	3,431	-9.7	12.3	1,640	1,956	19.3
Interest payments	15,619	-12.4	15,946	2.1	-9.4	7,484	6,521	-12.9
Current transfers	72,225	11.9	77,338	7.1	9.8	33,207	36,467	9.8
Contingency fund and other unforeseen expenses	—	—	3,028	—	—	—	—	—
Investment	9,037	0.7	9,956	10.2	19.6	3,889	4,601	18.3
Capital transfers	7,487	2.0	9,541	27.4	37.9	2,944	3,692	25.4
3 CASH-BASIS BALANCE (3 = 1 – 2)	11,471	—	3,620	—	—	1,153	4,168	—
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	147,205	13.1	146,328	-0.6	13.3	62,595	70,332	12.4
Uses	140,135	10.6	144,152	2.9	7.6	60,026	64,257	7.0
NET LENDING (+) OR BORROWING (–)								
	7,070	—	2,176	—	—	2,569	6,075	—
(as a percentage of GDP)	0.8	—	0.2	—	—	0.3	0.6	—

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.

income from work between February and June, applying the new personal income tax rates, stood at 8.5% in comparison with the same period last year, whereas they grew by 11.3% in 2006. Corporate income tax slowed following the first prepayment in April to growth of 22.5%. Indirect taxes posted slightly more restrained growth and slowed with respect to Q1, due in particular to the behaviour of VAT. Nevertheless, the recovery in excise duties should be noted; they grew by 14.4% in contrast to the weak growth of recent years (of approximately 3%). As regards the items under the *Other revenue* heading, the strong increase in interest payments (of more than 80%) and capital transfers from ERDF funds are worth noting.

Cash-basis expenditure quickened slightly in Q2 although the rate of change was lower than budgeted. This acceleration was determined by operating costs (wages and salaries and goods and services), partly linked to election costs. In particular, the deviation in goods and services from the budgeted decline is worth noting. Conversely, the *Interest payments* heading posted a fall of 12.9% as against a budgeted increase of 2.1%, since the recording of cash

The Social Security System posted a surplus of €9,676 million to April 2007, 14.8% up on the same period a year earlier. Revenue increased by 8.5% to April with respect to the same month in 2006, while the increase in expenditure amounted to 6.4% (see accompanying table).

Revenue from social security contributions increased by 7.5% to April, below the rate budgeted for 2007 as a whole. The number of Social Security registrations grew by 3.8% in the first half of the year, once the effects of the immigrant regularisation process had petered out, underscoring the high buoyancy of the labour market.

Turning to expenditure, that on contributory pensions grew by 6.7% to April, significantly lower than the rate budgeted for the year as a whole. The rate of increase in the number of contributory pensions in the first six months of the year (1.3%) was more moderate than in the previous year (2.3% for 2006 as a whole). This is partly due to the effect on the figures for 2006 of the former Elderly and Disability Insurance Pensions (SOVI) being recognised as compatible with widowhood pensions[1]. Although the growth rate of expenditure on sickness was notably high at 8.7% to April, this was also lower than the budget projection for 2007.

As regards the SPEE (State Employment Public Service), the information on revenue for 2007 is not yet available. Cumulative growth in expenditure on unemployment benefits to April 2007 stood at 5.7% in year-on-year terms. The eligibility rate in March was 67.4%, seven points higher than the figure posted in March 2006. The number of beneficiaries increased, on data to March, by 6.9% in comparison with the same month of the preceding year, whereas registered unemployment fell by 4.3% in year-on-year terms in the same period. However, the latest information available on registered unemployment show a cumulative contraction of 0.1% in the first half of the year which underlines the significant slowdown in the rate of decline in Q1.

1. Law 9/2005 of 6 June 2005.

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

EUR m and %

	Budget			Outturn JAN-APR		
	2006	2007	% change	2006	2007	% change
	1	2	3=2/1	5	6	7=6/5
1 REVENUE	97,547	106,142	8.8	33,739	36,592	8.5
1.1 Social security contributions (c)	90,625	97,942	8.1	31,317	33,680	7.5
1.2 Current transfers	5,295	5,963	12.6	1,794	2,041	13.8
Other (d)	1,628	2,237	37.5	628	870	38.6
2 EXPENDITURE	90,562	98,390	8.6	25,307	26,915	6.4
2.1 Wages and salaries	2,165	2,253	4.1	676	658	-2.7
2.2 Goods and services	1,733	1,807	4.2	487	487	0.0
2.3 Current transfers	86,133	93,743	8.8	24,115	25,721	6.7
Benefits	86,131	93,742	8.8	24,115	25,721	6.7
Contributory pensions	*73,832*	*80,099*	*8.5*	*20,720*	*22,098*	*6.7*
Sickness	*6,656*	*7,313*	*9.9*	*1,790*	*1,947*	*8.7*
Other	*5,644*	*6,330*	*12.2*	*1,605*	*1,677*	*4.5*
2.4 Other (e)	530	588	10.8	29	49	68.2
3 BALANCE	6,986	7,752	11.0	8,432	9,676	14.8

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

a. Only data relating to the system, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security funds are not available until April 2007.
b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.
c. Including surcharges and fines.
d. Excluding surcharges and fines.
e. Reduced by the disposal of investments.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 4

EUR m

		JANUARY-APRIL	
		2006	2007
CREDITS	Current account	94,975	106,258
	Goods	*56,225*	*60,473*
	Services	*23,652*	*25,681*
	— Tourism	10,013	10,494
	— Other services	13,639	15,187
	Income	*10,862*	*14,254*
	Current transfers	*4,236*	*5,849*
	Capital account	1,628	2,259
	Current + capital accounts	96,602	108,517
DEBITS	Current account	124,483	140,597
	Goods	*81,072*	*86,664*
	Services	*19,477*	*21,641*
	— Tourism	3,784	4,096
	— Other services	15,692	17,546
	Income	*16,448*	*22,490*
	Current transfers	*7,487*	*9,802*
	Capital account	538	449
	Current + capital accounts	125,021	141,046
BALANCES	Current account	-29,509	-34,339
	Goods	*-24,847*	*-26,191*
	Services	*4,176*	*4,040*
	— Tourism	6,229	6,399
	— Other services	-2,053	-2,358
	Income	*-5,586*	*-8,235*
	Current transfers	*-3,251*	*-3,952*
	Capital account	1,090	1,810
	Current + capital accounts	-28,419	-32,529

SOURCE: Banco de España.

a. Provisional data.

was affected by the maturity schedule of government debt. Similarly, the *Investment* heading continued to record notably higher-than-budgeted growth.

4.5 The balance of payments and capital account

In the first four months of 2007 the overall balance on current and capital account was a deficit of €32,529 million, 14.5% up on the same period in 2006 (see Table 4). The current account deficit widened by 16.4% in this period to €34,339 million, while the surplus on capital transactions improved notably to €1,810 million. The balances of the main current account items worsened in the first four months except for the tourist surplus which improved slightly. All the same, these data show a noticeable moderation in the pace at which the Spanish economy's external deficit is widening, following the strong increases in recent years, which is largely due to the slowdown in the trade deficit. By contrast, the income and current transfers balances deteriorated markedly in the first four months of 2007.

In the January-April period, the pace at which the trade deficit was widening eased to 5.4%, in contrast to the trend of strong deterioration in recent years. This improvement occurred against a backdrop of a slowdown in Spain's foreign trade, which was more intense in the case of imports although they continued to show higher increases in real terms than exports. However, the increase in the real terms of trade enabled exports to grow at a slightly higher rate than imports in nominal terms (7.6% and 6.9%, respectively). The energy bill fell in this period in step with the moderation shown in crude oil prices on international markets in the early months of the year and with the appreciation of the euro against the dollar, while the non-energy trade deficit continued to widen.

The surplus in the services balance dropped in the first four months of the year in relation to the levels seen in the same period a year ago due to the increase in the non-tourist services deficit which could not be fully offset by the improvement in the tourist surplus. Tourist revenue began the year on an expansive note, easing notably in April and growing by a total of 4.8% the first four months of the year, slightly down on the increase seen on average in 2006. Tourist expenditure increased by 8.2% in the first four months of 2007, down on the average increase in 2006, in keeping with the gradual slowdown in other components of household consumer spending. The revenue and expenditure of other services remained highly positive in this period (with growth rates of 11.4% and 11.8%, respectively).

The deficit on the income balance widened notably over the first four months of 2007 to €8,235 million, which represents a deterioration of €2,649 million in comparison with the same period in 2006. Both revenue and expenditure were highly expansive in Q1 with growth rates of more than 30% in both cases. By institutional sector, the deficits of financial institutions and other resident sectors widened notably while the general government deficit was corrected slightly. All instruments contributed to the widening of the deficit and in particular expenditure on portfolio investment income and other investments (essentially loans, deposits and repos).

The deficit of the current transfers balance rose to €3,952 million in January-April 2007, up €702 million on the deficit posted in the same period in 2007. Revenue increased by 38%, owing to the increase in the flows of EU funds under EAGGF-Guarantee and the European Social Fund, at the same time as there was a notable rise in other transfers received by the private sector. Expenditure also grew at a very high rate (30.9%), as a result of the notable buoyancy in public sector expenditure and that of other resident sectors which included most notably the high rise shown by immigrants' remittances (32.7%).

Finally, the capital account surplus stood at €1,810 million in the first four months of 2007, up €720 million on the same period in 2006. This improvement was essentially due to the expansionary behaviour of structural funds from the ERDF which, however, are usually very erratic in the opening months of the year.

5 Financial developments

5.1 Overview

Private-sector financing conditions continued to tighten between April and June. Consequently, the cost of loans for households and firms increased in parallel with the rise in money market interest rates (the 1-year Euribor climbed 40 bp in this period to 4.51%). Corporate funding through the issuance of fixed-income securities also became more expensive and only in equity financing was there a slight decline in cost (see Chart 24).

In Q2 the upward trend on most international equity markets continued, although there were once more some bouts of instability which, in any event, were not on the same scale as those recorded at the end of February. The rise in volatility was sharper for Spanish stock prices due to greater uncertainty concerning the valuation of certain real estate firms. The Madrid Stock Exchange General Index (IGBM) appreciated 1.1% between April and June, which was less than the euro area EURO STOXX index (6.3%) and the US S&P 500 (5.8%). The cumulative gain of the IGBM for the year to date stood at 5%, which was also lower than that of the other two international indices (10% and 6%, respectively).

According to Spanish Ministry of Housing data for Q2, the year-on-year growth rate in appraised open-market housing stood at 5.8%, practically 1.5 pp lower than at the beginning of the year and 5 pp lower than twelve months ago. Thus, the orderly normalisation of property market prices continues.

In this setting private-sector financing slowed once again in the first three months of 2007, essentially as a result of the diminished dynamism in household liabilities, including hereunder house-purchase loans. Provisional information for Q2 indicates that moderation might also have begun to extend to funds earmarked for financing consumption and for other purposes.

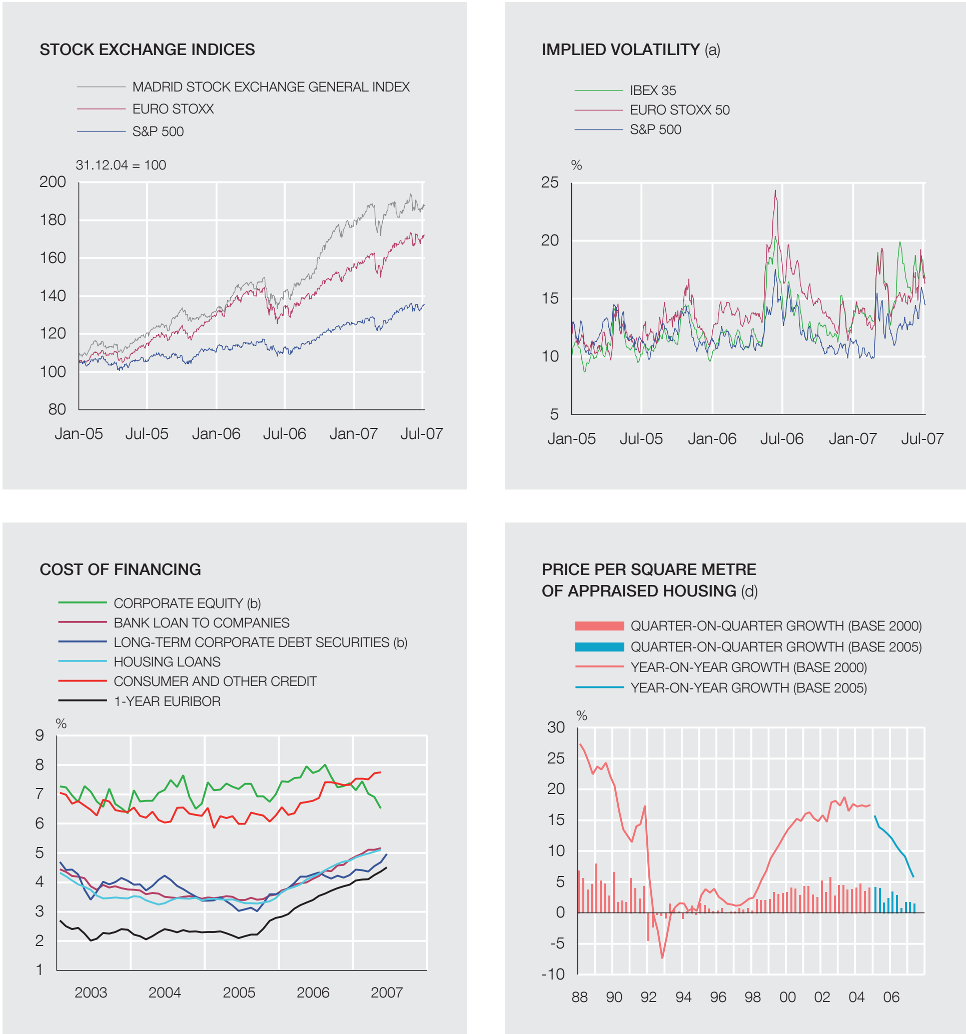
The external funding of non-financial corporations was also less expansive, although it maintained a growth rate of approximately 23% which, on provisional data, could have continued during Q2. The breakdown by activity of credit, the principal component of firms' borrowing, shows that fewer funds were earmarked for real estate services and construction in 2007 Q1, that there was a slight rise in those allocated to industry and that those employed in other productive activities held practically stable.

The increase in household borrowing exceeded their incomes, triggering a fresh rise in the household debt ratio (Box 7 analyses the contribution of the number of borrowers and their average debt to the recent increase in this ratio). Similarly, additional lengthening of new-loan terms was not enough to offset the combined effect of larger liabilities and higher rates and, consequently, the debt interest burden also rose, but it should be taken into account that this indicator incorporates the effects of money market interest rate rises gradually. Saving not earmarked for debt service, which also gradually includes these effects, improved slightly thanks to the growing trend of the gross saving ratio; however, as a result of buoyant household investment, as illustrated by the financial accounts, household net borrowing increased slightly in relation to GDP in Q1. Their net wealth grew at a similar rate to GDP, due particularly to the behaviour of residential property prices (see Chart 25).

The corporate debt and debt burden ratios rose, although there were no significant changes in returns on capital, which remained high at approximately 10%. The quarterly Central Balance Sheet Data Office (CBQ) data show, however, greater moderation in the debt and debt

FINANCING CONDITIONS AND ASSET PRICES

CHART 24



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

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

burden ratios in 2007 Q1 among reporting firms (which, as previously indicated, are predominantly large firms). As a result of this trend, together with stable returns, the synthetic indicators of financial pressure on investment and employment in this sub-group of the sector remained at similar levels to previous quarters (see Chart 26).

The increase in net borrowing by the non-financial private sector in Q1 outpaced the recovery in general government saving. Thus, the nation's net borrowing increased in cumulative twelve-month terms to 7.9% of GDP (see Table 5). Sizable funds from the rest of the world continued to be raised through credit institutions, although the volume of funds channelled through other financial institutions continued to rise and accounted for more than half of the new liabilities accumulated, in gross terms, by the nation in the last year.

In short, households' resort to debt continued to slow gradually, as could be expected against a background of tightening monetary conditions. However, the aggregate data for non-financial corporations do not yet display similar moderation, although there seem to be signs of a

GROWTH IN HOUSEHOLD CREDIT: NUMBER OF BORROWERS AND AVERAGE DEBT LEVELS

Data from the Banco de España Central Credit Register (CCR) are used in this box to analyse the role of average debt levels and the number of borrowers in the growth of Spanish household liabilities in recent years.

The CCR contains itemised information on the loans extended by resident credit institutions exceeding a certain threshold (more details are available in the Spanish-language publication *Memoria de la Central de Información de Riesgos*). However, the unit of reference is not households, as in the financial and non-financial accounts of the economy, but the individual who receives the funds. Likewise, the CCR does not allow a distinction to be drawn between liabilities on the basis of the purpose for which the funds are used (housing, consumption and other), though it is possible to ascertain, alternatively, whether the transactions have any specific type of guarantee.

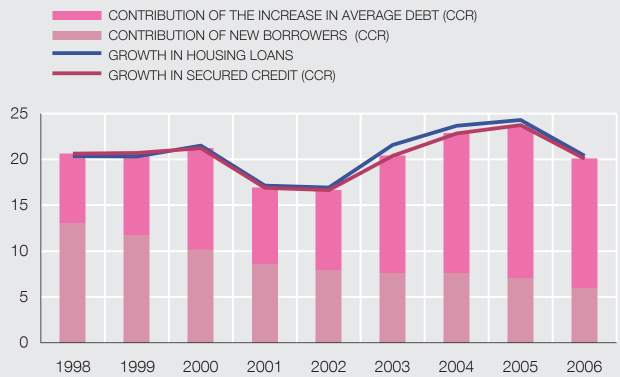
The charts in the upper panels show, firstly, that the growth rates of secured and unsecured loans provide an acceptable approximation of household house-purchase, consumer and other-purpose loans, respectively. On the basis of this approximation, it is possible to break down growth in both aggregates into the effects associated first, with the increase in the number of individuals with some type of debt, and further, with changes in the average debt per individual.

Accordingly, in the case of secured lending (which is used in this box as an approximation of housing loans), the increase in the number of borrowers accounted for a substantial share of growth in the early years of the sample, but its relative weight has gradually decreased. In 2006, it only accounted for 6 pp of the approximately 20 pp total rise recorded. Conversely, in the case of consumer and other-purpose loans (whose behaviour is approximated using that of unsecured credit), the expansion in total debt mainly corresponded to greater numbers of borrowers, which in 2006 accounted for two-thirds of the change in this type of credit.

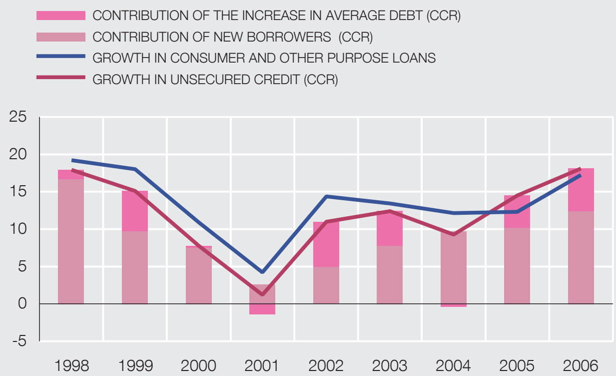
The two charts in the lower panels compare the trend in the number of borrowers and the average debt with a key reference variable. The first shows the changes in the ratio between the number of individuals in debt and the number of inhabitants over 18 years old. As can been seen, the ratio increased by 14 pp between 1998 and 2006. Growth is similar (15 pp) if numbers employed are used as an approximation of the population able to apply for a loan, since employment is practically a prerequisite for obtaining a loan. Furthermore, the behaviour is quite similar for secured and unsecured loans.

The bottom-right panel shows a clear increase in average debt relative to gross disposable income per inhabitant aged over 18, which has multiplied by slightly less than 1.5 between 1998 and 2006 (in terms of average gross wages the rise would be slightly greater at about 80%). This behaviour of the ratio is a result both of the increase in the average amount of housing loans and growth in the percentage of individuals with secured and unsecured loans at the same time, which rose from 4% to 10% of the adult population in the period considered.

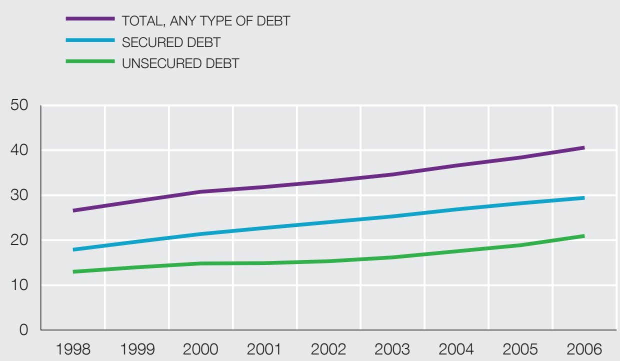
SECURED CREDIT AND FACTORS CONTRIBUTING TO ITS GROWTH



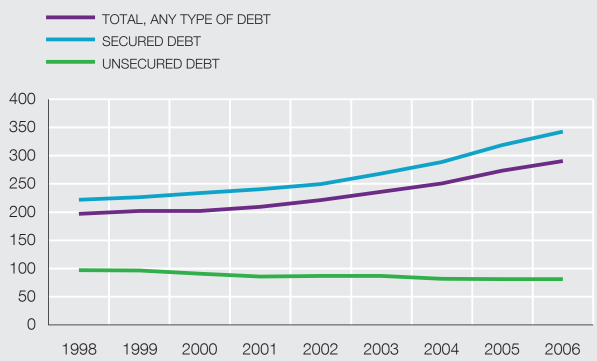
UNSECURED CREDIT AND FACTORS CONTRIBUTING TO ITS GROWTH



PERCENTAGE OF INDIVIDUALS IN DEBT WITH RESPECT TO POPULATION OVER AGE OF 18



AVERAGE DEBT PER PERSON WITH RESPECT TO GDI PER PERSON OVER AGE OF 18



SOURCES: Banco de España and INE.

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 25

SOURCE: Banco de España.

a. From 1999, the sectoral National Accounts data corrrespond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Includes bank credit and off-balance-sheet securitised loans.
c. Assets 1 = Total financial assets – "other".
d. Assets 2 = Assets 1 - shares (excluding mutual fund shares) - shares in FIM.
e. Estimated interest payments plus debt repayments.
f. Balance of households' use of disposable income account.
g. Gross saving less estimated debt repayments.
h. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre. This is a new house price statistic for 2005.
i. CNE, base 2000.

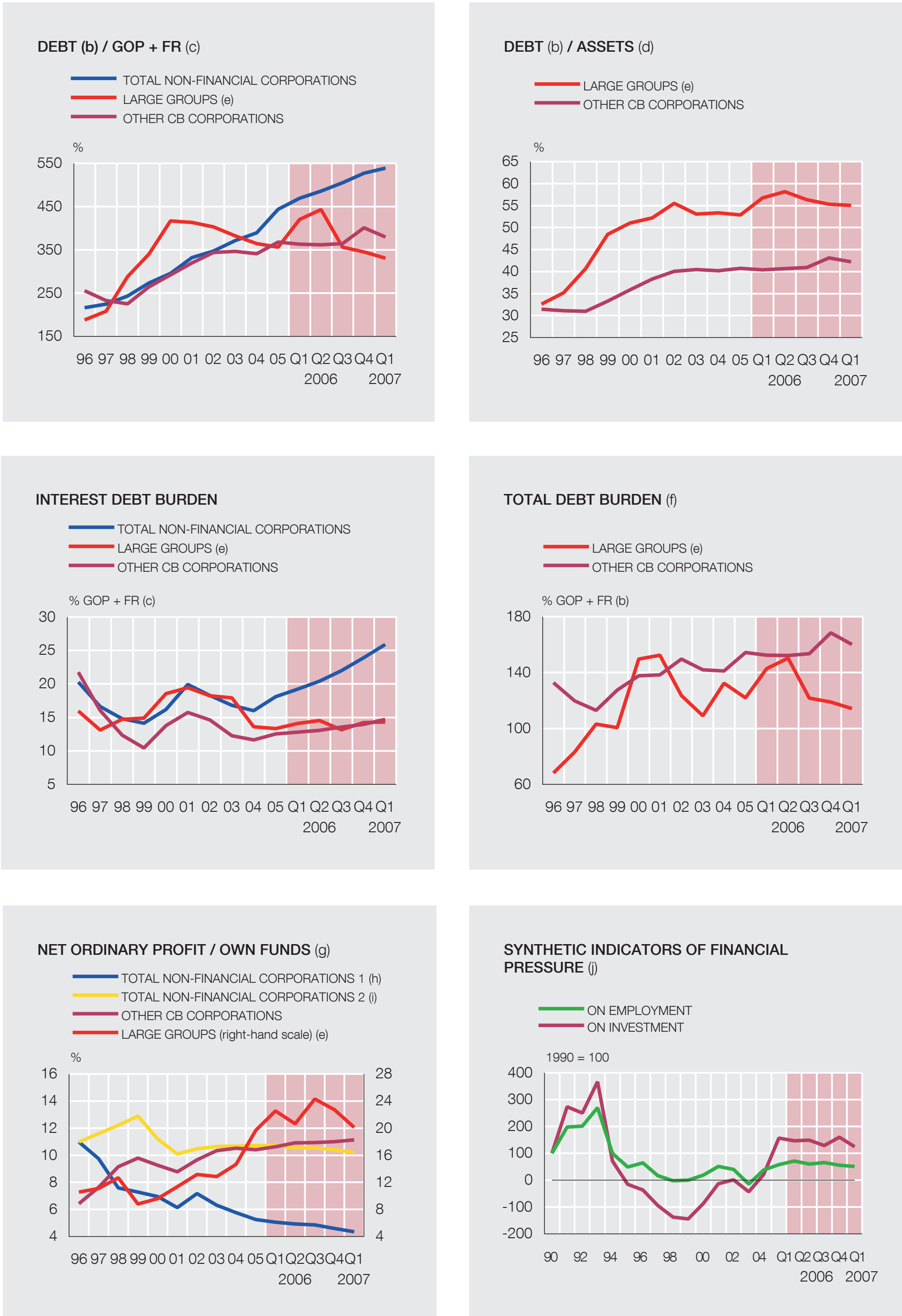
slight slowdown in the rise in debt at large firms. The ongoing buoyancy shown by private-sector liabilities and some of their characteristics such as the lengthening of repayment terms and the continuing prevalence of variable-rate loans have raised the sector's exposure to possible unexpected adverse changes in its revenue, net worth or financial costs. Although the progressive nature of the normalisation of monetary conditions and property markets reduces the likelihood that such disturbances may become significant, the leeway it provides must be used by firms and households to continue re-balancing the relative roles of their current revenue and borrowing to finance spending decisions.

5.2 Households

In Q2 financing conditions for households tightened again. The interest rates applied by credit institutions to new business rose 13 bp between March and May for housing loans and 24 bp for consumer and other purpose loans. The cumulative rises in the cost of these funds in

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 Spanish 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.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP	2002	2003	2004	2005	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1
National economy	-2.7	-2.9	-4.8	-6.5	-7.0	-7.2	-7.6	-7.8	-7.9
Non-financial corporations and households and NPISHs	-3.5	-3.9	-5.3	-8.4	-9.3	-10.0	-10.6	-10.4	-10.8
Non-financial corporations	-4.2	-4.1	-4.6	-7.0	-7.7	-7.6	-8.5	-8.9	-9.2
Households and NPISHs	0.7	0.1	-0.6	-1.3	-1.6	-2.4	-2.1	-1.5	-1.6
Financial institutions	1.2	1.0	0.6	0.7	0.6	0.7	0.7	0.7	0.8
General government	-0.3	0.0	-0.2	1.1	1.7	2.1	2.2	1.8	2.1
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.6	-8.3	-8.9	-10.9	-14.0	-14.4	-15.7	-15.8	-13.6

SOURCE: Banco de España.

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

comparison with the low recorded in October 2005 are 180 bp and 147 pb, respectively. Also, according to the latest Bank Lending Survey, institutions anticipated more restrictive credit-extension terms for both types of loan between April and June.

Against this backdrop, the growth rate of household debt continued to decline and fell by approximately 1.5 pp between January and March. The breakdown by component of this variable shows that growth in loans for house purchases was clearly more moderate whereas the rate of expansion of consumer and other purpose loans was more stable. The provisional information for Q2 indicates that the slowdown in housing loans will continue and the novelty is that it will begin to spread to other types of loans.

Household investment in financial assets also eased slightly and, according to information on 2007 Q1, it reached 11.2% of GDP in cumulative annual terms, 0.7 pp less than the end-2006 figure (see Table 6). The breakdown by instrument reveals that households continued to prefer lower-risk instruments (cash and deposits). In particular, there was a striking rise in time deposits, which are included under the heading other deposits and fixed-income securities, at the expense of shares in mutual funds, where negative net subscriptions were posted amounting to 0.5% of GDP. Households also continued selling shares in net terms, albeit for a small amount and, at the same time, the share of new saving in the form of insurance technical reserves held steady (1.6% of GDP).

The rate of increase of household borrowing remained higher than household income growth and, consequently, according to data available for Q1, the debt ratio increased to more than 125% of household GDI (see Chart 25). Until the end of 2005, the effects of the expansion of liabilities on the financial burden had been partially cushioned by lower interest rates and longer terms. Whereas in the case of this latter factor there remains little room for further lengthening, the cost of funds has embarked on an upward path, whose effect on the debt burden ratio will gradually pass through in full. The percentage of income earmarked for debt service rose in the early months of 2007 to slightly above 16% of GDI and, according to the provisional information available between April and June, growth in this and the debt ratio continued.

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

TABLE 6

% GDP	2003	2004	2005	2006		2007
				Q3	Q4	Q1
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.6	9.4	10.3	10.9	11.9	11.2
Cash and cash equivalents	4.1	3.9	-13.1	3.2	3.2	2.3
Other deposits and fixed-income securities (a)	-0.3	1.2	18.9	4.7	5.9	6.6
Shares and other equity (b)	0.5	0.3	0.2	-0.5	-0.8	-0.1
Mutual funds	2.3	1.5	1.9	0.8	0.2	-0.5
Insurance technical reserves	1.8	1.8	1.9	1.5	1.6	1.6
Of which:						
Life assurance	*0.7*	*0.7*	*0.8*	*0.6*	*0.6*	*0.6*
Retirement	*0.9*	*0.8*	*1.0*	*0.7*	*0.8*	*0.8*
Other	0.1	0.6	0.5	1.1	1.8	1.4
Financial transactions (liabilities)	8.5	10.1	11.6	13.0	13.4	12.8
Credit from resident financial institutions (c)	9.2	10.8	12.3	13.2	13.1	12.5
House-purchase credit (c)	*7.0*	*8.7*	*10.3*	*10.2*	*9.9*	*9.3*
Consumer and other credit (c)	*2.2*	*2.1*	*2.2*	*3.0*	*3.2*	*3.2*
Other	-0.7	-0.8	-0.7	-0.2	0.3	0.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	12.1	12.3	17.2	22.1	22.8	19.6
Cash and cash equivalents	0.9	1.0	2.0	2.5	2.2	1.7
Other deposits and fixed-income securities (a)	1.2	0.3	1.5	2.3	2.4	2.8
Shares and other equity	7.4	6.4	7.1	10.9	10.4	7.9
Of which:						
Vis-à-vis the rest of the world	*4.5*	*3.8*	*3.9*	*7.3*	*6.8*	*4.2*
Other	2.6	4.7	6.6	6.4	7.8	7.2
Financial transactions (liabilities)	16.2	16.9	24.2	30.6	31.7	28.8
Credit from resident financial institutions (c)	6.1	8.3	12.9	16.5	17.8	17.8
Foreign loans	2.6	0.7	2.1	3.5	3.3	1.2
Fixed-income securities (d)	-0.2	0.0	0.3	1.6	1.8	1.2
Shares and other equity	5.1	4.4	3.6	3.3	2.3	2.4
Other	2.5	3.5	5.3	5.6	6.5	6.2
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.8	16.3	21.2	24.3	24.2	21.1
Households and NPISHs	19.1	20.2	20.9	20.6	19.6	18.3
Non-financial corporations	13.4	13.2	21.4	27.4	27.9	23.3

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.

The recovery in the gross savings ratio in 2007 Q1 resulted, despite the expansion of the financial burden, in a slight rise in the sector's ability to save after discounting payments linked to liabilities. The increase in household net wealth was similar to that in GDP, meaning that the ratio between both aggregates remained stable, comfortably above 600%.

5.3 Non-financial corporations

Financing conditions also tightened for corporations in 2007 Q2. Consequently, the synthetic indicator of the marginal cost of new funds received by firms stood at 5.2% in May, 12 bp higher than the March figure. This increase stemmed fundamentally from the rise in the interest rate (which rose by more than 30 pb) on short and, particularly, long-term fixed-income securities, since bank interest rates climbed moderately and the cost of own funds fell slightly.

In this setting, firms cut the rate of expansion of their debt, which in March posted a year-on-year growth rate of 23%, 4 pp lower than at 2006 year-end. However, this decrease is largely due to a base effect and, in fact, according to provisional information for Q2, corporate financing grew at a similar rate as in March thanks mainly to buoyant bank credit and foreign loans.

By productive activity, the latest information (for 2007 Q1) shows the first clear signs of a slowdown in funds earmarked for the property and construction sectors notwithstanding their still-high growth rates (46% and 30%, as against 51% and 33% in December 2006). In the other sectors, bank financing increased moderately, although in some cases, like industry, the year-on-year growth rate climbed slightly.

The volume of corporations' asset-side transactions clearly slipped and accounted in March for 20% of GDP in cumulative four-quarter terms (3 pp less than in the previous quarter). Although this drop was across the board (with the exception of other deposits and fixed-income securities), it was acquisitions of equity and, within this item, foreign acquisitions which fell most significantly. However, like financing, this trend is influenced by the effect of a specific corporate operation at the beginning of 2006.

The Financial Accounts information for 2007 Q1 shows a further increase in firms' financing needs, which pushed above 9% of GDP in cumulative twelve-month terms. The financing gap, which approximates the funds needed to undertake real investment and permanent foreign financial investment, showed a significant decline linked to changes in investment abroad (see Table 5).

The increase in firms' recourse to external funds coupled with the rise in the average cost of the outstanding amount of such funds, triggered a further climb in the sector's debt and debt burden ratios, which seems to have continued in Q2. As for their income, the latest data for Q1 show that the rate of return on capital held steady.

For the companies reporting to the CBQ, the latest available information for 2007 Q1 indicates a moderate rise in the proportion of revenue allocated to debt service. Also in this sample, which is dominated by large companies, there was a slight drop in the debt ratio, which was sharper for large business groups. The aggregate return on equity fell somewhat but remained high (around 14%), which was in line with a fresh improvement in the industrial sector. As a result of the combined effect of these variables, the synthetic indicators of financial pressure on investment and employment were relatively unchanged on end-2006.

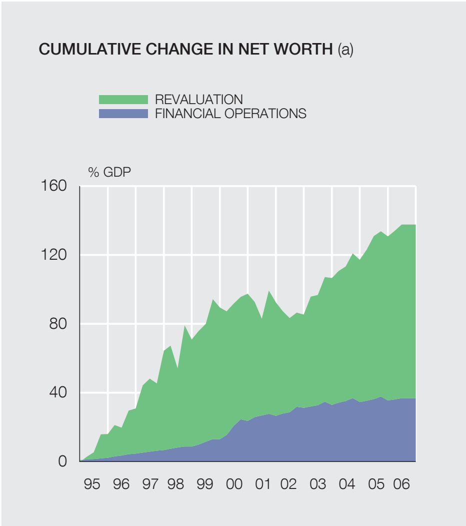
Lastly, there were no significant changes in analysts' long and short-term projections on the increase in listed non-financial corporations' earnings, although the former showed some improvement on the previous quarter (see Chart 27).

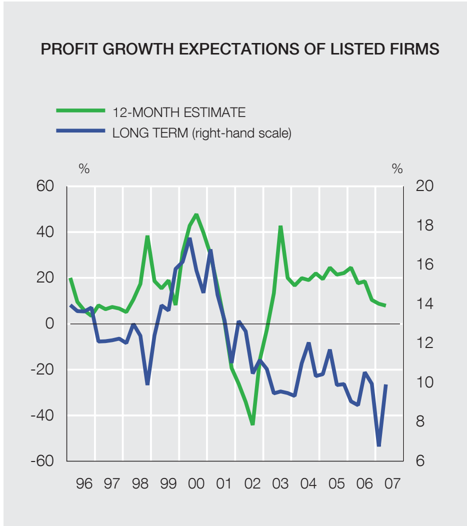
5.4 General government

In the first three months of the year, general government net lending improved so that in March it accounted for 2.1% of GDP in cumulative twelve-month terms, up 0.3 pp on the end-2006 figure (see Chart 28). By instrument, the sector made a net redemption of short-term securities, whereas the net issuance of long-term securities was positive. At the same time, there was an increase in investments in deposits and a contraction of the volume of loans, with the result that the heading that reflects changes in the net balance of these two items remained positive and equivalent to 2.3% of GDP. Lastly, despite the higher cost of financing, interest payments as a percentage of GDP continued on a downward path, thanks to the decline in the debt ratio.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 27



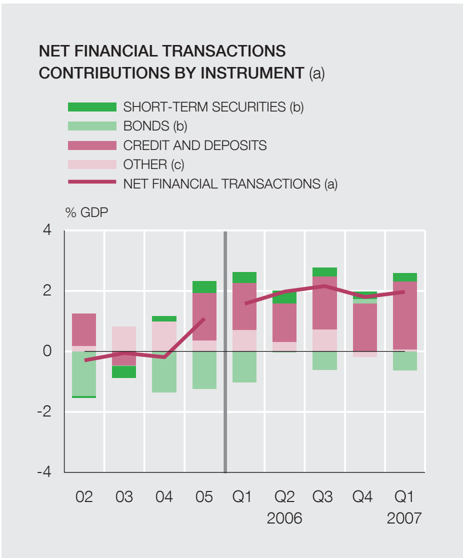


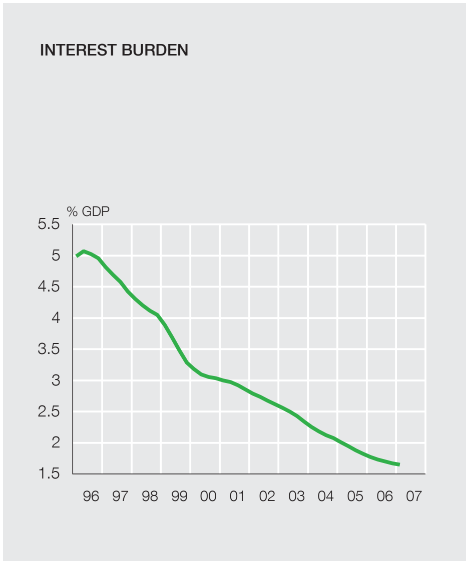
SOURCES: I/B/E/S and Banco de España.

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

GENERAL GOVERNMENT
Four-quarter data

CHART 28





SOURCE: Banco de España.

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

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2003	2004	2005	2006 Q3	2006 Q4	2007 Q1
NET FINANCIAL TRANSACTIONS	-2.9	-4.8	-6.5	-7.6	-7.8	-7.9
FINANCIAL TRANSACTIONS (ASSETS)	13.1	13.3	18.4	19.0	16.8	14.1
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	0.7	3.2	2.2	4.8	5.5	7.5
Of which:						
Interbank (a)	*0.5*	*0.7*	*3.2*	*3.5*	*3.4*	*6.2*
Securities other than shares	6.5	1.8	8.8	0.8	-1.2	-1.0
Of which:						
Credit institutions	*3.5*	*1.0*	*6.6*	*-0.3*	*-2.0*	*-1.5*
Institutional investors (b)	*3.5*	*0.3*	*2.2*	*0.8*	*0.7*	*0.5*
Shares and other equity	4.7	6.8	5.2	10.1	9.3	5.9
Of which:						
Non-financial corporations	*4.5*	*3.8*	*3.9*	*7.3*	*6.8*	*4.2*
Institutional investors (b)	*1.1*	*0.8*	*0.9*	*1.7*	*1.2*	*0.2*
Loans	0.3	0.8	1.1	1.7	2.1	0.8
FINANCIAL TRANSACTIONS (LIABILITIES)	16.0	18.2	25.0	26.6	24.6	22.0
Deposits	6.9	1.7	5.7	0.8	0.3	0.4
Of which:						
Interbank (a)	*5.3*	*5.0*	*7.2*	*1.3*	*0.6*	*0.4*
Securities other than shares	5.3	12.4	15.8	21.6	21.4	20.5
Of which:						
General government	*-1.0*	*2.7*	*0.2*	*1.6*	*1.3*	*1.0*
Credit institutions	*3.5*	*4.6*	*6.3*	*8.1*	*7.8*	*6.8*
Other non-monetary financial institutions	*2.8*	*5.1*	*9.3*	*11.9*	*12.3*	*12.7*
Shares and other equity	1.1	2.7	0.9	0.3	-0.8	-0.4
Of which:						
Non-financial corporations	*1.3*	*1.7*	*1.0*	*0.4*	*-1.1*	*-0.3*
Loans	2.8	1.3	2.3	3.7	3.5	1.4
Other, net (c)	-0.9	-0.6	-0.9	-1.4	-0.9	-0.7
MEMORANDUM ITEMS						
Spanish direct investment abroad	3.3	5.8	3.7	7.5	7.3	4.8
Foreign direct investment in Spain	2.9	2.4	2.2	2.6	1.6	1.7

SOURCE: Banco de España.

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

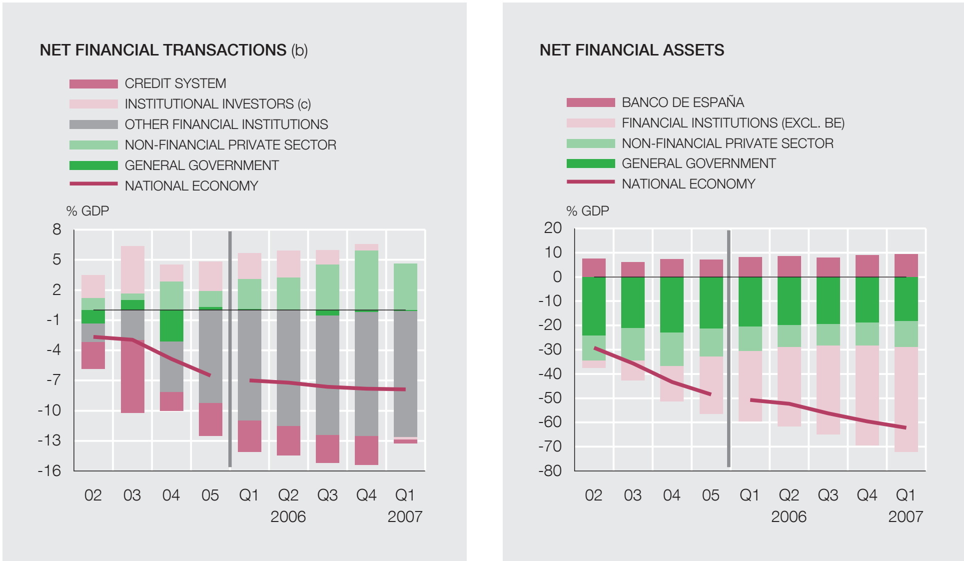
5.5 The rest of the world

In 2007 Q1 the net debit balance of the nation's financial transactions rose to 7.9% of GDP in cumulative four-quarter terms, 0.1 pp higher than at the end of 2006. This was due to the greater need for funds of households and, especially, of companies, which was not offset by the improvement in general government saving.

The acquisition of foreign assets fell to 14.1% of GDP in cumulative four-quarter terms. By instrument, the most important changes were the increase in investment in liquid assets included under the cash and deposits heading and, especially, the decrease in flows linked to acquisitions of shares and other equity. Accordingly, Spanish foreign direct investment fell in Q1 to 4.8% of GDP (in cumulative twelve-month terms), 2.5 pp down on the end-2006 figure.

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.

Net capital inflows required to finance both the gap between national savings and investment and the acquisition of financial assets abroad climbed to 22% of GDP in Q1 (in cumulative twelve-month terms), 2.6 pp down on the figure at the end of the previous year (see Table 7). Most of these funds were invested in securities other than shares. The flow of acquisitions of shares and other equities by non-residents was once again negative, although lower in terms of GDP than in the previous quarter, thanks to a slight rise in foreign direct investment in Spain. Lastly, the financing raised through bank loans contracted again.

The analysis of these flows in net terms and by agent show that the bulk of the funds raised from the rest of the world was channelled once more through Financial Vehicle Corporations (FVCs) created to hold securitised assets and the subsidiaries of financial and non-financial corporations specialising in securities issuance (see Chart 29). The credit system also contributed to this channelling of funds from abroad, although the new liabilities accumulated in net terms were 2.5 pp of GDP lower than the previous quarter. Lastly, contrary to their usual behaviour, institutional investors offloaded, in net terms, assets vis-à-vis non-residents.

As a result of the trend in cross-border financial flows and of the changes in asset prices and the exchange rate, there was a further rise in the balance of net liabilities accumulated vis-à-vis the external sector (see Chart 29). This increase mainly stems from the rise in the net debit position of financial institutions among which, as discussed above, FVCs and the subsidiaries of financial and non-financial corporations specialising in securities issuance continue to play a pivotal role in the channelling of savings from the rest of the world to the Spanish economy.

27.7.2007.