QUARTERLY REPORT ON THE SPANISH ECONOMY

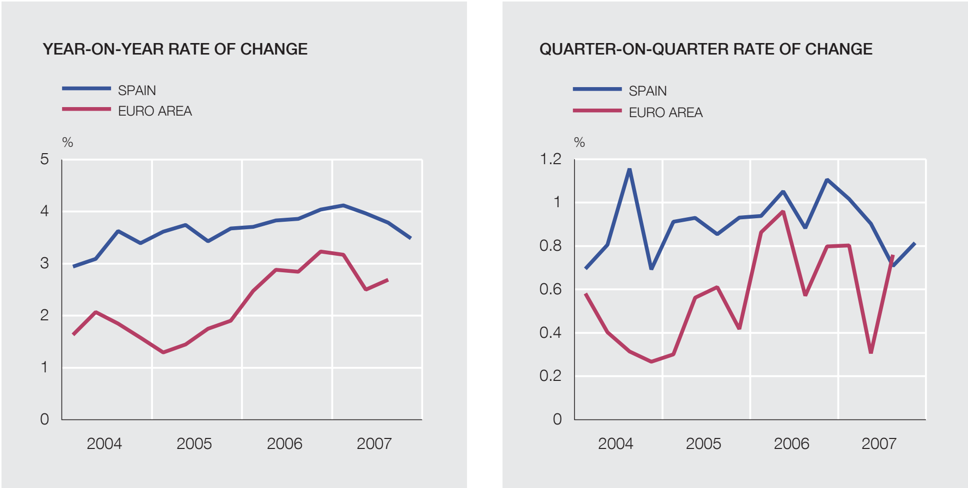
1 Overview

During the first three quarters of 2007, growth in the Spanish economy held at a rate that was high, though on a slightly declining trend, taking the annual rate of change to 3.8% in Q3. On the latest available information, this pattern is expected to have held in 2007 Q4, with GDP estimated to be standing at 3.5% year-on-year. Behind the mild slowdown in activity over the year lies a decline in the rate of increase of national demand, to a year-on-year rate of 3.6% in Q4, and an improvement in the contribution of net external demand, which stood at –0.3 pp in the final quarter.

Estimates for Q4 place GDP growth for the whole of 2007 at 3.8%, 0.1 pp down on 2006. This is the result of a slightly sharper reduction in the growth rate of national demand than that seen in 2006, and of a further and significant correction in the negative contribution of net external demand, which is expected to stand at –0.7 pp. All the domestic demand components posted somewhat lower increases than in 2006 with the exception of residential investment, which registered a slightly more marked slowdown, and of investment in capital goods, whose already high growth rate the previous year stepped up during the course of 2007. On the supply side, employment held at a high growth rate of around 3% for the year on average, although it exhibited a slowing profile throughout the year, in step with the loss of momentum of activity in the construction sector. The notable generation of employment in 2007 once again enabled the sizable increases in the labour force to be absorbed, while there were fresh cuts in the unemployment rate, which dipped to a low of 8% mid-year, although it edged back up to 8.6% in Q4. On the inflation front, the growth rate of the CPI stood at 2.8% for the year on average, below the average figure for 2006 (3.5%); however, from the summer it moved on a progressively quickening path, ending the year at a growth rate of 4.2% year-on-year, placing the inflation differential with the euro area at 1.2 pp. The rise in oil prices in the closing months of 2007 and the high increases in specific food products compounded the effects of the profile inherited from the previous year, leading to a deterioration in the inflationary situation in the second half of 2007.

As regards the international economic scene, the financial turbulence that commenced in the summer further to the US sub-prime mortgage crisis extended into and stepped up during 2007 Q4. Signs of a clear weakening in US economic activity have begun to be perceptible, driven by the crisis in the real estate sector and by the attendant financial pressures. Nonetheless, figures released for Q4 point to the sustained buoyancy of the world economy as a whole, underpinned by the continuing strength of the emerging economies and by the resilience of most European economies. However, the climate of uncertainty has spread to many of the industrialised countries, bearing particularly on those where the business cycle is more dependent on real estate activity. Against this background, the growth outlook for the world economy has been revised downwards and the accompanying uncertainty has heightened.

On the international financial markets, one of the key aspects of this bout of instability has been the persistence of pressures on the money markets, despite the extraordinary liquidity-providing operations conducted by the main central banks, some on a coordinated basis, and accompanied in certain cases by cuts in intervention rates. The Federal Reserve shaved 25 bp off its intervention rate in December (and cut it once again by 75 bp on 22 January, meaning there has been a total reduction of 175 bp since the start of this episode) while the Bank of England also cut its official rate by 25 bp that same month. At the same time, the upward revision of credit risk premiums continued during the quarter, and stock market values fell further, GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

with such movements intensifying in January to date. On the foreign exchange markets, the dollar held on the depreciating trajectory that it had followed since the start of the year. Finally, there were further increases in the price of oil in the closing months of 2007 and in early 2008, up to a high of over $90 per barrel at the close of the year, though it has turned down slightly in recent weeks.

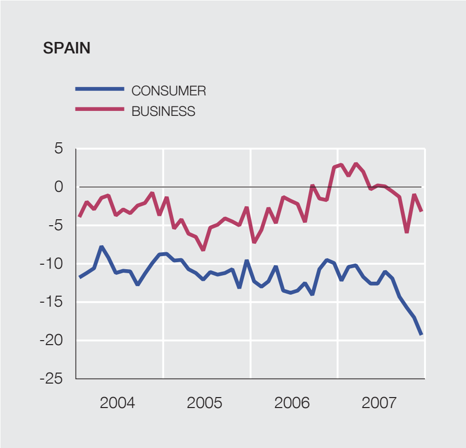
As earlier commented, despite the strong deterioration in the financial climate in the developed countries, the world economy continued showing signs of dynamism in the final quarter. In the United States, in contrast, following the relatively favourable GDP figure for Q3, the partial information available for Q4 points to a substantial weakening in activity, with the slowdown in consumption and employment compounding the greater intensity of the real estate adjustment. Accordingly, the US growth outlook for the coming quarters has worsened significantly, leading the authorities to announce the adoption of a major package of fiscal measures. Economic prospects have also worsened in Japan and the United Kingdom.

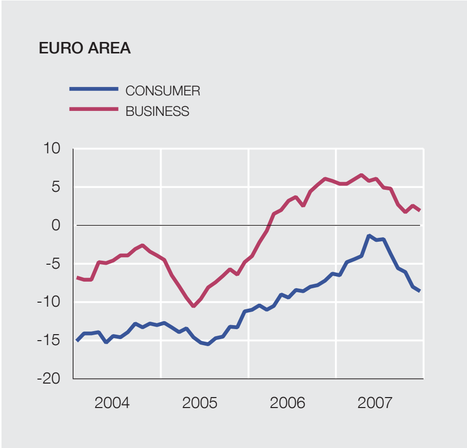
Despite this weakening in activity, inflation rates increased in the closing months of the year owing to the rebound in oil prices and the rise in food prices, in response to a prolonged period of substantial increases in agricultural commodity prices. Behind this latter development are various factors, some more conjunctural, linked to weather-related factors, and others more structural, linked to changes in consumption patterns or in the land set aside for crops. The outcome has been excess demand for these types of products, the effect of which on agricultural commodity prices may persist for some time.

In the euro area, activity in Q3 proved relatively expansionary, underpinned by the buoyancy of domestic demand (in particular, investment in equipment), the strength of industry and favourable employment developments. The latest indicators point to an easing in the pace of GDP in Q4, with a loss of momentum in private consumption and exports, although investment in equipment should remain somewhat more dynamic.

As in other geographical areas, inflation rose notably in the euro area in the closing months of the year owing to the impact on consumer prices of higher energy and food commodity prices, which were offset only in part by the appreciation of the euro. Overall, and despite the greater

CONFIDENCE INDICATORS CHART 2





SOURCE: European Commission.

stability of services prices, the upward course of core inflation during the quarter steepened, ending the year at an annual rate of change of 2.3%. The HICP posted a year-on-year rate of change of 3.1% in December.

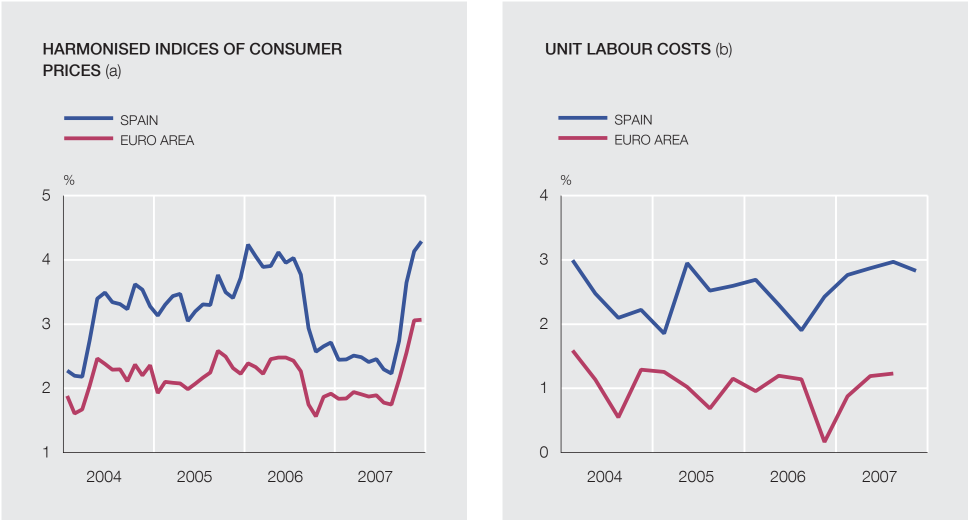
The assessment of the inflation outlook by the ECB in recent months portrays a relatively unfavourable picture, since increases in the HICP are forecast to hold at over 2% for a certain number of months. However, the ECB also perceives a high risk that further price increases will occur. And these, combined with the potential emergence of wage pressures and with the forceful dynamism of monetary and credit aggregates, might pose a threat for price stability in the medium term. Nonetheless, the prolongation of the episode of financial turbulence adds considerable uncertainty to the scale of the impact it may exert on the euro area economy. These considerations have led the ECB to hold its intervention interest rates at 4%, unchanged since August 2007. But it remains, in turn, determined to act pre-emptively, so as to prevent second-round effects on wages from materialising and to keep inflation expectations firmly anchored.

Developments in the Spanish economy have, during the last quarter, therefore unfolded against the background of a slowing international environment and continuing financial tensions. With minor oscillations during this period, money market rates have held at relatively high levels and corporate credit spreads have once again risen. Stock market prices, which had proven considerably resilient in 2007 Q4, while on a highly volatile trajectory, posted heavy falls in the opening weeks of January which were partly corrected subsequently. Yet the prolongation of this episode of instability on financial markets in Q4 has, to date, had a relatively limited impact on private-sector borrowing conditions. In the real estate sector, the adjustment initiated some quarters back continued, whereby house prices continued gradually to slow, ending the year at a year-on-year rate of increase of 4.8% in Q4 and average growth of 5.8% (compared with respective rates of 9.1% and 10.4% in the same period a year earlier).

Despite some worsening in the climate of uncertainty and in agents' confidence, household spending during the quarter moderated to a similar extent to that of the previous period. And, once again, this easing was more marked in the residential investment component. As a result, the growth rate of household consumption continued to draw closer to that of disposable income, in a setting in which increases in both financial and real estate wealth were more limited. In turn, the rate of expansion of disposable income fell moderately, despite the dynamism of

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.

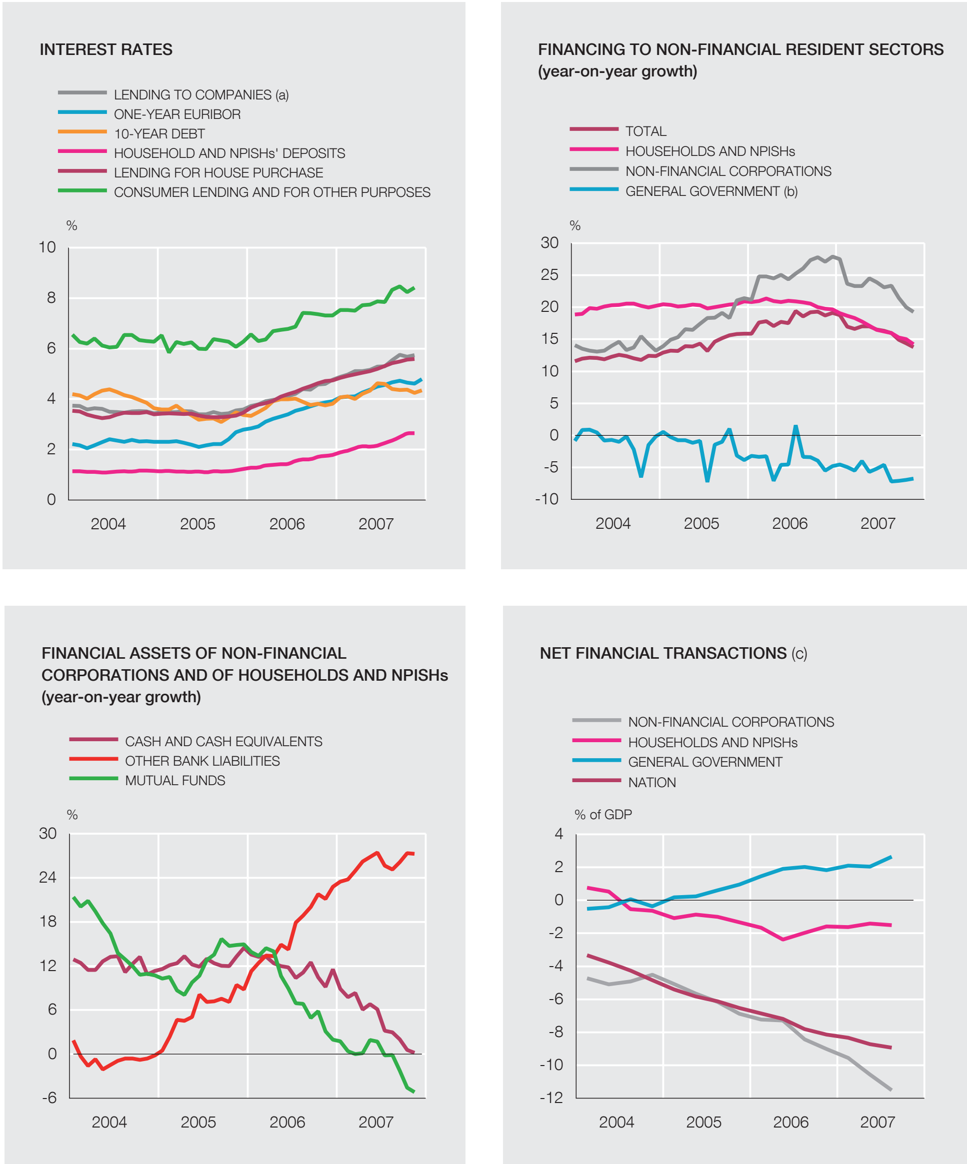
wage income, given that the high growth of direct tax takings and the increase in interest payments exerted a contractionary effect, while the rise in inflation reduced household purchasing power in the closing months of the year.

Residential investment continued to slow in Q4, confirming the change in cycle in the real estate sector. Adding to the trigger factors (basically the tightening of borrowing conditions and diminishing expectations of a rise in property prices) behind this adjustment have, in recent months, and amid the financial turbulence already described, been the increase in uncertainty and the deterioration in agents' confidence. Naturally, given the slowdown in household spending, the demand for credit eased off further. Consequently, the year-on-year growth of credit to households stood in November at around 14%, 1 pp less than in September. This reduction is due to the decline in the pace of house-purchase loans, since loans for consumption and other purposes did not undergo appreciable changes. Further to this set of decisions, the year 2007 will foreseeably close with the household saving rate holding stable, and with increases in the household debt-service and – to a lesser extent – debt ratios.

Business investment continued to advance firmly in Q4, although there was a reduction in the pace of both investment in capital goods and, above all, in non-residential construction compared with the previous quarter. However, spending on capital goods was once again the most dynamic component of domestic demand, underpinned by the high growth rates of corporate earnings, continued expectations of favourable returns following the good results in Q3 and the dynamism of final demand. Also discernible in this case is an easing in the expansion of external financing, which posted a year-on-year growth rate of close to 19% in November. The slowdown in corporate liabilities during Q3 reflected the loss of momentum of funds raised to finance real estate services and construction activities, since the financing earmarked for other activities remained very dynamic, especially in relation to industry. Despite this deceleration in the resort to borrowed funds, the debt and debt-service ratios increased moderately in the final months of 2007, and an increase in the sector's net borrowing, which stood at 11.5% of GDP in Q3 (in cumulative 12-month terms), is forecast for the year as a whole.

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCE: Banco de España.

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

The general government sector contributed in 2007 to the expansion in expenditure, both through government consumption and via the investment component. Investment was concentrated in the opening months of the year, when sizeable civil engineering projects were completed, coinciding with the holding of regional and local elections. The buoyancy of activity throughout 2007 was also reflected in a notable increase in tax revenue, mainly from direct taxes, despite the reform of personal and corporate income tax. As a result, on the latest official figures, the general government balance in 2007 ran an above-budget surplus of 1.8%. For the next three years, the government's fiscal projections set out in the Updated Stability Programme approved in late 2007 point to the attainment of fiscal surpluses of 1.2% of GDP in each year of the forecasting horizon (2008-2010).

In 2007 Q4 the contribution of net external demand to output growth improved by an additional 0.3 pp, meaning that its contribution to the increase in GDP stood at –0.3 pp, furthering the correction initiated in 2005. This improved contribution of net external demand during 2007 came about in a setting in which world trade flows remained considerably buoyant, albeit lower than the previous year, owing to the slightly slacker growth of demand from United States and from other developed economies. The habitual indicators of price competitiveness worsened on a scale similar to that seen in previous years, due mainly to the appreciation of the euro over the course of the year. A significant exception here were the indicators calculated using unit labour costs, which improved marginally.

The partial information available in Q4 points to the continuing buoyancy of exports, upheld by the sound march of the emerging countries, and to somewhat less expansive imports, in the face of the mild slowdown in final demand. The relatively differentiated behaviour of goods exports and services exports is expected to have continued. This is particularly so in the case of exports of tourist services, which were once again relatively sluggish, perhaps reflecting the effect of the loss of competitiveness. As a result of these developments in trade in goods and services, the trade deficit continued to widen in the closing months of the year, albeit at a lesser pace than in the past, as did the nation's net borrowing, which stood in Q3 at a figure equivalent to 9 % of GDP (in cumulative four-quarter terms).

On the supply side, the slowdown in value added in the market economy in Q4 was due to the loss of momentum of activity in the construction sector and, to a lesser extent, in manufacturing industry, prolonging in both cases the tendency that had become perceptible in prior quarters. In the case of construction, the slowdown in activity came about above all in the residential construction component, which had begun to respond to the diminished buoyancy of the demand for housing. In the case of industry, the gradual loss of steam observed since the start of the year might be due to the ongoing deceleration in final demand, compared with the figures attained the previous year, and, above all, to the construction-sector cycle, which may have prompted an appreciable decline in the demand for certain industrial products. Finally, mention should be made of the strong growth in services activity during 2007, with a growth rate of over 4% in both the market and non-market components.

The slowdown in GDP in the year as a whole fed through with similar intensity to the pace of job creation, meaning that the growth in employment in 2007 on average may be standing at around 3%, 0.2 pp below the rate recorded in 2006. Across the productive branches, the loss of dynamism in job creation in Q4 was sharper in construction, while in industry and in non-market services the slowdown was more moderate. Employment in the market services branch remained notably resilient. According to EPA figures, the temporary employment ratio dipped significantly in Q4 to 30.9% (33.8% a year earlier).

Developments in labour costs in 2007 made for a rise in compensation per employee in the market economy for the year on average to a rate of 3.8%, compared with 3.3% in 2006. On this estimate, and unlike in previous years, the increase in compensation per employee outpaced wages under collective bargaining agreements, where settlements stood at 3.2% (an agreed increase of 2.9% for the year and 0.3 pp more further to the application of the indexation clauses). As a result, wage drift should have ceased to act as a factor of wage moderation, despite the fact that in 2007 the characteristics of new labour market entrants did not change substantially. The acceleration in compensation per employee has passed through to unit labour costs in a similar proportion, since these rose to 2.5% (compared with 2% in 2006), although their growth rate has drawn closer to the growth of costs in countries with which Spain competes internationally. This behaviour of labour costs, along with the continuing widening of margins (albeit less intensely than in recent years) and the successive shocks that have affected the prices of products basic to productive processes and consumption, has meant that there were no appreciable improvements in the inflationary situation in 2007. In this respect, the core inflation rate held at 2.7% for the year on average (compared with 2.9% in 2006), although the sizeable slowdown in non-energy industrial goods prices during the year should be viewed favourably. Yet the rise in the CPI at year-end to a growth rate of 4.2% year-on-year is a cause for concern; despite being due in principle to temporary factors, it may ultimately generate permanent effects on cost and price formation processes via the indexing mechanisms in place.

The Spanish economy ended 2007 with notable growth, after having undergone a mild slowdown similar in intensity to that forecast at the start of the year. The year has seen further progress in the rebalancing of the economy's sources of growth, with a significant correction in the contribution of net external demand to GDP growth and a restructuring of domestic spending towards productive investment. A slowdown in lending extended to households and firms has begun, in line with the course of their fundamentals, enabling a more sustainable trend in private-sector debt to be envisaged. Sufficient factors are therefore in place so that the Spanish economy may face the foreseeable slowdown in the coming quarters and see such a deceleration unfold on a gradual path. However, this outlook is shrouded in greater uncertainty than in the past, owing to the episode of financial turbulence besetting the world economy since last summer, the true scale and duration of which is only now becoming apparent.

2 The external environment of the euro area

During the last quarter the international economic environment continued to be marked by the behaviour of the financial sector. From mid-October, the tensions on credit and money markets worsened, spurred by several factors. These included most notably the announcement of heavy losses linked to sub-prime mortgages by leading global – and in particular US – financial institutions, which confirmed their sizeable exposure to sub-prime mortgage market-related assets and other structured products; the further downgrading of these products; and the continuing deterioration of the US housing market. Against this background, the Federal Reserve agreed on two cuts, each for 25 bp, at its October and November meetings. Moreover, to ease money market pressures, heightened by year-end seasonal factors, the main central banks conducted extraordinary liquidity-providing operations, some on a coordinated basis, and the Federal Reserve announced the creation of a new instrument, the TAF (Term Auction Facility). After a short lull, financial volatility worsened in early January following the adverse figures on economic activity and the reporting of negative banking results for Q4 in the United States. On this occasion, the impact on stock markets and on corporate credit spreads was particularly marked. Overall, the weakening in indicators and growth prospects coupled with the deterioration in financial conditions prompted a significant additional cut of 75 bp to interest rates by the Federal Reserve, one week ahead of its scheduled meeting. The emerging markets, which had been showing greater resilience in the face of the turbulence than in previous episodes, also saw financial conditions worsening. As a result, sovereign spreads widened in 2007 Q4, marking a two-year high, and stock markets fell sharply. Brent oil prices increased strongly, reaching an all-time high of around $98 per barrel in early January, although the worsening US economic outlook has led to an adjustment to below $90 in recent days. The rise in energy prices and, above all, in food prices fed through to inflation rates, which rose across the board (see Box 1).

In the United States, the final GDP estimate for Q3 showed annualised quarterly growth of 4.9%, up on the initial estimate. However, the higher frequency indicators point to signs of a slowdown in Q4. Consumer confidence indicators continued to worsen, although consumer spending was not significantly affected until December, when retail sales declined sharply. All the housing market indicators reflected the scale of the adjustment the residential sector is undergoing; in particular, the indicators of business confidence in the construction industry fell to historical lows. The PMI services index remained in positive territory and industrial production held stable in November and December, although the PMI manufacturing index fell into negative territory in the latter month, posting its lowest level since April 2003. Finally, the labour market, which had proven notably resilient to the slowdown, showed signs of weakening in December. Employment creation fell to 18,000 net jobs, the lowest figure since August 2003, and the unemployment rate rose from 4.7% to 5%, the highest level since November 2005. Inflation surged notably, driven by energy and food prices, and ended 2007 at a year-on-year rate of 4.1%, compared with 2.7% in September, while the core inflation rate stood at 2.4%. In the light of this, and as indicated, the Federal Reserve cut its federal funds target rate by 75 bp ahead of the FOMC meeting scheduled for end-January, making for a total reduction of 175 bp since the start of the turbulence, with further cuts expected.

In Japan, the latest indicators suggest some loss of dynamism in industrial activity in recent months. There was a significant deterioration in the business confidence indices for Q4 and a decline in industrial production in November. Nonetheless, the PMI manufacturing index rose in December. On the demand side, the consumer spending indicators continue to trend favourably in November, but the consumer confidence indicators fell to a four-year low, set against a

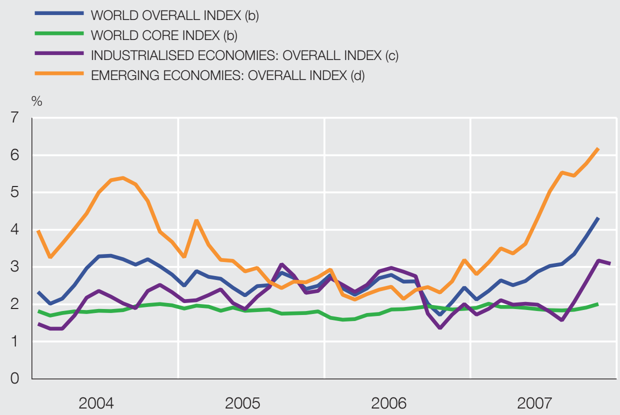
One of the key characteristics of recent quarters has been the world-wide rise in inflation, driven by the high growth of international commodity prices. Given the current uncertainty surrounding the international economic outlook, this rise might trigger monetary policy dilemmas in some countries, developed and emerging alike. This box reviews the global rise in inflation in 2007 and its relationship to food and energy price developments.

During 2007 global inflation grew significantly, rising in year-on-year terms from 2.4% at end-2006 to 4.3% in November (see Panel 1). In contrast, core inflation - which excludes energy and food prices[1] - held in a narrow range around 2%, and with little difference between developed and emerging countries. A similar episode, involving a rise in overall inflation and unchanged core inflation, occurred in the first half of 2004, but on that occasion the gap was smaller. Indeed, the difference between both rates at present, at 2.3 pp, is at a five-year high.

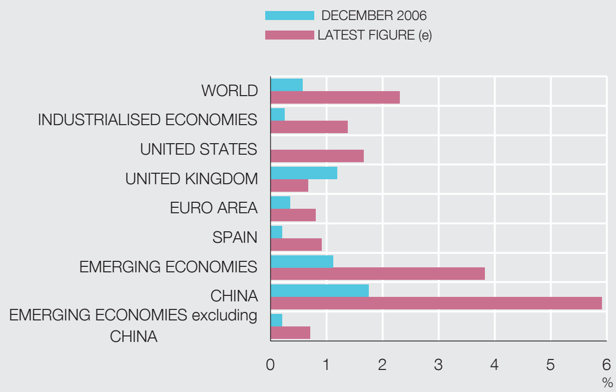
As can be seen in Panel 1, the course of prices in the emerging economies accounts for approximately two-thirds (1.1 pp) of the increase in global inflation to November 2007. It should be clarified that most of the rise seen in Panel 1 for the emerging economies (3 pp) can be explained by inflation developments in China, given the sizable weight (60%) of this economy in the aggregate of emerging countries and the strong surge in Chinese inflation. Specifically, China accounts for 2.5 pp of the inflation increase in the emerging countries and 0.9 pp of the world total. However, in other emerging economies, such as Chile or certain Eastern European countries, prices have also risen significantly, while in

1. The lack of homogeneity in the construction of the core inflation series in the different countries means that the aggregate core inflation series depicted in Chart 1 may include processed food in some countries, Spain and the euro area among them.

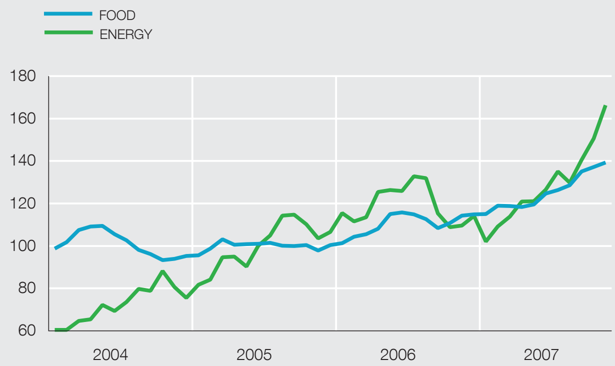
1 CPI: OVERALL AND CORE INDICES (a)



2 HEADLINE AND CORE INFLATION. INFLATION GAP



3 COMMODITY PRICE INDICES (f)



4 CHANGE IN INFLATION AND WEIGHT OF FOOD AND ENERGY IN THE CPI (x-axis) (g)

SOURCES: IMF, national statistics and Banco de España.

a. Year-on-year rates of change.
b. Aggregate calculated drawing on data from 39 countries accounting for more than 70% of global GDP.
c. United States, Canada, Japan, euro area, United Kingdom, Denmark, Norway and Sweden.
d. Brazil, Chile, Mexico, Colombia, Venezuela, Peru, Poland, Hungary, Bulgaria, Romania, Czech Republic, Estonia, Latvia, Lithuania, Slovakia, China, Korea, Thailand and South Africa.
e. November 2007 for emerging countries and world total, and December for the rest.
f. IMF Commodity Food Price Index and Commodity Fuel (energy) Index. The latter includes oil, coal and natural gas. For both indices, 2005 = 100.

other countries the rises have not been so marked although they are of interest from a qualitative standpoint. For instance, Brazil's overall inflation, after having moved for several years on a declining trend, began to rise in the second half of 2007, outpacing core inflation.

In most areas and countries there has been an observable widening of the gap between overall and core inflation since end-2006 (see Panel 2). The difference increased from 0.6 pp at end-2006 to 2.3 pp in November last year. In the developed economies, the gap widened by 1.1 pp to 1.4 pp in this period. In the United States it was 1.7 pp, while in the euro area it was 0.5 pp. The United Kingdom is an exception, since the gap has narrowed relative to that in place at end-2006. In the emerging economies, the increase in the gap was 2.7 pp (on data to November), with the figure for China (4.2 pp) standing out. Without China, the increase in the aggregate of emerging economies was less than that in the developed countries, since overall and core inflation trended similarly in Latin America, and in Eastern Europe core inflation also rose in 2007.

The widening gap between overall and core inflation can be accounted for by dearer food and energy, the prices of which have risen significantly on international markets. Food prices have grown at a year-on-year rate in excess of 10% since mid-2006, while energy prices have been more volatile, stabilising in the first eight months of the year, but posting a year-on-year growth rate in December of close to 45% (see Panel 3). The impact of these rises on each country's inflation depends on two things: i) the extent to which they pass through to domestic consumer prices, and ii) the weight of food and energy in the CPI, i.e. the composition effect.

Regarding i), there is some evidence that food consumer prices have grown more in the emerging economies than in the industrialised countries. Specifically, according to the IMF[2], the year-on-year rate of food prices increased by around 2 pp more in the emerging countries in the first four months of 2007.

Panel 4, which shows the relationship between the rise in inflation in the past year and the weight of food and energy in the price index, provides evidence on the composition effect. The sample includes data on the weight of food in 58 countries (19 of which industrialised, and 39 emerging and developing) and data on the weight of energy in 33 countries (18 industrialised, and 15 emerging and developing). The panel illustrates the positive and statistically significant relationship between the weight of food and the rise in overall inflation during 2007. This relationship may, however, be affected by the fact that the weight of food is greater in the less developed economies, which usually also have higher structural inflation. Moreover, higher inflation will foreseeably be accompanied by greater volatility and, therefore, a sharper rise.

In the case of energy, fewer data are available and the relationship, though positive, has a lesser slope and is not significant; accordingly, with the sample available, it could not be stated that the greater the weight of energy in the CPI, the higher the rise recorded. The moderate trend of energy prices for most of the year may have contributed to this lack of a statistical relationship.

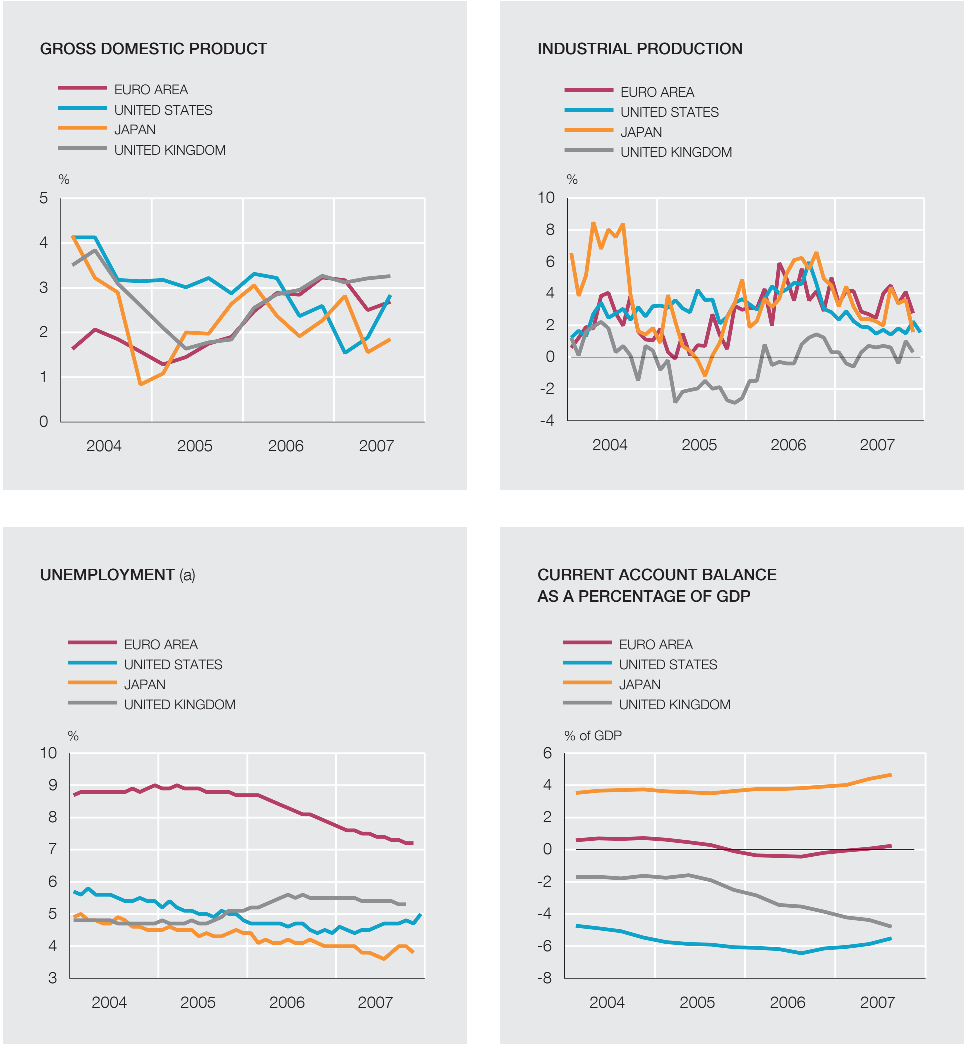
2. *World Economic Outlook*, September 2007: Box 1.1, "Who is Harmed by the Surge in Food Prices?"

worsening labour market. Here there was a further decline in the ratio of vacancies to job-seekers, which is indicative of a potential easing in the pace of job creation, and a moderate fall in wages. The construction industry continued to contract, as a result of the enactment of new regulations, but there were signs that the adjustment might be nearing its end, which would allow for some normalisation in the coming months. On the external front, there was a slowdown in exports in November and a rise in imports, linked to dearer oil. The year-on-year rate of change of consumer prices rose in November, standing at 0.6% for the overall index and at 0.4% for the core index, as a result of the rise in the prices of oil and oil derivatives and, to a lesser extent, of food. The Bank of Japan official interest rate held unchanged at 0.50%.

In the United Kingdom, GDP in Q3 posted a quarterly rate of 0.7% (3.3% year-on-year). In Q4, growth was 0.6% up on the previous quarter, which reduced the year-on-year rate to 2.9%, a somewhat better figure than expected. In fact, after a relatively sluggish start to Q4, the latest indicators of activity and demand showed an unexpected improvement, as testified by the increase in November retail sales and the rises in the PMI indices for services and construction in December. Conversely, the PMI manufacturing index dipped in December and orders fell heavily. Uncertainty persists over the housing market, where prices have eased back to rates of 5.2% and 4.8%, respectively, according to the Halifax and Nationwide indices. The latest mortgage loans figures reveal these have stagnated at the lower levels reached in October, far down on those of a year ago. The Bank of England

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

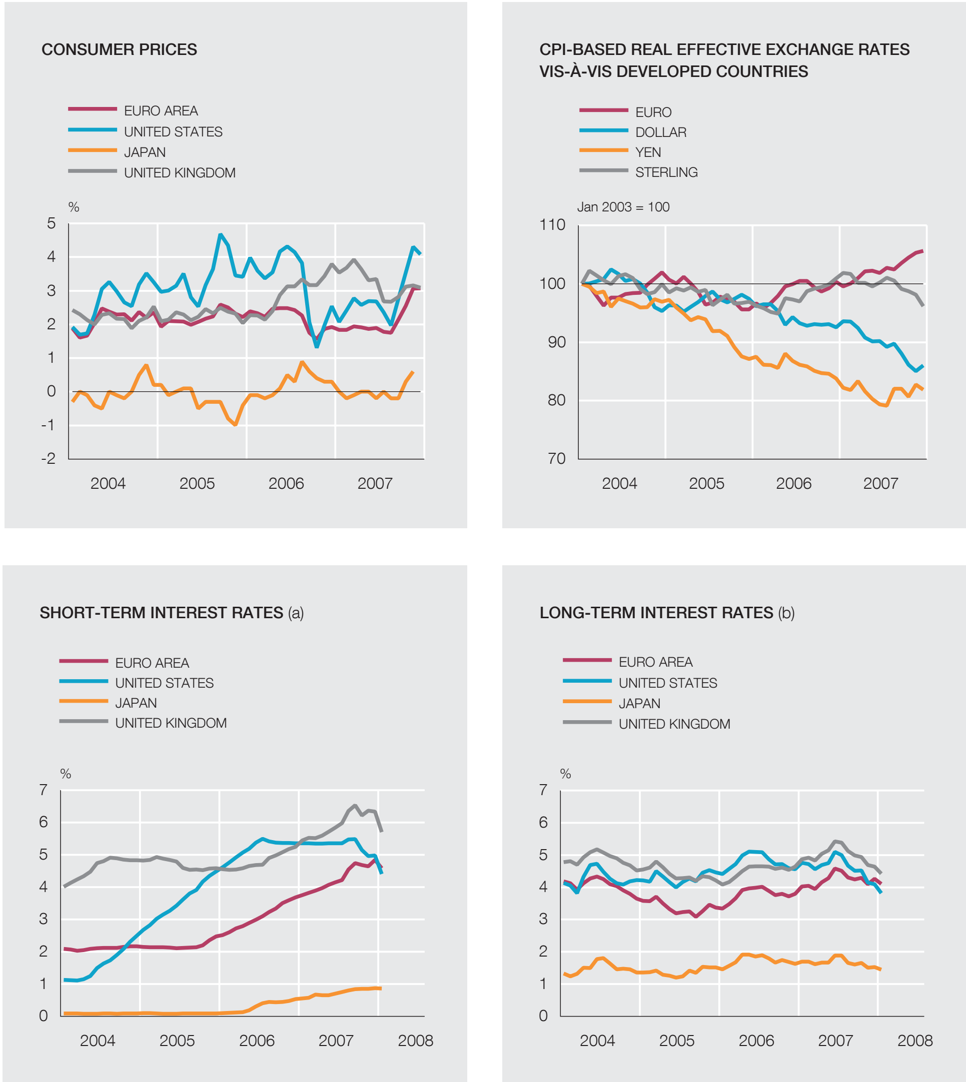
cut its official interest rate in December by 25 bp to 5.5%, holding it at this level at its January meeting.

The aggregate GDP of the new Member States of the European Union slowed slightly, as expected, to a year-on-year rate of 5.7%, compared with 6.2% the previous quarter. Of note was the weakness of Hungary, whose GDP grew by only 0.9% year-on-year. The indicators of industrial production and retail sales for Q4 show that moderation remains the keynote. Inflation rates – and their dispersion – continued to increase in November, in a range from 2.3% in Slovakia to 13.7% in Latvia. Official interest rates were held unchanged, with the sole exception of Romania, where they were raised by 50 bp to 8%. The currencies participating in the Exchange Rate Mechanism (ERM II) trended around their central parities, with the exception of the Slovak koruna, which has appreciated by close to 5%. In the political realm, Cyprus and Malta adopted the euro on 1 January 2008, raising the number of euro area member countries to 15.

In China, GDP grew by 11.2% year-on-year in 2007 Q4, 0.3 pp down on Q3. The rate for the year as a whole thus stood at 11.4%, compared with 11.1% in 2006. Industrial production and

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

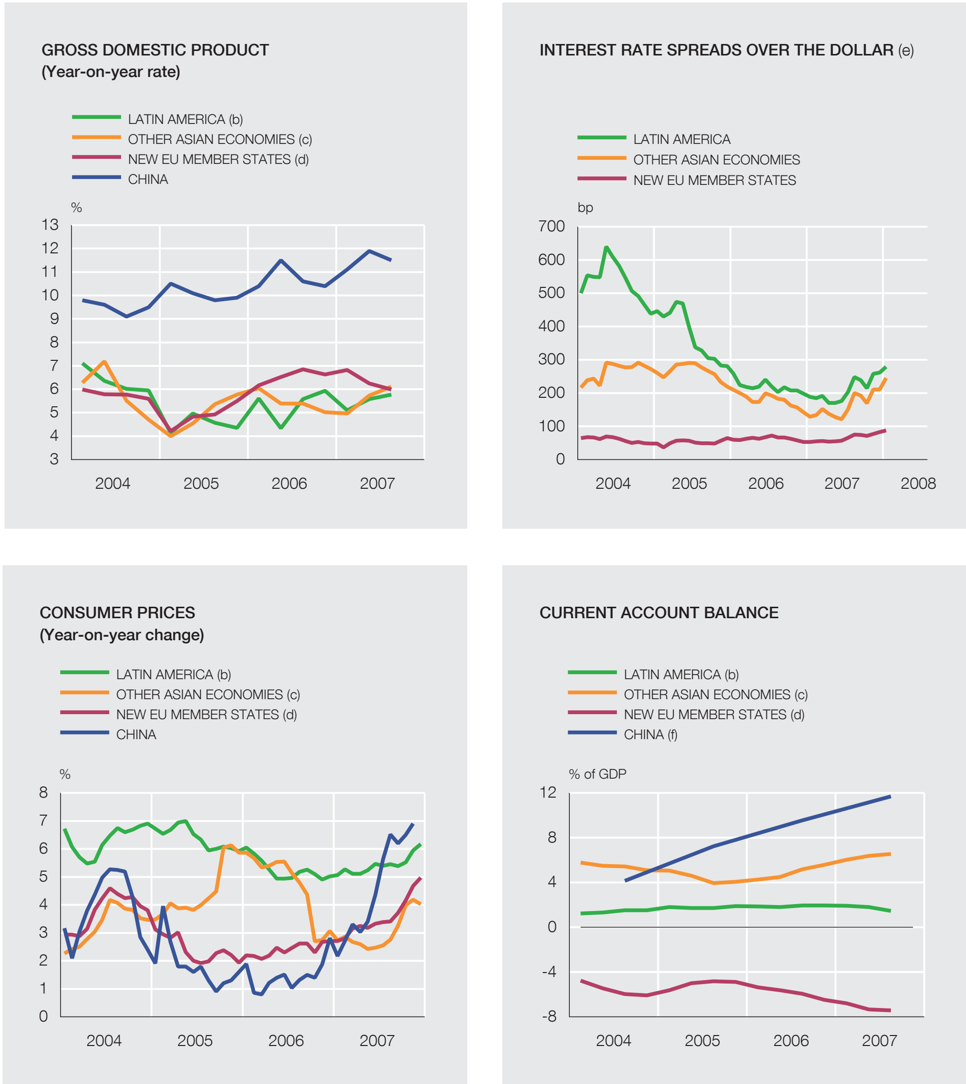
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

investment in fixed assets showed signs of easing at the end of the year, while retail sales quickened. The trade surplus continued to widen, and for 2007 as a whole it was 47.4% greater than that in 2006, although mention should be made of the mild slowdown in exports in the closing months of the year. The year-on-year growth of consumer prices eased slightly in December to 6.5%, 0.4 pp down on November, partly reflecting a base effect. Against this background, the economic authorities announced a change in monetary policy stance for 2008 (from moderate to restrictive), they raised the benchmark interest rates for loans and deposits (by 18 and 27 bp, respectively), they increased the bank reserve requirement on three occasions (to 15%), they allowed the renminbi to appreciate somewhat more rapidly, and they introduced taxes on cereal exports and selective price controls. In the rest of Asia, economic activity tended to slow slightly in 2007 Q4 and inflation continued to rise gradually, driven by higher energy and food prices. In December, Hong Kong and the Philippines cut their official rates by 25 bp.

GDP growth in Latin America in 2007 Q3 was 5.8% year-on-year, compared with 5.6% the previous quarter. Domestic demand accelerated – with investment remaining the most dynamic com-

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 World Bank 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, Slovakia, 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.

ponent in all the countries – and the contribution of external demand was more negative. All the countries, except Chile and Colombia, posted higher growth, which was particularly notable in Mexico, Venezuela and Uruguay. Indicators for Q4 suggest economic dynamism will hold firm in most of the countries. Concerning prices, regional inflation stood at 5.8% in December as a result of an across-the-board rise, markedly so in Chile and, above all, Venezuela. Core inflation edged up from 5.3% in September to 6.1% in December. As to monetary policy, during the quarter there was an increase in official rates of 50 bp in Chile, and of 25 bp in Colombia, Mexico, Peru and Uruguay. Finally, both Chile and Ecuador saw their credit ratings upgraded. In Brazil, the government announced expenditure-cutting measures and tax rises to offset the repeal of the tax on financial transactions. Mexico resorted to the international capital markets under favourable conditions. And in Argentina there were further episodes of the energy crisis.

The information available on activity in 2007 Q4 is consistent with significant moderation in the GDP growth rate. The persistence of high oil prices, the strength of the euro, the reduced buoyancy of the economies of the euro area's main trading partners and the prolongation of financial tensions form a somewhat less favourable scenario for 2008 than that considered in the October edition of this Bulletin. This is indeed apparent in the most recent forecasts by private bodies, which point to GDP growth at slightly below potential in the coming quarters. However, the euro area continues to enjoy sound fundamentals, employment is displaying a favourable trend and, externally, the emerging economies continue to drive the area's exports (see Box 2). That said, the uncertainty surrounding the rate of growth of activity in the medium term is very high and dominated by downside risks, which have been growing in recent months. Notable among them are the possibility that the re-pricing of risk on financial markets will be prolonged and will have a greater than expected macroeconomic impact, the potential for further increases in commodity prices and disorderly adjustment of international imbalances (see Box 3).

In 2007 Q4, inflation rose significantly, as a consequence of fresh increases in energy and food commodity prices. The latter affected underlying inflation, which stood at over 2% in December. The presence, in addition, of significant base effects on energy prices amplified the impact of the upward shocks in the quarter, which was only partially offset by euro appreciation. In the coming months inflation can be expected to remain at rates significantly above 2%, although it will foreseeably start to moderate gradually in the second half of 2008. However, two conditions must be met for this moderation to take place: there must be no further rises in commodity prices; and generalised second round effects on wage and price setting must not be triggered.

Against this background, the ECB's Governing Council decided to leave the key ECB interest rates unchanged at 4%, referring again to the presence of upside risks to medium-term price stability. The ECB also stated its determination to act pre-emptively so that second-round wage effects do not materialise and inflation expectations remain firmly anchored in line with its objective of price stability. As regards fiscal policy, the general government deficit was reduced in 2007 by 0.7 pp, to 0.8%, according to the aggregation of the deficits presented in the stability programmes. According to these sources, in 2007, for the first time since 2000, not a single country in the area recorded a deficit of more than 3%. However, implementation of the preventive arm of the Stability and Growth Pact has not been sufficient; while the economic boom and extraordinary revenues have created favourable conditions for progress towards medium-term objectives (MTOs), the structural impact of fiscal consolidation has been limited.

On 1 January 2008, Cyprus and Malta joined the Monetary Union. Both countries successfully completed adoption of the euro in January.

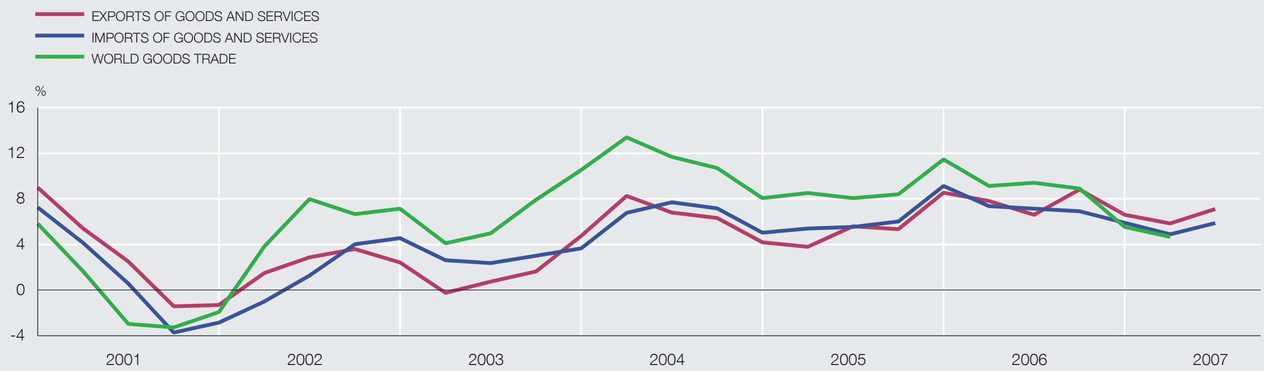
3.1 Economic developments

According to the second National Accounts estimate for 2007 Q3, euro area GDP grew by 0.8% quarter-on-quarter, 0.5 pp more than in the preceding period (see Chart 8). The acceleration in output stemmed from stockbuilding, which contributed 0.2 pp to growth, after deducting 0.3 pp from the previous quarter's GDP increase, and from the contribution of domestic demand, which increased to 0.7 pp (0.4 pp in the previous quarter). The strength of the latter was underpinned by gross fixed capital formation, as a result of the recovery in

According to National Accounts data available to Q3, euro area external trade flows decelerated in 2007, following their exceptional buoyancy in 2006 (see Chart 1). Exports of goods and services slowed, to an average growth rate of 6.5% between January and September (from 7.6% in the same period of 2006), as a consequence of lower world trade growth and the materialisation of the effects of the appreciation of the euro exchange rate which, in nominal effective terms, rose by more than 6% between the beginning of 2006 and September 2007. Imports, meanwhile, suffered a larger loss of momentum in the same period, since their growth rate fell from 7.9% in 2006 to 5.6% in 2007. This was attributable to the smaller increase in euro area final demand, since, in the other direction, the appreciation of the euro reduced their relative price.

In relation to exports of goods, and based on data to September, the loss of momentum was greater in the case of intra-euro area sales than in that of those outside the euro area, so that the weight of the former within total exports continued to decline. With regard to geographical

1 EXTERNAL TRADE (a)



2 GOODS EXPORTS. BY AREA

	2006			2007				
	(%)	J-Dec	J-Sep	(%)	J-Sep	Q1	Q2	Q3
TOTAL		**6.6**	**6.3**		**4.9**	**5.8**	**4.1**	**4.9**
INTRA-AREA	48.2	**4.7**	**4.8**	**47.7**	**3.3**	**4.6**	**2.3**	**3.0**
EXTRA-AREA	51.8	8.3	7.7	52.3	6.5	7.1	5.9	6.6
United Kingdom	8.1	2.3	2.5	8.0	1.9	1.8	0.2	3.6
United States	7.8	4.6	4.5	7.5	-1.5	-0.9	-1.7	-1.8
Russia	2.0	22.7	18.9	2.2	19.3	22.4	22.7	14.1
Japan	1.4	1.4	1.1	1.4	1.0	0.4	7.0	-3.9
China	2.0	19.4	17.6	2.1	10.1	7.6	15.0	8.1
South-east Asia	1.6	9.0	6.0	1.6	10.5	10.9	15.6	5.4
Latin America	2.2	14.0	14.1	2.3	11.4	11.1	10.9	12.2
Switzerland	2.7	6.0	3.3	2.7	5.2	9.2	4.2	2.3

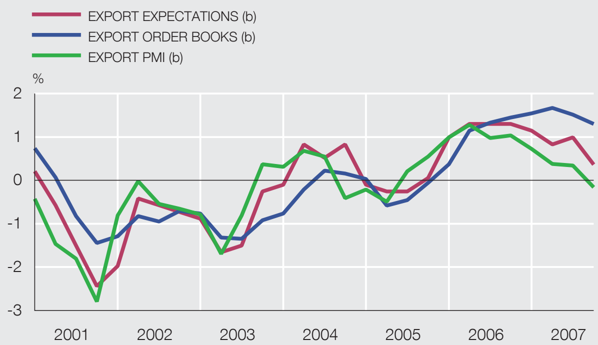
3 GOODS IMPORTS. BY PRODUCT

	2006			2007				
	(%)	J-Dec	J-Sep	(%)	J-Sep	Q1	Q2	Q3
TOTAL		6.2	6.0		4.0	4.8	3.1	4.1
EXTRA-EURO AREA	51.3	6.8	6.7	51.5	4.2	5.8	2.8	4.1
Food	7.6	3.6	3.9	7.5	3.2	4.4	2.8	2.5
Commodities	4.1	9.6	7.5	4.1	4.2	10.3	4.6	-2.0
Oil	9.6	1.6	1.7	9.0	-4.5	-7.0	-3.0	-3.5
Manufactures	78.1	7.4	7.2	79.2	5.6	6.9	4.1	5.9
— Chemical products	14.0	7.2	6.6	14.8	9.5	11.4	7.5	9.7
— Transport equipment	38.4	7.2	7.5	37.9	4.0	4.1	2.3	5.7
— Other	25.9	7.8	7.0	26.5	5.8	8.5	4.9	4.0

4 EXTERNAL GOODS TRADE IN NOMINAL TERMS. RECENT DEVELOPMENTS (a)

	2006	2007				
		Q1	Q2	Q3	Oct	Nov
EXPORTS	**10.7**	**8.4**	**7.5**	**8.0**	**8.6**	
INTRA-AREA	9.4	8.0	6.3	6.7	6.6	
EXTRA-AREA	12.1	8.8	8.9	9.3	9.6	4.5
IMPORTS	**12.4**	**6.0**	**5.1**	**6.4**	**8.2**	
INTRA-AREA	10.2	7.2	7.4	7.7	8.6	
EXTRA-AREA	14.5	4.8	2.9	5.2	7.4	6.7

5 CONFIDENCE INDICATORS



SOURCES: Eurostat and IMF.

a. Year-on-year rates of change.
b. Normalised data.

destination, the data show that, among the most developed countries, sales to the United States contracted, while those to the United Kingdom and Japan grew at similar rates to the previous year, which were well below average. On the other hand, exports to emerging regions were highly buoyant, so that they maintained or, in some cases, intensified their role as the main recipients of European products. Notable within this group, were the exports to China, Latin America, south-east Asia and Russia, which grew at rates of over 10%.

According to data that is still provisional and only reaches the first half of 2007, the slowdown in world trade was stronger than that in euro area external sales, so that the euro area's loss of market share in international goods markets was curbed in 2007, despite the appreciation of the euro. A positive contribution to this phenomenon may have been made by the geographic diversification of European exports towards emerging countries with high economic growth rates, to the detriment of other more developed regions, whose markets are less dynamic and, moreover, more affected by the world economic slowdown.

Meanwhile, imports of goods, both intra and extra-euro area ones, lost momentum in the period analysed. As regards product types, the growth rates of all goods categories, with the exception of chemical products, declined (see Table 3). The fall in imports of oil products, mainly concentrated in Q1, and the reduced buoyancy of manufactures and machinery and transport were notable. In fact, capital goods suffered the largest deceleration in the period January-September 2007, which may indicate that firms are expecting a smaller increase in future demand.

The still-incomplete Q4 data indicate that the strength of the external sector was maintained in that period. Thus, nominal exports and imports according to the trade balance and qualitative indicators, like the assessment of export order books and euro area producers' export expectations compiled by the European Commission, held at high levels in 2007 Q4 (see Table 4 and Chart 5). More in the medium term, the strength of exports will depend to a large extent on future developments in the euro area's external environment, which is currently subject to uncertainties relating to the extent of the effects of the financial turmoil. The euro area's external purchases, meanwhile, will continue to expand in line with final demand and will benefit from the appreciation of the euro.

construction investment and the continued buoyancy of equipment investment, since government and private consumption grew at rates of around 0.5%. Finally, net external demand deducted 0.1 pp from output growth, as against the positive 0.2 pp contribution of the previous period, as imports accelerated by more than exports. In year-on-year terms, the GDP growth rate was also stronger, at 2.7%. The breakdown of output by sector reveals particular strength in industry (1.4%) and in market services, while construction was subdued.

Developments in activity in the main euro area countries followed a similar pattern to the euro area as a whole. Thus, with the exception of Spain, where activity slowed moderately from very high growth rates, GDP in the largest countries grew at a higher rate than in the previous quarter. Gross fixed capital formation was generally highly buoyant. In Germany, output grew by 0.7%, its composition showing similar patterns to those of the aggregate for the area, while in France (where a 0.8% increase was observed) the strength of private consumption was notable. In Italy, GDP growth accelerated to 0.4%, well below the euro area average.

Employment grew in 2007 Q3 at a rate of 0.3%, half of that rate recorded in Q2 (see Chart 9). However, in year-on-year terms the rate was close to 2%, the highest since early 2001. Thus, labour productivity increased by 0.8%, so that the slowdown observed in the first half of the year halted. Labour costs, meanwhile, still showed no sign of wage pressures. Compensation per employee increased by 2% year-on-year, so that unit labour costs grew by 1.2%, a similar rate to that of the preceding quarter and below that of the GDP deflator. This entailed a further widening of margins.

The most recent indicators point to a reduction in the pace of real activity in 2007 Q4 (see Chart 10). On the supply side, the industrial production index (on data to November)

In 2007 Q4, the tensions that emerged in global credit and structured-product markets last summer intensified, against a background of deterioration in the US real-estate market and great uncertainty surrounding the eventual losses that financial intermediaries exposed to sub-prime mortgages and derivatives may suffer. Risk indicators deteriorated, especially those relating to financial firms (see Chart 1). Moreover, this further review of risk also affected covered bonds and mortgage-backed securities issued in the euro area, widening their yield spread. These are both instruments that have been playing an important role in the financing of mortgage lending.

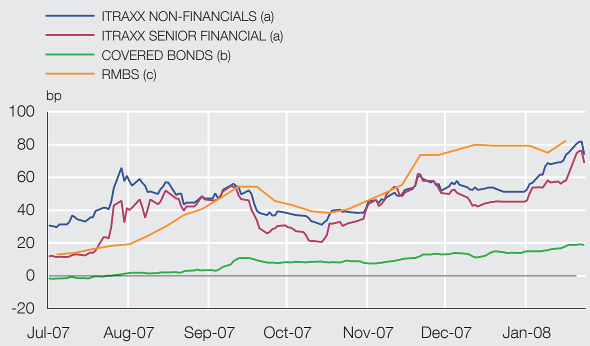
The increase in the cost of debt made it difficult for the euro area private sector to obtain medium and long-term funds on the markets. According to the information available to November, there was a decline in the issuance of debt securities by non-financial corporations (see Chart 2). In the case of monetary financial institutions, the rise in the cost of long-term issuance has prompted greater recourse to short-term instruments. By contrast, non-monetary institutions maintained relatively high volumes of long-term issuance, mainly of asset-backed securities. It is possible that the latter are being acquired by the same institutions that originate the loans, so that they have a larger amount of assets eligible as collateral in transactions with the Eurosystem.

Again, the tightening of pressures was particularly evident in the money markets,[1] since the higher fund requirements at the end of the year increased the institutions' fear of finding themselves short of liquidity, and interbank deposit rates rose notably from mid-November, especially when the term began to include the change of year (see Chart 3).

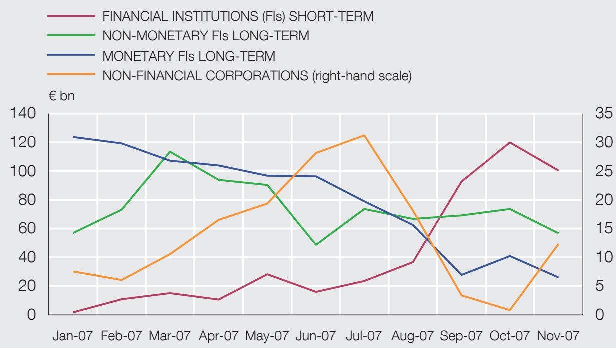
This situation led to further interventions by the ECB, sometimes in co-ordination with other central banks, like the possibility of offering dollar funding through a swap line with the Federal Reserve. In November, the ECB announced that it would satisfy liquidity demands beyond the neutral or benchmark amounts in its main refinancing operations, at least until the end of the year. In addition, the tender of 19 December, whose maturity was exceptionally two weeks, was preceded by the announcement that all bids at or above the weighted average rate of the last tender (i.e. 4.21%) would be satisfied, which entailed an allotment of €168 billion above the benchmark amount[2] (see Chart 4). These interventions were combined with subsequent liquidity-absorbing operations, so that the total lending

1. For a description of developments in the interbank market since the summer, see Box 3 of the October 2007 Quarterly Report.

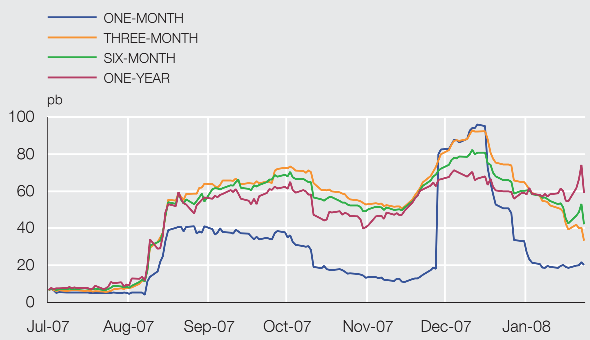
1 RISK INDICATORS



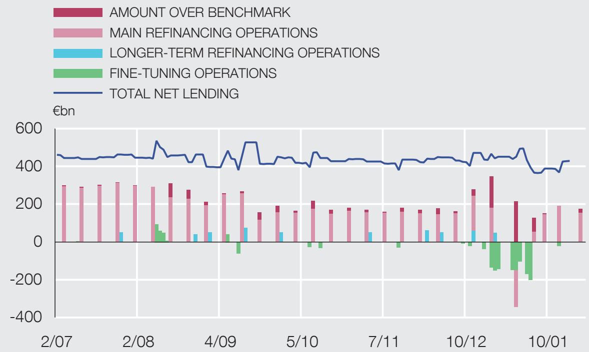
2 NET FIXED-INCOME ISSUANCE IN 2007 (d)



3 EURIBOR-REPO SPREAD



4 VOLUMES ALLOTTED IN ECB OPEN MARKET OPERATIONS (e)



SOURCES: European Central Bank, Datastream and JP Morgan.

a. Traded indices of a basket of credit default swaps.
b. Spread over swaps. Five-day moving averages.
c. Euro-denominated AAA-rated mortgage-backed securities. Spread over three-month Euribor. Unweighted average of the indices available for countries.
d. Cumulative three-month data.
e. Includes regular one-week operations (main refinancing operations), three-month operations (longer-term refinancing operations) and non-regular fine-tuning operations.

granted in open market operations did not change significantly with respect to previous months. In this respect, the liquidity provided by the ECB since the summer has entailed a change in the maturities and in the rate at which institutions accumulate liquidity in the maintenance periods, but have not had an expansionary effect on monetary conditions, beyond what may be inferred from their impact on money market rates.

The announcement and implementation of these actions reduced the upward pressures on unsecured interbank deposit rates, especially at the shortest maturities. This gradual relaxation continued at the beginning of 2008, although the spread over deposits with agreed maturity backed by government securities (repos) is still at similarly high levels to last summer. Also, private-debt spreads and risk indicators continued to deteriorate in January.

slowed with respect to the preceding quarter. On a positive note, the weakening of industry would be partially compensated by the notable increase in industrial orders in the same period of time. The opinion indicators obtained from confidence surveys also fell in Q4, more sharply in the services sector than in industry. However, the levels of these opinion indices are currently at around their long-term average and compatible with growth in activity at close to potential. Finally, the employment indicators behaved more favourably than the production ones. Thus, in Q4 the euro area unemployment rate fell further, to 7.2%, and the opinion surveys components referring to intentions to create jobs only declined slightly.

The short-term spending-related indicators indicate a loss of buoyancy in private consumption (see Chart 10). Specifically, retail sales and new car registrations fell in October and November. Likewise, the confidence of retailers and consumers deteriorated in 2007 Q4. Notable in the second of these two indicators was the component of willingness to purchase consumer durables, which stands at very low levels. This may reflect the tightening of credit conditions seen in the latest bank lending surveys and the persistent uncertainty surrounding resolution of the current financial turbulence. Investment indicators, such as order books and, to a lesser extent, capacity utilisation, have continued the downward trend that began six months ago, when they were at very high levels, but their level is consistent with relatively strong equipment investment. Finally, the indicators relating to the external sector reveal that both assessments of order books and export expectations deteriorated, which would indicate the possibility of a further fall in external orders in the coming quarter and of a possible export slowdown (see Box 3).

The deterioration in the activity indicators seen in 2007 Q4 reflects the combined action of various factors: rising oil prices, euro appreciation, the worsening outlook for the world economy and the effects that episodes of financial instability may be having on economic agents' financing conditions and confidence. In 2008, according to the latest forecasts, output may grow at below potential, if the negative consequences of the shocks mentioned above are exacerbated, although there are still some factors conducive to growth, such as the resilience of the emerging economies, the favourable financial position of non-financial corporations and the positive employment developments. Moreover, the latest bank lending survey reports a significant tightening in credit standards. Looking forward, a further tightening of these standards or more persistent restrictive conditions might exert a stronger than expected drag on spending.

The increase in the HICP was 3.1% in the last two months of the year, one percentage point more than in September (see chart 11). This notable rise in inflation has been caused by the energy component and by the trend in processed food prices. In the case of energy, the base

EURO AREA ECONOMIC INDICATORS (a) TABLE 1

	2006			2007				2008
	Q2	Q3	Q4	Q1	Q2	Q3	Q4 (a)	Q1 (b)
GDP								
Year-on-year growth	2.9	2.9	3.2	3.2	2.5	2.7		
Quarter-on-quarter growth	1.0	0.6	0.8	0.8	0.3	0.8		
IPI (c)	4.3	4.2	4.0	3.9	2.7	4.0	*3.4*	
Economic sentiment	106.8	108.2	109.9	110.0	111.6	109.3	105.2	
Industrial confidence	2.3	3.7	5.7	5.3	6.3	4.3	2.3	
Manufacturing PMI	57.1	56.9	56.7	55.5	55.3	54.2	52.3	*52.6*
Services confidence	18.7	19.0	19.7	20.7	22.3	20.0	15.0	
Services PMI	59.2	57.3	57.1	57.6	57.5	56.9	54.4	*52.0*
Unemployment rate	8.4	8.1	7.9	7.6	7.5	7.3	*7.2*	
Consumer confidence	-9.7	-8.3	-7.0	-5.3	-2.3	-4.0	-7.7	
HICP (annual growth) (d)	2.5	1.7	1.9	1.9	1.9	2.1	3.1	
PPI (annual growth) (d)	5.8	4.6	4.1	2.8	2.3	2.7	*4.2*	
Oil price in USD (d)	68.1	61.2	62.8	62.3	71.8	78.2	91.2	*92.4*
Loans to the private sector (annual growth) (d)	11.0	11.4	10.8	10.6	10.8	11.0	11.0	
Euro area ten-year bond yield	4.0	4.0	3.9	4.1	4.4	4.5	4.3	*4.2*
US-euro area ten-year bond spread	1.08	1.00	0.82	0.67	0.47	0.32	-0.03	*-0.36*
Dollar/euro exchange rate (d)	1.271	1.266	1.317	1.332	1.351	1.418	1.472	*1.466*
Appreciation/ depreciation of the euro (d)	7.8	7.3	11.6	1.1	2.5	7.7	11.8	*-0.4*
Dow Jones EURO STOXX Broad index (d)	4.2	11.9	20.3	3.4	9.9	6.1	4.9	*-13.0*

SOURCES: Eurostat, ECB and Banco de España.

a. Quarterly average. The information in italics does not cover a full quarter.
b. Information available up to 24 January 2008.
c. Year-on-year growth rates of working days adjusted data.
d. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

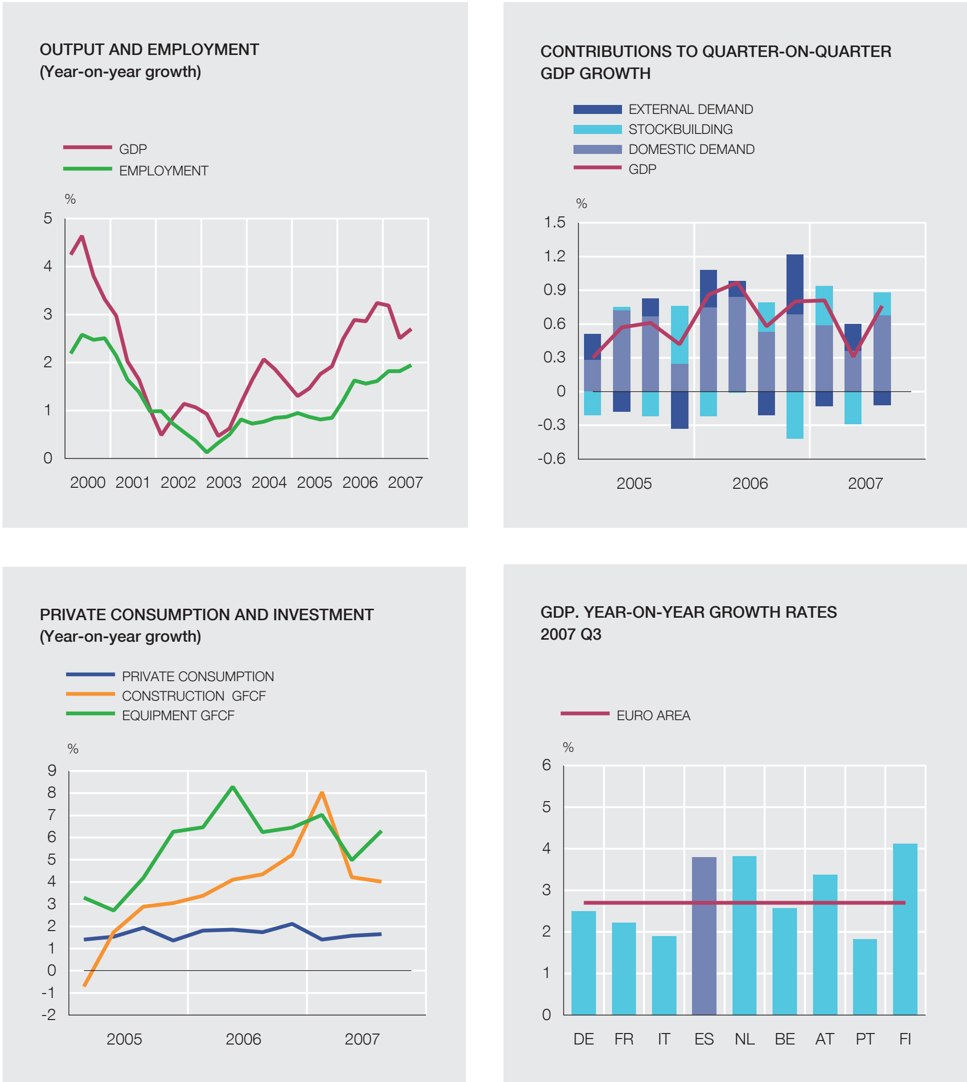
effect arising from the positive behaviour recorded in late 2006 has compounded the recent rise in the price of oil, which is currently at around 100 dollars per barrel of Brent. For their part, processed food prices accelerated constantly over the last five months, from 1.9% in July to 5.1% in December, owing to the notable increases in food commodity prices. This, in turn, was a result of the increase in demand (from the emerging economies, mainly China and India, and, to a lesser extent, from biofuel producers), but also of certain supply restrictions (e.g. in the case of cereals, owing to droughts). Thus, although the growth in services prices has remained steady in recent months, the upward trend in underlying inflation, evident since early 2006, has strengthened. Underlying inflation, as measured by the year-on-year rate of change in the HICP excluding unprocessed food and energy, ended 2007 at 2.3%, 0.7 pp above its December 2006 rate.

Producer prices accelerated in the second half, to a year-on-year rate of 4.1% in November, mainly as a result of the surge in energy prices. Also, the prices of non-durable consumer goods rose at progressively faster rates, owing to the behaviour of producer prices in the food industry. Nonetheless, the slowdown during the year in the prices of intermediate goods and, to a lesser extent, of capital goods counteracted the trend in the most inflationary components.

Headline inflation is expected to remain high in the coming months and to decline gradually during 2008 to levels more in line with price stability, provided that there are no further shocks. However, against the background of a relatively tight labour market, persistent high rates of inflation may lead to a deterioration in agents' expectations and activate second-round effects on wages. On

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

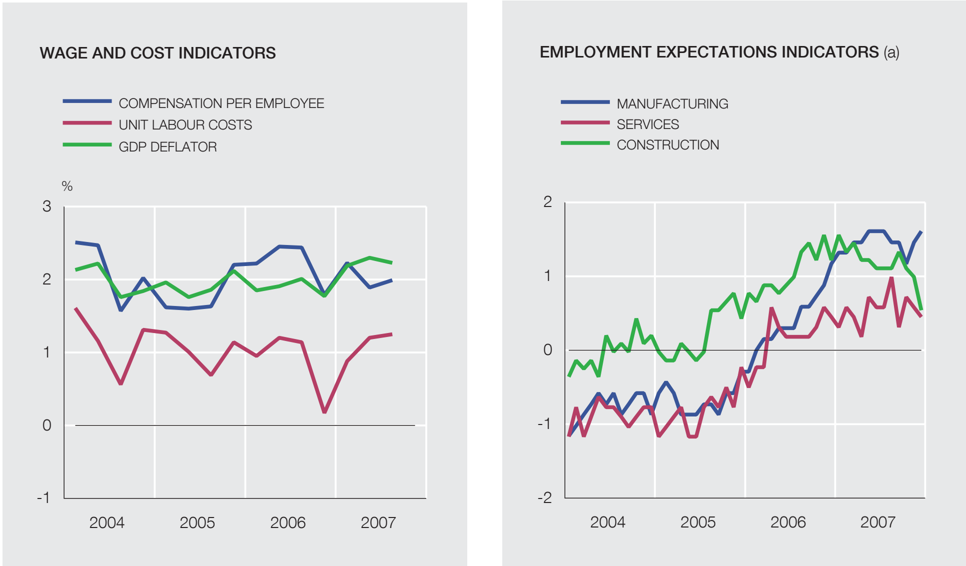
a more positive note, the structural labour market reforms of recent years have reduced the unemployment rate compatible with an absence of inflationary pressures (NAIRU), which would moderate the pressure on wages stemming from the fall in the actual rate of unemployment.

According to the estimates published by the ECB, the current account of the balance of payments recorded a surplus of €12.4 billion in 2007 (around 0.2% of GDP), as against a deficit of around 0.4% of GDP in the same period a year earlier. This improvement was mainly the result of a larger goods surplus (as exports increased by more than imports, with year-on-year increases of 9% and 5.2% respectively) and, to a lesser extent, of the improved services balance, which more than offset the increase in the income and current transfers deficit. At the same time, between January and October 2007 there were net capital inflows in the form of portfolio investment of €243 billion, 25% up on the same period of 2006. The net outflows of direct investment (€92.3 billion) were similar to those recorded the previous year. Thus, the basic surplus between January and October 2007 increased notably with respect to the same period a year earlier (see Chart 14).

According to the aggregated December 2007 stability programme updates, the euro area budget deficit is estimated to have fallen by 0.7 pp with respect to the previous year, to 0.8%

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.

of GDP (see Table 2). This figure coincides with the latest Commission forecasts, of autumn 2007. The decline in the deficit is largely due to a fall in public spending prompted by cyclical and temporary factors (in 2006 euro area spending was 0.3% higher, owing to the enforced refund of VAT receipts on certain products and the assumption of railway debt in Italy). Revenues held firm, as the cut in direct taxes and social security contributions was made up for by an increase in indirect taxes. The correction in the structural deficit was smaller, from 1.1% of GDP in 2006 to 0.7% in 2007.

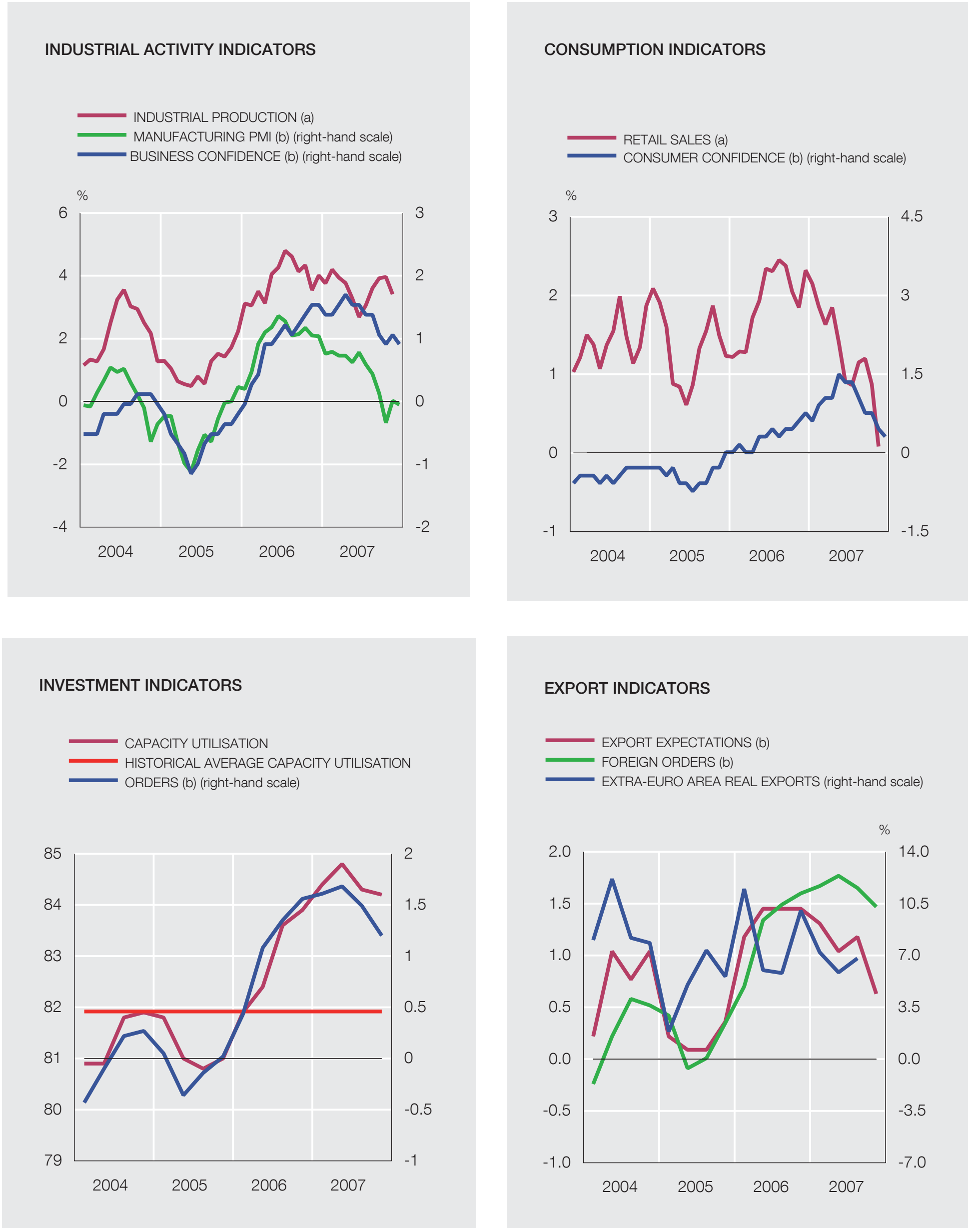
Notably, for the first time since 2000, not a single country in the euro area had a budget deficit exceeding the limit established in the Stability and Growth Pact (including Italy and Portugal, which are subject to excessive deficit procedures). However, of the ten euro area countries that have still not fulfilled the medium-term objectives, only Germany, Italy and Portugal have reduced their structural deficit by at least 0.5%, as agreed in the SGA. France is running a budget deficit, despite the favourable macroeconomic situation, largely on account of a discretionary tax cut following the May 2007 presidential elections. As for Italy, the sharp fall in the deficit estimated for 2007 has mainly been caused by temporary factors (already mentioned in the previous paragraph), and by the increase in direct tax receipts. In 2007, the public debt/GDP ratio in the euro area is estimated to have fallen to 66.5% (from 68.6% in 2006).

Greater fiscal consolidation efforts are not expected this year. According to the Commission's autumn report and the aggregated stability programmes, the budget deficit is projected to remain unchanged (at 0.9% of GDP). The reduction in spending as a percentage of GDP will be offset by a reduction in receipts due to cuts in taxes (corporation tax in Germany) and social security contributions (in Germany and in France). Moreover, some governments plan to use part of the extraordinary income to increase spending, instead of to reduce the deficit and debt.

Accordingly, the preventive arm of the Stability and Growth Pact is not being sufficiently implemented. Although the economic boom and extraordinary temporary revenues have created

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.

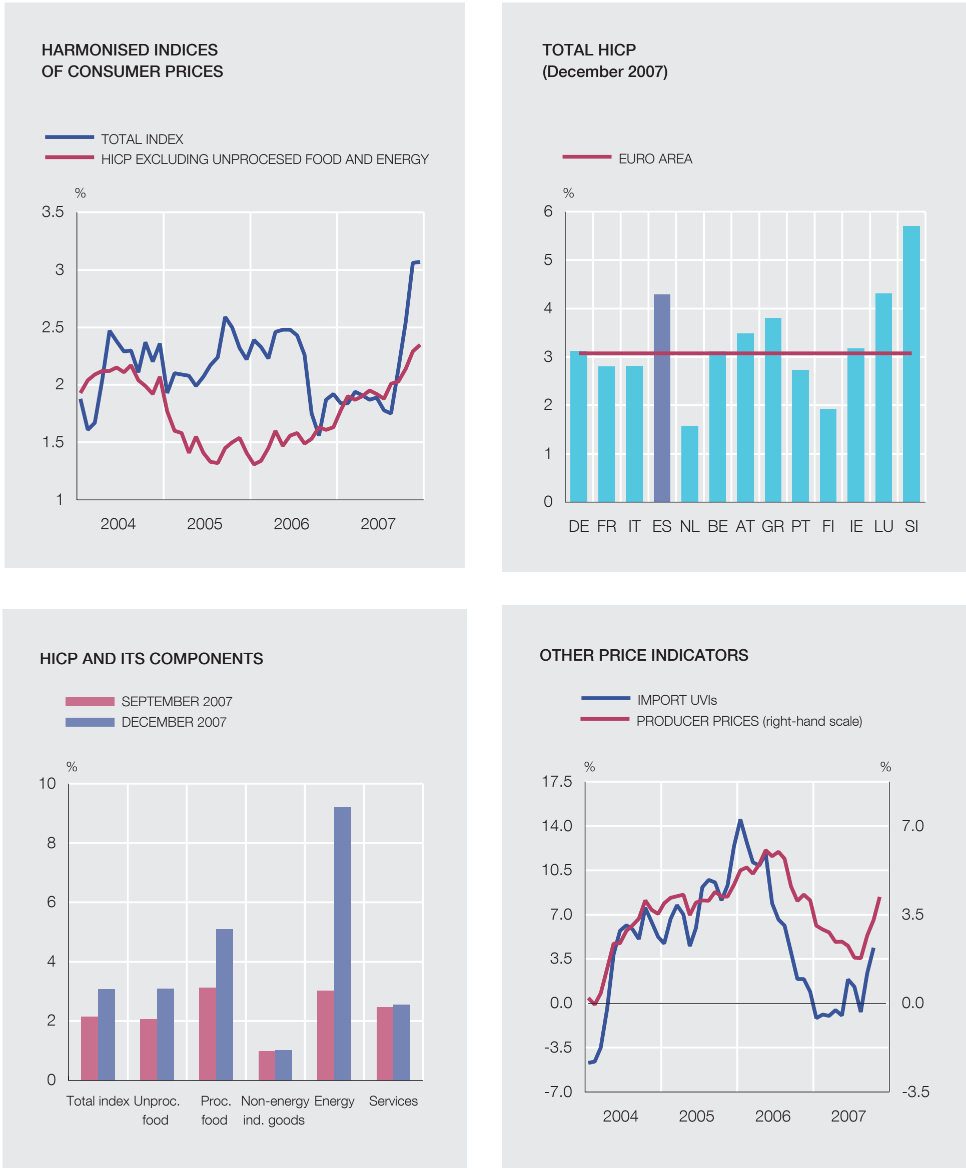
favourable conditions for rapid progress towards the MTOs in those countries that have still not fulfilled them, fiscal consolidation efforts falling short in structural terms.

3.2 Monetary and financial developments

In 2007 Q4, the financial tensions triggered last summer by the problems in the American subprime mortgage market heightened. During this period, and especially at the end of the year, all markets were dominated by high levels of volatility, the reappraisal of risk intensified and market liquidity problems (particularly in the interbank market) worsened. Compounding these shocks were the rises in the prices of energy and food commodities, and fresh data on the slowdown in the US economy. These events triggered stock market corrections and downward pressures on the US dollar.

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

CHART 11



SOURCES: Eurostat and European Central Bank.

Against this background, the ECB's Governing Council left the key ECB interest rates unchanged at 4%, given the uncertainty regarding the potential impact on the euro area economy of the ongoing reappraisal of risk in financial markets. However, at the same time, it stressed that the information available fully confirmed the upside risks to price stability in the medium term, in a context of sound economic fundamentals and highly vigorous money and credit growth. In addition, the Governing Council indicated its readiness to act pre-emptively so that second-round effects do not materialise and, consequently, medium and long-term inflation expectations remain firmly anchored in line with the objective of price stability.

In the interbank markets the tension observed since August, stemming from the reluctance of banks to lend each other funds for more than one week (see Chart 12), mounted over the quarter. As a result, although the EONIA fluctuated around 4% with some volatility, interest rates on deposits with an agreed maturity of one month or more rose again to 4.9%

GENERAL GOVERNMENT BUDGET BALANCES AND PUBLIC DEBT OF EURO AREA COUNTRIES

TABLE 2

% of GDP

	BUDGET BALANCES (a)						DEBT (b)	
	2006	2007 (c)	2007 (d)	2008 (c)	2008 (d)	2009 (d)	2007 (d)	2008 (d)
Belgium	0.4	-0.2	-0.3	-0.4	-0.4	-0.4	84.6	81.7
Germany	-1.6	0.0	0.1	-0.5	-0.1	0.2	64.5	62.6
Greece	-2.5	-2.7	-2.9	-1.6	-1.8	-1.8	93.7	91.1
Spain	1.8	1.8	1.8	1.2	1.2	0.6	36.3	34.6
France	-2.5	-2.4	-2.6	-2.3	-2.6	-2.7	64.3	64.1
Ireland	2.9	0.5	0.9	-0.9	-0.2	-0.6	25.2	26.9
Italy	-4.4	-2.4	-2.3	-2.2	-2.3	-2.3	104.3	102.9
Luxembourg	0.7	1.0	1.2	0.8	1.0	1.4	6.6	6
Netherlands	0.6	-0.2	-0.4	0.5	0.5	1.3	46.8	44.8
Austria	-1.4	-0.7	-0.8	-0.6	-0.7	-0.4	60	58.4
Portugal	-3.9	-3.0	-3.0	-2.4	-2.6	-2.4	64.4	64.7
Slovenia	-1.2	-0.6	-0.7	-0.9	-1.0	-0.8	25.6	24.5
Finland	3.8	4.5	4.6	3.7	4.2	4.0	35.7	32.4
Malta	-2.5	-1.6	-1.8	-1.2	-1.6	-1.0	63.1	61.3
Cyprus	-1.2	1.5	-1.0	0.5	-0.8	-0.6	60.5	53.3
MEMORANDUM ITEMS: euro area (including Malta and Cyprus)								
Primary balance	1.3	2.2	2.1	2.1	2.0	2.0		
Total balance	-1.5	-0.8	-0.8	-0.9	-0.9	-0.8		
Public debt	68.6	66.6	66.5	64.8	65.0	63.4		

SOURCES:European Commission and national stability programmes.

a. Deficit (–) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. Public debt as a percentage of GDP. The debts that exceed 60% of GDP have been shaded.
c. Targets of the stability programmes presented in late 2007 and early 2008
d. European Commission autumn 2007 forecasts.

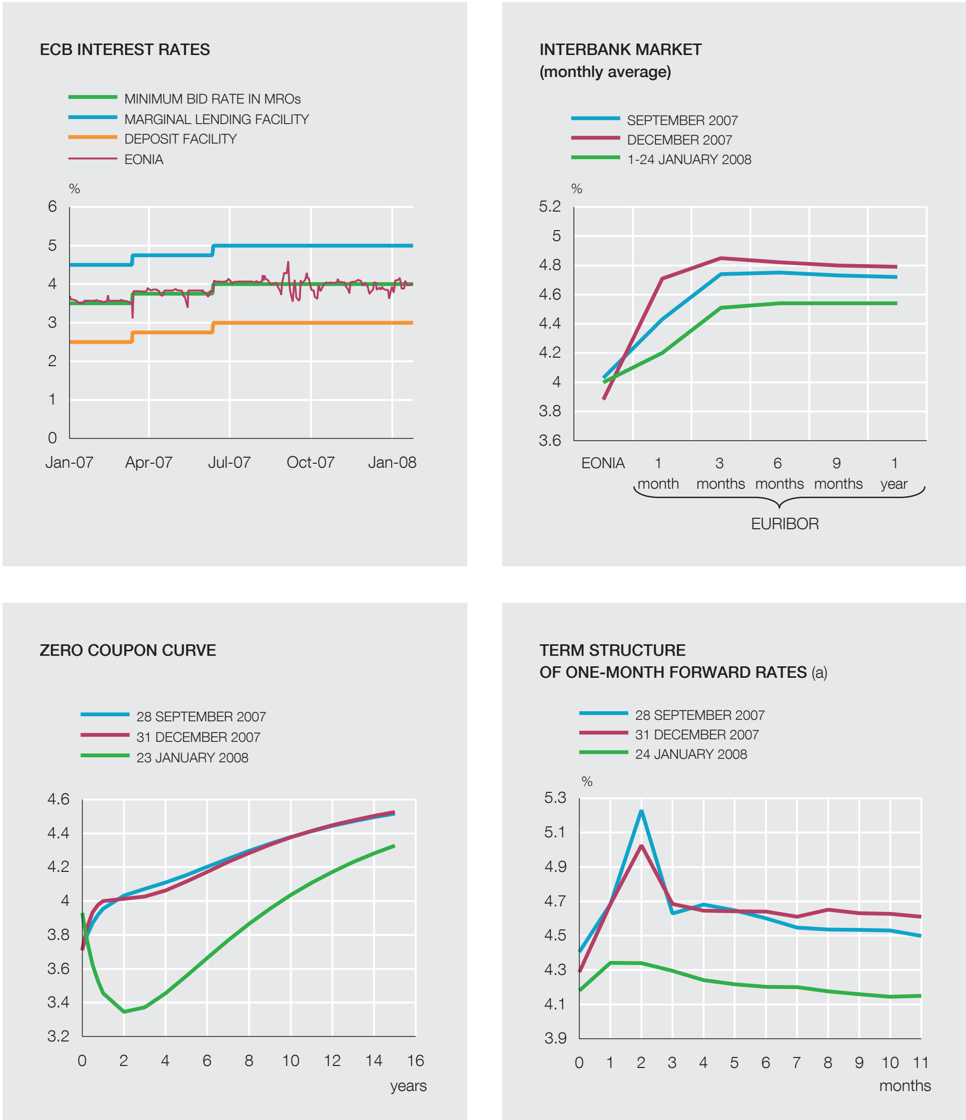
in mid-December, partly because of a year-end calendar effect. As explained in Box 3, these tensions led to intervention by the ECB, which managed partially to correct the situation in the markets, so that interest rates on deposits with an agreed maturity of over one month are currently fluctuating at around 4.3%, i.e. some 30 bp below their end-October levels.

Ten-year government bond yields were somewhat volatile in 2007 Q4, in line with movements of funds in search of a safe haven and the rise in inflation expectations (see Chart 13). Since the beginning of 2008 they have fallen by somewhat more than 30 bp and stand, as this Bulletin goes to press, at around 4.1%. On the private bond markets, as illustrated in Box 3, the gradual widening of yield spreads continued. This, along with the lack of liquidity, made it difficult to obtain medium and long-term funds.

Stock market indices in Q4 were characterised by the absence of any clear trend and levels of volatility that were relatively high, albeit below those observed in the preceding quarter. Thus, in 2007 as a whole the EURO STOXX broad index rose almost 5%. However, in January to date there have been several days of losses, which intensified with the sharp correction across world stock markets on 21 January. That day alone the EURO STOXX broad index fell 6.5%, so that since the beginning of the year it has fallen by more than 13%. In any event, it is still early to make a balanced assessment of this latest episode of turbulence. Price adjustment continued in the construction and financial services sectors, which have recorded notably larger falls since October than the overall indices.

EURO AREA INTEREST RATES

CHART 12



SOURCES: European Central Bank and Banco de España.

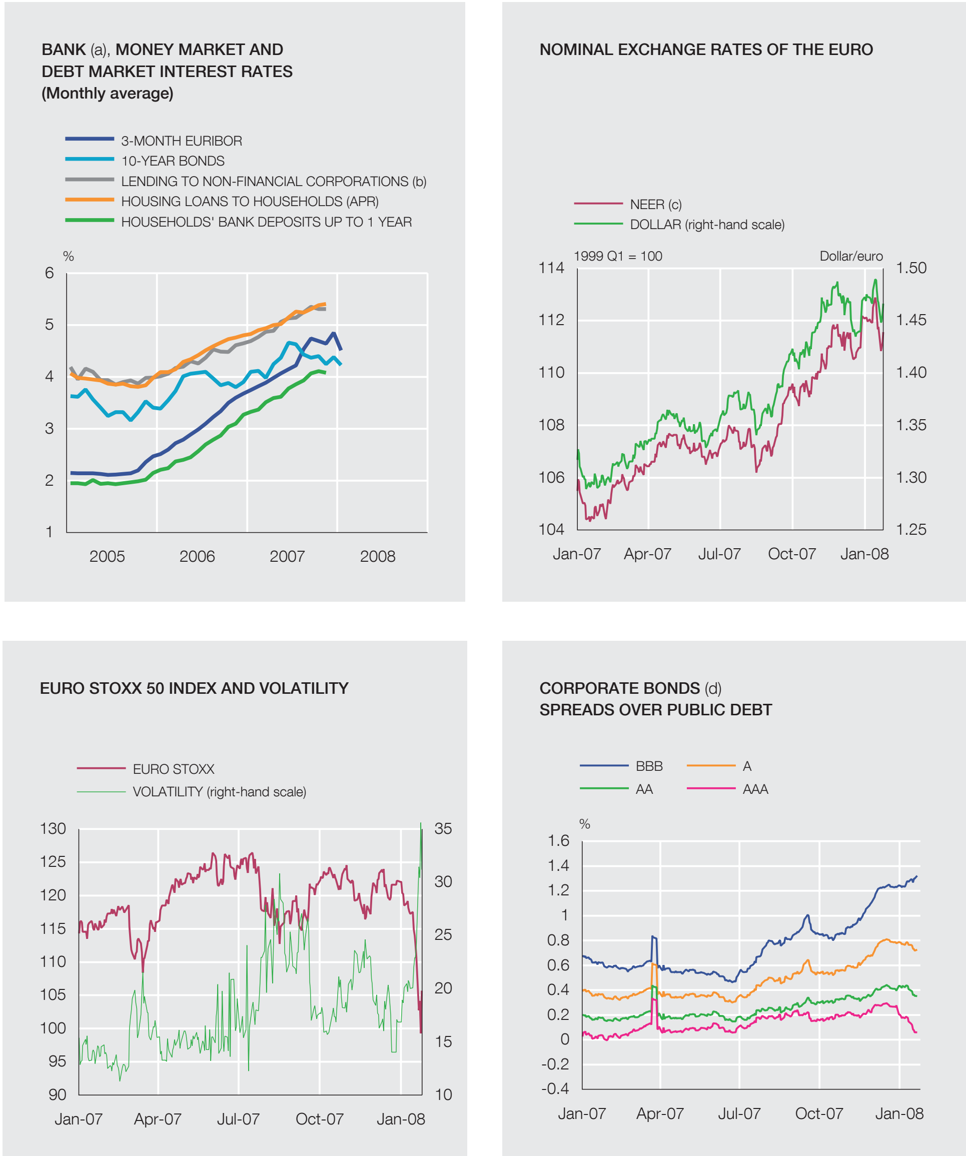
a. Estimated using Euribor data.

The euro exchange rate was also affected by the episodes of financial instability, the slowdown in the US economy and the prospects of divergence between the interest rates in the United States and in the euro area. As this Bulletin went to press, the euro had appreciated since the end of September by 2% in effective terms, and by almost 3.4% against the dollar (see Chart 13).

The demand for safe and liquid assets remained relatively strong against the background of a roughly flat yield curve and an increase in perceived risk levels. On data to November, M3 grew at high year-on-year rates, of over 12% (see Chart 14). Within the broadest aggregate, the most liquid components (cash and short-term deposits) decelerated, while marketable securities grew at rates of over 20%.

Lending to the private sector remained highly buoyant in Q4. By component, loans to non-financial corporations quickened, to 14% in November, while those to households slowed across all purposes, to a rate of 6.5%. As regards the latter, loans for house pur-

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



SOURCES: European Central Bank and Banco de España.

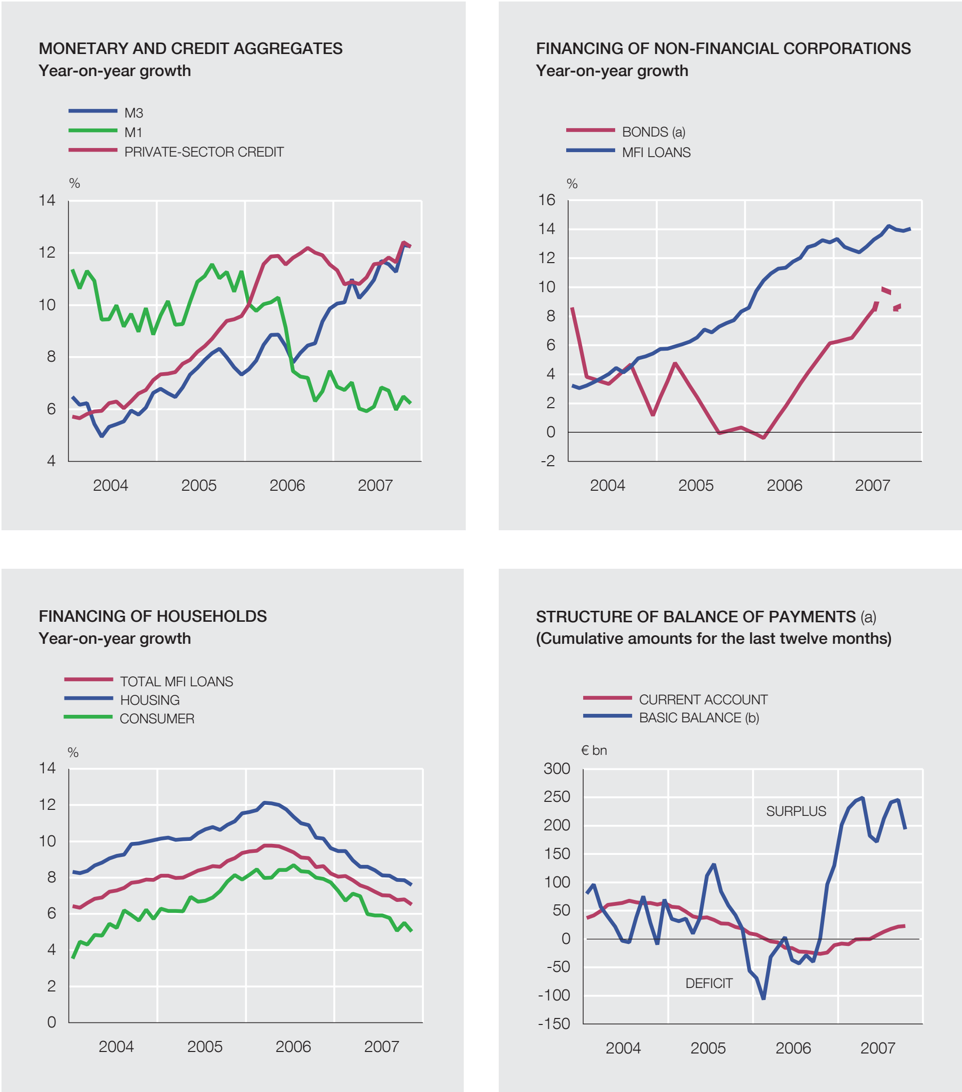
a. Interest rate statistics compiled by the ECB for new business.
b. Interest rates on loans of over five years.
c. Nominal effective exchange rate index (EER-23). Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

chase grew by 7.6%, while consumer loans grew by 5%. For their part, loans to non-monetary financial institutions accelerated to a rate of over 23%. This component, whose weight in the total is not significant, probably owed its dynamism to the difficulty these institutions are having, in the context of the current liquidity crisis, financing themselves on the market and to their resort to the renewal or extension of their credit lines with banks.

In any event, despite the buoyancy of credit in the period to November, the January Bank Lending Survey (relating to 2007 Q4) recorded a further tightening of the credit conditions applied by banks to non-financial corporations and households, against a background of deteriorating expectations regarding the general economic situation. The restriction affected larger firms and loans with longer maturities to a greater extent. As for households, the condi-

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS

CHART 14



SOURCES: European Central Bank and Banco de España.

a. The broken 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.

tions for obtaining loans also became stricter owing, apart from economic expectations in general, to the deterioration in the housing market outlook (in the case of loans for house purchase) and the perception of a deterioration in the credit quality of consumers (in the case of consumer loans).

On QNA estimates, GDP grew in 2007 Q3 by 3.8% year-on-year, 0.2 pp less than in Q2. That meant a continuation of the slight slowdown seen since the start of the year which was accompanied by further progress in the rebalancing of the respective contributions of the domestic and external components of spending. In quarter-on-quarter terms the slowdown was on the same scale, and the related rate of increase was 0.7%. The information available for 2007 Q4 suggests that the trends witnessed during the year have remained in place, meaning that the year-on-year rate of growth of output may be expected to have slowed by a further 0.3 pp to 3.5%, with a quarter-on-quarter rate of increase 0.1 pp up on that in Q3. This easing in the buoyancy of activity will have arisen from the loss of momentum of national demand (the growth rate of which is expected to have declined by 0.5 pp to 3.6%), while the contribution of the external sector to GDP growth will have continued improving, to stand at –0.3 pp (see Chart 15).

With this estimate for 2007 Q4, GDP growth for the whole of the year is expected to be 3.8%, 0.1 pp down on the 2006 figure. This slight easing in the rate of increase in the economy's output came about due to the lesser dynamism of national demand, which grew at a rate of 4.3%, 0.5 pp down on the previous year's figure, while the contribution of the net external balance to GDP growth improved by this same amount to –0.7% of GDP. Among the national demand components, the loss of momentum was patent in the case of private consumption and, in particular, in that of investment in construction, while the dynamism of investment in capital goods increased in relation to 2006. The improvement in the net external balance was the outcome both of the notable thrust of exports and of the slowdown in imports, in line with the diminished robustness of final demand.

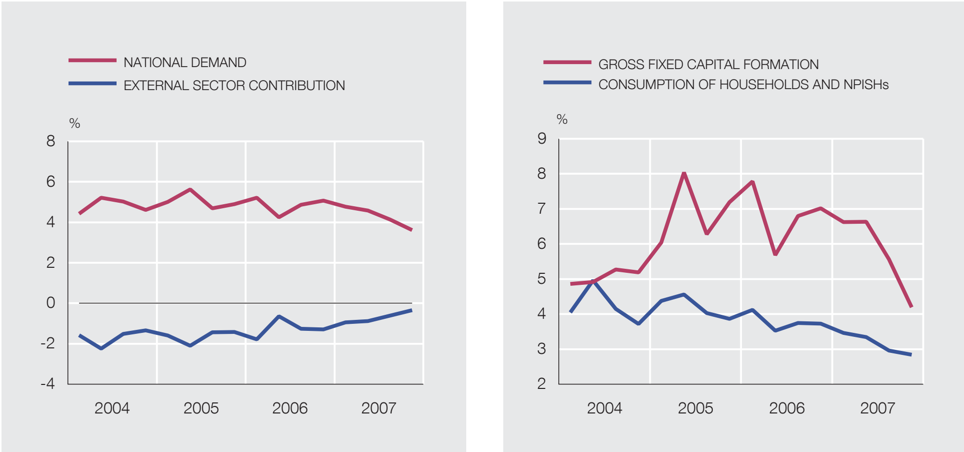
On the supply side, it is estimated that the slowdown in value added was extensive in Q4 to all the productive branches, with the exception of energy. That said, market and non-market services activity was notably robust. The employment indicators also point to some loss of momentum, on a scale somewhat greater than that in output. Accordingly, apparent labour productivity is expected to have risen, growing in the economy as a whole at a rate of around 1%. Compensation per employee is also estimated to have expanded at a similar rate to that posted since the start of the year, meaning that unit labour costs will have grown at below 3%. As regards consumer prices, there was a surge in Q4 in the year-on-year rate of increase of the CPI, which ended the year at 4.2%, compared with 2.7% in September. This unfavourable development was due, as in other countries, to dearer energy goods and processed food.

4.1 Demand

In 2007 Q3, the final consumption spending of households and NPISHs grew by 3% year-on-year, 0.3 pp down on the previous quarter, extending the gradual downturn of the preceding quarters. The latest conjunctural information points to a continuation of this trend in the final quarter of the year (see Chart 16). Specifically, the consumer and retail trade confidence indicators posted significant declines in Q4, compared with Q3, probably influenced by the uncertainty created by the turbulence on financial markets. Among the quantitative indicators, the tax authorities' data for October and November on large corporations' domestic sales of consumer goods and services suggest less dynamism, once adjusted for certain anomalies observed in this period. The real retail trade index slowed substantially in this same period on the previous quarter, consistent with the diminished confidence of retail traders. Lastly, under the heading of consumer durables, new car registrations performed better in Q4, although this result is affected by the positive figure for December. Purchases were probably brought forward to this latter month ahead of the entry into force in 2008 of the new car registration tax.

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.

The moderate worsening of the outlook for private consumption in the final part of the year is consistent with this variable's determinants. While household disposable income is expected to have continued growing in a sustained fashion in nominal terms as a result of the strength of job creation, the inflationary rise in the closing months of the year will have dented such income in real terms. Further, the reduction in the rate of increase of household wealth, real and financial alike, along with diminished household confidence and tighter financial conditions might have begun to be conducive to the stabilisation of the household saving rate, following its decline in recent years. However, the non-financial accounts of the institutional sectors for 2007 Q3 reveal that, until then, the declining trend had not been interrupted. The dynamism of general government final consumption increased in 2007 Q3 to a year-on-year rate of 5.8% (0.8 pp up on Q2). The information available from the State budget outturn on net purchases of goods and services augured a continuation of the vigorous growth of this demand component in the last three months of 2007.

While on a notably forceful course, gross fixed capital formation showed less momentum in 2007 Q3. It posted growth of 5.6%, 1 pp less than in Q2. This was the outcome of the slowdown in all its components, somewhat more sharply so in the case of investment in capital goods, whose growth rate eased by 1.9 pp to 11.2% (see Chart 17). Investment in construction and in other products slowed by 0.8 and 0.7 pp, respectively, posting growth of 3.8% and 3.5%. Drawing on the information from the indicators for 2007 Q4, this trend should continue, with a further easing in the pace of growth of the various components of gross fixed capital formation.

The indicators of spending on equipment suggest the prospects for this component, which continues to be the most dynamic demand variable, remain strong. The indicator of apparent investment in equipment, calculated with incomplete data for 2007 Q4, has continued to trend in the recent period on the moderating path initiated at the start of the year, the result of the easing in the rate of increase of the domestic production of this type of good and of the recovery in exports. The business confidence indicator for the equipment industry rose in October and November as a result of the improvement in expectations of future output. Moreover, there was also a rise in the forecast order book.

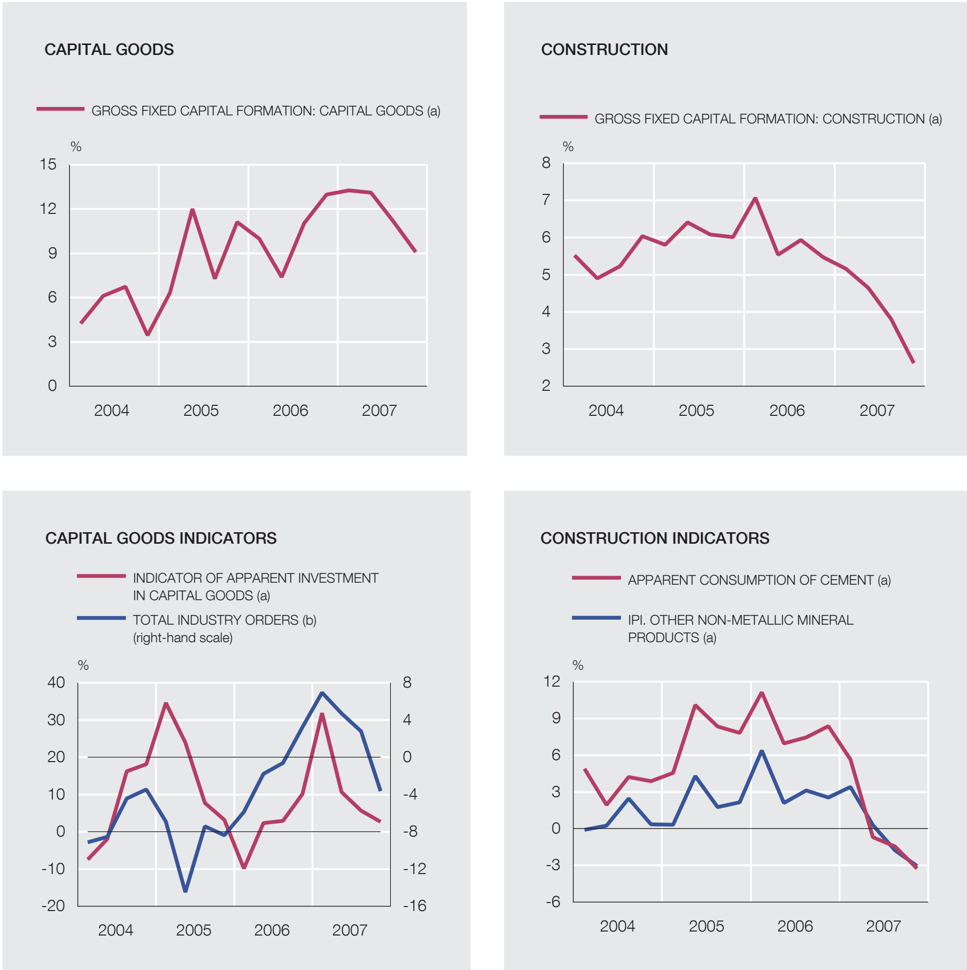
In the recent period investment in equipment has continued to be underpinned by the relative strength of final demand, in a setting in which the high growth rate of corporate earnings is providing for the availability of own funds to finance spending. Nonetheless, the slight reduction in the level of capacity utilisation in Q4 is a sign that the gradual slowdown in demand might begin to temper corporate investment plans. In addition, the application of such plans might be hampered by the increase in the financial burden stemming from the growing resort to external sources of financing (as highlighted by the gradual increase in the net borrowing of overall non-financial corporations, which amounted to 10.6% of GDP in cumulative four-quarter terms to 2007 Q3), against a background of rising lending rates. Finally, the current environment of instability on credit markets might entail a tightening of credit extension conditions.

The weakening in investment in construction seen since 2006 Q2 continued into the summer months, despite which this demand component remained considerably dynamic. Specifically, on QNA figures, the growth of this variable in 2007 Q3 was 3.8%, 0.8 pp down on the previous quarter. This loss of steam was common to residential investment and to other construction, the rates of increase in which fell by 0.8 and 0.9 pp to 2.9% and 4.8%, respectively.

The latest available indicators point to a continuation of these trends in the final quarter of the year, owing to the diminished dynamism shown by residential and non-residential building alike. Pointing in this direction are the indicators of employment and inputs for the sector,

GROSS FIXED CAPITAL FORMATION

CHART 17



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, INEM and Banco de España.

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

whose contemporaneous nature helps assess the situation of the construction sector as a whole. On one hand, the slowdown in the number of Social Security-registered employees in this branch apparent at the end of Q3 intensified in Q4, posting a year-on-year rate of close to zero. At the same time, registered unemployment in construction increased significantly during the quarter. On the other hand, the pace of the contraction of intermediate products evident in the previous months quickened, while cement consumption was as depressed in Q4 as it was in Q3. Finally, the business confidence indicator for the industry worsened notably in the closing months of the year, posting its lowest value since August 2002.

In the case of residential investment, the figures available to October drawn from the series of new housing approvals continued to show a sharp pace of contraction in year-on-year terms, although they remained distorted by the entry into force in 2006 of the Spanish Technical Building Code. Moreover, the decline in housing starts augurs greater moderation in investment in housing in the future, consistent with the lesser momentum of demand discernible from the recent fall-off in the number of transactions. In the case of non-residential building, the outlook is somewhat more positive since, although the number of officially approved projects has also shrunk, this has been less intense than in the case of housing. Finally, civil engineering works are expected to maintain the dynamism shown in the final months of 2007,

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.

albeit on a possibly more moderate course judging by the recently observed slide in tenders for new projects.

On the latest QNA figures, net external demand subtracted 0.6 pp from GDP growth in 2007 Q3, 0.3 pp less than in the first half of the year, meaning that the correction initiated in mid-2005 continues. This improvement came about against a background of more dynamic foreign trade flows, especially in goods and services exports, whose year-on-year growth rate increased by 3.2 pp to 8% (see Chart 18). Imports also accelerated, albeit on a lesser scale, posting a growth rate of 8.3%, 1.7 pp up on the figure for the previous quarter. Nonetheless, these results have come about in a setting of slowing world trade which, after having grown at over 9% the previous year, has fallen back to around 6% in 2007 Q3. This is due both to the lesser momentum of imports from some of Spain's main markets – such as Germany and the United Kingdom – and to the easing in demand from the US market and from other developed economies, while the emerging countries have remained substantially dynamic. Given the appreciation of the euro, the price-competitiveness indicators calculated with consumer prices deteriorated in Q3, although those based on unit labour costs (both for the whole economy and for manufacturing) improved.

The still-incomplete information available for 2007 Q4 suggests the buoyancy of exports will continue, underpinned by the soundness of the emerging markets; that said, their growth rates may have been curbed somewhat by the appreciation of the euro and some loss of steam in European markets. Despite the cheaper prices resulting from the euro's appreciation, imports of goods and services are expected to have continued to be less expansionary, in line with the diminished strength of final demand. As a result of these developments in trade flows, the contribution of net external demand to GDP growth is expected to have improved further in 2007 Q4, standing at –0.3 pp of GDP.

The year-on-year rate of increase of real goods exports was up by 1.6 pp to 6.4% in 2007 Q3 on QNA figures, extending the improving profile initiated the previous quarter. According to foreign trade figures from the customs authorities, real goods exports grew by 8.2% in the October-November period, a step-up on the more expansionary behaviour shown by this indicator in 2007 Q3 (in which the rate of increase was 6.7%), following the greater slackness in the first half of the year. By geographical area, the growth rate of exports to both the euro area and to the EU as a whole eased in real terms to below 2%. In non-European markets, in contrast, the increases were much bigger, with high rates observed in exports targeted on China, Russia, the United States and the OPEC countries, areas which, however, account overall for a proportion of less than 10% of total sales abroad. By product group, exports of capital goods were more dynamic, while sales of intermediate goods remained on the expansionary course shown in Q3. According to customs data, the growth rate of real goods exports eased over the course of the first ten months of the year to 4.8%, compared with 5.6% on average in 2006. In terms of product groups, this is in response to the less expansionary course of foreign sales of consumer and capital goods.

On QNA figures, the performance of real exports of tourist services was once again contractionary in 2007 Q3, though less so than in the three previous months, in line with the moderately improving profile of the main real indicators of tourism during the summer. Specifically, this variable declined by 0.7%, compared with the rate of –2.2% in Q2. The sectoral indicators point to the continuation of this more expansionary profile in the closing months of the year. In this respect, both inflows of foreign tourists into Spanish territory and the number of overnight hotel stays remained on a rising path in Q4. However, total spending by these tourists grew in Q4 at an identical nominal year-on-year rate to that in Q3, as a result of the slowdown in average spending per tourist.

Real exports of non-tourist services were very buoyant in 2007 Q3, growing by 22.8%, far above the figure of 11.9% for the previous quarter. In particular, according to the nominal balance of payments indicator, there was a notable surge in receipts from business services, and other headings of less weight in the export structure, such as IT, financial and insurance services, gathered considerable momentum. The scant information available on other services in Q4, which is confined to the nominal balance of payments figures for October, points to a continuation of the strongly expansionary behaviour of receipts under this heading.

In 2007 Q3, the pace of real goods imports stepped up by 1 pp to a rate of 7.2%, according to QNA figures. The related customs data for October and November suggest a notable slowdown to 3.5%, as a result of the diminished vigour of purchases abroad of consumer and intermediate goods (energy and non-energy alike). In contrast, imports of capital goods gained in momentum, resuming a positive rate of increase following the decline in Q3. This easing in imports in the final part of the year is consistent with the slowdown in final demand and in industrial production. As regards the first ten months of 2007, real goods imports grew by 6%, according to customs figures, 2.6 pp below the average increase observed in 2006. This deceleration was due to the intermediate (both energy and non-energy) and non-food consumer goods components. Conversely, capital goods imports rose forcefully over the period.

Lastly, the QNA figures show an acceleration in real services imports in 2007 Q3 to 12.8% year-on-year (4.3 pp up on the previous quarter). The greater robustness of this import component was essentially due to the notable momentum of the non-tourist services component, the year-on-year rate of which quickened by 5 pp to 14.3%. According to the balance of payments indicator, the dynamism of nominal payments for other services was boosted by the transport and business services headings, while other smaller items, such as financial and construction services, also accelerated. Likewise, royalties increased notably, in contrast to their continuing slide in the four previous quarters. On the latest balance of payments figures for October, the buoyancy of nominal payments for other services is expected to have increased during that month. As to real imports of tourist services, these also quickened in Q3, with their year-on-year growth rate standing at 6% (4.5% in Q2).

4.2 Output and employment

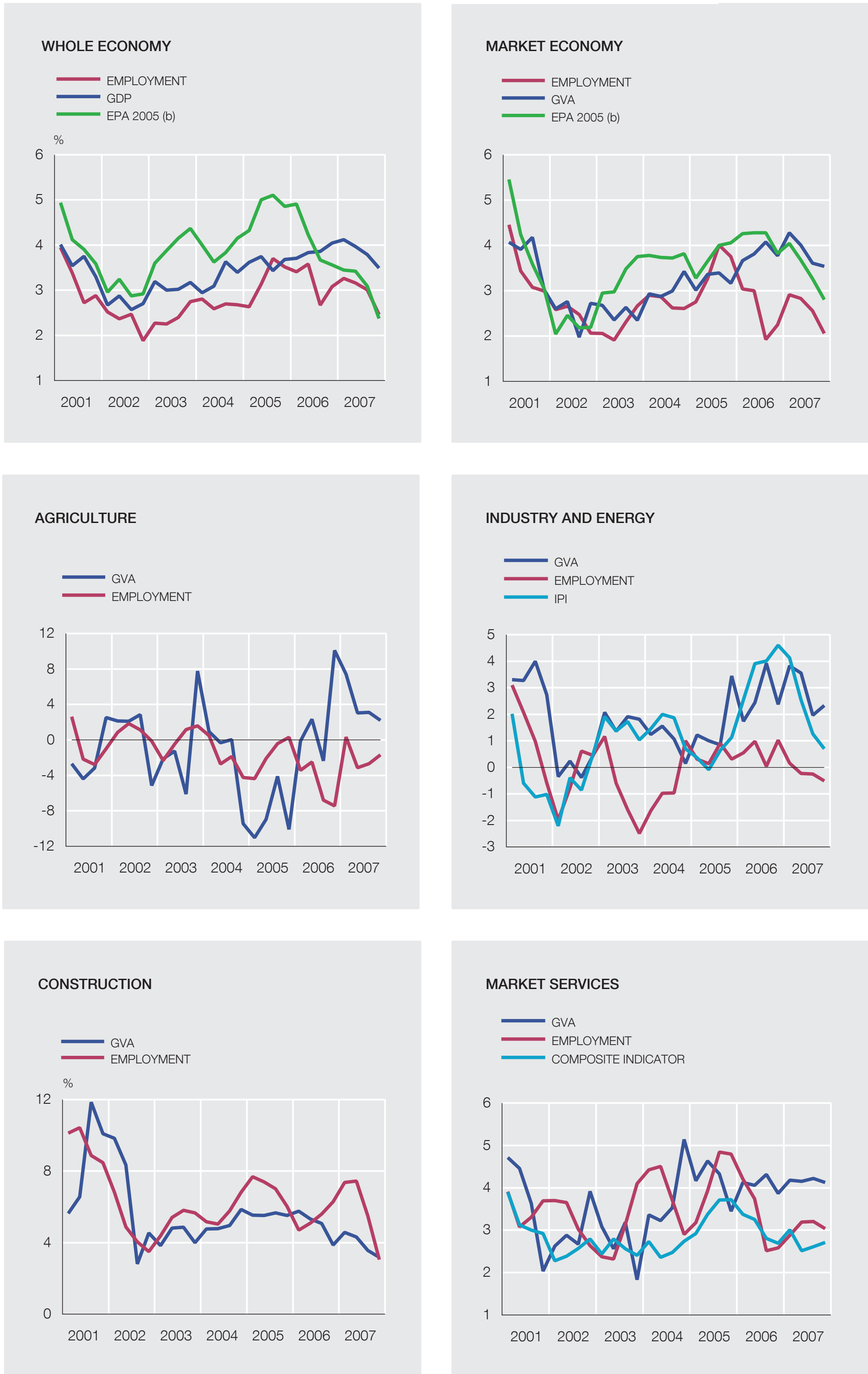
In 2007 Q3, activity in the market economy slowed, meaning that the growth rate of its gross value added declined, on QNA figures, by 0.4 pp in relation to Q2 to 3.6% (see Chart 19). Behind this development was the weakening in the rate of expansion of industry and energy and of construction, while agriculture and fisheries and market services grew at very similar rates to those in Q2. The information available for Q4 suggests a further moderation in value added in the market branches, which is expected to be of greater intensity in construction and in industry.

In the agriculture and fisheries branches, the dynamism observed in 2007 Q3 was similar to that shown in the three previous months, on which there was a 0.1 pp rise in the related growth rate to 3.1%. Pending figures for Q4, the year 2007 proved expansionary, underpinned both by arable production and by the recovery in animal farming output. However, there were declines in relation to 2006 in some crops (such as pulses, vegetables, fruit and vines), as a result of bouts of bad weather.

Turning to production in the industrial and energy branches in 2007 Q3, there was a notable steepening of the slowing profile previously observed – much more modestly – in Q2, and there was a 1.6 pp decline in the year-on-year rate of increase to 2%. The loss of momentum was more marked in the case of the energy sector, where value added slowed by 3.7 pp, posting a decline of 0.3%. This fall-off is in response to a base effect prompted by the high summer temperatures in 2006, which required higher electricity consumption for air conditioning. As to the industrial sector, there was a 1.2 pp decline in its rate of increase to 2.4%, the outcome of the lesser momentum of national demand. In this branch, the slowing profile continued into 2007 Q4, according to the conjunctural information available. With regard to the quantitative indicators, the behaviour of the industrial production index (IPI) was notable; its non-energy component slowed in October and November, with its growth rate turning negative in the latter month, a similar trend to that of domestic sales of industrial goods by large corporations in the same period. The opinion-based surveys also provide signs of weakness concerning industrial activity. The European Commission's confidence indicator fell by 2 pp in Q4, while the PMI manufacturing index did so by 2.2 pp. In any event, the external setting continues to contribute to upholding the prospects for the industrial sector. The Spanish business assessment of the foreign order book thus remains at the highest level seen in recent years.

Construction activity in Q3 continued to move on the slowing path initiated in Q2. Specifically, it grew at a rate of 3.6% in the summer months, 0.7 pp down on the April-June period. As indicated on analysing investment in construction, this tendency to lose steam persisted in the closing months of the year, as start-ups of new residential and non-residential building projects

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



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

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

fell off and the momentum behind civil engineering works began to decline, despite which it still remains considerably buoyant.

The rate of increase in gross value added in the services branch as a whole rose to 4.4% in 2007 Q3, after having held stable at 4.2% in the four preceding quarters. While both market and other services evidenced this greater dynamism, the acceleration in activity (by 0.5 pp to 5%) was greater in the latter case. As regards market services, growth of 4.2% was recorded, up 0.1 pp on the previous quarter. In Q4, the momentum of market services held at a similar level to that in Q3, if regard is had to the stability seen in the pace of job creation, based on the number of Social Security registrations. Other conjunctural data, such as the indicators of activity in the services sector and the composite market services indicator, also portray a favourable picture for the closing months of the year. Set against this, the growth rate of large corporations' services sales, in real and calendar-adjusted terms, declined in October and November in relation to Q3. Moreover, the European Commission's confidence indicators for the services sector and for the retail trade fell off in the closing months of the year, as did the PMI index. Overall, the growth of market services is expected to have held virtually stable in Q4, since the lesser dynamism shown by wholesale and retail trade and transport is liable to have been offset by the greater momentum in the communications and the hotel and restaurant sectors.

On QNA data, the moderate pace of job creation observed in 2007 Q2 continued into Q3. Specifically, the year-on-year rate of increase in employment stood at 3% in the economy as a whole and at 2.6% in the market economy. In both cases, this entailed growth that was 0.2 pp down on the previous quarter. The mild slowdown in employment was on a somewhat lesser scale than that in economic activity, meaning that apparent labour productivity growth dipped by 0.1 pp to 0.8% in the economy as a whole, and to 1% in the market economy.

The information for 2007 Q4 shows that the tendency of employment growth to moderate has intensified somewhat. Specifically, the year-on-year increase in Social Security registrations, calculated with average data, slowed by 0.3 pp in the final quarter of last year to 2.6%. Further, the rate of decline of INEM-registered new hires quickened in Q4, posting a year-on-year rate of –2.1% (compared with the decline of 0.7% the previous quarter). Finally, the EPA data for 2007 Q4 show a slowdown of 0.7 pp in the pace of job creation to a rate of 2.4%.

As to the breakdown of QNA data for Q3 by productive branch, there was a sharp slowdown in employment in construction, the year-on-year rate of which was cut to 5.5%, almost 2 pp less than at the end of the first half of the year. However, this branch continued to be that showing the highest rate of employment generation. In services, numbers employed grew, as in Q2, by 3.2% in the market branches, while employment quickened by 0.3 pp to 4.9% in the non-market branches. Finally, employment in industry and agriculture posted negative year-on-year growth for the second quarter running. Judging by the indicators available for Q4, the diminished buoyancy of activity in this period gave rise to a slowdown in employment, which was sharper in the case of construction. According to the EPA figures, employment in this branch slowed by 2.2 pp in 2007 Q4 to 2.7%. In services, the slowdown – by 0.7 pp to 3.5% – was slacker, essentially as a result of developments in non-market services, since market services remained notably robust (5%). The EPA data confirm the pattern of moderate declines in employment in industry observable throughout 2007 (–1.2% in Q4). Lastly, employment in agriculture improved slightly, although it continued to fall in year-on-year terms to a rate of -1.7%. Overall, employment in the market economy grew at a rate of 2.8% during Q4, showing a slightly less marked path of deceleration than that seen in the economy as a whole.

In Q3, on QNA figures, dependent employment remained more dynamic than self-employment. Specifically, the growth of dependent employment in this period was 3.4% economy-wide and 3% in the market economy, while the increase in the numbers of self-employed was 0.5%. According to the Q4 figures on Social Security registrations, the creation of dependent employment (2.6%) remained more intense in this period than self-employment (1.6%), although registrations of dependent employees have tended to slow, with the opposite trend apparent in the case of self-employed registrations. The EPA data for Q4 reveal, however, a loss of buoyancy in the case of the self-employed, too.

The EPA data for Q4 infer that, although the slowdown in employment affected both Spanish nationals and foreigners alike, the latter continued to post much higher growth rates. As regards contract duration, permanent employment retained substantial momentum during 2007 Q4, with a year-on-year growth rate of 7%; that rate is, however, 0.3 pp down on the previous quarter. The year-on-year rate of decline in temporary employees steepened to –6.3%. As a result, the ratio of temporary to total employees fell significantly during the quarter to 30.9%, a figure 3 pp down on that posted a year earlier. This year-on-year comparison still partly reflects the effects of the rebates accorded to the conversion of temporary into permanent contracts which took place in the second half of 2006. Lastly, as regards the duration of the working day, part-time hiring slowed to a lesser extent than full-time hires, giving rise to a 0.5 pp increase in the part-time/full-time employment ratio to 11.6%.

The year-on-year rate of increase in the working population stood at 2.7%, 0.3 pp less than in Q3, but similar to that in the first half of the year. The growth rate in the population of working age and the participation rate held at 1.8% and 59.1%, respectively. In terms of the breakdown by sex, the rise in the female participation rate countered the reduction in the male rate (49.4% and 69.2%, respectively).

Finally, the slowdown in employment translated into growth of 135,700 in the number of unemployed in Q4. This increase entails an acceleration in the annual rate of change in the number of unemployed to 6.5%, which placed the unemployment rate at 8.6%, 0.6 pp up on the previous quarter. Registered unemployment also trended unfavourably in the final months of the year, with the positive year-on-year rate of increase observed since the summer months accelerating to 3.9% for Q4 on average and to 5.3% in December.

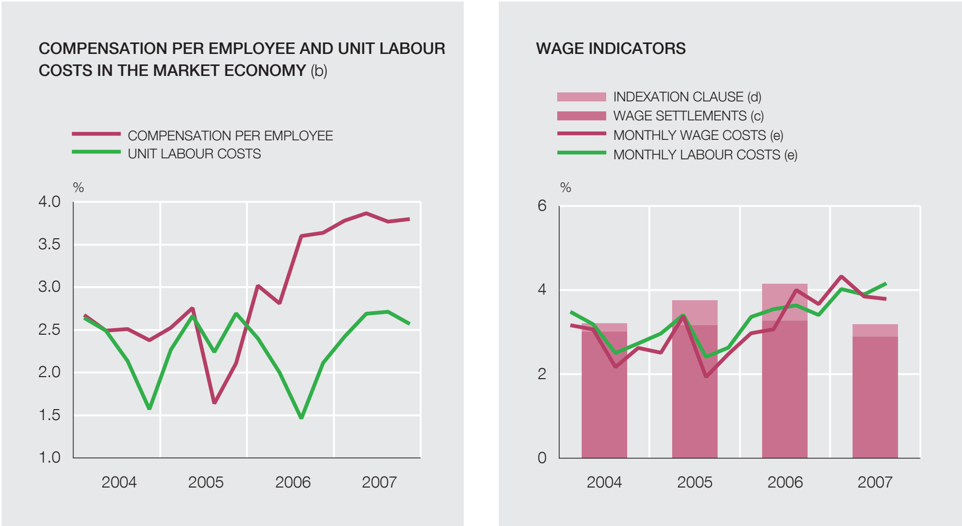
4.3 Costs and prices

In 2007 Q3, economy-wide compensation per employee held at a year-on-year growth rate of 3.7%, unchanged on the previous quarter, following the upward revision of the figures for this variable relating to the first half of the year (see Chart 20). In the market economy, there was a 3.8% increase in compensation per employee, 0.1 pp less than in Q2. By branch of activity, services moved on a growing profile, posting a 0.6 pp rise to 3.5%, and construction eased by 1.3 pp, which placed its year-on-year rate of increase also at 3.5%. The information available for Q4 indicates that the pace of compensation per employee is expected to have held stable at a rate similar to that observed in the first three quarters. The collective bargaining agreements recorded to end-December, which affect almost 78% of workers, include rises in agreed wage rates of 2.9%, almost 0.4 pp down on the increase agreed the previous year. This slowdown in wage rises was extensive to all the branches, with the exception of construction. The estimated impact of the application of the indexation clauses corresponding to 2006, which affect more than 69% of workers with a registered agreement in the course of 2007, is 0.3 pp, a figure 0.6 pp lower than that of the previous year.

In the market economy, the aforementioned developments in the growth rate of compensation per employee, along with a slight recovery in productivity, might have given rise to a marginal

WAGES AND LABOUR COSTS (a)

CHART 20



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

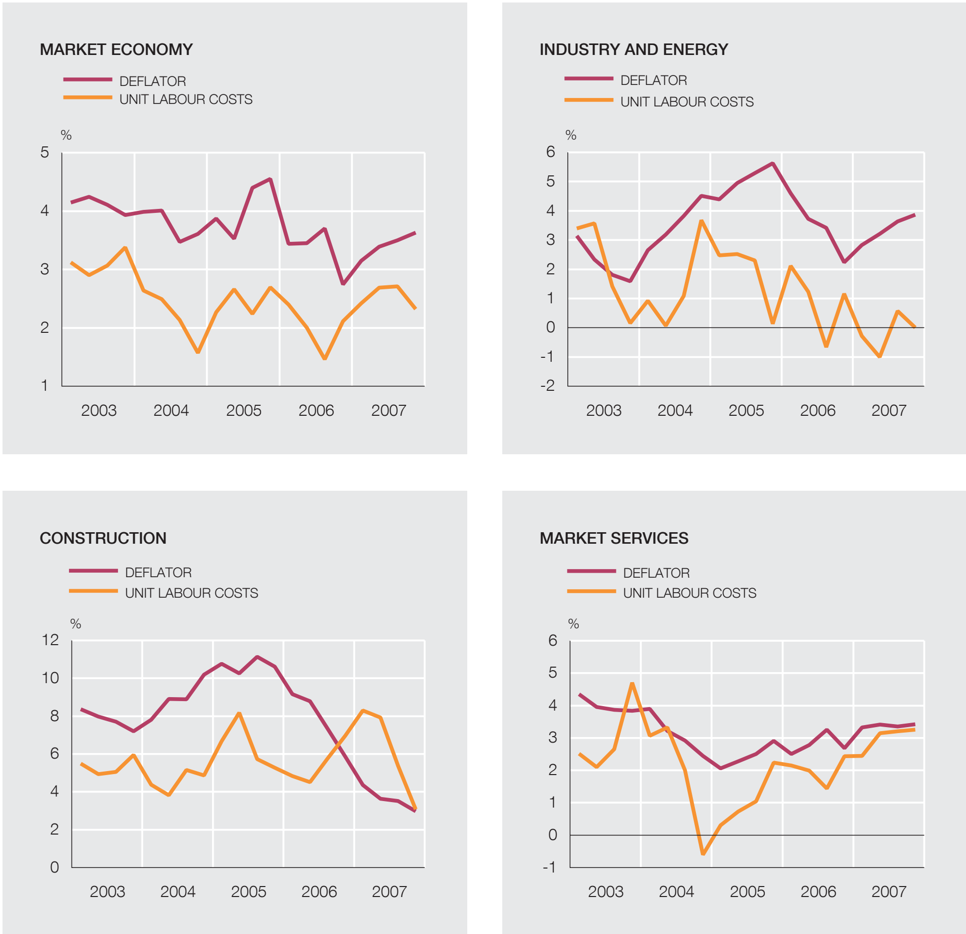
a. Percentage change on same quarter a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information from registered collective bargaining agreements to September 2007.
d. Previous year's indexation clause.
e. ETCL (quarterly labour costs survey).

slowdown in unit labour costs in 2007 Q4 (see Chart 21). It is further estimated that the gross value added deflator for the market economy might have undergone an additional acceleration in the closing months of the year, which would be attributable to its behaviour in the energy and agricultural branches.

The growth of the final demand deflator is estimated to have risen to 3.2% in 2007 Q4, thereby interrupting the slowing path initiated in the second half of 2006. That would have been the outcome of the quickening pace of the imports deflator (by over 2 pp to 3.6%), following the rise in oil prices on international markets, the effect of which would have prevailed over the lower import prices stemming from the appreciation of the euro. The year-on-year growth of the GDP deflator is expected to have increased to 3.1%.

The initially declining and subsequently stable path of the various price indicators witnessed since the second half of 2006 was interrupted in 2007 Q4 (see Chart 22). The year-on-year rate of the CPI rose in the final quarter of 2007 by 1.6 pp to 4% in quarterly average terms. The end-year figure was 4.2%, the highest rate recorded since early 2006. This acceleration in prices is due virtually in its entirety to the behaviour of the energy goods and processed food components. In particular, the year-on-year rate of change in energy products increased in 2007 Q4 to 9.7%, compared with a decline of 0.4% in the July-September period. Along with the stripping out of the base effect on the year-on-year rate stemming from the falls experienced a year earlier, this development can be accounted for by the intensification during the quarter of the ongoing rise in oil prices, the knock-on effect of which has been strong increases in the prices of vehicle fuel and lubricants, other fuels and, with a delay, of gas too. The acceleration in the energy component of the CPI would have been even greater had the increase in the price in dollars of crude oil on international markets not been partly offset by the 12.3% appreciation (in quarterly average terms) of the euro against the dollar. In the opening days of January oil prices continued to rise, up to an all-time high, although this trend has subsequently reversed.

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



SOURCES: INE and Banco de España.

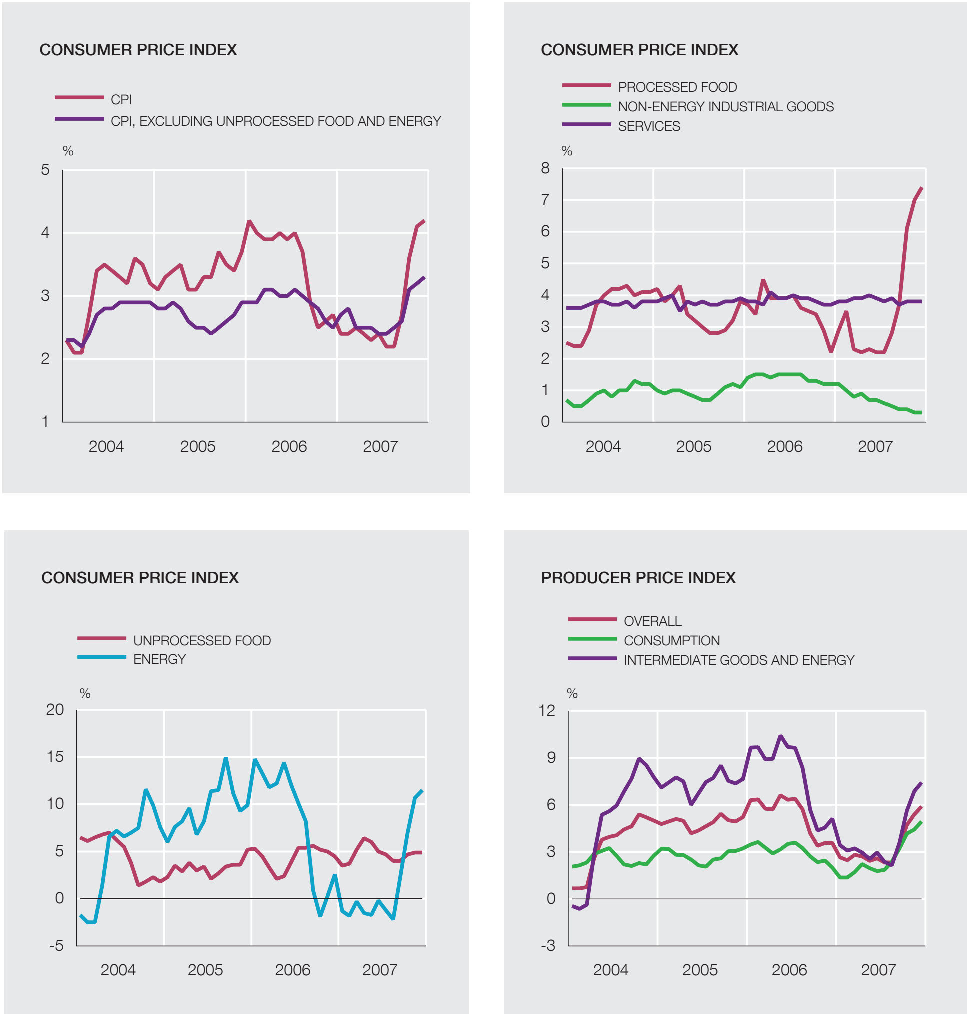
a. Percentage change on a year ago based on QNA seasonally adjusted series.

The average year-on-year growth rate of processed food rose to 6.8% in 2007 Q4, almost 4 pp up on Q3. This was largely due to the strong rise in the prices in source markets of milk and cereals, which passed through subsequently to the final consumer prices of these products and of their derivatives. Developments in the remaining CPI components exerted a much lesser impact on the overall index. The prices of unprocessed food – the most inflationary component in the previous quarters – quickened by 0.6 pp to 4.8%, essentially as a result of the higher price of eggs and of certain meats. In contrast, the slowdown in the price of cars and of electronic and IT products intensified in the closing months of the year, allowing the inflation of non-energy industrial goods as a whole to improve by 0.2 pp to 0.3%. Finally, the growth rate of services prices held stable at 3.8%. This was the outcome of the acceleration in prices in bars, restaurants and cafeterias, which was offset by the fall in prices of package tours and of hotels and other accommodation.

As in the case of the CPI, Spanish inflation measured by the HICP rose by 1.6 pp in 2007 Q4 to stand at an average of 4%. In the euro area as a whole, the rise amounted to only 1 pp (to 2.9%). Accordingly, the differential between Spanish and euro area inflation grew to 1.1 pp, a similar level to the average observed since the euro area came into being. This widening of the differential can be explained by the more inflationary performance of processed food and of energy products in Spain, along with the comparatively greater weight of these groups of goods in Spain's consumption basket. Conversely, the growth rate of the prices of non-energy industrial goods stabilised in the euro area, compared with the slowdown in Spain, which contributed to

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

widening the negative differential in this group of goods by 0.2 pp. Finally, the price differentials of services and of unprocessed food changed but slightly, holding stable at high levels.

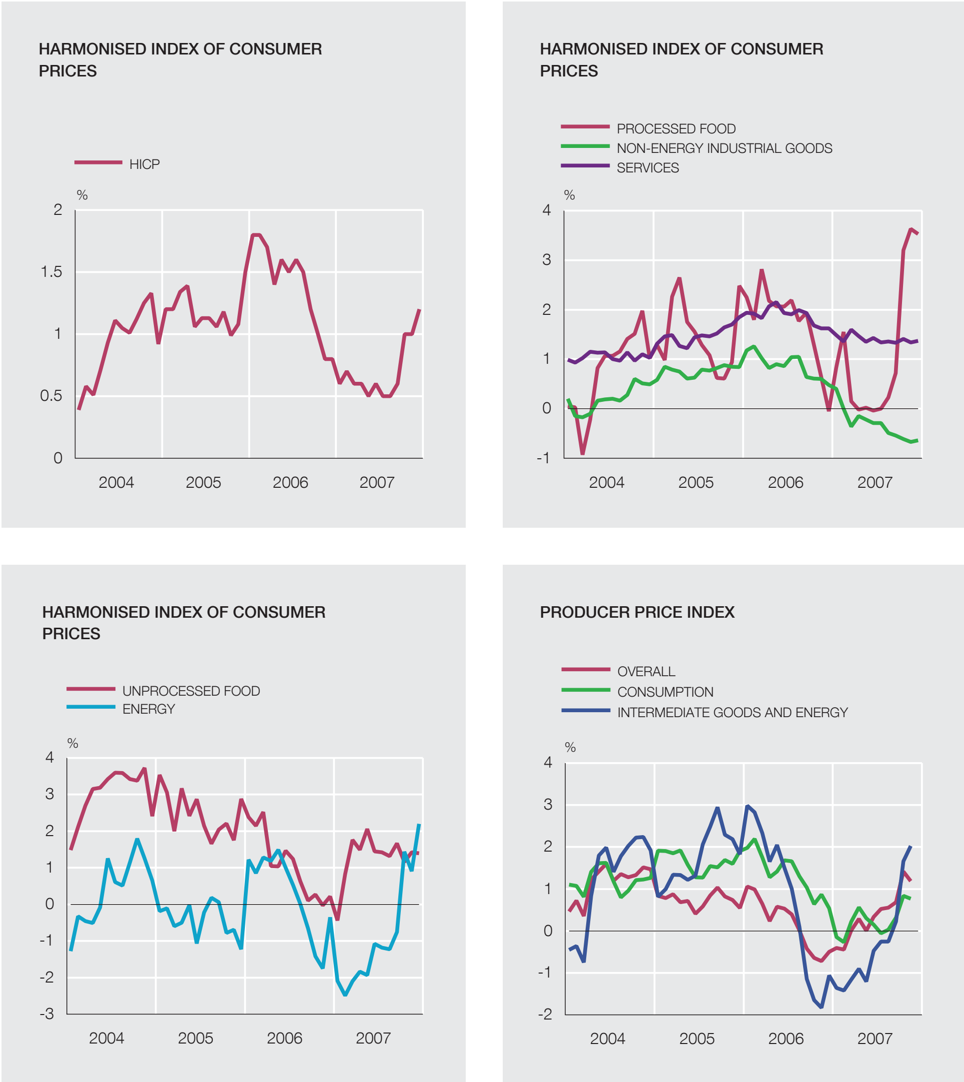
The year-on-year growth rate of the producer price index quickened in Q4 to 5.9%, 2.5 pp up on the figure at the end of Q3. This rising trajectory is due, above all, to the strong increase in the dynamism of energy goods producer prices, although there was also a significant surge in the non-durable consumer goods component, tied to the sharp price increases in the food industry. In November, the differential between the growth rates of producer prices in Spain and in the euro area as a whole widened by 0.6 pp in relation to Q3 to 1.2 pp. The behaviour of the various components of import and export producer prices in November was similar to that described for producer prices as a whole. Thus, the small rise in the overall producer price index in both foreign trade facets was due to the strong acceleration in the energy goods component and to the modest increase in non-durable consumer goods. As a result of the appreciation of the euro, the remaining components tended to post small slowdowns in their growth rates, which fell to zero or even turned negative.

4.4 The State budget

The government presented the ninth Stability Programme Update (SPU) in late December 2007, with macroeconomic and fiscal estimates and projections for the 2007-2010 period.

PRICE INDICATORS CHART 23

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



SOURCES: Eurostat and Banco de España.

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

As regards the State budget, the SPU maintained estimated real GDP growth for 2007 at 3.8%, and revised the growth forecast for 2008 downwards to 3.1%, compared with the previous figure of 3.3%. General government balances have been revised, especially for the year 2007, and a surplus for the general government sector of 1.8% of GDP has now been projected, this being expected to fall to 1.2% of GDP in 2008. In the following years, against the background of the stabilisation of growth in the economy at a rate slightly above 3%, the general government surplus is projected to hold at 1.2% of GDP. In terms of the sub-sectors, the 2007 surplus will be determined chiefly by the Social Security surplus, for which a figure of 1.1% of GDP is expected, and, to a lesser extent, by central government, with a surplus of 0.8% of GDP. Conversely, the regional (autonomous) governments will post a deficit of 0.1% of GDP, while local government finances will be in balance. The reduction in the surplus projected for the sector in the year 2008 is due to the sub-sectors of central government, whose surplus will be halved, and of the Social Security, with a surplus of 0.8% of GDP, while the regional and local government budgets will be in balance (see Box 4).

As a State structured on so-called "Autonomous Communities", Spain has seen the ongoing decentralisation of budgetary powers towards the Regional (Autonomous) Governments (RGs). This has led these governments to manage a substantial portion of overall general government revenue and expenditure. Significantly, they raised 44% of indirect taxes in 2006 and 21% of direct taxes, while 59% of wages and salaries and 38% of investment were in their hands.

These volumes highlight the need to pay attention to the activity of the RGs for the analysis of fiscal variables and, in particular, to the importance of these governments in ensuring the goal of maintaining healthy public finances and complying with budgetary stability legislation, the reformed version of which comes into force in 2008. In this respect, on 11 July 2007 the Fiscal and Financial Policy Council approved the distribution of the budgetary stability target[1] for the RGs for the three-year period 2008-2010. Under this arrangement, an individualised target of a surplus of 0.25% of GDP was set, providing for a reduction in this figure by 0.25% of GDP, in order to obtain balanced end-year accounts, if the expenditure giving rise to this reduction is earmarked for productive investment. This latter target of balanced RG accounts was reflected in the Updated Stability Programme 2007-2010, recently released by the government, and would involve a small improvement on the latest official forecast of a deficit, of 0.1% of GDP, for RGs as a whole in 2007.

Against this background, the RGs submitted their draft budgets for 2008 in the second half of 2007. The main budgetary figures drawn from these drafts show that RGs as a whole[2] anticipate a slight deterioration in the aggregate balance when compared with the initial budget for 2007 (see accompanying table). This is the result of a growth forecast for revenue somewhat below that for expenditure. In any event, and as in recent years, both items show high rates of increase, outpacing actual or forecast nominal GDP growth.

Before discussing the various headings, it should be recalled that the comparison is made between initial budgets and, therefore, the forecasts for 2008 have already taken into account revenue and expenditure developments during 2007. The RG budgets expect direct taxes to continue to be dynamic, due above all to the high growth of personal income tax in 2007. Conversely, in the case of indirect taxes, the growth rate budgeted by the RGs shows a significant slowdown. This might be due to the fact that property transfer and stamp duty taxes, which have been fully assigned to the RGs, have a considerable weight in these governments and their revenue has contracted in 2007 according to the information available to date (with a fall of 5.4% between January and September 2007 in relation to the same period the previous year). In addition, the slowdown in indirect taxes reflects the moderate course of VAT in 2007 in relation to the initial budget. Overall, the indirect taxes budgeted by the RGs seem to reflect, to a greater extent than the State, the impact on revenue of the property market slowdown, given the likewise greater weight on their accounts of the taxes associated with property transactions. Regarding other revenue, mention should be made, in view of their volume, of the acceleration budgeted for the revenue heading of current transfers. The

1. Note that the target is set in National Accounts terms.

2. The autonomous city enclaves of Ceuta and Melilla are not considered.

	Regional Governments							State
	€m				Rate of change			
	2005	2006	2007	2008	06/05	07/06	08/07	08/07
REVENUE	126,475	140,662	154,770	168,117	11.2	10.0	8.6	8.3
Current revenue	118,147	132,093	145,978	158,584	11.8	10.5	8.6	7.8
- Direct taxes	21,590	24,396	27,215	32,153	13.0	11.6	18.1	8.1
- Indirect taxes	42,753	47,765	54,692	56,192	11.7	14.5	2.7	5.2
- Charges, prices and other revenue	3,723	3,852	4,220	4,430	3.5	9.6	5.0	11.8
- Current transfers	49,655	55,671	59,454	65,250	12.1	6.8	9.7	4.4
- Interest and dividends	425	409	396	560	-3.7	-3.1	41.2	70.4
Capital	8,328	8,569	8,792	9,532	2.9	2.6	8.4	49.7
- Disposal of investments	651	678	717	626	4.2	5.7	-12.6	15.2
- Capital transfers	7,677	7,891	8,075	8,906	2.8	2.3	10.3	52.1
EXPENDITURE	127,882	141,540	154,891	168,469	10.7	9.4	8.8	6.6
Current expenditure	103,301	113,951	124,830	135,907	10.3	9.5	8.9	7.0
- Wages and salaries	40,300	43,576	47,442	52,068	8.1	8.9	9.8	7.1
- Goods and services	19,490	22,047	24,834	27,525	13.1	12.6	10.8	3.8
- Interest payments	2,171	2,269	2,376	2,486	4.5	4.7	4.6	4.3
- Current transfers	41,289	45,910	50,021	53,654	11.2	9.0	7.3	7.8
- Contingency fund	51	150	157	175	194.4	4.6	11.7	2.4
Capital	24,582	27,589	30,061	32,562	12.2	9.0	8.3	4.1
- Investment	12,563	13,787	15,337	16,381	9.7	11.2	6.8	6.3
- Capital transfers	12,019	13,802	14,724	16,181	14.8	6.7	9.9	1.7
BALANCE	-1,408	-879	-120	-353	...	...	...	...

projected rate is in line with that budgeted by the State for transfers to the RGs.

Turning to the various expenditure items, the budgeted growth rate for wages and salaries (9.8%) is higher than that of the State, concerning the pattern observed in recent years, which would be warranted only in part by the successive transfers of powers. In the case of expenditure relating to goods and services and to current transfers, which are very closely linked at the RG level to health-care and education powers, high growth has been budgeted, as in previous years. In contrast, interest payments are budgeted to grow moderately, and this remains the only heading that is traditionally budgeted for with rates below nominal GDP. Finally, a higher increase than that in the State budget is projected for capital expenditure, although this marks a slowdown in relation to the 2007 budget. Further, the bigger increase in this expenditure at the RG level is centred on capital transfers (with growth of 9.9%, compared with the 6.8% increase in investment), while State expenditure on this item is projected to grow only slightly.

Turning to the budget outturn, according to National Accounts methodology and on the information available to November 2007, the State accounts posted a surplus of 2.8% of GDP, notably higher than the surplus of 2.3% of GDP a year earlier (see Table 3). Despite the fact that the State balance is highly seasonal and that December is a month which traditionally sees a substantial reduction in the surplus attained up to the previous month, the result to November suggests that the end-year central government surplus may be higher than projected.

In cash-basis terms, the State accounts posted a surplus of €24,104 million to November, compared with a surplus of €17,070 million the previous year. The discrepancies between both balances (National Accounts and cash-basis) are chiefly due, as is habitual, to adjustments for the different interest allocation criterion and for the change in outstanding rights and obligations.

Likewise on a cash basis, State revenue grew notably above forecast in the Budget Outturn Projection, while the growth of expenditure was below forecast. The higher revenue was due principally to direct taxes and, to a lesser extent, to other revenue. With the exception of the goods and services heading, expenditure was contained to some extent under all headings, compared with the figures forecast in the Outturn Projection.

To analyse revenue, information is available on total receipts from the main taxes, both the portion assigned to the State and that corresponding to the ordinary-regime regional governments, although only the State figures are included in Table 3. According to this information, receipts eased off across the board in the closing months, although they remain considerably buoyant. Of particular note was the vigour of direct taxes, the figures for which reveal growth rates far higher than those reflected in the Outturn Projection. In the case of personal income tax, and despite the tax reform in early 2007, receipts grew by 16.4%, underpinned by the strength of withholdings on income from work and by the withholdings on income from capital and on gains on mutual funds. The growth rate of corporate income tax slowed following the October prepayment to 20.3%, a figure which in any event reflects the sound course of corporate earnings and is far above the Outturn Projection for the year as a whole. As regards indirect taxes, VAT continued to show signs of sluggishness, increasing by 1.2%, while excise duties eased to 6.7%, above the Outturn Projection for the year as a whole, driven largely by the tax on hydrocarbons and that on tobacco products. Finally, the increase in the captions grouped under other revenues slackened slightly, posting a rate of 16.2% to November.

The slowdown in State expenditure in the closing months was across the board, with the sole exception of capital transfers. Given their scale, mention should be made of the moderation in

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2006	Percentage change 2006/2005	Outturn projection 2007	Percentage change 2007/2006	Outturn JAN-SEP percentage change 2007/2006	Outturn 2006 JAN-NOV	Outturn 2007 JAN-NOV	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	141,846	10.1	151,329	6.7	11.9	132,362	148,407	12.1
Direct taxes	81,130	14.8	87,716	8.1	20.1	75,132	89,798	19.5
Personal income tax	*41,451*	*15.3*	*43,000*	*3.7*	*10.4*	*39,156*	*46,237*	*18.1*
Corporate income tax	*37,207*	*14.5*	*41,842*	*12.5*	*31.8*	*33,710*	*40,540*	*20.3*
Other (a)	*2,472*	*11.5*	*2,874*	*16.3*	*39.4*	*2,266*	*3,020*	*33.3*
Indirect taxes	48,328	8.3	49,739	2.9	-1.6	46,719	46,396	-0.7
VAT	*35,424*	*10.7*	*35,491*	*0.2*	*-7.6*	*34,944*	*32,924*	*-5.8*
Excise duties	*9,895*	*1.0*	*11,015*	*11.3*	*18.4*	*9,012*	*10,518*	*16.7*
Other (b)	*3,009*	*7.0*	*3,233*	*7.5*	*7.0*	*2,763*	*2,954*	*6.9*
Other net revenue	12,388	-8.2	13,874	12.0	16.8	10,511	12,214	16.2
2 EXPENDITURE	130,375	6.2	143,843	10.3	9.3	115,292	124,304	7.8
Wages and salaries	22,209	7.4	23,859	7.4	6.4	19,293	20,455	6.0
Goods and services	3,799	12.1	4,319	13.7	16.8	3,045	3,511	15.3
Interest payments	15,619	-12.4	14,607	-6.5	-7.3	15,470	14,326	-7.4
Current transfers	72,225	11.9	79,560	10.2	11.8	64,779	70,681	9.1
Contingency fund	...	...	...	...	...	...	...	...
Investment	9,037	0.7	11,357	25.7	15.5	7,228	7,937	9.8
Capital transfers	7,487	2.0	10,141	35.4	26.8	5,477	7,394	35.0
3 CASH-BASIS BALANCE (3 = 1 – 2)	11,471	...	7,486	...	...	17,070	24,104	...
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	147,201	13.1	156,377	6.2	10.8	136,331	151,812	11.4
Uses	142,422	10.8	154,276	8.3	9.7	116,661	125,977	8.0
NET LENDING (+) OR BORROWING (–)	4,779	...	2,101	...	...	19,670	25,835	...
(as a percentage of GDP)	0.5		0.2			2.3	2.8	

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.

current transfers and in wages and salaries. As regards interest payments, the key development was the marked loss of dynamism in investment, which grew at a rate of 9.8% to November.

Box 5 addresses the main aspects of the Social Security budget outturn to October.

4.5 The balance of payments and capital account

The Spanish economy's net borrowing (i.e. the overall balance on current and capital account) amounted in the first ten months of 2007 to €81,911 million, 21.3% up on the same period a year earlier (see Table 4). The current account deficit widened by 19.8% in this period to €85,259 million. While more moderate than in previous years, the pace of the widening of the Spanish economy's external deficit remained considerable, a gradual slowdown being discernible in the months following the step-up recorded in the summer months. The balances of the main current account components worsened in the first ten months of 2007, with the exception of the services surplus, which improved moderately as a result of the increase in the tourism surplus and the partial correction of the deficit on other services; the income deficit, meanwhile, increased substantially. The surplus on capital transactions posted a decline of 7.1%, amounting to €3,348 million.

The Social Security system posted a surplus of €17,482 million in the period January-October 2007, up €2,120 million (13.8%) on the same period a year earlier (see accompanying table). These outturn figures entail, however, a less favourable trend than that recorded to July, given that the dynamism of revenue eased off, posting an 8.2% increase in October, while the growth of expenditure held virtually stable at around 7%.

Revenue from social security contributions posted growth of over 7% in recent months, though some easing was observed. That reflected the slowdown in the number of Social Security registrations during 2007, which ended the year with growth of 2.3%, 1 pp down on the rate recorded at the end of 2006.

Turning to expenditure, the growth of that earmarked for contributory pensions held at 6.5% to October, below the figure budgeted for the year as a whole. The growth in the number of contributory pensions remained practically stable in the second half of the year at around 1.3%. The growth rate of expenditure on sickness benefits stepped up to 5.4% to October, a rate also below budget.

As regards the SPEE (National Public Employment Service), the data for which are not included in the accompanying table, contributions received increased by 6.4% to August, while rebates on contributions in respect of employment-promoting contracts increased by 11.1% in the same period.

Finally, the expenditure earmarked for unemployment benefits rose by 7.4% to November (similar to the 7.6% increase for 2006 as a whole), while the number of beneficiaries grew by 13% to October (as against 3% average growth in 2006). In addition, the increase in registered unemployment continued to quicken, rising to 4.4% in November, in marked contrast to the average decline of 1.9% in 2006. This gave rise to a further increase in the coverage ratio, which stood at 69% in October 2007, compared with the end-2006 level of 66.6%.

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

EUR m and %

	Outturn	Budget		JAN-JUL	Outturn JAN-OCT		
	2006	2007	% change	% change	2006	2007	% change
	1	2	3=2/1	4	5	6	7=6/5
1 REVENUE	103,987	106,142	2.1	9.0	85,992	93,003	8.2
1.1 Social security contributions	96,522	97,942	1.5	7.5	80,017	85,898	7.3
1.2 Current transfers	5,313	5,963	12.2	13.0	4,403	5,042	14.5
1.3 Other	2,152	2,237	3.9	82.8	1,572	2,063	31.3
2 EXPENDITURE	90,646	98,390	8.5	7.0	70,630	75,522	6.9
2.1 Wages and salaries	2,169	2,253	3.9	0.8	1,730	1,738	0.5
2.2 Goods and services	1,859	1,807	-2.8	0.4	1,381	1,408	2.0
2.3 Current transfers	86,095	93,743	8.9	6.8	67,285	71,726	6.6
Contributory pensions	73,725	80,099	8.6	6.5	57,511	61,221	6.5
Sickness	6,850	7,313	6.7	3.8	5,338	5,628	5.4
Other	5,519	6,331	14.7	13.9	4,436	4,877	9.9
2.4 Other	523	588	12.5	172.7	234	650	177.3
3 BALANCE	13,342	7,752	-41.9	20.1	15,362	17,482	13.8

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

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

BALANCE OF PAYMENTS: SUMMARY (a) TABLE 4

EUR m

		JANUARY-OCTOBER	
		2006	2007
CREDITS	Current account	254,850	282,131
	Goods	*142,368*	*153,080*
	Services	*71,471*	*79,232*
	— Tourism	35,811	37,006
	— Other services	35,660	42,226
	Income	*29,100*	*37,018*
	Current transfers	*11,911*	*12,801*
	Capital account	4,840	4,701
	Current + capital accounts	259,690	286,832
DEBITS	Current account	325,992	367,390
	Goods	*208,971*	*224,426*
	Services	*51,306*	*58,393*
	— Tourism	11,096	11,980
	— Other services	40,210	46,414
	Income	*47,690*	*62,952*
	Current transfers	*18,025*	*21,618*
	Capital account	1,237	1,352
	Current + capital accounts	327,229	368,742
BALANCES	Current account	-71,142	-85,259
	Goods	*-66,603*	*-71,346*
	Services	*20,165*	*20,839*
	— Tourism	24,715	25,027
	— Other services	-4,550	-4,188
	Income	*-18,590*	*-25,935*
	Current transfers	*-6,114*	*-8,818*
	Capital account	3,603	3,348
	Current + capital accounts	-67,539	-81,911

SOURCE: Banco de España.

a. Provisional data.

In the period from January to October 2007, the trade deficit increased by €4,743 million in relation to the same period a year earlier, rising to a figure of €71,346 million, making for an increase in the first ten months of the year of 7.1%. This rate runs counter to the greater deterioration that had been characterising the previous years. The improved terms of trade meant that, in nominal terms, exports increased in the first ten months of the year at a rate similar to that of imports (7.5% and 7.4%, respectively). Over the course of this period there was a decline in the energy bill, against the background of the appreciation of the euro against the dollar and of small increases in crude oil prices in dollars on international markets (until the more recent phase, when these prices surged). However, the non-energy trade deficit increased in both nominal and real terms.

In the first ten months of 2007, the services balance posted a surplus of €20,839 million, 3.3% higher than in the same period in 2006. The rise was due both to the slight improvement (by 1.3%) in the tourism surplus and to the 8% reduction in the other services deficit. Tourism revenues have been somewhat more expansionary in recent months than during the spring and early summer. However, their dynamism remains moderate. Specifically, the increase in the first ten months was 3.3%, 2.5 pp below the rate observed in the same period in 2006, which might be explained by the appreciation of the euro in nominal effective terms and by the greater pressure exerted by eastern Mediterranean destinations competing with Spain. Tourism payments increased by 8% in the January-October period, a rate 1.5 pp slower than that of the first ten months of the previous year, which is consistent with the gradual slowdown in overall household expenditure. The correction of the deficit on other services took place in a setting of high dynamism of both revenues and payments, which respectively grew at rates of 18.4% and 15.4% in the January-October period.

The income deficit widened forcefully over the course of the first ten months of 2007, standing at €25,935 million, entailing a deterioration of 39.5% compared with the same period the previous year. Both revenues and, in particular, payments moved on an expansionary course throughout the first ten months of 2007, with year-on-year growth rates of 27.2% and 32%, respectively. Developments in this balance were in response to the rise in interest rates – which was particularly marked in the case of short-term rates – and to the growing net debit position of the Spanish economy, as a result of its net borrowing in recent years. By institutional sector, the increase in the deficit was attributable, above all, to the increase in the investment income deficit of other resident sectors and, to a lesser extent, of financial institutions, while the general government deficit widened much more modestly.

In the first ten months of 2007, the deficit on the balance of current transfers grew by 44.2% to €8,818 million. Revenues increased at a year-on-year rate of 7.5%, thanks to the favourable trend in EU flows connected to the European Social Fund and in other transfers received by the private sector, particularly those relating to taxes and donations. Payments – with a buoyant growth rate of 19.9% – outpaced revenues, reflecting the significant increase in both the payments by the public sector and by other resident sectors, with those relating to taxes and donations standing out in both cases. Migrant remittance payments continued to increase notably (25.3%).

Finally, the capital account surplus fell in the first ten months of the year in relation to the same period a year earlier. This was due to the reduction in revenues and the rise in payments. The deterioration in revenues was above all due to the strong decline in revenues received by general government in relation to debt forgiveness and, to a lesser extent, from the Cohesion Fund. The increase in the structural funds received from the ERDF was unable to offset this deterioration.

5.1 Highlights

In 2007 Q4, the financial turbulence that broke out last summer as a result of the rise in the default rate on sub-prime mortgages in the United States intensified. Thus, following the improvement between late September and early October, tensions resurfaced in the final part of the year. In the money markets, the uncertainty generated by the recognition of fresh losses by certain US investment banks, along with the desire of many intermediaries to end the year with a comfortable liquidity position, meant that interbank rates rose again, especially at the shorter maturities. Thus, while one-year EURIBOR fell in October and November to an average rate in the latter month of 4.61% (down 8 bp from September), it rose in December to an average rate of 4.8%.

Turbulence also affected other financial markets. Thus the credit spreads of financial and non-financial firms widened again in November and December, following their recovery in the two previous months, to stand at their highest levels since 2003. The climate of greater uncertainty stimulated the demand for low-risk assets, although this development was partially reversed at the end of the year. Stock markets remained highly resilient up to the end of the year, although there was a rise in their volatility (see Chart 24). Thus, the Madrid Stock Exchange General Index (IGBM) rose by 3% in Q4, to make a 6% gain in 2007 as a whole, which was slightly larger than those recorded by the Euro Stoxx broad index of European firms (5%) and by the S&P 500 (4%) of US ones.

During the first few weeks of 2008, credit spreads continued to widen, especially in the case of financial firms, while share prices declined. On Monday 21 January, amid sharp falls across international equity markets, the IGBM (Madrid Stock Exchange General Index) lost 7.1%, although it partially rebounded subsequently. Over the period 1-24 January the IGBM fell by a total of 13.8%. On the money markets by contrast, the tensions observed in December partially subsided and twelve-month EURIBOR fell on average to 4.5%. In any event, given the dominant background of considerable uncertainty at the time this report was drafted, more time is clearly needed before the true purport of these movements can be properly assessed.

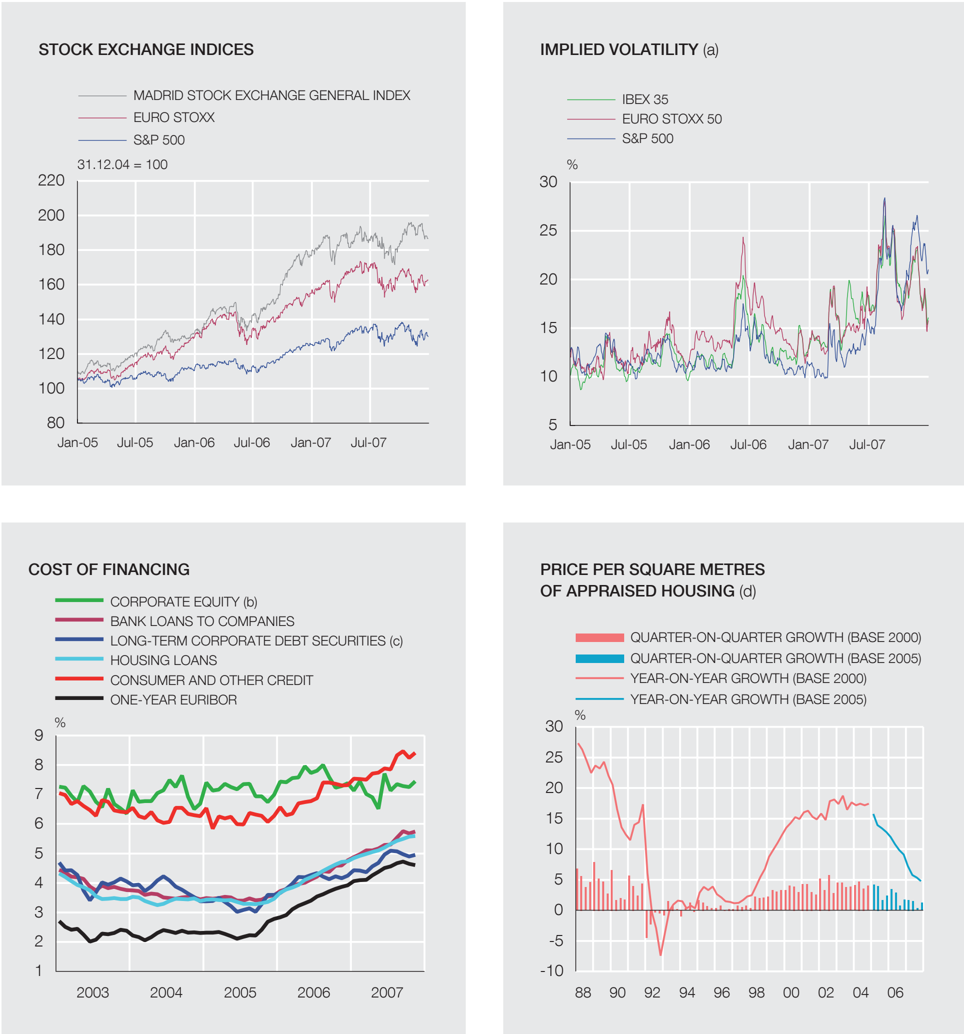
Despite the financial turbulence, the information available on 2007 Q4 (to November) does not show a significant increase in the costs of new flows of private-sector financing. However, according to the results of the December Bank Lending Survey (BLS), in Q4 the banks tightened their credit standards for new lending to both households and businesses. Also, credit standards were forecast to continue to tighten in 2008 Q1.

In the property market, according to the latest data supplied by the Ministry of Housing, in 2007 Q4 the pattern of gradual moderation in the rate of growth of house prices, which began more than two years ago, continued. The year-on-year growth rate of the price of appraised unsubsidised housing stood, in 2007 Q4, at 4.8%, half a percentage point less than in September and more than 4 pp lower than at end-2006.

Against this background, in 2007 Q4, private-sector debt slowed further. In the case of households, the year-on-year growth rate of credit stood in November at around 14%, down one percentage point from September. This reduction is explained by the fall in the rate of growth of loans for house purchase, since there was no significant change in that of consumer and other loans. The provisional information for December points to a further reduction in the buoyancy of household liabilities.

FINANCING CONDITIONS AND ASSETS PRICES

CHART 24



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

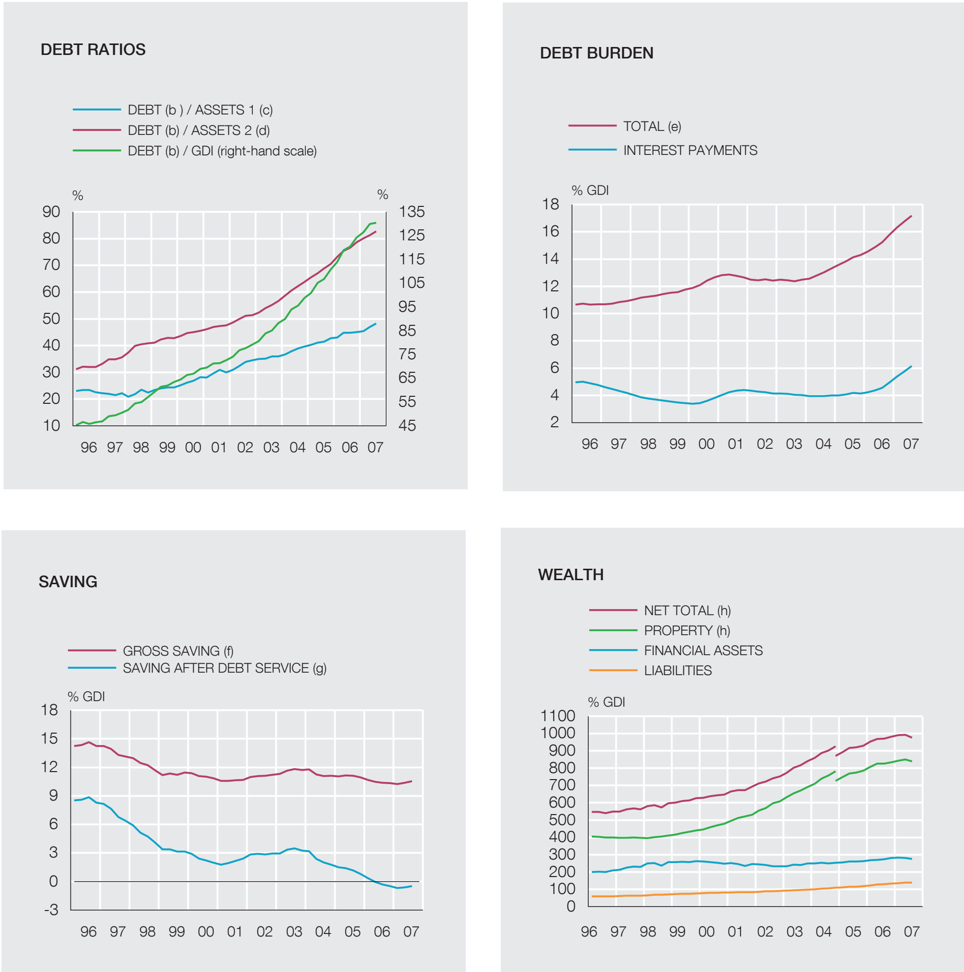
a. Five-day moving averages.
b. The cost of equity is based on the three-stage Gordon dividend discount model.
c. The interest rate on long-term debt securities is approximated by the sum of the 5-year euro swap rate and a weighted average of the 5-year CDS premiums of Spanish non-financial corporations.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

The growth rate of corporate borrowing fell more sharply (by more than 2 pp between September and November) to stand at around 19%, a trend that continued in December according to the preliminary data for that month. The latest information available shows that the recent slowdown in lending to businesses is the result of mixed developments at the sectoral level. Thus, the slowdown in 2007 Q3 was exclusively attributable to the loss of momentum in borrowing by property services and construction, since the borrowing of other sectors was more buoyant. The further acceleration in lending to industry, which grew by around 22% year-on-year, was especially notable (see Box 6).

Despite the moderation in the growth of household liabilities, they continued to grow faster than household income, so that in 2007 Q3 the household debt and debt-burden ratios continued to rise, the latter also being driven by the higher average cost of outstanding credit (see Chart 25). According to the provisional data available, this trend continued in 2007 Q4. Meanwhile, according to the financial accounts, between July and September 2007, household net borrow-

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. There is a new house price statistic from 2005.

ing showed no significant change; neither did household net wealth, which remained at around the comfortable levels observed in the first half of the year.

The corporate debt and debt-burden ratios also rose further in 2007 Q3 and, according to the preliminary figures, this pattern continued in Q4. The latest information on corporate income, relating to September, shows that the increase in financial costs continued to curb the growth of profits, which led to a slight decline in the return on capital. The data for the sample of firms that respond to the quarterly survey of the Central Balance Sheet Data Office (CBQ) also showed an increase in their debt burden and a reduction in profitability, although the latter remains at comfortable levels. However, these developments were accompanied by a certain decline in the degree of indebtedness of these companies. As a result of these changes there was a moderate rise in the synthetic indicators of financial pressure on investment and employment (see Chart 26). During the same period, according to the financial accounts, the

Financing granted by Spanish credit institutions to productive activities (non-financial corporations and sole proprietorships) displayed a pattern of continuous acceleration between 2002 and end-2006 to reach a year-on-year growth rate of approximately 29%. As shown in panels 1 and 2, this trend was driven essentially by funds earmarked for construction and real estate services, whose growth rates rose to around 35% and 50%, respectively. These two branches account for approximately two thirds of the average growth in corporate loans in this period. The reasons for these developments are notably robust construction, especially in the residential segment, as shown by the activity indicators (see panels 3 and 4), and the upturn in M&A activity, which was extensively financed through bank debt.

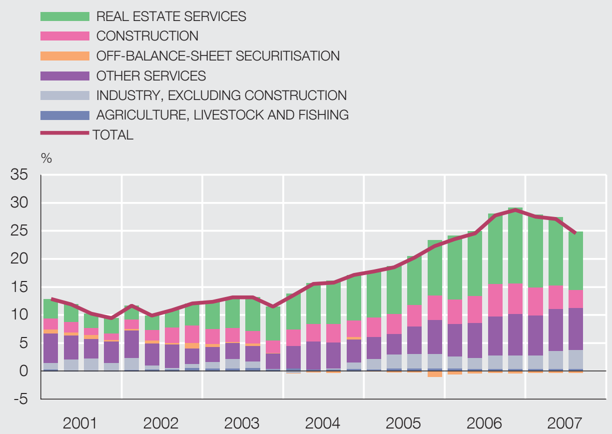
Conversely, since the beginning of last year, bank credit for productive activities has gradually slowed. Between December 2006 and September 2007 its year-on-year growth rate fell 4 pp, to 25%. The breakdown by sector shows that this pattern of moderation is accounted for exclusively by loans granted to construction and real estate services whose year-on-year growth rates dropped considerably in the same period, from 33% and 51%, respectively, to 18% and 35%. By contrast, in the other sectors growth rates held steady, as in other services, or even quickened strongly, as in industry.

Moderation in the growth rate of funds raised by the construction and real estate sectors is essentially linked to the slowdown in the activity of these two branches. The gross capital formation undertaken by them and housing starts indicators have been decelerating noticeably since mid-2006. Less buoyant M&A activity must have also contributed to these developments. Conversely, the greater resilience of investment by other sectors will have tended to support credit growth.

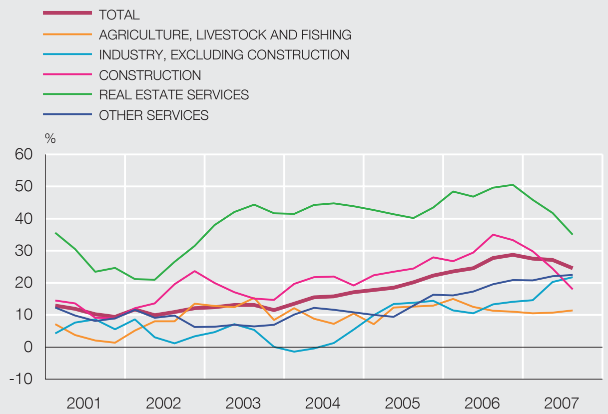
Apart from demand, recent developments in bank lending to corporations may have also been affected by supply-side factors. Credit institutions may have attempted to increase the sectoral diversification of their portfolios against a backdrop in which real estate activity was beginning to show signs of less buoyancy.

Recent changes in the sectoral distribution of lending to non-financial corporations, in addition to favouring the redistribution of risk within institutions' portfolios, could also have a positive effect on the productivity of the Spanish economy insofar as new funds are used to finance productive investment and help to smooth the transition to a new growth pattern in which construction has less importance in favour of other sectors.

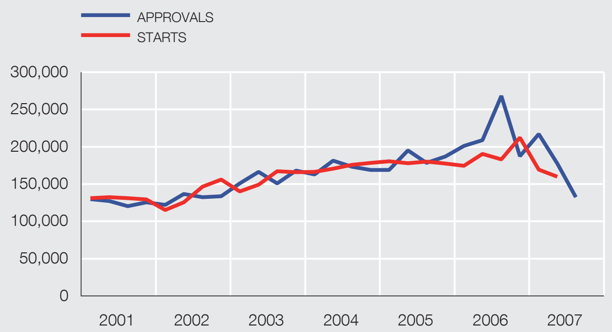
1 CONTRIBUTIONS TO GROWTH OF LENDING TO PRODUCTIVE ACTIVITIES



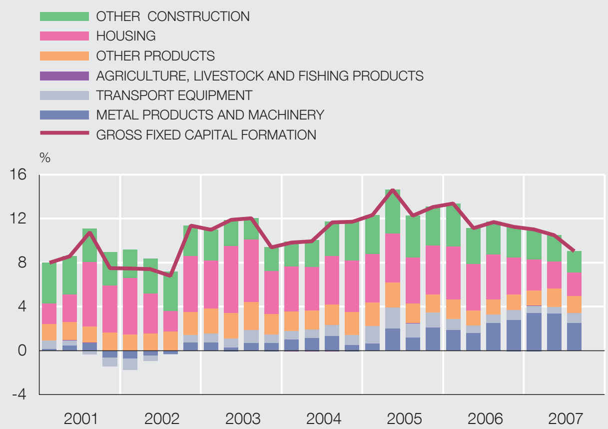
2 GROWTH RATES OF LENDING TO PRODUCTIVE ACTIVITIES



3 HOUSING APPROVALS AND STARTS



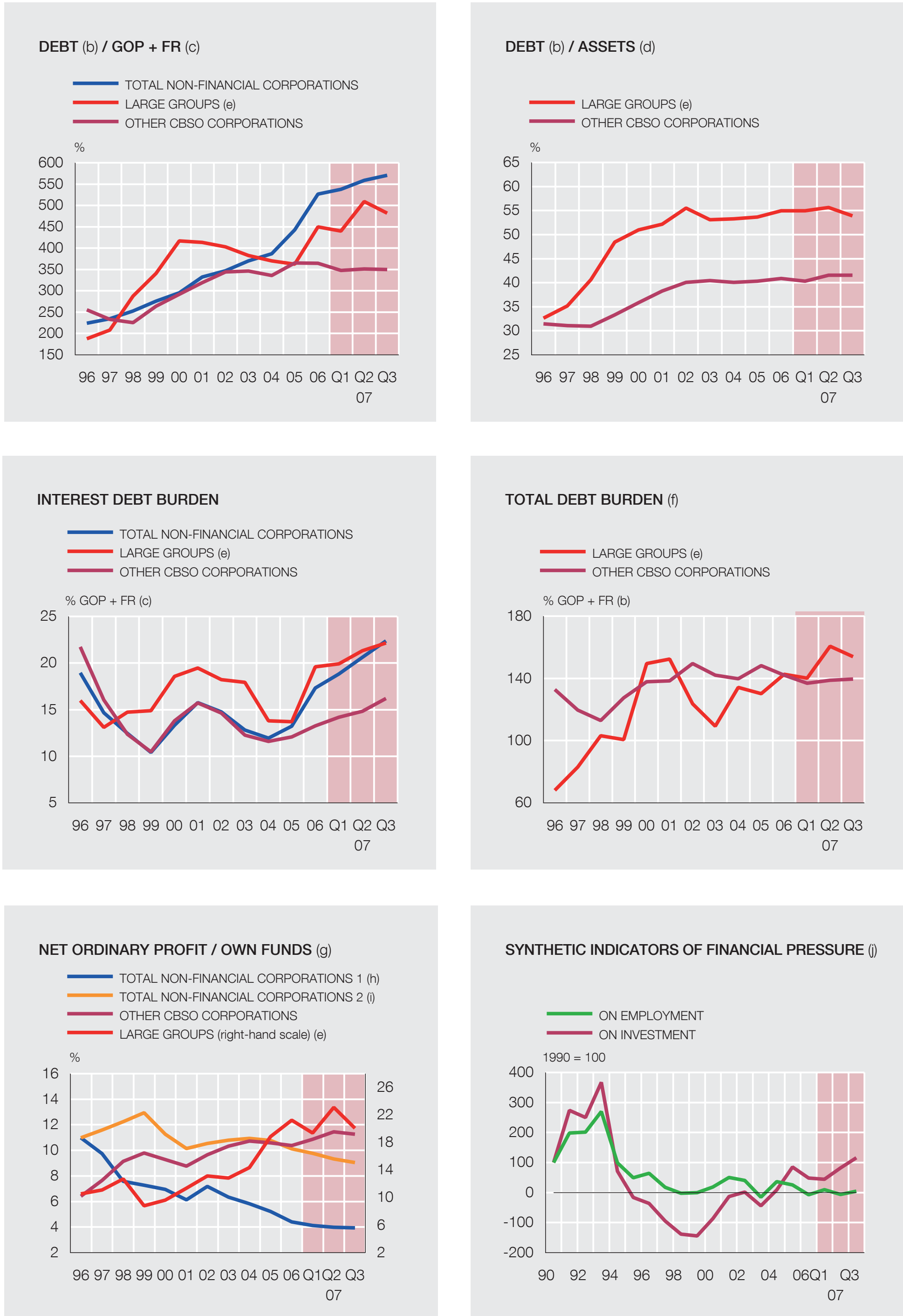
4 CONTRIBUTIONS TO GROWTH OF GROSS FIXED CAPITAL FORMATION



SOURCES: Instituto Nacional de Estadística, Ministerio de Vivienda and Banco de España.

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

CHART 26



SOURCE: Banco de España.

a. Based on CBA and CBQ data, except in the case of the "total non-financial corporations" series, which is based on the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
e. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
f. Includes interest plus interest-bearing short-term debt.
g. For total non-financial corporations, NOP = GOS + interest and dividends received – interest paid – fixed capital consumption.
h. Own funds valued at market prices.
i. Own funds calculated by accumulating flows from the 1996 stock onwards.
j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP

	2002	2003	2004	2005	2006		2007		
					Q3	Q4	Q1	Q2	Q3
National economy	-2.7	-2.9	-4.8	-6.5	-7.8	-8.1	-8.3	-8.7	-8.9
Non-financial corporations and households and NPISHs	-3.3	-3.8	-5.1	-8.2	-10.4	-10.6	-11.2	-12.0	-13.0
Non-financial corporations	*-4.0*	*-3.9*	*-4.5*	*-6.9*	*-8.4*	*-9.0*	*-9.5*	*-10.6*	*-11.5*
Households and NPISHs	*0.7*	*0.1*	*-0.6*	*-1.3*	*-2.0*	*-1.6*	*-1.6*	*-1.4*	*-1.5*
Financial institutions	1.2	1.0	0.6	0.7	0.6	0.6	0.7	1.2	1.4
General government	-0.5	-0.2	-0.4	1.0	2.0	1.8	2.1	2.0	2.6
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.5	-8.2	-8.7	-11.1	-15.6	-15.9	-13.9	-15.7	-16.3

SOURCE: Banco de España.

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

sector's net borrowing increased further, to 11.5% of GDP, in cumulative twelve-month terms, almost one percentage point higher than in June.

The increase in the shortfall in corporations' funds was not offset by the recovery in the public sector's and, to a lesser extent, in financial institutions' saving. Given the stability displayed by this indicator in the case of households, this meant that the nation's net borrowing, according to the financial accounts, increased in 2007 Q3 to 8.9% of GDP, in cumulative annual terms, up 0.2 pp from June (see Table 5). The rise in credit spreads owing to the financial turbulence led domestic intermediaries to reduce their recourse to the international fixed-income markets, so that these agents performed a less active role in raising the funds necessary to finance the gap between domestic income and spending and financial investment abroad.

In short, the private sector's financial position did not change significantly in Q4, so that on aggregate there are still no signs of vulnerability that might constrain its spending decisions. At the same time, the latest information shows that both households and corporations are moderating their rate of accumulation of liabilities in an orderly manner, in line with the tighter financing conditions in recent quarters. The financial turbulence does not appear to have had a significant effect on the cost of borrowing, beyond that arising directly from the increase in interbank rates. However, a prolonged duration of the tensions on financial markets would probably eventually have a greater effect on the conditions on which households and corporations can obtain funds.

5.2 Households

The latest information on the cost of households' new liabilities shows no significant increases. Thus, between September and November 2007, the average rate of interest applied to new loans for house purchase rose by 10 bp, while that for consumer and other finance fell by 5 bp, although the latter tends to be more variable partly on account of seasonal behaviour (see Chart 24). However, according to the latest BLS, in December, banks tightened their credit standards in 2007 Q4 for both types of loan and expected a further tightening of lending criteria in 2008 Q1.

Against this background, the growth rate of household debt continued to moderate, so that in November it stood at around 14%, as against 15% at the end of Q3. In terms of purpose, this

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

TABLE 6

% GDP	2004	2005	2006	2007		
				Q1	Q2	Q3
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	9.4	10.2	11.6	11.3	10.6	9.4
Cash and cash equivalents	3.9	4.0	3.1	2.2	1.7	0.5
Other deposits and fixed-income securities (a)	1.2	1.6	6.1	6.8	7.1	7.3
Shares and other equity (b)	0.3	0.2	-0.8	0.1	0.0	0.2
Mutual funds	1.5	1.9	0.2	-0.5	-0.6	-0.6
Insurance technical reserves	1.8	1.9	1.6	1.6	1.5	1.5
Of which:						
Life assurance	*0.7*	*0.7*	*0.6*	*0.6*	*0.6*	*0.5*
Retirement	*0.9*	*1.0*	*0.8*	*0.9*	*0.8*	*0.8*
Other	0.6	0.6	1.4	1.3	0.8	0.6
Financial transactions (liabilities)	10.1	11.5	13.2	13.0	12.0	10.9
Credit from resident financial institutions (c)	10.8	12.3	13.0	12.5	11.6	11.0
House purchase credit (c)	*8.7*	*10.2*	*9.9*	*9.3*	*8.9*	*8.5*
Consumer and other credit (c)	*2.1*	*2.2*	*3.1*	*3.1*	*2.7*	*2.5*
Other	-0.8	-0.8	0.1	0.5	0.4	-0.1
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	12.3	17.3	22.5	19.3	20.2	16.9
Cash and cash equivalents	1.0	2.0	2.3	1.7	1.2	0.4
Other deposits and fixed-income securities (a)	0.3	1.4	2.7	2.7	4.3	3.5
Shares and other equity	6.4	7.2	10.2	7.6	8.8	7.5
Of which:						
Vis-à-vis the rest of the world	*3.8*	*3.9*	*6.8*	*4.2*	*5.6*	*4.4*
Other	4.7	6.7	7.4	7.2	5.9	5.5
Financial transactions (liabilities)	16.9	24.2	31.5	28.8	30.7	28.4
Credit from resident financial institutions (c)	8.3	12.9	17.7	17.7	17.9	16.9
Foreign loans	0.7	2.1	3.3	1.2	2.6	2.4
Fixed-income securities (d)	0.0	0.3	1.8	1.2	0.8	0.8
Shares and other equity	4.2	3.4	2.1	2.2	3.3	4.0
Other	3.6	5.5	6.7	6.6	6.0	4.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	16.3	21.2	24.2	21.1	20.6	18.8
Households and NPISHs	20.2	20.9	19.6	18.3	16.4	15.3
Non-financial corporations	13.2	21.4	27.9	23.3	23.9	21.5

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.

was basically a result of the behaviour of funds to finance house purchase, whose year-on-year growth rate fell to below 15%, while the liabilities for consumption and other purposes barely changed.

According to the financial accounts, households' acquisition of financial assets moderated again in Q3 and, in cumulative annual terms, accounted for less than 10% of GDP, somewhat more than 1 pp below the June figure (see Table 6). By instrument, the most important decline was in flows in the form of cash and cash equivalents, which represented barely 0.5% of GDP, as against 1.7% three months earlier. This reduction basically reflects the shift from sight to more highly remunerated time deposits. As a result, the relative weight of the item other deposits and fixed-income securities (which includes those instruments) increased to more than 7% of GDP. There were no significant changes in the other items, with the exception of the slight rise in direct purchases of shares.

The fact that borrowing continued to grow at high rates meant that the household debt ratio continued to rise, although at a lower rate than during the preceding quarters. In September 2007 it exceeded 130% of GDI. This, along with the increase in the average cost of outstanding loans, led to a further increase in the related debt burden, which stood in the same period at more than 17% of GDI (see Chart 25). However, in cumulative twelve-month terms, there was hardly any change in either the sector's net borrowing or in the level of its saving after debt service. Neither were there any significant changes in household net wealth which, relative to GDI, held at around first-half levels.

5.3 Non-financial corporations

Between September and November 2007 there was a slight rise in the average cost of capital, although the most disaggregated information shows declines in some of its elements (see Chart 24). Thus, while the interest rates applied to bank loans of less than one million euro rose by 8 bp, those on higher amounts fell by 13 bp. The cost of fixed-income issuance also fell, both in the case of short-term (14 bp) and long-term securities (2 bp), but that of equity rose. As in the case of households, the results of the latest BLS show a further tightening of credit standards during Q4, a trend that the institutions expected to continue in 2008 Q1.

Against this background, the year-on-year growth rate of corporate debt fell between September and November by more than 2 pp, to around 19%. By instrument, this moderation is basically explained by the behaviour of credit from resident institutions, which is the main source of financing for this sector.

The latest data for the breakdown of bank credit by productive activity show that the slowdown in this form of corporate financing during 2007 Q3 was exclusively attributable to the decline in the rate of growth of that extended to real estate services and construction. Thus, in line with the lower buoyancy of activity in these sectors, the year-on-year growth rates fell by more than 6 pp, although they remain high, at around 35% and 18%, respectively. By contrast, credit to the rest of the sectors accelerated, somewhat more sharply in the case of funds raised by industry, which grew by almost 22% from the same period of 2006.

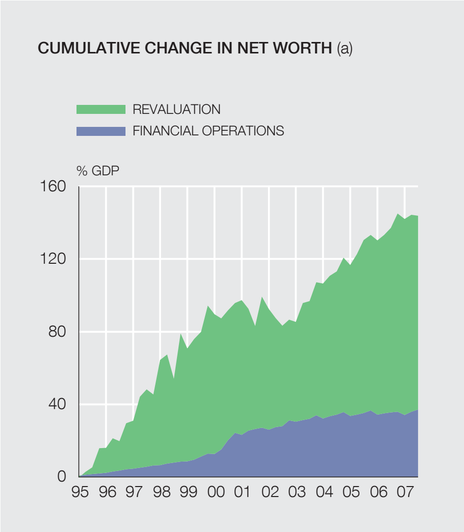
For their part, corporate asset-side transactions, in cumulative twelve-month terms, contracted to 17% of GDP in September 2007, more than 3 pp less than in Q2. This decline was seen across all instruments. Shares and other equity continued to account for the bulk of investment (see Table 6).

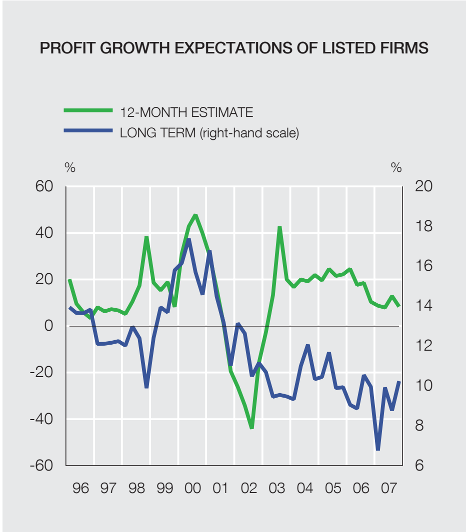
According to the Financial Accounts, the sector's net borrowing increased again, to 11.5% of GDP in September 2007, in cumulative annual terms, almost one percentage point more than in the preceding quarter (see Table 5). For its part, the financing gap, which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, also widened, albeit more moderately, reflecting the reduced buoyancy of Spanish corporate acquisitions in the rest of the world.

Despite the slowdown in corporate borrowing, it continued to grow at a high rate, so that there was a further increase in the debt-to-earnings ratio in 2007 Q3 (see Chart 26). This trend, combined with the rise in the average cost of these funds, caused interest payments to increase further relative to profits, until they reached 22% thereof. This behaviour by financial

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 27





SOURCES: I/B/E/S and Banco de España.

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

costs continued to contribute to moderating the growth in the sector's income, leading to a slight decrease in the return on capital.

The data of the sample of companies reporting to the CBQ, which is dominated by large corporations, also show a certain decline in the profitability of these firms in 2007 Q3, although it remained at comfortable levels, and an increase in the debt burden. However, the debt ratio of these companies declined slightly. As a result of these changes there was a moderate rise in the synthetic indicators of financial pressure on employment and investment.

Finally, in Q4, analysts revised downwards their expectations for listed firms' profit growth over the next 12 months, although the projected rate of growth remained high, at close to 9%. Moreover, this development was accompanied by a certain improvement in the longer-term outlook (see Chart 27).

5.4 General government

In September 2007, general government saving, in cumulative twelve-month terms, was equal to 2.6% of GDP, 0.6 pp more than in the middle of the year (see Chart 28). The distribution by instrument shows, most notably, an increase in the net balance between deposits and credit, as well as a net redemption of short-term securities and a net issuance of long-term securities. As regards interest payments, they showed no significant change relative to GDP, remaining at 1.6%, as the increase in the cost of funds was offset by the reduction in outstanding debt.

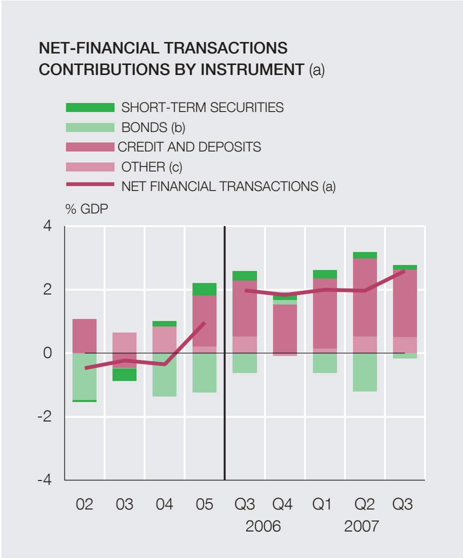
5.5 The rest of the world

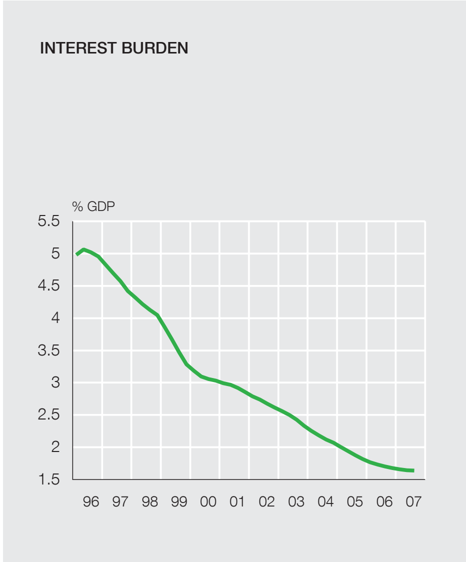
In 2007 Q3, the debit balance of the nation's financial transactions increased again to stand, in cumulative annual terms, at 8.9% of GDP, up 0.2 pp from the middle of the year. The sectoral breakdown shows that firms increased their net borrowing by almost one percentage point of GDP, households kept their net borrowing at similar levels to June and both financial institutions and, especially, general government, increased their surplus.

Private financial institutions played a less active role in the channelling of funds from the rest of the world to the Spanish economy (see Chart 29). Specifically, the total net funds raised by this sector abroad (excluding institutional investors) amounted to 12.4% of GDP, in cumulative

GENERAL GOVERNMENT
Four-quarter data

CHART 28



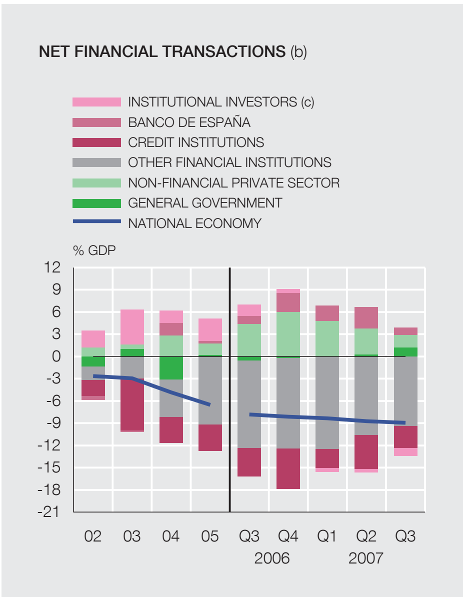


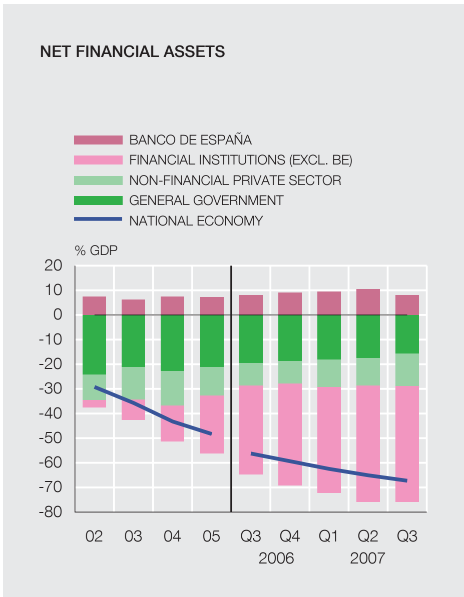
SOURCE: Banco de España.

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

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

CHART 29





SOURCE: Banco de España.

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

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2004	2005	2006	2007 Q1	2007 Q2	2007 Q3
NET FINANCIAL TRANSACTIONS	-4.8	-6.5	-8.1	-8.3	-8.7	-8.9
FINANCIAL TRANSACTIONS (ASSETS)	13.3	18.4	16.4	13.6	16.7	15.3
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.2	2.2	5.5	7.3	6.3	5.6
Of which:						
Interbank (a)	*0.7*	*3.1*	*3.4*	*6.1*	*4.7*	*5.9*
Securities other than shares	1.8	8.8	-1.2	-1.0	2.2	2.2
Of which:						
Credit institutions	*1.0*	*6.6*	*-2.0*	*-1.5*	*1.4*	*1.8*
Institutional investors (b)	*0.3*	*2.3*	*0.5*	*0.3*	*0.1*	*0.1*
Shares and other equity	6.8	5.1	9.2	5.9	7.5	6.1
Of which:						
Non-financial corporations	*3.8*	*3.9*	*6.8*	*4.2*	*5.6*	*4.4*
Institutional investors (b)	*0.8*	*0.9*	*1.2*	*0.2*	*0.5*	*-0.3*
Loans	0.8	1.1	2.1	0.9	0.3	0.9
FINANCIAL TRANSACTIONS (LIABILITIES)	18.1	24.9	24.5	22.0	25.4	24.3
Deposits	1.7	5.6	0.3	0.4	3.6	5.4
Of which:						
Interbank (a)	*5.0*	*7.2*	*0.6*	*0.4*	*4.1*	*5.3*
Securities other than shares	12.4	15.8	21.3	20.4	18.3	14.5
Of which:						
General government	*2.7*	*0.2*	*1.3*	*1.0*	*0.6*	*-0.4*
Credit institutions	*4.6*	*6.3*	*7.7*	*6.8*	*7.0*	*5.5*
Other non-monetary financial institutions	*5.1*	*9.3*	*12.3*	*12.6*	*10.6*	*9.4*
Shares and other equity	2.7	0.9	-0.7	-0.3	0.4	1.7
Of which:						
Non-financial corporations	*1.7*	*1.0*	*-1.1*	*-0.2*	*0.6*	*1.7*
Loans	1.3	2.3	3.5	1.3	3.0	2.7
Other, net (c)	-0.6	-0.9	-0.6	-0.3	-0.2	-0.6
MEMORAMDUM ITEMS						
Spanish direct investment abroad	5.8	3.7	7.3	4.8	5.8	6.1
Foreign direct investment in Spain	2.4	2.2	1.6	1.6	2.1	1.9

SOURCE: Banco de España.

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

twelve-month terms, 2.8 pp less than in the middle of the year. This decline was attributable to the reduced recourse by these intermediaries to the international financial markets, against a background in which, as a consequence of the financial turbulence, the cost of issuing long-term fixed-income securities increased. This decline in the volume of capital inflows was more than offset by a reduction in the rate of accumulation of foreign net assets by firms, households and the Banco de España.

Capital inflows moderated to represent 24.3% of GDP, in cumulative twelve-month terms, as against 25.4% in Q2 (see Table 7). Most of these funds continued to be in the form of securities other than shares, those issued by financial institutions being especially relevant, although the amount of this item declined with respect to June by 2.7 pp of GDP. By contrast, investment by non-residents in shares and other equity increased again, to 1.7% of GDP. Also, the amount of funds raised through the interbank market increased, although, in net terms, these flows continued to display a credit balance.

The acquisition of foreign assets also slowed, to account for 15.3% of GDP, in cumulative annual terms, 1.4 pp less than in June. By instrument, the most notable development was the moderation in investment in shares and other equity, whose volume represented 6.1% of GDP, as against 7.5% in Q2.

Inflows of direct investment also moderated (they accounted for 1.9%, in cumulative twelve-month terms), while, by contrast, outflows increased slightly (6.1% of GDP as against 5.8% in mid-2007).

These changes in cross-border financial flows, along with the changes in asset prices and the exchange rate, meant that in 2007 Q3 the value of net liabilities accumulated vis-à-vis the rest of the world increased further (see Chart 29). This was mainly attributable to the rise in the debit balance of non-financial corporations, although financial institutions (excluding the Banco de España) continued to be the most externally indebted sector in net terms.

However, the change described in the pattern of flows of financing in Q3 has subsequently become more marked owing to the continued impact of financial turbulence, but there is still not enough information available to outline the main developments in Q4.

25.1.2008.