

QUARTERLY REPORT ON THE SPANISH ECONOMY

## 1 Overview

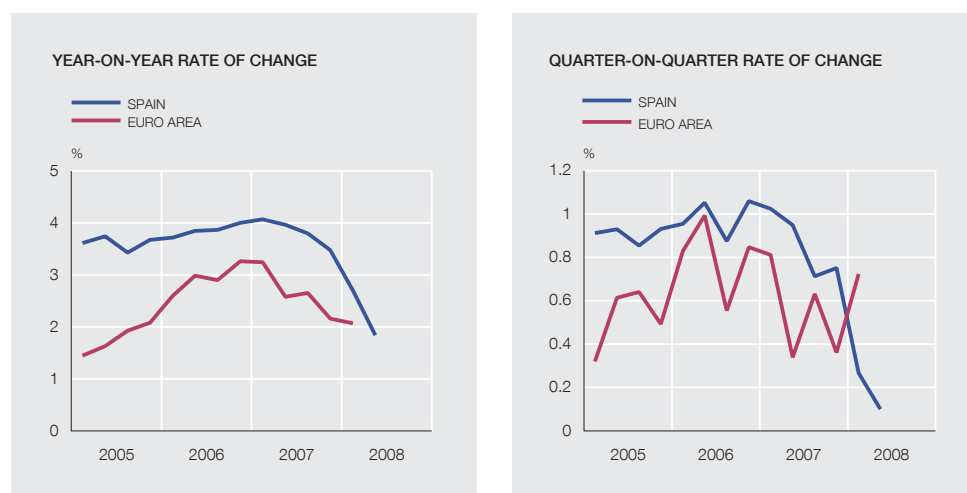
During the first half of 2008, the trajectory of adjustment on which the Spanish economy had embarked the previous year intensified. In Q1, the year-on-year growth rate of GDP declined by 0.8 pp to 2.7%, while the related quarter-on-quarter rate was 0.3%, 0.5 pp less than the previous quarter. Behind this loss of momentum was the marked weakening in national demand, which was marginally cushioned by the contribution of net external demand to output growth.

The economic indicators for 2008 Q2 point to a more pronounced adjustment, and one particularly sharp in private consumption and in employment, against a background in which the extension of the bout of financial turbulence and the climb in crude oil prices are heightening uncertainty over economic developments, with significant effects on agents' confidence. The Spanish economy's high dependence on external saving along with the importance of oil and oil derivatives in its productive structure are contributing to spreading the effect of the shocks assailing it. In this setting, the estimates made drawing on the available conjunctural information suggest that the year-on-year growth rate of GDP in Q2 was 1.8% (0.1% in terms of its quarter-on-quarter rate), as a result of a significant cut in the growth rates of the different components of national demand — which overall are expected to have increased at a rate of 1.9% (2.8% in the previous quarter) — and of a 0.2 pp improvement in the contribution of net external demand, which is estimated to stand at -0.1 pp. On the supply side, the correction in the residential sector has become more acute in recent months and is exerting a marked impact on employment, which would be acting as the main transmission channel of the real estate adjustment to the rest of the economy. The EPA data for Q2 show a strong cut in job creation, the growth rate of which was 0.3% on a yearly basis. The unemployment rate rose to 10.4%. As to prices, the deterioration in inflation continued in Q2, and the increase in oil prices was quickly reflected. As a consequence, the HICP rose in June to a year-on-year growth rate of 5.1%, which placed the differential with the euro area at 1.1 pp, the average level since the start of Monetary Union.

Turning to the international economic picture, 2008 Q2 saw the continuation of the episode of financial instability, the upward course of oil prices, the deterioration in the inflation outlook and the macroeconomic adjustment in the main developed economies, which is proving particularly pronounced in the United States. These developments have shaped a more uncertain scenario than that of recent quarters, increasing the likelihood that the down phase of the world business cycle will continue well into 2009.

There were strong rises in oil prices during the quarter, up to levels close to \$145 per barrel in mid-July (an all-time high in real terms), although this was corrected partially in the following days. The hike in oil prices is generating a progressive increase in the industrialised and emerging economies' inflation rates, raising the perception of inflationary risks globally. Accordingly, during the quarter there was a change in the outlook for the monetary policy stance in the second half of the year, which was reflected in a relatively widespread upward revision in expectations about official interest rates.

After the somewhat more stable behaviour of the financial markets in April and May, there were fresh outbreaks of financial strains in June and July, which took the form of a further increase in credit risk premiums, a more negative tone on stock markets — which posted significant losses — and increases in long-term bond yields, although the latter underwent a slight down-



SOURCES: ECB, INE and Banco de España.

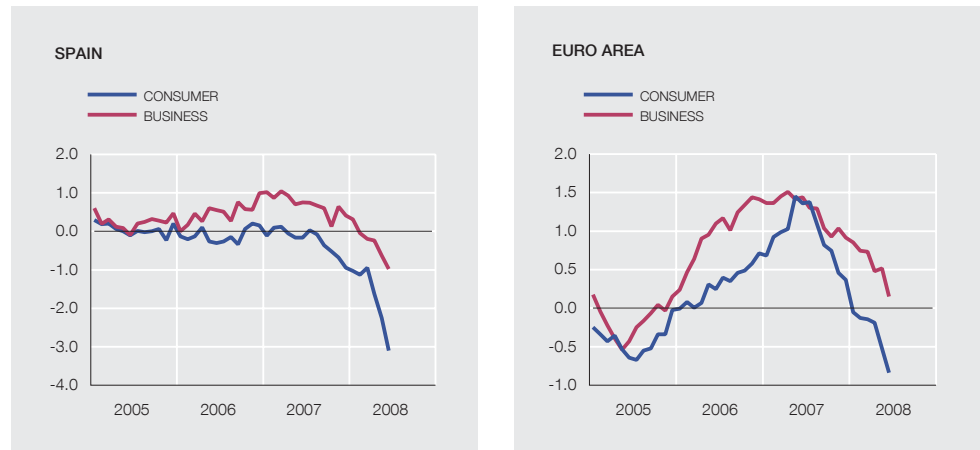
a. Seasonally adjusted series.

ward correction in July. Contributing to these strains, along with the aforementioned perception of inflationary risks, was the downgrading of some of the main monoline bond insurers, the disclosure of further losses by some US investment banks and, into July, the financial difficulties of two major mortgage institutions, which led the US government to announce a contingency plan to support them. In these circumstances, the main central banks continued to perform sizable liquidity assistance operations (raising, in some cases, the ceiling on specific liquidity injection mechanisms) and the Federal Reserve made a one-off cut during the quarter, specifically in April, to its federal funds target rate, taking it to 2%. The dollar depreciated slightly against the euro in a setting of high volatility.

Activity in the world economy remained highly influenced by the adjustment of the US economy, despite the fact that US GDP in Q1 was somewhat higher than initially estimated. The latest indicators show further weakening owing to the deepening of the adjustment in the real estate sector and the decline in employment, despite some improvement in the consumption indicators due to the effect of the tax aid. The economic outlook has worsened in Japan and, above all, in the United Kingdom, given the rapid deterioration in the residential sector. In the emerging economies, activity generally remained more dynamic, although some signs of easing were observed and inflation continued rising across the board, which prompted the tightening of the monetary policy stance in a good number of these countries.

As regards economic developments in the euro area, the latest data suggest a notable reduction in the pace of GDP in 2008 Q2. The slowdown in activity reflected in part the correction of certain factors that had exceptionally boosted growth in Q1 but, more fundamentally, it highlighted the effect of a weaker external setting and of financial conditions that have become more restrictive as a result of the extension of the period of financial instability, the rise in oil and food commodity prices, and the appreciation of the euro.

Inflation in the euro area also moved on a rising trend in recent months, essentially as a result of the energy component, while the contribution of the food component remained high. Nonetheless, the price aggregate that excludes energy and unprocessed food prices underwent a small cut during the quarter to 2.5% in June. In a setting in which the labour market remains relatively tight, the upside risks to inflation in the area are high, due both to possible further



SOURCE: European Commission.

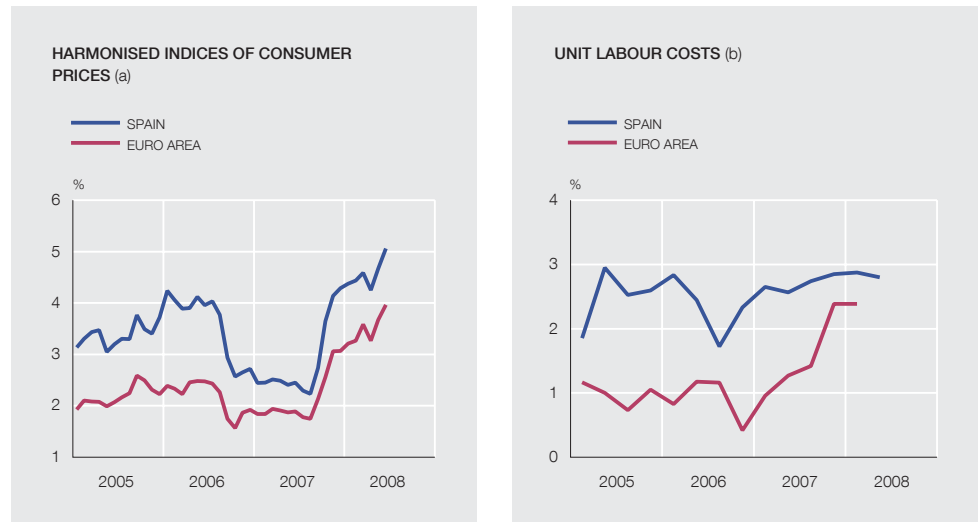
a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

rises in oil prices and because price and wage-setting mechanisms may give rise to the spread of second-round effects if inflation expectations deteriorate further.

Against this backdrop, the ECB governing Council decided at its meeting in early July to raise the interest rate on its main refinancing operations by 25 bp to 4.25%, in order to pre-empt the emergence of such effects and to counter the growing upside risks to price stability in the medium term.

All these factors meant that the external environment of the Spanish economy continued to weaken during the quarter. At the same time, household and corporate financing conditions tightened further, as manifest in the additional increases in the cost of funds obtained — in line with the rises in interest rates on the benchmark markets — and in the application of stricter lending standards by banks, against a background of global risk re-pricing. As earlier mentioned, volatility on stock markets remained high and the main stock exchange indices resumed a declining trajectory as from the second half of May which accelerated during July, checking the revaluation of financial wealth. Lastly, in the real estate market, house prices showed very modest average increases in year-on-year terms (2%) in Q2, entailing a quarter-on-quarter decline of 0.3%. As a result, the revaluation of real estate wealth is expected to have continued slowing.

In the setting described, household spending is following a fairly marked pattern of adjustment. The sharp slowdown in household consumption seen in Q1 continued during Q2, for which a year-on-year growth rate of close to 1% is estimated. Underlying the rapid response of consumption are, as in previous quarters, the low increases in disposable income and the slacker rises in wealth, in both its financial component and that linked to real estate value. But a further element in recent months must be added, namely the persistence of a highly uncertain economic environment in which the deterioration of consumer confidence is adversely affecting spending decisions. In the case of disposable income, mention should be made of the contractionary effect that the reduction in the pace of job creation is exerting and the increase in the inflation rate, further to the hike in energy prices. Their impact on income has exceeded the impulse stemming from the rise in wages and from the expansionary conduct of the public sector in the opening months of the year, although when estimating the latter, the tax rebate that came into force in late June has not been taken into account, since its effects



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

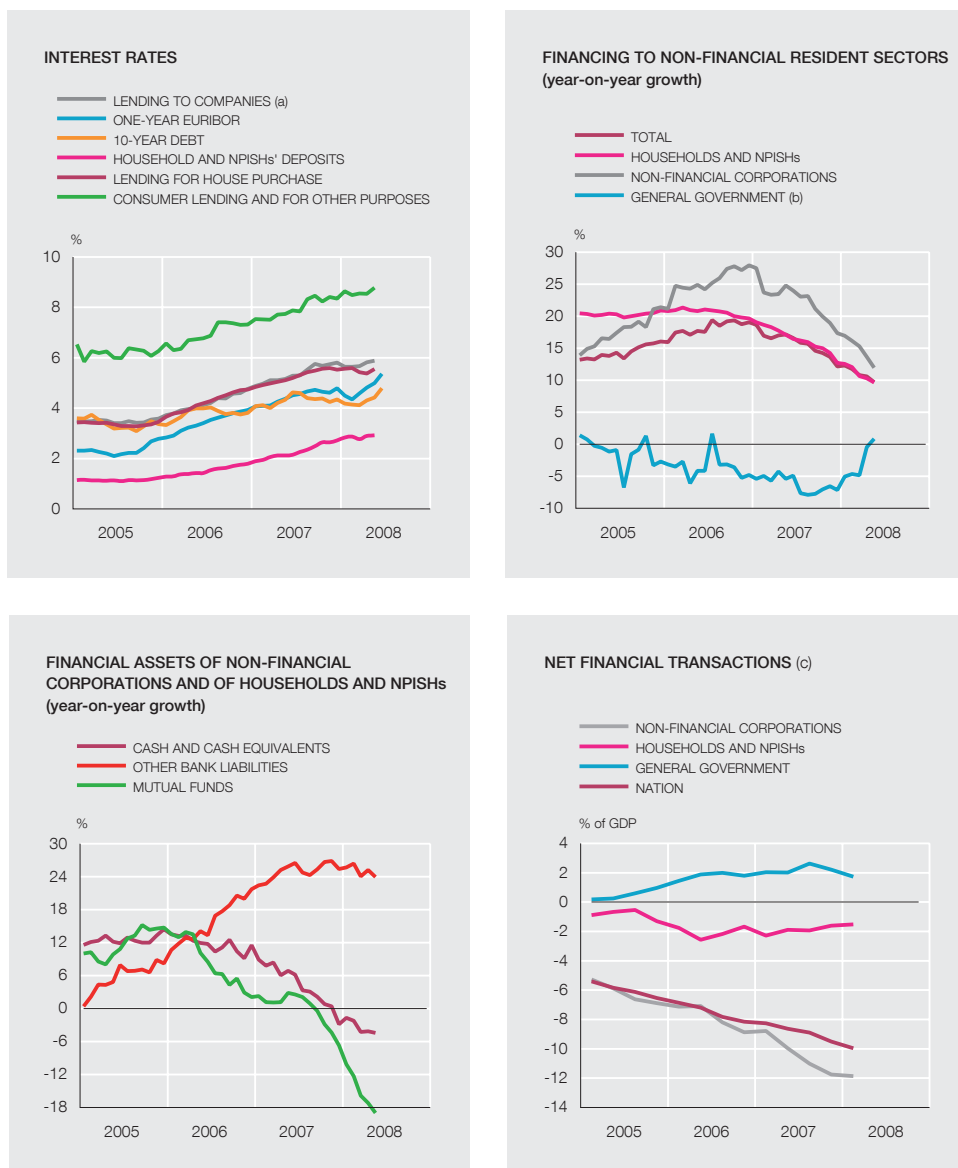
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

will, irrespective of the magnitude they acquire, foreseeably arise fundamentally in the second half of the year. That said, it is highly likely that the reduction in the growth rate of consumption is beginning to be more marked than that of its determinants, whereby the saving ratio might have begun to rise already in Q2, in line with the scenario of greater uncertainty portrayed in the foregoing paragraphs. The rise in interest rates would have acted along these same lines, encouraging the substitution of future consumption for present consumption and raising the saving ratio. In these circumstances, the course of recovery of household saving is expected to continue during the rest of the year.

Turning to residential investment, the intensity of the adjustment in Q2 was greater than that observed in the opening months of the year, with estimated declines of around 3%. As in the case of consumption, the climate of uncertainty and the fall in confidence have made the correction of the sector under way since the second half of 2006 more acute, in step with the progressive transmission towards residential investment of the change in expectations about real estate prices and the tightening of the cost of financing. Furthermore, the correction is taking place in a phase in which there is a high volume of house completions, which is contributing to increasing the stock of unsold properties.

Throughout the household spending adjustment phase, there has been a containment of the pace of household debt. This trajectory has continued in the year to date, in a more sluggish macroeconomic setting and one marked by an increase in the cost of funds. As a result, the growth rate of credit has drawn closer to that of income in the sector, which has allowed the household debt ratio to stabilise, this having stood in Q1 at somewhat over 130% of GDI. The year-on-year growth of the financing of the household sector stood in May at slightly below 10%, almost 1 pp down on the previous quarter, with declines both in credit for house purchases, the year-on-year growth rate of which stood at 10%, and in funds earmarked for consumption and other purposes, which increased by 8% over the last 12 months.

Business investment also shows signs, albeit somewhat milder ones, of weakening, prolonging the slowing profile observed since the second half of 2007. The loss of momentum of in-



SOURCE: Banco de España.

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

vestment in capital goods, which is estimated to have reached a year-on-year rate of somewhat below 3% in Q2, is in line with the profile of economic activity and with the strong deterioration in business confidence. As to financial developments at companies, there was a fresh tightening of lending standards during the quarter and some turnaround in companies' profit ratios, chiefly as a consequence of the increase in the interest burden. That said, these ratios remain at levels which, in the absence of the climate of deterioration in economic prospects, would enable the development of new spending plans.

The progressive tightening of financing conditions for companies and the loss of steam in business activity continued contributing to the slowdown in the rate of increase of corporate debt, which grew at a rate of close to 12% in May, more than 3 pp below the March figure. By pro-

ductive activity, the latest information, for 2008 Q1, shows that the reduction in the rate of increase of credit is proving very sharp in that intended to finance real estate activities and more moderate in construction, while funds earmarked for the industrial sector and other services retain their dynamism, despite the sluggishness of activity, with year-on-year growth rates of 19% and 22%, respectively. In line with the progressive deceleration in debt, the level of corporate indebtedness has tended to stabilise in recent quarters, although the interest burden has continued to increase.

In Q2, the contribution of net external demand to GDP growth is estimated to have improved by 0.2 pp to -0.1 pp, as a result of the relatively dynamic behaviour of exports, which posted similar increases to those of the previous quarter (around 5%), and of a reduction in the pace of imports which, as in similar cyclical phases, swiftly feel the impact of the loss of vigour of final demand. All these developments were against an external background in which the slowdown in global trade flows continued and in which the price-competitiveness indicators deteriorated somewhat, chiefly as a consequence of the appreciation of the euro over the last few months. In this respect, the maintenance of Spanish exports should be related to some extent to the buoyant imports of the oil-producing countries, as a result of the extraordinary revenue they are receiving. Regarding tourist services, the indicators available denote some recovery in exports of this type of activity, albeit on a moderating trajectory, and a slowdown in imports. The pace of foreign trade in non-tourist services has diminished in the opening months of the year.

It should be stated, however, that the gradually improving trajectory of the contribution of net external demand to GDP growth which began approximately two years ago has not prevented the nation's net borrowing from increasing. In Q1, and in cumulative 12-month terms, this variable rose to 10.0% of GDP. In this respect, the rise in oil prices poses further difficulty to the correction of the trade deficit and, therefore, of the external deficit.

On the supply side, the reduction in spending was rapidly reflected in activity and employment, where all sectors performed more weakly than in the previous quarter, with cuts in value added and in employment in the construction and manufacturing sectors (which were greatly affected by the sluggishness of consumption and by the decline in inputs attributable to construction-related activities). Countering this, services activities were more dynamic, albeit on a slowing trajectory which progressively became more marked, in the market services component, as the quarter unfolded. Of note was the rapid response of employment to the cyclical change, a pattern which was already observable in the opening months of the year but which has stepped up to a level of great intensity in the most recent period. From increasing at a rate close to 3% in the second half of 2007, employment has posted increases of virtually zero in Q2 this year. Furthermore, as in previous contractionary phases, temporary employment is bearing the brunt of the adjustment, as evidenced by the rapid downward correction in the ratio of temporary to total employees in recent quarters. In addition, the vigour of the labour force means that the increase in joblessness is being accompanied by rapid increases in the unemployment rate, which rose to 10.4% in 2008 Q2. Overall, the reduction in the pace of job creation in market branches was greater than that in activity, whereby apparent productivity rose slightly to around 1.5%.

Despite the notable loss of dynamism in the labour market, wages continued to increase. That reflected the rise in average wage settlements under collective bargaining agreements (which stood at 3.5% in June, 0.4 pp up on the previous year) and the impact of the activation of indexation clauses owing to the deviation by inflation from the official target in 2007 (this meant a further 1.1 pp increase). Accordingly, compensation per employee in the market economy is

expected to stand at a rate somewhat higher than 4% in Q2. In terms of unit labour costs, the increase would be somewhat lower owing to the offsetting effect exerted by the productivity gains observed.

The rise in labour costs and the strong increase in energy and, to a lesser extent, food commodity costs, in a setting in which margins are not sufficiently flexible in certain activities, shape a scenario of price pressures, despite the weakening in activity, and of a worsening inflation outlook for the rest of the year. Although the increase in the inflation rate in the most recent period (to a year-on-year rate of 5% in June in terms of the CPI) has been essentially due to the direct impact of the hike in energy prices, the rise in the services component in the last month suggests that indirect effects might be starting to emerge. In any event, the risk of energy price increases being incorporated into cost and price-formation processes and generating second-round effects has increased notably in recent months. Specifically, the existence of indexation clauses in collective bargaining — a feature virtually absent in other euro area countries — raises the likelihood of such increases (whether they are permanent or not) feeding through to wages next year, hampering the adjustment of the economy in the face of these shocks.

In the year to date, the Spanish economy has moved onto a more intense and rapid path of adjustment than had been expected some time back. In an external environment which will continue to weaken, the outlook is for a continuation of this process, depending on the scope of the adjustment in employment. From the financial standpoint, the slowdown in financing to households and firms tends to channel the dynamic of private-sector indebtedness towards a more sustainable pattern. However, the level of debt in some household and corporate segments, along with the increase in the cost of borrowing and the weakening in activity, is likely to be increasing the proportion of segments under greater financial pressure, as reflected in the rise in default ratios in recent months. Further, in a setting in which the Spanish economy continues to depend greatly on external saving, the extension of the episode of financial instability poses an additional factor of risk.

In these circumstances, economic policy should be geared to smoothing the adjustment and to raising the economy's growth potential. It will be of paramount importance here to contain inflationary pressures, promoting the necessary adaptation of all agents to the inevitable effects of dearer oil. It is also necessary to heighten efforts to maintain budgetary stability, in line with the requirements assumed, in a setting in which the rapid deterioration of the budget balance brought about by weakening revenue demands greater austerity in fiscal policy management. Lastly, the economy's flexibility will prove vital when it comes to regulating the scale and depth of the adjustment process, meaning that structural measures, particularly those relating to the labour market that may help limit job losses, will be of great importance.



## 2 The external environment of the Spanish economy

In the past quarter, developments in the external environment of the euro area were characterised by the transition from a situation of relative calm – following the US authorities' measures in support of the financial system in mid-March – to a scenario in which inflation concerns emerged forcefully further to the hike in commodity prices, with doubts resurfacing subsequently over the financial situation and activity.

Following some improvement in May on the credit and stock markets, June saw a qualitative change on international financial markets as the instability that had marked the first quarter re-emerged. This fresh step-up in turmoil came about against a background of heightening concern over global inflationary risks and the reappearance of problems at certain financial institutions (the downgrading of some of the main bond insurers and the disclosure of further losses by certain US investment banks). The latest manifestation of these renewed problems in the US financial sector was the financial support, in mid-July, by the US authorities to Fanny Mae and Freddie Mac, the government-sponsored mortgage securitisation agencies currently assailed by major financial difficulties. Further to these developments, during the quarter the monetary authorities toughened their line, 10-year interest rates increased by approximately half a point to mid-June in the main economies (which was subsequently reversed in part) and there was a significant correction on stock markets.

The emerging economies experienced a sharper deterioration in market sentiment than in previous episodes. Among other reasons, this was because inflationary risks are perceived to be greater in this group of countries. As a result, the emerging markets behaved this time in a similar way to other developed international markets: stock markets posted losses (exceeding those in the developed economies in some countries) and sovereign spreads in all regions widened. Oil prices continued on a rising trend in a setting of high volatility, standing at around \$145 per barrel in the opening weeks of July, although in recent weeks there has been a notable correction. The dollar depreciated against the euro from early May to mid-July, and the all-time high of \$1.6 per euro attained in late April was almost restored. However, it is not clear that there is causality between the developments in the dollar and oil prices (see Box 1). As regards other commodities, food prices continued to rise at a similar rate to that in Q1, while that of industrial metals dipped owing to the increase in stocks of certain minerals.

In the United States, the final GDP estimate for 2008 Q1 confirmed an annualised quarterly growth rate of 1%. Although the impact of the fiscal impulse meant that consumption improved somewhat towards the end of the quarter, pointing to a rise in growth in Q2, the remaining indicators for this period suggest an underlying weakening in activity. The consumer confidence indices fell sharply, the housing market indicators continued to evidence a deep adjustment in the residential sector (housing starts, construction permits and house sales all fell year-on-year in Q2) and confidence in the construction industry in July fell to a new low. While the manufacturing ISM index rose above the expansion threshold during Q2, industrial production fell and the non-manufacturing ISM index stood at levels associated with a contraction in activity. The labour market weakened further with a rise in the unemployment rate to 5.3% and net destruction of 191,000 jobs during the quarter. CPI inflation increased once again in Q2 to 5% year-on-year in June – 1 pp up on March – as a result of the rise in energy and food prices, while core inflation posted a year-on-year rate of 2.4% in June, unchanged on March. Against this backdrop, the Federal Reserve has held its official interest rate stable at 2% since May.

The doubling of oil prices since the start of the financial turmoil (July 2007) has placed this commodity at its all-time high in nominal and real terms, far exceeding the levels reached in the early 80s. This sustained increase in oil prices, which marks a step-up in the upward trend seen since 2003, happens to have come about at a time when the world economy – especially the industrialised economies – is undergoing a phase of strong deceleration, brought on precisely by the financial turmoil. This apparent dislocation between the course of the world economy and oil prices has prompted the search for possible factors other than supply and demand fundamentals so as to explain oil price developments.

One of the hypotheses put forward is that the weakness of the dollar might explain, at least in the main, the recent increase in the price of oil, which is quoted in this currency on international markets. Indeed, since 2002 and, in particular, early 2007, there has been a sustained depreciation of the dollar, coinciding with the increase in oil prices (see panel 1). The correlation between the increases in both variables is at a peak for the last 10 years (see panel 2), although it is not too different from that observed the previous year at the start of the turmoil on financial markets.

The first channel through which the weakness of the dollar might be reflected in an increase in oil prices is the so-called “numeraire effect”: if the actual price of oil is determined in equilibrium by fundamentals and there is a reduction in the value of the US currency, then the oil price in dollars should increase by the same proportion as that by which the dollar depreciates. However, the numeraire effect would only explain part of the increase in the oil price, since this is not consistent with the fact that the price has also increased in other currencies, such as in euro, for example (see panel 1).

To justify the price increases in other currencies, two alternative hypotheses point to effects other than that of the numeraire. Firstly, a depreciation of the dollar might detract from the attractiveness of financial assets denominated in this currency and channel financial investment flows towards the oil market, which would raise its price. Yet the role of financial flows in the recent increase in oil prices is

debatable, given the lack of evidence of an increase in crude oil stocks.

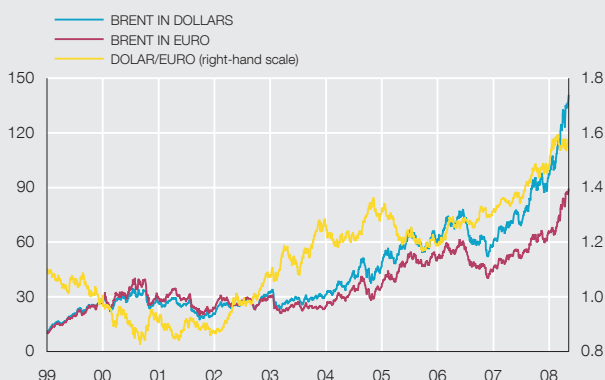
The second hypothesis complementing the numeraire effect argues that the depreciation of the dollar might lead to a relaxation of the monetary policies of countries with fixed exchange rates against the dollar, which would stimulate aggregate demand and, in turn, the global demand for oil. Thus considered, this hypothesis would not indicate causality between the exchange rate of the dollar and the oil price, but between exchange-rate regimes pegged to the dollar and the oil price, since what would lead to the expansion of aggregate demand (and oil demand) in these countries is the monetary impulse in the United States.

In this respect, it seems more likely that the recent increase in the correlation between the depreciation of the dollar and the rise in oil prices is determined by a common factor: monetary policy developments in the United States. Concerning the dollar, a lax monetary policy in the United States tends to depreciate the exchange rate of the dollar against other currencies. Further, as previously indicated, a lax monetary policy in the United States will be reflected in an aggregate demand (and oil demand) impulse in those economies whose exchange rate against the dollar is characterised by scant flexibility.<sup>1</sup> It is worth noting that it is precisely the regions with a greater proportion of countries with stable exchange rates against the dollar (emerging Asia and the Middle East) that have most driven the increase in the world demand for oil in recent years.

Accordingly, the correlation between the exchange rate of the dollar and oil prices should not be understood as a causality relationship but, rather, as the reflection of changes in a third variable – the relaxing of monetary policy in the United States – that exerts some influence on developments in the first two variables.

1. See also Jeffrey Frankel, *The Effect of Monetary Policy on Real Commodity Prices*, NEBR Working Paper 12713, 2006. This paper suggests alternative reasons for why a reduction in interest rates may boost commodity prices. The empirical analysis reveals a negative and significant relationship between real commodity prices and real interest rates for the period from 1950 to 2005.

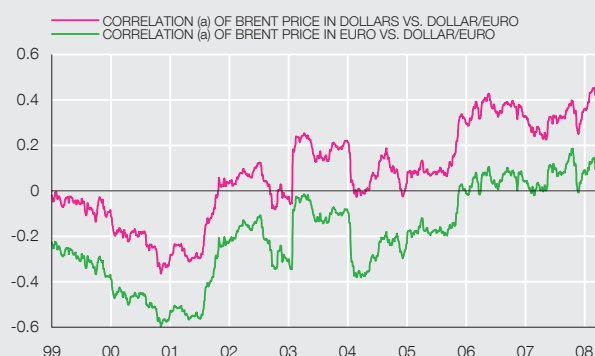
1 OIL PRICE AND DOLLAR/EURO EXCHANGE RATE

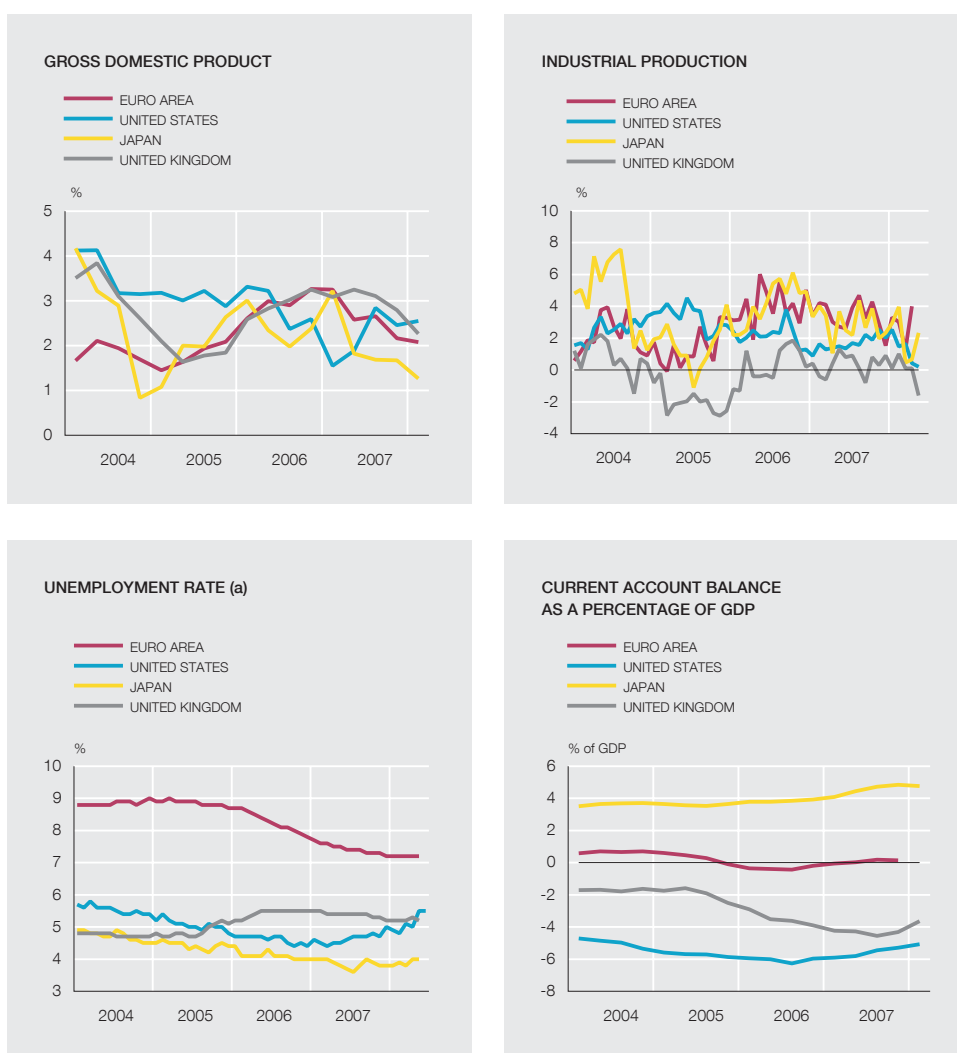


SOURCE: Datastream.

a. Annual correlations of weekly growth rates. One-year moving window.

2 CORRELATION OF OIL PRICE TO DOLLAR/EURO EXCHANGE RATE

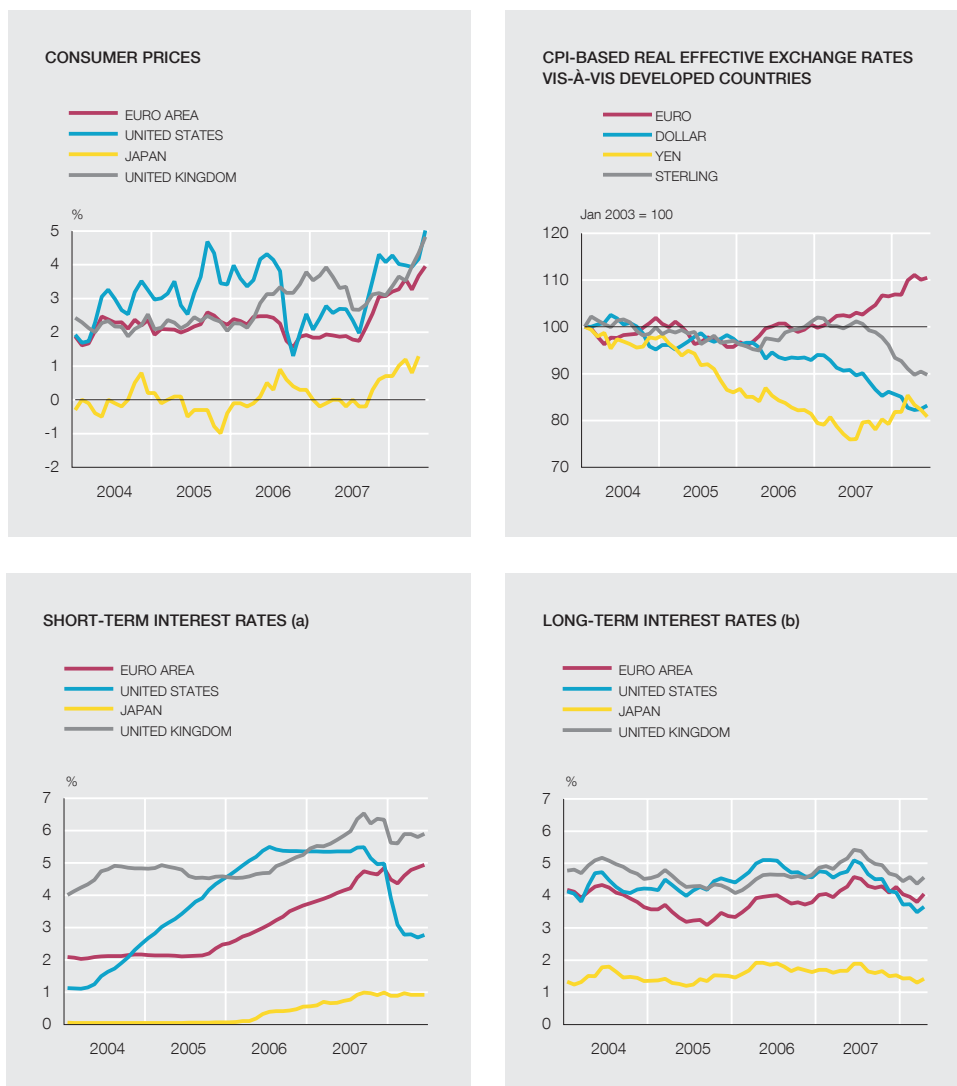




SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

In Japan, GDP in 2008 Q1 grew by 4% in annualised quarterly terms, up on the figure of 2.9% for the preceding quarter. However, the latest indicators point to a notable slowdown in activity in the short run. The growth rate of industrial production dipped in April and May compared with the same two-month period a year earlier, and the Tankan business confidence survey showed a negative trend, the result of the deterioration in the terms of trade. The construction sector offered mixed signals, and the current slackness of demand appears to be holding back its recovery. The private consumption indicators available for Q2 trended unfavourably, with household spending and consumer confidence both declining further to the loss of purchasing power and the weakness of the labour market. The unemployment rate edged up in April, and held in May at 4%, while the slowdown in nominal wages continued. On the external front, the trade balance figures for Q2 evidenced a strong cut in the surplus compared with a year earlier. Inflation continued to rise, posting a year-on-year rate of 2% in June as a result of the rise in energy and fresh food prices. Stripping out these two components, the price index grew at a year-on-year rate of 0.1%. Over the course of the quarter the Bank of Japan held its official interest rate at 0.5%.



SOURCE: Banco de España.

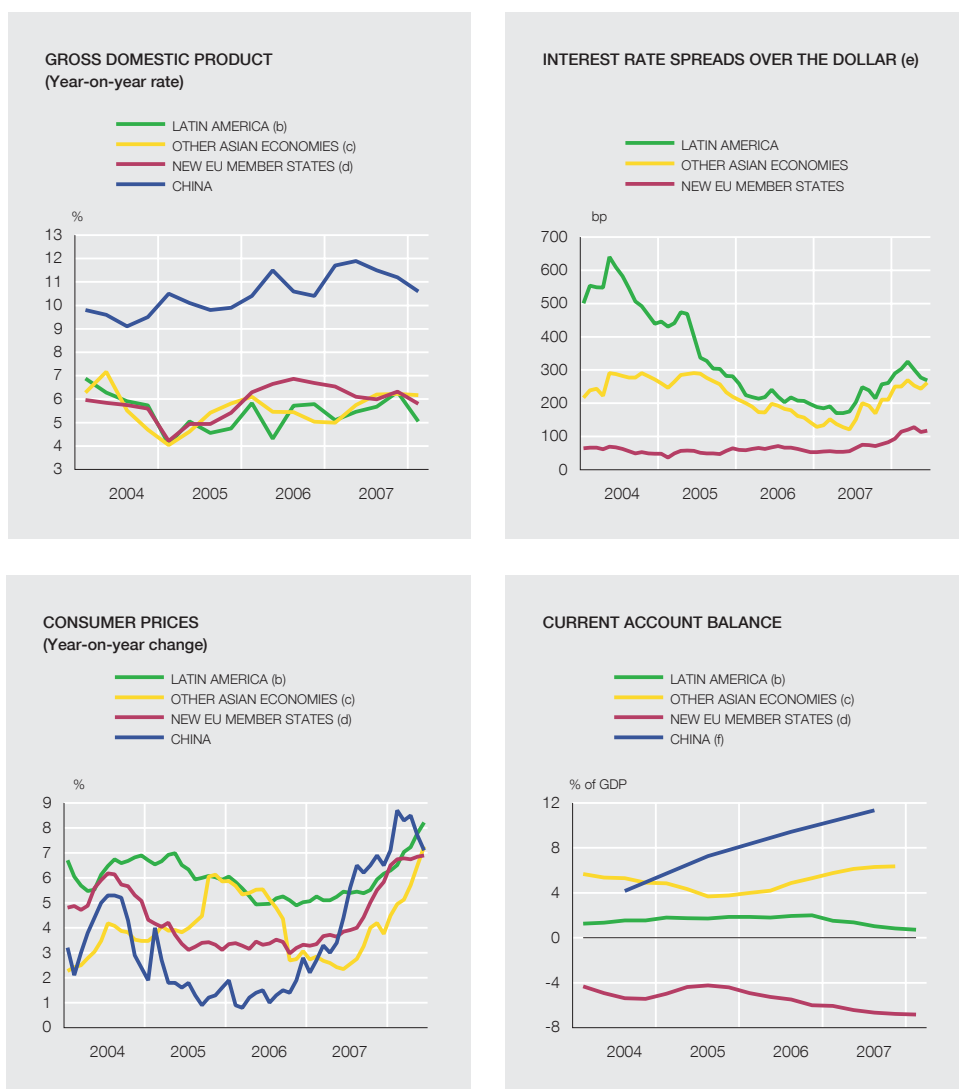
- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

In the United Kingdom, GDP grew at an annualised quarterly rate of 1.1% in Q1 (2.3% year-on-year), 1.1 pp down on the previous quarter. Nonetheless, the indicators for Q2 denote a deterioration in activity – as reflected in an initial GDP growth estimate for Q2 that is 0.3 pp below (annualised quarterly) growth in Q1 – against a background of worsening inflation. On the supply side, the PMI indices for the manufacturing and services sectors fell to levels associated with a contraction in activity, while the tightening of credit conditions for households and firms continued. House prices posted a year-on-year decline for the first time since 1996 (3.9% in Q2), while the 12-month inflation rate stood at 3.8% in June, 1.3 pp more than in March. Although the Bank of England forecasts that inflation will be around 4% at the end of the year (2 pp above target), it decided to hold its official interest rate at 5% throughout the quarter. As regards financial measures, in late April the Bank of England instituted its Special Liquidity Scheme, an arrangement under which banks can swap assets for government bonds in order to alleviate liquidity problems on the financial markets.

GDP in the new EU Member States not belonging to the euro area slowed by 0.6 pp in Q1 to a year-on-year rate of 5.8%. There was a greater-than-expected expansion in Bulgaria

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

and Romania, while economic activity underwent a strong adjustment in the Baltic states owing to the deceleration in domestic demand against a background of slowing credit. The indicators of industrial production and retail sales for Q2 offered signs of sluggishness in consumer demand and of diminished dynamism in activity. Inflation rose during the quarter and posted a rate of 6.9% for the region as a whole in June, standing at over 11% in the Baltic states and in Bulgaria. Greater inflationary pressures drove the tightening of the monetary policy stance in Poland, Hungary and Romania. In the institutional sphere, the ECOFIN formally approved on 8 July the adoption of the euro by Slovakia, scheduled for 1 January 2009, with a conversion rate equal to its current central parity against the euro.

In China, GDP grew by 10.1% in 2008 Q2, down from 10.6% in Q1. The monthly indicators continued to show signs of holding up, especially as regards retail sales, although industrial production remained somewhat tempered in relation to its trend in 2007. On the external front, the trade surplus in Q2 was 11.8% down in relation to the previous year, despite which international reserves continued to grow strongly, by \$127 billion in Q2 to \$1.81 trillion in June. Inflation eased during the quarter (though remaining at high levels in relation to 2007), standing at a year-on-year rate of 7.1% in June, 1.2 pp less than in March. Against this background, the authorities raised the bank reserve requirement on two occasions during the quarter, from 16% to 17.5%. In the rest of Asia, growth in most economies was similar or higher than that of the previous quarter, although the figures available point to a year-on-year reduction in that of industrial production in Q2. Inflation rose in all countries in the region; in some, such as India and Malaysia, it did so notably, against a backdrop of upward readjustments to energy prices. In this setting, several countries raised their official interest rates during the quarter, in particular India and Indonesia (each by a total of 75 bp).

In 2008 Q1, GDP growth in Latin America slowed to a year-on-year rate of 5%, down from 6.3% the previous quarter, as a result of domestic demand developments. The slowdown was particularly marked in Mexico, Chile, Venezuela and Colombia, while growth remained relatively robust in Argentina, Brazil and Peru. Some of the slowdown may be attributed to seasonal effects, although the indicators of economic activity suggest an ongoing easing in growth in Q2. The increase in food prices and domestic demand pressures drove inflation across the board during the quarter, taking it to 8.2% in June. As a result, and with the sole exception of Brazil, inflation stands above its explicit targets in those countries where central banks have implemented this type of monetary regime. Given this situation, all the central banks continued to tighten their monetary policies. During the quarter Chile, Peru and Colombia registered downward exchange rate movements, in notable contrast to the appreciating trend their currencies had previously shown. Lastly, several rating agencies upgraded sovereign debt in Uruguay, Colombia, Brazil and Peru (to investment grade in the latter two countries).

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

The latest data on developments in the euro area economy suggest a notable reduction in GDP growth in 2008 Q2. The slowdown in activity will, in part, likely offset a number of factors that unusually drove growth in Q1, but beyond the volatility in the quarterly figures, it reflects the combined action of the unfavourable elements that have been building up over the past year. These include most notably the rise in oil and food prices, the progressive loss of momentum of world growth, the appreciation of the euro, the deterioration in consumer and business confidence, and more restrictive financing conditions due to the prolonged period of financial instability dating back to August last year, which has shrouded the global economic outlook in considerable uncertainty. Medium-term forecasts point to the continued slowing of GDP growth in the euro area and place it at year-end levels clearly below potential, with the consequent negative impact on growth in 2009. Most recent forecasts also invoke this central scenario.

Euro area inflation has continued on the rising trend that started in autumn 2007 as a result of the growing contribution of the energy component, stemming from the surge in oil prices, while the contribution of the food component remains significant. The price aggregate excluding both these groups of goods is fairly stable on account of the opposing forces exerted, on one hand, by the indirect effects of the oil price rise on other items – mainly certain services – and, on the other, by worsening growth prospects. Labour costs quickened in 2008 Q1, although their impact on price formation in the economy is being partly countered by stable profit margins. Against this background, the rate of inflation will foreseeably ease as the growth rate of oil prices moderates, as anticipated by the futures markets, although it will remain above 2% for many months to come. The risks to this scenario are on the upside, however, owing to the possibility that an oil price rise may exceed – once again – current forecasts and that price and wage-setting mechanisms may lead to widespread second-round effects if inflation expectations were to deteriorate further.

Against this backdrop, the Governing Council of the ECB decided at its meeting at the beginning of July to raise its intervention rate by 25 bp in order to pre-empt widespread second-round effects and to counter the increasing upside risks to medium-term price stability. With regard to fiscal policy, and in line with the European Commission's spring forecasts, the continued improvement in public finances observed over the past four years in the euro area will be interrupted, since the economic slowdown and the implementation of a number of discretionary measures (which will lead to a fall in revenues) will increase the euro area fiscal deficit by an estimated 0.4 pp to 1%. Further, the high degree of uncertainty surrounding the economic outlook may entail difficulties for those countries that have little room for manoeuvre to keep their budget deficits below the ceiling of 3% of GDP.

#### **3.1 Economic developments**

On the second National Accounts estimate, euro area GDP in 2008 Q1 was more dynamic than expected and grew by 0.7%, 0.3 pp more than in the preceding quarter (see Chart 8). This acceleration was in response, first, to favourable developments in domestic demand (excluding inventories), whose contribution to output growth rose by 0.3 pp to 0.5 pp; and further, to stockbuilding, which contributed 0.2 pp to GDP growth (having subtracted 0.1 pp in the previous quarter). Nevertheless, the quickening in domestic demand was largely determined by the influence of exceptional factors, namely the good weather, which boosted construction investment, and some fiscal measures, which helped investment in equipment to maintain a robust rate of growth (particularly in Germany). However, private consumption re-

	2006		2007			2008		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
<b>GDP</b>								
Year-on-year growth	3.3	3.2	2.6	2.7	2.2	2.1		
Quarter-on-quarter growth	0.8	0.8	0.3	0.6	0.4	0.7		
<b>IPI (c)</b>								
Economic sentiment	109.3	109.4	111.0	108.7	104.3	100.5	96.5	
Industrial confidence	5.7	5.3	6.3	4.3	2.3	0.3	-3.0	
Manufacturing PMI	56.7	55.5	55.3	54.2	52.3	52.4	50.2	
Services confidence	19.7	20.7	22.0	20.0	15.0	10.7	8.0	
Services PMI	57.1	57.6	57.5	56.9	54.4	51.5	50.6	
Unemployment rate	7.9	7.6	7.5	7.4	7.3	7.2	7.2	
Consumer confidence	-7.0	-5.7	-2.7	-4.0	-7.7	-12.0	-14.7	
HICP (annual growth) (d)	1.9	1.9	1.9	2.1	3.1	3.6	4.0	
PPI (annual growth) (d)	4.1	2.8	2.3	2.7	4.4	5.8	7.1	
Oil price in USD (d)	62.8	62.3	71.8	78.2	91.2	104.3	132.0	137.1
Loans to the private sector (annual growth) (d)	10.8	10.5	10.8	11.0	11.2	10.8	10.4	
Euro area ten-year bond yield	3.9	4.1	4.4	4.5	4.3	4.1	4.5	4.7
US-euro area ten-year bond spread	0.82	0.67	0.47	0.32	-0.03	-0.46	-0.60	-0.79
Dollar/euro exchange rate (d)	1.317	1.332	1.351	1.418	1.472	1.581	1.576	1.586
Appreciation/ depreciation of the EER-22 (d)	4.5	0.9	1.5	3.7	6.3	3.6	3.4	3.4
Dow Jones EURO STOXX 50index (d)	15.1	1.5	9.0	6.4	6.8	-17.5	-23.8	-24.2

SOURCES: Eurostat, ECB and Banco de España.

a. Quarterly average. The information in italics does not cover a full quarter.

b. Information available to 21 July 2008.

c. Year-on-year growth rates of working days-adjusted data.

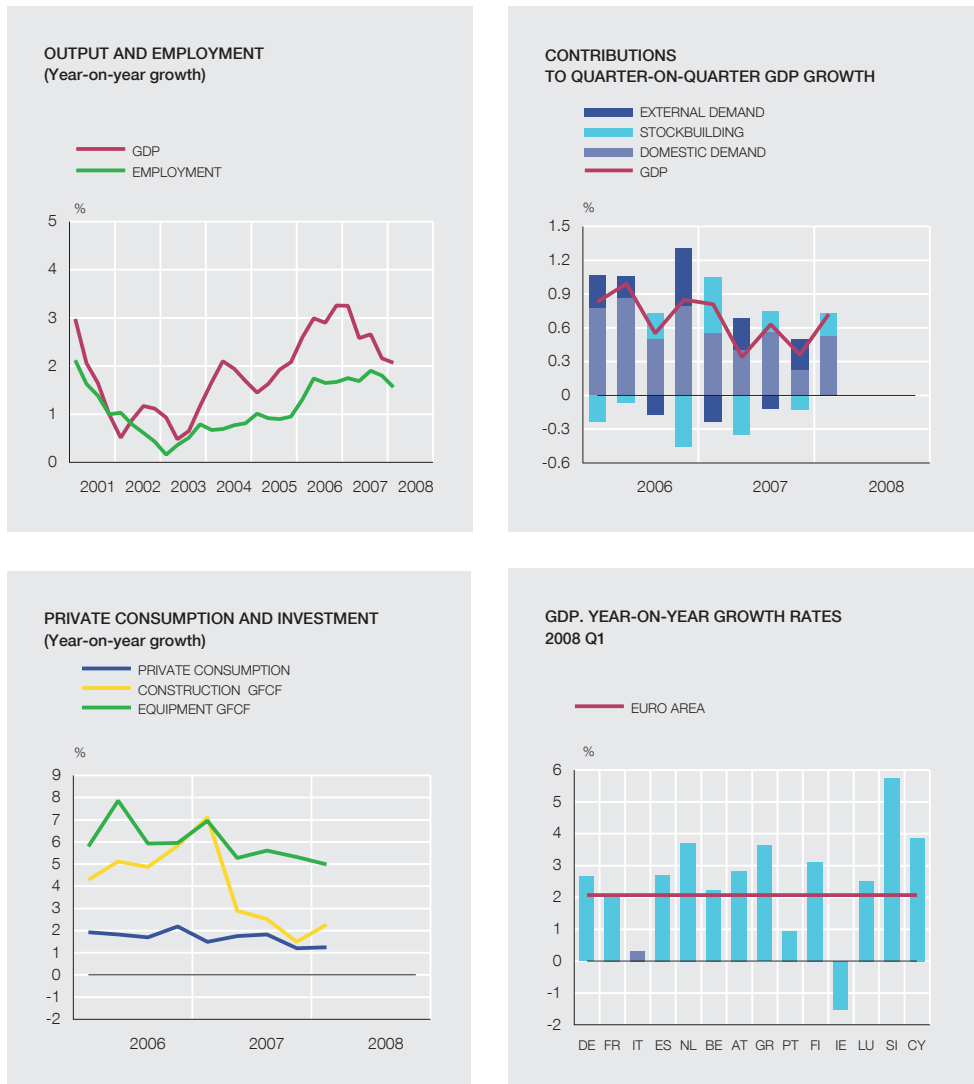
d. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

mained sluggish, although it did accelerate. The contribution of the external sector to growth declined by 0.3 pp on account of a stronger rebound in imports than in exports. On an annual basis, euro area GDP grew by a rate of 2.1% in Q1, 0.1 pp less than in the last quarter of 2007. The breakdown of value added at the sectoral level shows a widespread increase in quarter-on-quarter growth for 2008 Q1, which was particularly sharp in construction.

The greater economic dynamism in the euro area was largely the result of strong growth in the German economy, which posted a quarter-on-quarter growth rate of 1.5%, up 1.2 pp on the previous quarter. Nonetheless, there were notable differences across countries. In Germany, the upturn applied to all components, although the good performance of investment and the sizeable positive contribution of changes in inventories were particularly notable. The upturn in Italy was also significant, with GDP growing by 0.5% – driven mainly by the positive contribution of net external demand – after falling 0.4% in the last quarter of 2007. In France, the growth rate of output rose slightly (by 0.1 pp, to 0.5%) as a result of the build-up in stocks, which – having shaved 0.6 pp off growth in the previous quarter – offset the slowdown in the other domestic demand components and in net exports. However, in Spain and the Netherlands, the economy weakened notably, with growth falling by 0.5 pp to 0.3% and by 1.1 pp to 0.4%, respectively.

In 2008 Q1, employment recorded quarter-on-quarter growth of 0.3%, unchanged from the second half of 2007. On an annual basis, however, it slowed further, falling off 0.3 pp to 1.5%. This development, together with the continued economic dynamism in the euro area during the opening months of 2008, gave rise to a small increase in the growth rate of labour produc-

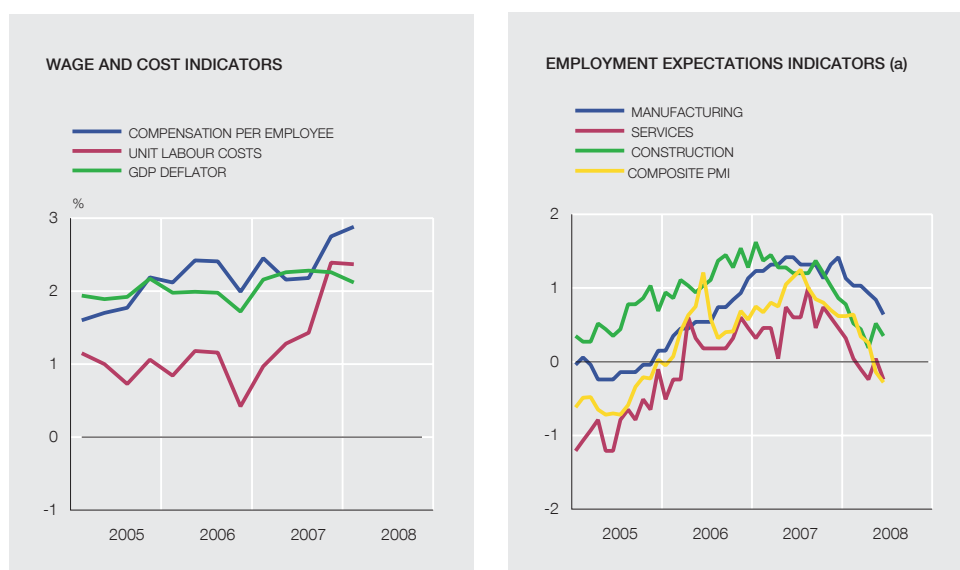




SOURCES: Eurostat and national statistics.

tivity to 0.5%. The acceleration in productivity partly offset the increase in the growth of compensation per employee, which rose to 2.9% (compared with 2.7% in 2007 Q4), leaving the growth rate of unit labour costs steady at 2.4% (see Chart 9). Furthermore, the performance of margins helped cushion the increase in labour costs, growth in which was virtually nil for the second consecutive quarter.

The conjunctural data available for 2008 Q2 reflect significantly slower euro area growth. This stems partly from the offsetting effect of a number of exceptional factors that drove activity in Q1 more than expected, but also points to a loss of dynamism in the economy (see Chart 10). Thus, on the supply side, the industrial production index fell sharply in May, placing the April-May average below that of the previous quarter and taking the annual rate of change into negative territory (-0.6%) for the first time in three years. Similarly, the qualitative indicators worsened over the entire quarter. According to the European Commission's sentiment surveys, in Q2 confidence fell both in the manufacturing sector and in services and construction. A similar pattern was revealed by the indices compiled using the purchasing managers' surveys (PMI), which, moreover, fell below 50 points in June and thereby seem to point to a decline in economic activity in both sectors at the end of the quarter. Additionally, the indicators



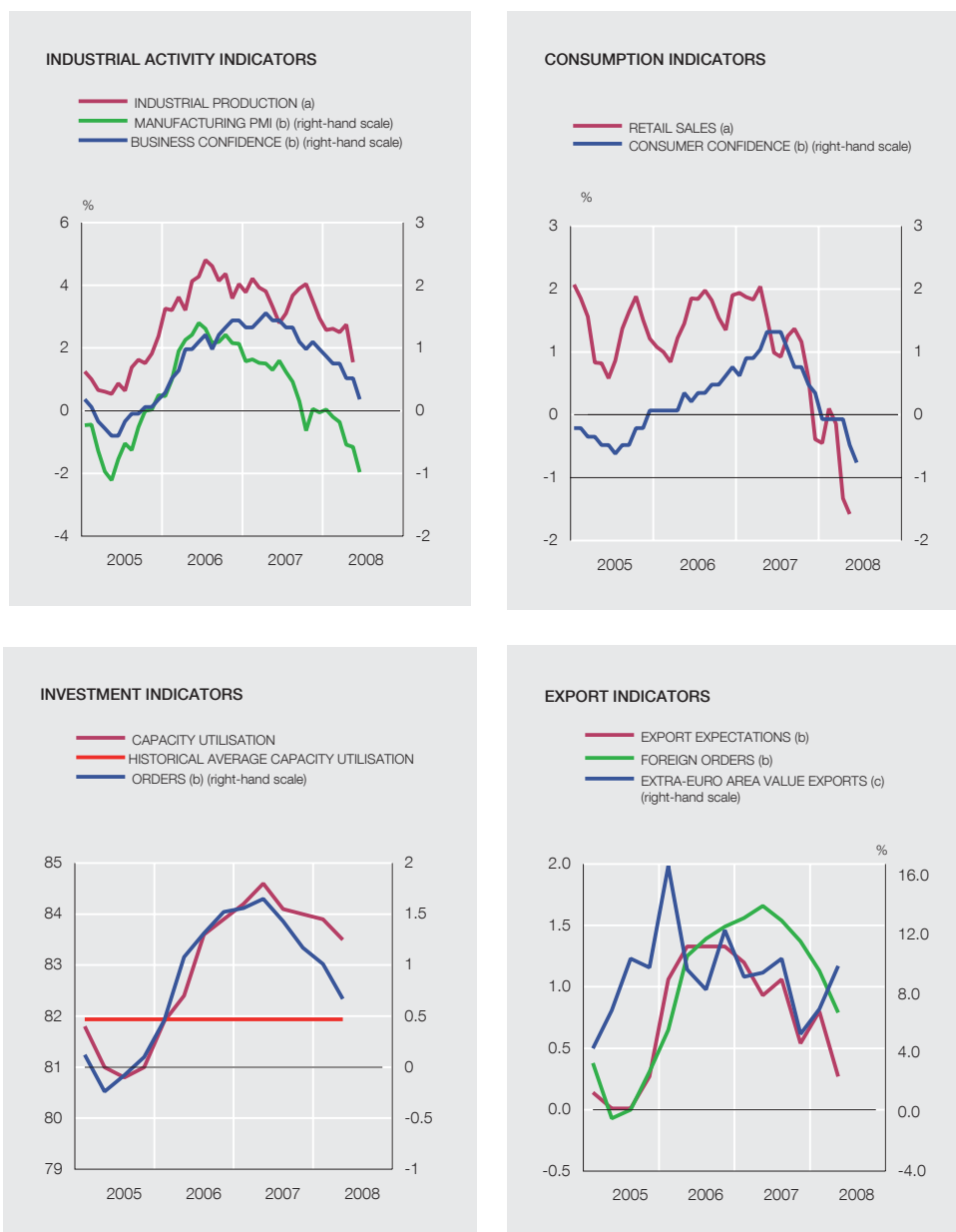
SOURCES: Eurostat and ECB.

a. Expectations based on European Commission sentiment indicators and Reuters PMI survey. Normalised data.

of job creation expectations continued to slow, while the unemployment rate held steady at 7.2%.

On the demand side, available indicators also portrayed a clearly weakening scenario, particularly regarding consumption, which may be reflecting the adverse impact of steep price rises. More specifically, although they were subject to some volatility, retail sales and new car registrations were lower in Q2 (in the case of sales, the data are only to May). Confidence fell over the second quarter both in the retail trade sector and among consumers – whose willingness to purchase durable consumer goods dropped sharply – against a background of continued tightening of financing conditions and of heightened uncertainty over economic prospects. As regards investment, both the assessment of order books and the level of capacity utilisation continued to trend downwards. Nevertheless, capacity utilisation remains higher than its long-term average, which may explain why, according to the European Commission's half-yearly industrial investment survey, firms are maintaining their capital expenditure for 2008 at levels similar to those of the past two years. Lastly, on the external demand front, nominal exports – despite performing soundly in April – fell subsequently in May. Along with the unfavourable course of export expectations and the assessment of export order books, this augurs an easing off of sales to the rest of the world in Q2.

In short, the available economic data reflect the overall effect of various adverse shocks on recent trends in euro area economic activity and, more especially, on prospects. These shocks include rising oil prices, the slowdown in the global economy, diminished wealth (financial and non-financial alike), the tightening of financing conditions and the impact of inflationary shocks and financial tensions on agents' confidence. Thus, euro area GDP will foreseeably continue to grow moderately in the second half of 2008, although the degree of uncertainty is very high and there are many doubts as to the depth and duration of the slowdown. Additionally, in the medium term, this scenario is subject to downside risks, including a potential further increase in energy prices and the possibility that the financial turmoil may



SOURCES: Eurostat and European Commission.

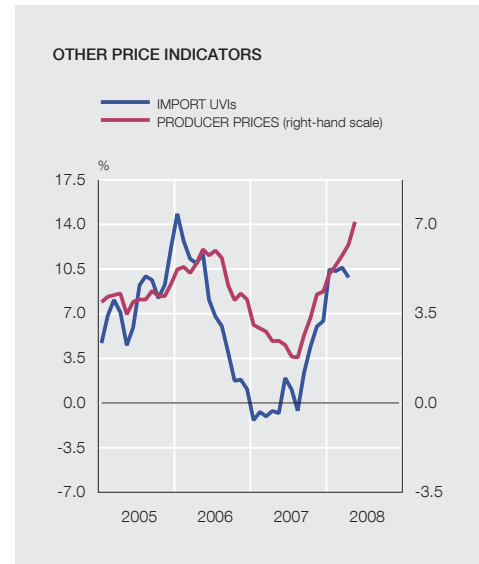
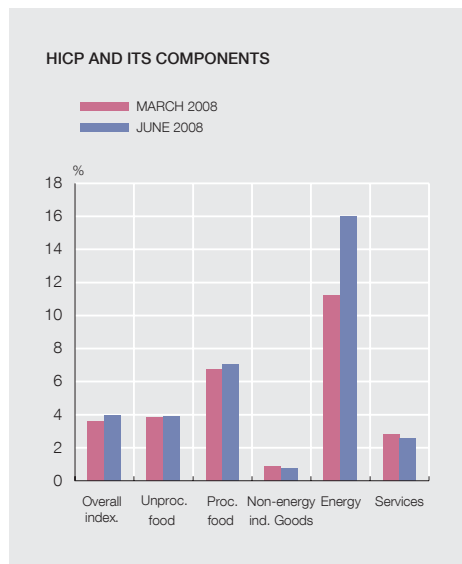
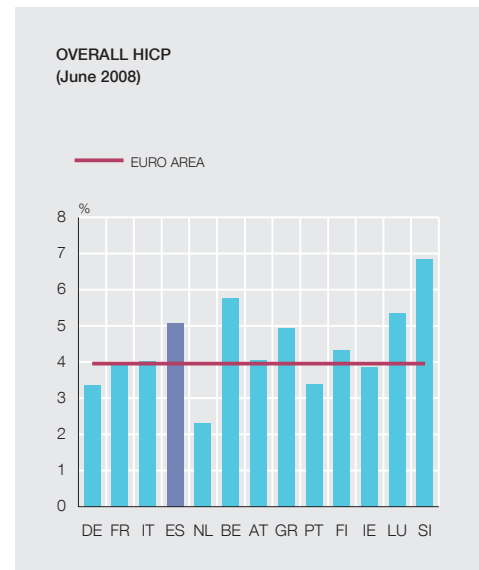
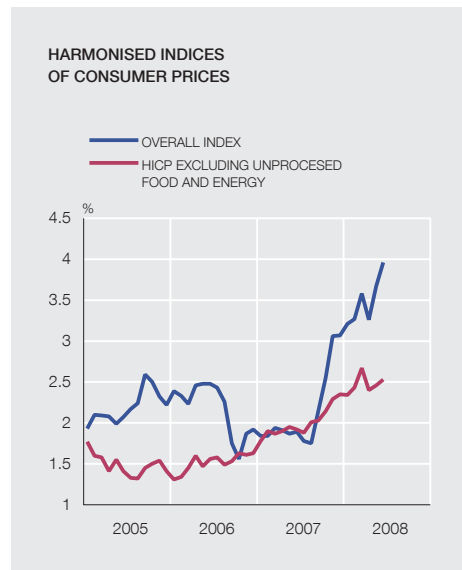
a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.

b. Normalised data.

c. Year-on-year rates of the original series. Quarterly average.

have a greater impact than expected on the real economy, especially if its effects spread to the emerging economies.

Euro area inflation has continued on an upward path in the last few months, owing mainly to energy price developments (see Chart 11). Year-on-year growth in the euro area HICP rose to 4% in June, more than one-third of which is attributable to the energy component (up 16% year-on-year), although the contribution from the processed food component is also very high. At the same time, the prices of unprocessed foods accelerated slightly. Services prices, having picked up in March owing to the impact of the Easter holidays, which last year fell in April, have returned to their average level for 2007 (2.5%), while the non-energy industrial goods compo-



SOURCES: Eurostat and ECB.

ment is still growing at a very moderate rate. As a result, core inflation – measured by the year-on-year rate of change of the CPI excluding unprocessed food and energy – stood at 2.5% in June, 0.2 pp less than in March.

The accelerating profile of producer prices has intensified in recent months, reaching a year-on-year rate of 7.1% in May, almost 3 pp above the end-2007 rate. Once again, the surge in energy prices is mainly responsible for the sharp acceleration in producer prices, although the rate of growth of capital goods prices has also been on an upward trend since the beginning of 2008.

In the short and medium term, and based on how the prices of commodity futures perform, inflation will foreseeably stand above 2% for a longer period of time than expected a few months ago, in line with the latest forecasts and with indicators of short-term inflation expectations. Only with a moderation in oil price growth rates, as currently implied by futures markets, will inflation start gradually to ease. Nevertheless, the upside risks to this outlook are high, on

GENERAL GOVERNMENT BUDGET BALANCES AND PUBLIC DEBT  
OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP						
BUDGET BALANCES (a)						
	2006	2007 (b)	2007 (c)	2008 (b)	2008 (c)	2009 (c)
Belgium	0.3	-0.2	-0.2	-0.4	-0.4	-0.6
Germany	-1.6	0.0	0.0	-0.5	-0.5	-0.2
Greece	-2.6	-2.7	-2.8	-1.6	-2.0	-2.0
Spain	1.8	1.8	2.2	1.2	0.6	0.0
France	-2.4	-2.4	-2.7	-2.3	-2.9	-3.0
Ireland	3.0	0.5	0.3	-0.9	-1.4	-1.7
Italy	-3.4	-2.4	-1.9	-2.2	-2.3	-2.4
Luxembourg	1.3	1.0	2.9	0.8	2.4	2.3
Netherlands	0.5	-0.2	0.4	0.5	1.4	1.8
Austria	-1.5	-0.7	-0.5	-0.6	-0.7	-0.6
Portugal	-3.9	-3.0	-2.6	-2.4	-2.2	-2.6
Slovenia	-1.2	-0.6	-0.1	-0.9	-0.6	-0.6
Finland	4.1	4.5	5.3	3.7	4.9	4.6
Malta	-2.6	-1.6	-1.8	-1.2	-1.6	-1.0
Cyprus	-1.2	1.5	3.3	0.5	1.7	1.8
MEMORANDUM ITEMS: Euro area (including Malta and Cyprus)						
Primary balance	1.6	2.2	2.3	2.1	1.9	1.8
Total balance	-1.3	-0.8	-0.6	-0.9	-1.0	-1.1
Public debt	68.5	66.6	66.4	64.8	65.2	64.3

SOURCES: European Commission, national stability programmes and Banco de España.

- a. As a percentage of GDP. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.  
b. Objectives of the Stability Programmes submitted between late 2007 and early 2008.  
c. European Commission forecasts (spring 2008).

account of the possibility that there will be further oil and food price rises and that price and wage-setting mechanisms will give rise to second-round effects if inflation expectations worsen further. These risks are only partly mitigated by diminished demand pressure, in a context of slower economic growth.

According to the information published by the ECB, the current account balance for the euro area posted a deficit of €25 billion (0.8% of GDP) between January and April 2008, in contrast to the surplus of €1.5 billion recorded for the same period last year. With the exception of the services balance, where the surplus increased slightly, the remaining balances contributed to this sharp deterioration in the euro area balance of payments during the opening months of the year. In particular, the surplus on trade in goods shrank significantly (as a result of the worsening in the terms of trade) and the income balance recorded a deficit after the surplus a year earlier. The current transfers balance went further into deficit. Meanwhile, with regard to the financial account, the period between January and April saw a large net outflow of capital in the form of direct investment amounting to €90.5 billion, far exceeding the figure recorded in the same period last year. At the same time, net capital inflows in the form of portfolio investment totalled €69.1 billion, less than half the amount one year before. Thus, in the first four months of 2008 the basic balance, which aggregates the current account balance and these two types of investment, showed a deficit of €46.4 billion, marking a sharp fall from the surplus of €132.6 billion as at April 2007 (see Chart 14).

According to the European Commission's spring forecasts, the budget deficit of the euro area as a whole decreased in 2007, for the fourth year running, to 0.6% of GDP (see Table 2). The

Since mid-2007, surging energy and agricultural commodity prices have prompted sharp rises in the rate of inflation. In particular, as the main body of the chapter describes, the HICP grew 4% year-on-year in June and the change in the CPI excluding energy and unprocessed food was 2.5%. The HICP is the single most important indicator of euro area inflation, given that it is the target variable for the Eurosystem's monetary policy. Published monthly, it measures developments in a representative basket of final consumer prices. However, a comprehensive assessment of inflationary developments requires an in-depth analysis of price and cost formation in the production process. The main source of information for this lies in the national accounts, is available only quarterly and is published with some lag to the reference period. For this reason, monthly price development indicators drawn from surveys provide information that helps make up this shortfall, albeit only partially.

In the monthly surveys – primarily the European Commission's harmonised surveys and the purchasing managers' surveys conducted by Reuters<sup>1</sup> (known as PMIs) – there are a number of questions on

various relevant price variables. Some of these qualitative indicators refer to input and sales prices and provide useful information on developments in prices, costs and margins.

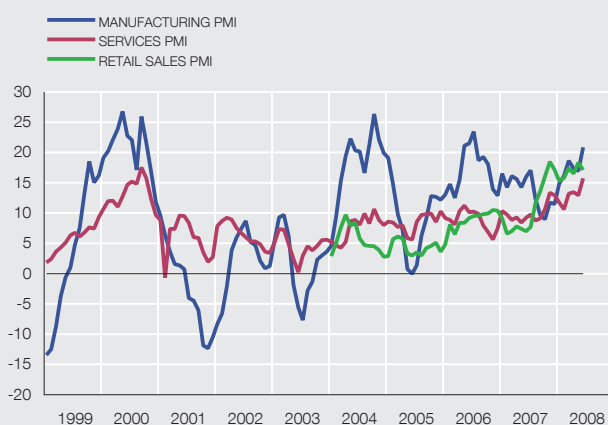
The questions in the Reuters surveys enquire about the prices of inputs in the manufacturing, services and retail trade sectors.<sup>2</sup> However, the underlying definition for these purchases varies considerably across sectors. For example, while the manufacturing survey does not include wages, the services survey does. The question addressed to retailers relates exclusively to purchases of goods for resale. In the questionnaires, employers are asked to compare the average price of their purchases with the situation one month previously. As can be seen in panel 1, all three sectors under review have posted increases in input prices since mid-2007, although in the case of the retail trade sector the increase is larger.

The surveys conducted by Reuters also gather data on sale prices developments in the manufacturing and services sectors relative to

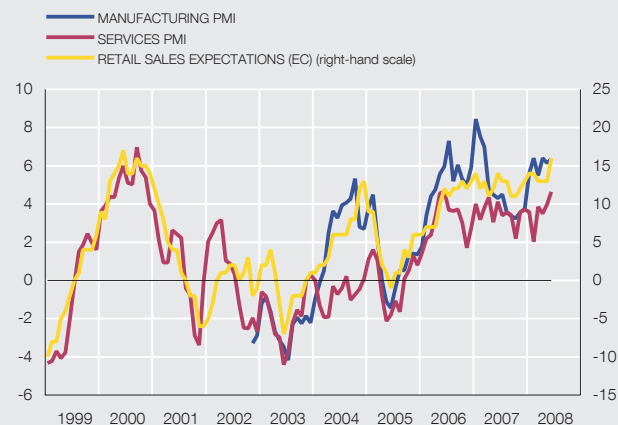
1. See European Commission (2003), "The Joint Harmonised EU Programme of Business and Consumer Surveys. User Guide" and the webpage of NTC Economics (<http://www.nteconomics.com/default.aspx>).

2. The Services PMI covers the transport and communication, financial intermediation, business services, personal services, IT and telecommunications, and hotel and restaurant sectors.

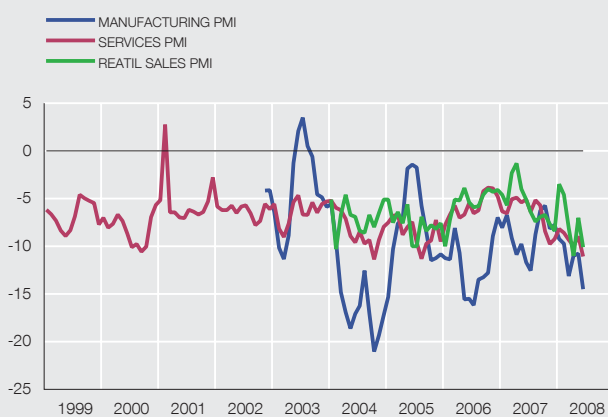
#### 1 INPUT PRICE INDICATORS



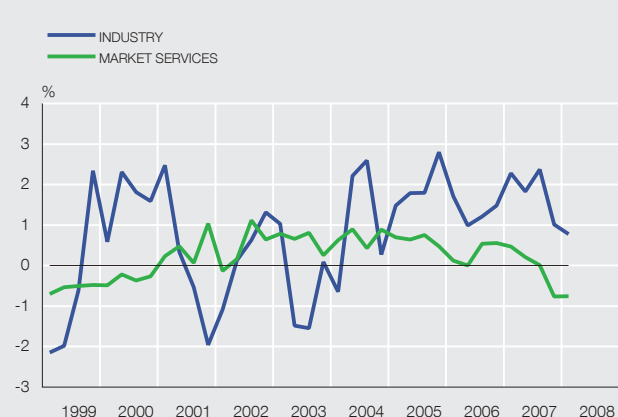
#### 2 PRODUCER PRICE INDICATORS



#### 3 MARGINS INDICATORS



#### 4 QUARTERLY MARGINS INDICATORS



SOURCES: European Commission, Reuters and Bloomberg.

the previous month's levels. In addition, the European Commission's harmonised survey of business proprietors asks their opinion on expected developments in their sales prices over the following three-month period (see panel 2). In recent months, all of these indicators have shown increases. However, the variables for industry and manufacturing have picked up significantly since mid-2007, in line with developments in the non-energy industrial price index, whereas in services the upturn has been on a smaller scale and with a greater lag.

With the sales price and input price variables from the Reuters surveys for the manufacturing and services sectors, it is possible to obtain, by difference, indicators that approximate margins in these sectors. The Reuters survey also provides direct measures of develop-

ments in margins in the retail trade sector. As panel 3 shows, from the closing months of 2007 to June 2008, when the latest data became available, the indicators pointed to a somewhat declining trend in the three sectors. These developments are consistent with the quantitative information from the euro area table of costs for 2008 Q1 (see panel 4).

In summary, an analysis of these indicators reveals that both sales and inputs prices have picked up significantly in recent months. A comparison of these prices in the industrial and services sector and developments in the indicator of margins in the retail trade sector suggest that increases in costs to firms have not been passed through fully to customers, indicating a squeeze on margins.

structural deficit, i.e. the budget balance net of cyclical factors and temporary measures, fell 0.5 pp in 2007 to 0.7% of GDP. Some of the structural improvement, however, stems from the substantial extraordinary revenues collected over recent years, which will foreseeably diminish significantly in 2008. These unexpected revenues (though to some extent temporary in nature, they are part of the structural balance) have mostly been used by governments to finance public spending rather than to improve fiscal positions, which leaves less room for manoeuvre in the current phase of slowing growth.

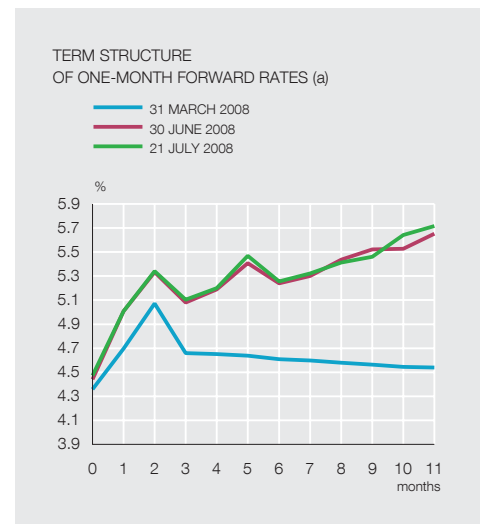
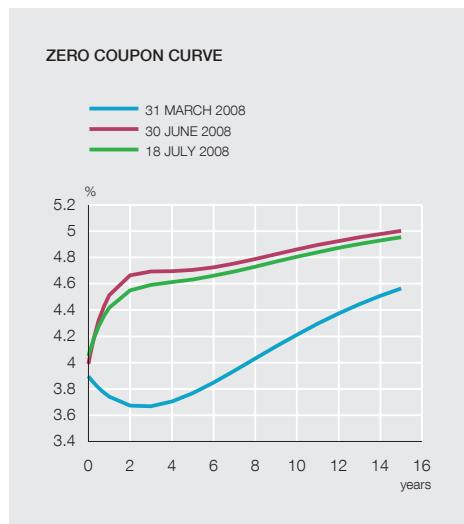
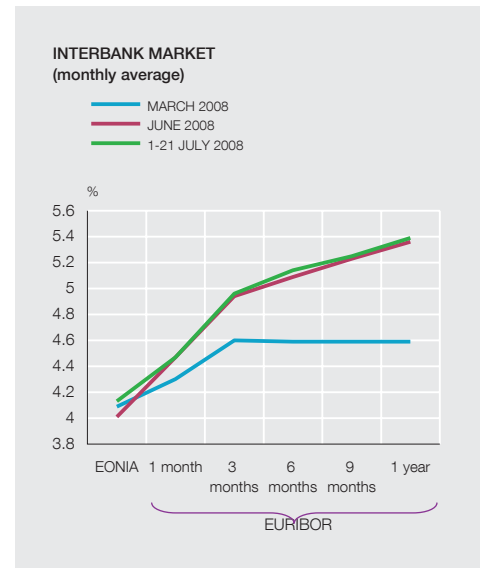
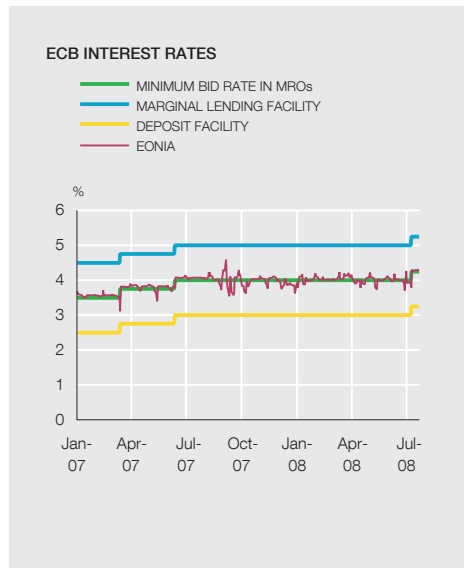
For 2008 the Commission forecasts a worsening of the euro area budget balance by 0.4 pp to -1% of GDP. This deterioration is likely to be the result mainly of lower rates of growth in the euro area and a reduction in tax elasticities from the exceptionally high levels previously observed, as well as of certain discretionary measures that will lead to a reduction in tax revenues as a percentage of GDP (some 0.4 pp), far higher than the marginal cut in public spending.

Country by country, the fiscal position in 2008 is expected to worsen in most euro area members, with the exceptions of Greece, the Netherlands, Malta and Portugal. Notwithstanding, on current forecasts no countries will exceed the 3% ceiling in 2008. Accordingly, on 3 June the ECOFIN Council concluded the excessive deficit procedures that had been opened against Italy and Portugal, after they had reduced their government deficits below this limit. However, several countries (in particular Greece, France, Italy and Portugal) have deficits above 2%, which, in a context of high uncertainty over future economic developments, leaves only a narrow margin separating them from the maximum reference value.

### **3.2 Monetary and financial developments**

Throughout Q2, financial developments were determined by increased concern over global inflationary risks and fresh bouts of financial instability following some easing in tensions in April and May.

After a prolonged period during which official interest rates held unchanged, the need to preempt second-round effects and to counter the increasing upside risks to price stability over the medium term led the ECB's Governing Council to increase rates by 25 bp at its meeting in early July. Accordingly, the minimum bid rate on the main refinancing operations of the Eurosystem was raised to 4.25%, and the rates on the deposit facility and the marginal lending facility to 3.25% and 5.25%, respectively (see Chart 12). This decision was taken against a background of high inflation, which is expected to last for a more protracted period than previ-



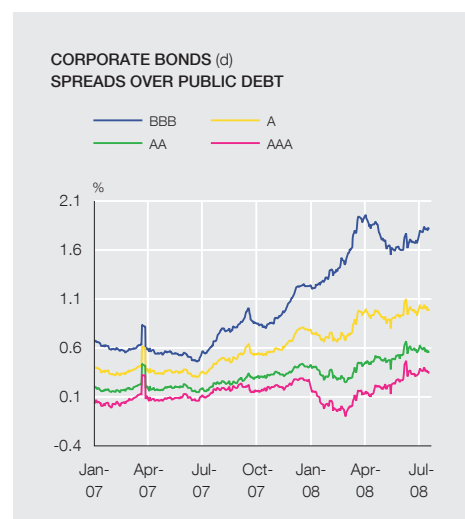
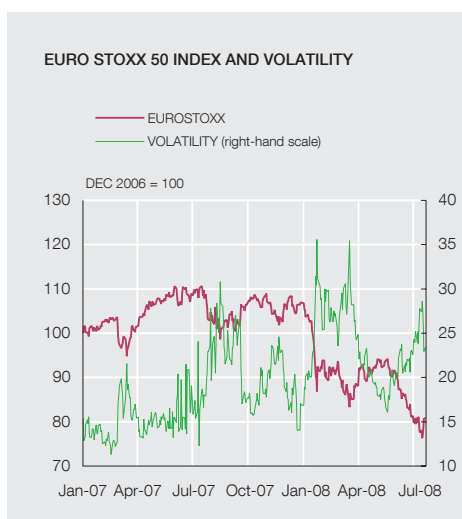
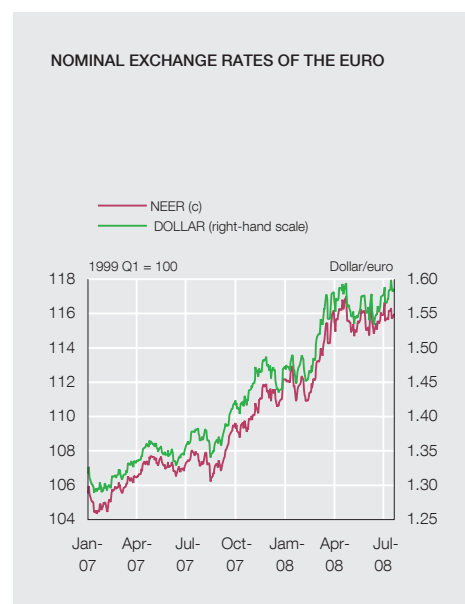
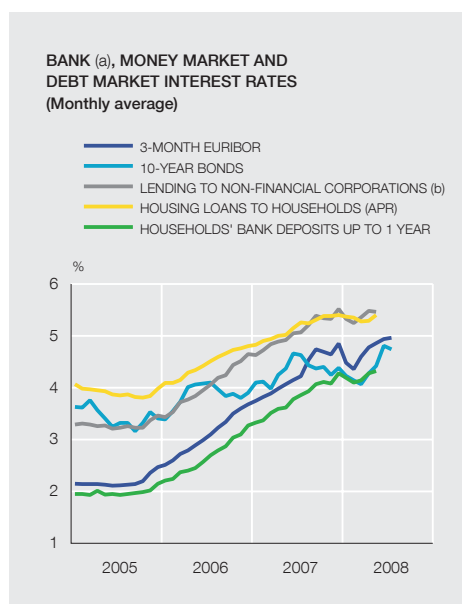
SOURCES: ECB and Banco de España.

a. Estimated using Euribor data.

ously thought, very dynamic money and credit aggregates, and the absence of significant constraints on banks' credit supply, despite ongoing financial market tensions. At the same time, the ECB reaffirmed its commitment to the objective of medium-term price stability and its determination to keep inflation expectations firmly anchored in line with price stability. Lastly, it expressed its view that the monetary policy stance following the decision to increase interest rates would contribute to achieving its objective.

This last statement tempered expectations of further rate increases, which had been building up since the June meeting of the ECB's Governing Council and had given rise to an increase, commensurate with terms, in interbank market interest rates. Since end-March, the one-month and twelve-month EURIBOR rates have risen by around 10 bp and 70 bp, respectively. On the days immediately after the June meeting they stood at levels around 4.5% and 5.4%, where they have since remained. The tensions in this market, linked to liquidity problems and counterparty risk, have continued. Hence the yield spread between unsecured (EURIBOR) and secured (EUREPO) interbank transactions stood at around 80 bp on 21 July on one-year ma-





SOURCES: ECB and Banco de España.

- a. Statistics on interest rates compiled by the ECB for new business.
- b. Floating interest rates and up to 1 year initial rate fixation.
- c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
- d. Euro-denominated bonds issued by non-financial corporations.

turity operations. Against this background, the ECB continued exceptionally to inject liquidity through its main refinancing operations, in which volumes above those considered to be neutral continued to be assigned, and through supplementary longer-dated operations and operations in dollars. By pursuing this policy, the ECB was successful in bringing shorter-term interest rates down to levels closer to the rate marking the monetary policy stance.

In government bond markets, yields continued on the upward trend dating back to mid-March. Ten-year bonds posted values above 4.9% in mid-June, although a subsequent slight downward correction left them lower at 4.7% on 21 July. The increase in ten-year government bond yields in the euro area – by some 70 bp over the period – was somewhat more pronounced than that observed in the United States, with the result that the negative spread between ten-year US bonds and euro area bonds has risen to close to 80 bp. In Q2, the spreads between German sovereign bonds and their

Since 2005, the growth rate of loans to non-financial corporations in the euro area has been increasingly robust, rising to 12% year-on-year in 2007 (see panel 1). For much of this period, lending was driven by the firming of economic expansion, favourable financing conditions, the sector's healthy balance sheet position and a high degree of M&A activity.

The financial tensions, in train since mid-2007, have led to a significant adjustment in risk assessment, a sharp contraction in liquidity on international credit markets and, in short, a tightening of financing conditions and a worsening of economic prospects. Nevertheless, flows of funds to euro area non-financial corporations have shown considerable resilience in the period to May at the aggregate level of the sector. Although the empirical evidence points to a late response by credit to the change in economic and financial conditions, the notably robust growth of this variable over the past year has raised the possibility that it may also be influenced by agents' decisions taken as a result of the turmoil.

By type of liability, loans granted by resident institutions (MFIs) have been the most expansive component, with growth rates of over 14% year-on-year since August 2007 (see panel 2). In terms of amounts, new business exceeding €1 million has been the most dynamic segment, potentially reflecting demand by the biggest corporations, given the difficulties in issuing securities. Overdrafts have also quickened notably, growing at a rate of over 15% year-on-year in May, up from 8% in June 2007, with a significant contribution from Germany, France and the Netherlands. Owing to their similarity with the activation of credit lines (except in Spain), the momentum behind overdrafts would be due to the tightening of the conditions of access to new financing and to the greater need to finance working capital in the current economic circumstances.

The breakdown by country shows that the strength of bank loans to euro area non-financial corporations to April is fairly widespread, with the exception of Spain and Ireland, where a significant slowdown from relatively high growth rates is taking place. Despite this widespread strength, Germany and the Netherlands, among the biggest countries in the area, stand out owing to the significant acceleration in this type of financing in recent months (see panel 3).

Fixed-income securities, which account for 10% of the sector's debt, have slowed slightly since the start of the financial tensions

(see Chart 4). Long-term securities, which have not expanded much since 2000, stood at a year-on-year rate of increase of 3% in May, down from 7% in July 2007, with a significant contribution from the French market, where almost 45% of the total issued by this sector in the euro area is concentrated. In contrast, short-term securities displayed notable dynamism to February, owing to the momentum of the German market. Their growth has since declined significantly.

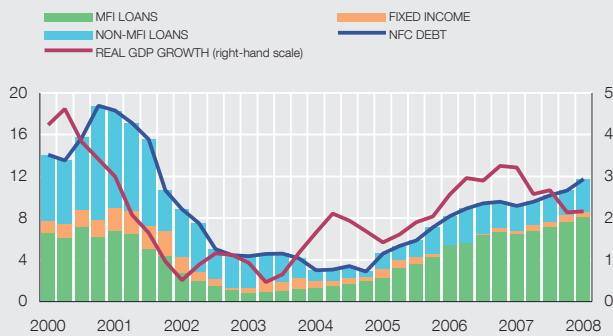
These developments have come about against a background of mounting borrowing costs, particularly for companies with a poor credit rating (see panel 5). In the case of loans, the interest rate on new business has increased by 39 bp since June 2007 to 5.5% in May. In loan contracts for less than €1 million, the related increase is 51 bp, to 6%. The breakdown of the latter by country shows sizeable discrepancies: increases of less than 20 bp in Germany and Finland, while in Spain, Slovenia and Portugal these exceeded 70 bp.

As panel 6 illustrates, the latest Bank Lending Surveys point to markedly more restrictive supply conditions since the onset of the financial turmoil in 2007, although this tightening has been relatively limited in some countries, such as Germany. In contrast, demand has begun to show signs of weakness only in the latest survey, for 2008 Q1, when the momentum of applications for funds to invest in fixed capital diminished significantly. In any event, the component most weakened by the financial tensions has been that relating to mergers and acquisitions, while the difficulties of issuing securities are considered to have prompted greater demand for loans.

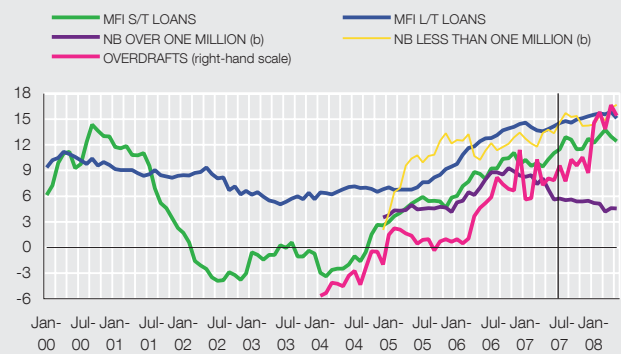
In sum, despite the bout of turbulence that began a year ago, financing of euro area non-financial corporations and, in particular, bank loans have continued to grow at relatively high rates. Although part of their momentum may stem from transitory factors relating to the financial tensions, corporations have accommodated loan demand in a setting marked by the sector's sound financial position and by higher interest rates. In any event, as the latest information available on bank loans in May might indicate, and as the empirical evidence shows, the continuation of the financial tensions and, above all, of the deterioration seen in the economic outlook will, combined with dearer financing, ultimately weaken the demand for credit in this sector with some delay.

(cont'd)

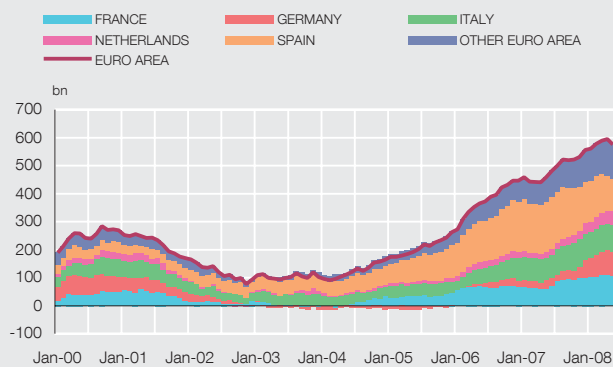
1 CONTRIBUTION TO YEAR-ON-YEAR GROWTH OF DEBT (a)



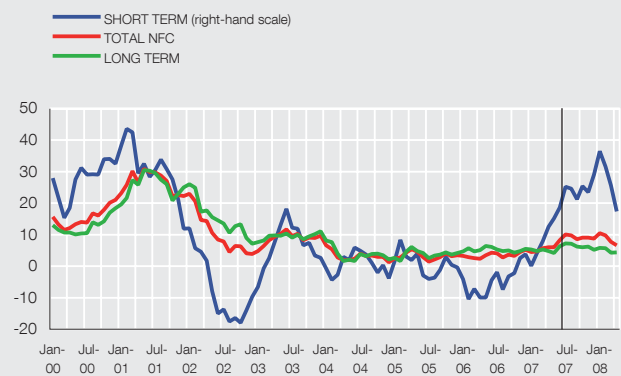
2 RESIDENT MFI LOANS. YEAR-ON-YEAR GROWTH



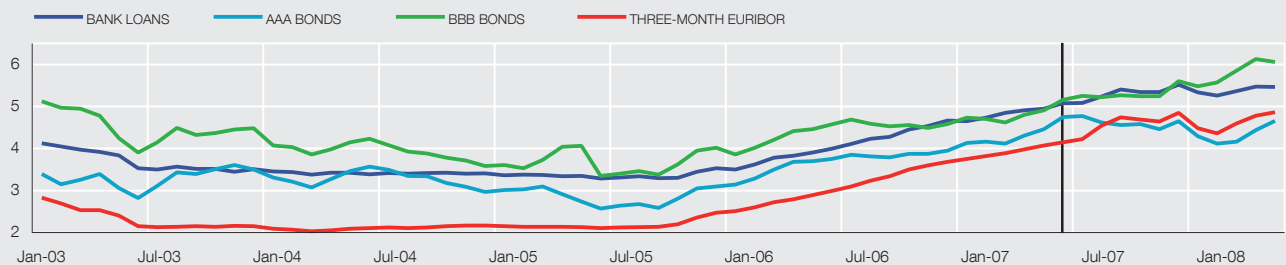
3 RESIDENT MFI LOANS (12-MONTH CUMULATED DATA)



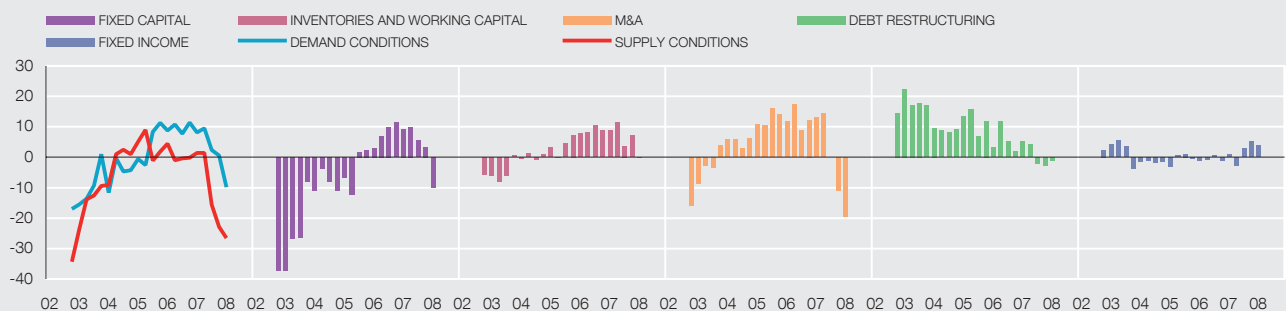
4 FIXED INCOME SECURITIES. YEAR-ON-YEAR GROWTH



5 NOMINAL COST OF FINANCING



BANK LENDING SURVEY AND DEMAND FACTORS (c)

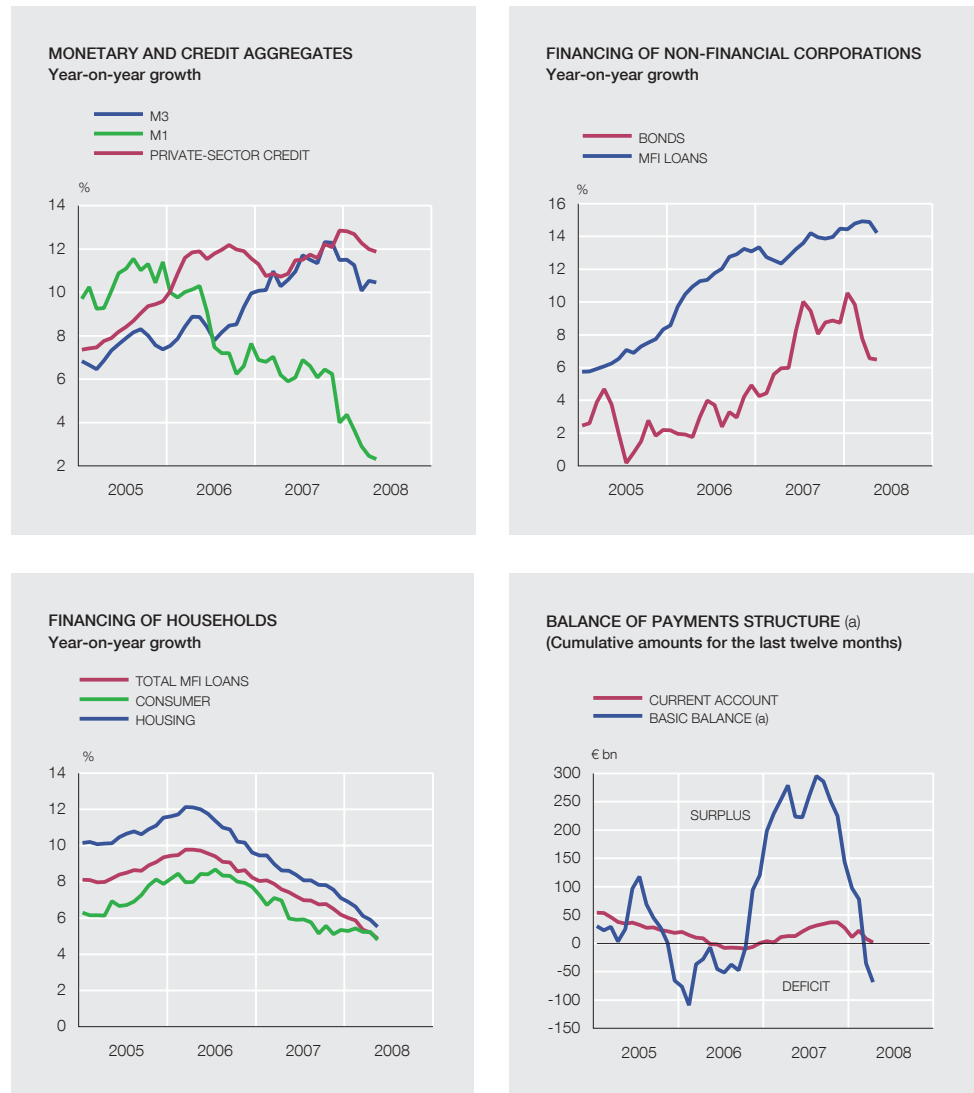


SOURCES: ECB, Eurostat and Banco de España.

a. Information drawn from the financial accounts to 2007 Q4. Estimate for 2008 Q1.

b. Year-on-year growth of new business (NB) (twelve-month cumulated data); in accordance with interest rate statistics.

c. Indicator = % of institutions indicating a considerable easing × 1 + % of institutions indicating some easing × 1/2 - % of institutions indicating some tightening × 1/2 - % of institutions indicating considerable tightening × 1. The demand factors are: investment in fixed capital, inventories and working capital, mergers and acquisitions (M&A), debt restructuring and fixed-income securities issues. Data to 2008 Q1.



SOURCES: ECB and Banco de España.

a. The basic balance is approximated adding the current account balance to direct and portfolio investment.

equivalents in other euro area countries narrowed somewhat after the strong pick-up in previous months. Compared with government bonds, yield spreads on the private fixed-income markets showed a sustained increase. The exception here was bonds of the lowest credit quality, whose yields fell slightly before this movement was reversed at the end of the period (see Chart 13).

The deterioration in growth expectations has been reflected in equity markets, which since May have seen a sharp fall in stock prices and increased volatility. As a result, many of the European indices recorded their lowest levels for the year. By 21 July the EURO STOXX 50 had accumulated a 14% loss since May, and a loss of over 24% for the year. The deterioration is practically across the board, although it has been more acute in the construction, banking and financial sectors. Meanwhile, during Q2 the euro exchange rate fluctuated considerably with no defined path. Since end-March, the euro has appreciated 0.3% against the dollar, while depreciating slightly in nominal effective terms.

A relatively flat yield curve and continued instability in financial markets gave rise to strong growth in the broad monetary aggregates (mainly driven by the dynamism of time deposits),

albeit at rates lower than those recorded at end-2007. Thus, M3 posted a year-on-year increase of 10.5% in May, the same as in the previous month and 1 pp less than the rate recorded in December (see Chart 14). At the same time, growth in the narrow monetary aggregate M1 slowed, falling to a year-on-year change of 2.3% in May as a result of moderation in the growth of cash in circulation and especially overnight deposits.

With regard to counterparties, growth in MFIs' credit to the private sector and its most important component – loans – moderated slightly; nevertheless, rates remain high (11.9% and 10.4%, respectively, in May). These developments mask behaviour that is uneven across the loan-taking sectors, with an acceleration in flows to the other financial intermediaries sector. By contrast, loans to households continued their deceleration, growing by less than 5% in May, with a loss of dynamism in consumer loans and, more particularly, in loans for house purchase. Loans to non-financial corporations, which are examined in greater detail in Box 2, continued to grow at relatively high rates, although the latest data point to a slowdown. In May, this component recorded an annualised month-on-month growth rate of 9.6%, considerably lower than the figure of 14% for the previous year.

## 4 The Spanish economy

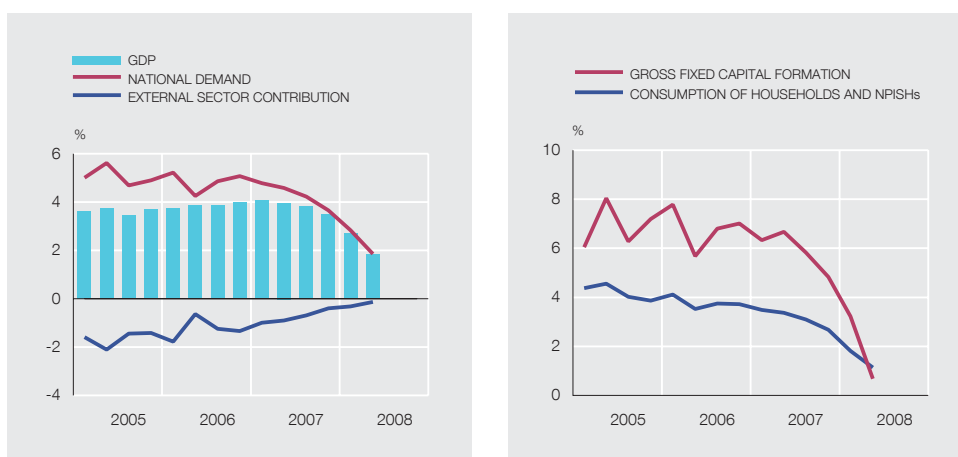
The adjustment process initiated by the Spanish economy in 2007, following a long phase of high economic growth, became more accentuated in 2008 Q1 according to QNA estimates. In this period GDP posted a year-on-year growth rate of 2.7%, 0.8 pp below the estimated figure for 2007 Q4. In quarter-on-quarter terms, the rate of increase of output was 0.3%. The slowdown reflected the loss of dynamism of national demand, the rate of which rose by 2.8% compared with the same period a year earlier (0.8 pp less than in the previous quarter), and, in particular, of private consumption and residential investment. In contrast, the contribution of the external sector to GDP growth improved by 0.1 pp to -0.3 pp. On the supply side, with the exception of agriculture, the pace of all sectors of activity eased off, and the sharpest loss of momentum was seen in construction and in industry. The pace of job creation reflected the slowdown in activity and, on QNA figures, eased considerably in the opening months of 2008, posting a year-on-year rate of 1.7%, 0.8 pp less than the end-2007 figure, whereby the rate of increase of productivity held at around 1%.

On the information available, the Spanish economy has once again seen a substantial reduction in its rate of expansion in 2008 Q2. The persisting instability on international financial markets and the climb in oil prices have accentuated the adverse effects of the adjustment in the real estate market, putting a brake on activity. Against this background, the data available suggest that the year-on-year rate of change of GDP might have undergone a further moderation of 0.9 pp in Q2 to 1.8%, which would correspond to a quarter-on-quarter rate of 0.1%. This slowdown in output would be attributable to the further loss of steam in national demand, whose year-on-year growth rate is estimated to have fallen to 1.9%, while the negative contribution of the external sector is expected to have continued to improve, to -0.1 pp (see Chart 15).

On the supply side, the slowdown in value added in the market economy in Q2 is estimated to have continued bearing mainly on the industry and construction sectors. As regards the labour market, the available indicators point to a sharp adjustment in the pace of job creation, on a greater scale than that foreseen for GDP growth. As a result, the rate of increase of productivity for the economy as a whole is expected to have exceeded the figure of 1% observed in Q1. At the same time, compensation per employee is estimated to have risen at a similar pace, meaning that the growth of unit labour costs would have stabilised in Q2. Turning to consumer prices, the 12-month rate of change in the CPI continued to climb in Q2 up to an average rate of 4.6%, 0.2 pp up on Q1. This was due to dearer energy and processed food prices. Core inflation held stable for the third quarter running at 3.2% year-on-year.

### 4.1 Demand

In 2008 Q1, final consumption spending by households and NPISHs grew at a year-on-year rate of 1.8% (0.2% in quarter-on-quarter terms), 0.9 pp less than in 2007 Q4, which highlights the notable loss of dynamism of this component of national demand at the start of the year. The latest conjunctural information suggests that the weakness of private consumption became more marked in 2008 Q2 (see Chart 16). Specifically, consumer and retail trade confidence indicators once again posted significant declines in this period, higher than those observed in the previous months. The former indicator showed an all-time low, and the latter displayed levels not seen in the last 13 years. Among the quantitative indicators, Tax Agency figures for April and May indicated diminished dynamism in large companies' domestic sales of consumer goods and services. In these two months the real retail trade index underwent a significant decline, greater than that in Q1, in step with the deterioration in retail confidence in this period. Finally, under consumer durables, there was a fall-off in car sales in 2008 Q2, although the decline recorded in June may have been amplified by the delaying of some pur-



SOURCES: INE and Banco de España.

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

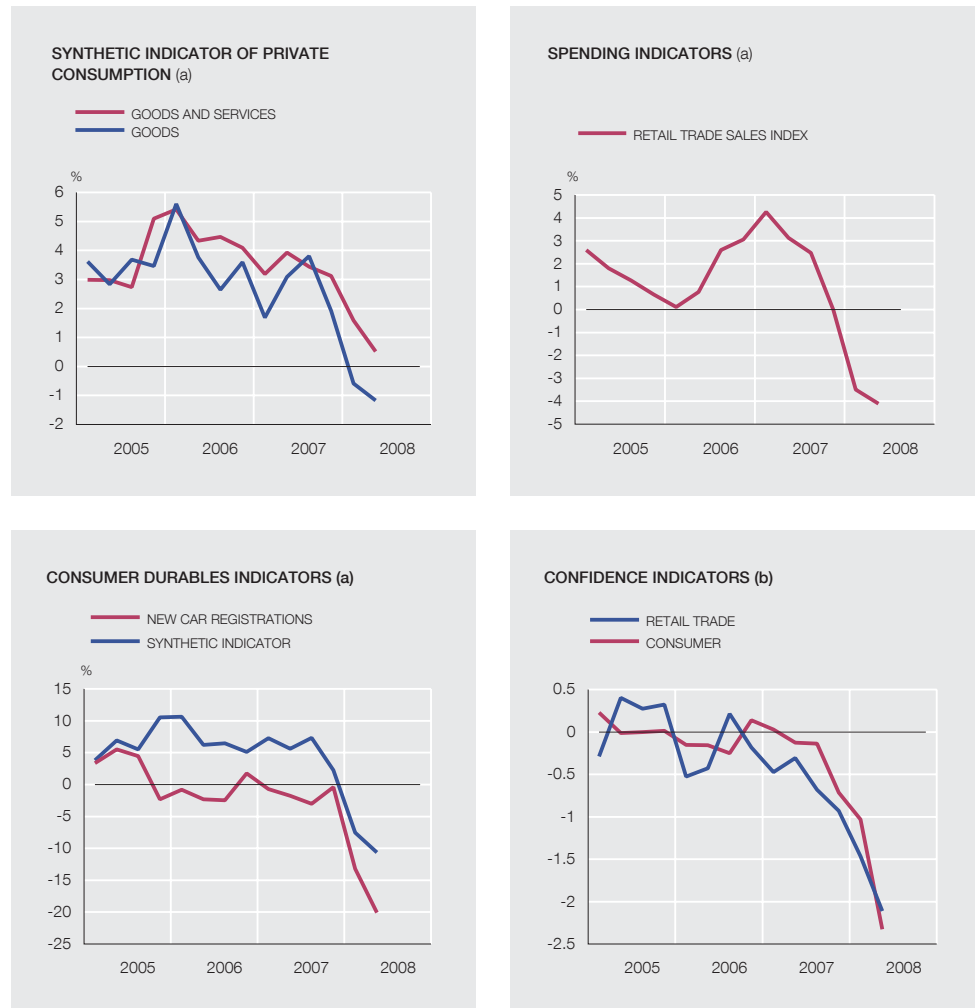
chases as consumers awaited the imminent entry into force of the VIVE plan (a scheme conceived to withdraw old cars and renew the national stock of vehicles).

The weakening of household consumption in Q2 is in response to diminished confidence brought on by the deterioration in the macroeconomic outlook and the less favourable course of its determinants. Hence, albeit in a setting of wage acceleration, the growth of household disposable income in nominal terms has begun to be dented by lower employment generation, an effect which has been heightened in real terms by the observed rise in inflation. Moreover, less accommodative financial conditions have probably contributed to households postponing durable consumption spending decisions, while the slowdown in the pace of households' real and financial wealth might be beginning to promote an increase in saving by these agents. However, in the latest non-financial accounts of the institutional sectors, for 2008 Q1, the saving rate still declined slightly.

The rate of increase of general government final consumption stepped up in Q1 to a year-on-year rate of 4.7% (1.7% quarter-on-quarter), 0.3 pp up on 2007 Q4. A further acceleration in this demand component is forecast for 2008 Q2, judging by the trend of compensation per employee in the public sector, based on the State budget outturn figures.

Gross fixed capital formation slowed notably in 2008 Q1 to a year-on-year rate of 3.2%, 1.6 pp less than the previous quarter. This figure reflects the loss of dynamism in all its components, sharply so in the case of investment in equipment, whose rate of increase eased by 2.3 pp to 6.3% year-on-year. Despite this, it remained the most vigorous component of national demand (see Chart 17). The slowdown in investment in construction was on a somewhat lesser scale; it grew at a year-on-year rate of 1.3% (1.6 pp less than at end-2007), the outcome of a 0.2% decline in residential investment – which slipped for the first time in five years – and of a 1 pp slowdown in investment in other construction, to 3%. The dynamism of investment in other products also slackened, although it held at a high growth rate of 5.2%, 0.9 pp down on the close of 2007. The information available for 2008 Q2 points to further easing in the rate of expansion of the various components of gross fixed capital formation and, in particular, of investment in equipment and residential investment.

In the specific case of capital investment, the indicator of apparent investment in capital goods, calculated with incomplete data for the quarter, recorded a significant decline in Q2, higher than that observed at the start of the year. The business confidence indicator in the capital goods in-



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

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

b. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

dustry continued to worsen in April and May, and the deterioration was particularly significant in order books. Likewise, a slowdown is also expected in investment in other products in Q2. From the standpoint of its determinants, a moderation in future investment plans is to be expected, given the deterioration in the prospects of some of the elements that have been underpinning the dynamism of this demand component in the recent past, such as the buoyancy of final demand and the favourable trend of corporate profits. Indicative here is the reduction in the level of capacity utilisation in industry in Q2. And adding to this is the less favourable environment for the resort to borrowed funds, which stems not only from the increase in the debt burden resulting from the rise in lending rates, but also from the tightening of the conditions of access to these sources of financing. In this respect, the data available on credit to non-financial corporations by end-purpose suggest that the tightening of credit access conditions by resident financial institutions is affecting, above all, companies linked to the construction and real estate development sector. That said, according to the non-financial accounts of the institutional sectors, net borrowing by non-financial corporations as a whole held stable at 10.6% of GDP in the four quarters to 2008 Q1.

The deceleration seen in investment in construction since 2006 stepped up in 2008 Q1, when this demand component grew at a year-on-year rate of 1.3% (stagnating in quarter-on-quarter





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

- a. Year-on-year percentage change based on the seasonally adjusted series.  
 b. Normalised indicator (difference between the indicator and its mean value, divided by the standard deviation)  
 c. Construction industry production index. Year-on-year rates base on the original series.

terms), 1.6 pp less than in the previous quarter. This slowdown reflects, in particular, the ongoing correction in the residential component, which posted a fall of 0.2% year-on-year (compared with positive growth of 1.8% the previous quarter), and, to a lesser extent, the loss of dynamism of the component of other construction, which increased by 3%, 1 pp less than in 2007 Q4. The coincident indicators of total investment in construction, such as inputs or employment, suggest that the adjustment of the sector has become more marked in 2008 Q2. Among the indicators of inputs, both the domestic production of construction materials and the apparent consumption of cement fell in April and May by a greater amount than in Q1. As to the coincident labour market indicators for Q2, the average number of Social Security registrations declined by 7%, compared with the fall of 2.2% in Q1, while the growth rate of the number of registered unemployed increased to 62.2% in Q2, 26.5 pp up on Q1. In addition, the construction industry production index fell in April (the latest month for which information is available) by 8% year-on-year, down more than 2.4 pp on Q1. Lastly, the European Commission's construction industry confidence indicator continued to worsen, albeit to a lesser extent than in the two previous quarters.

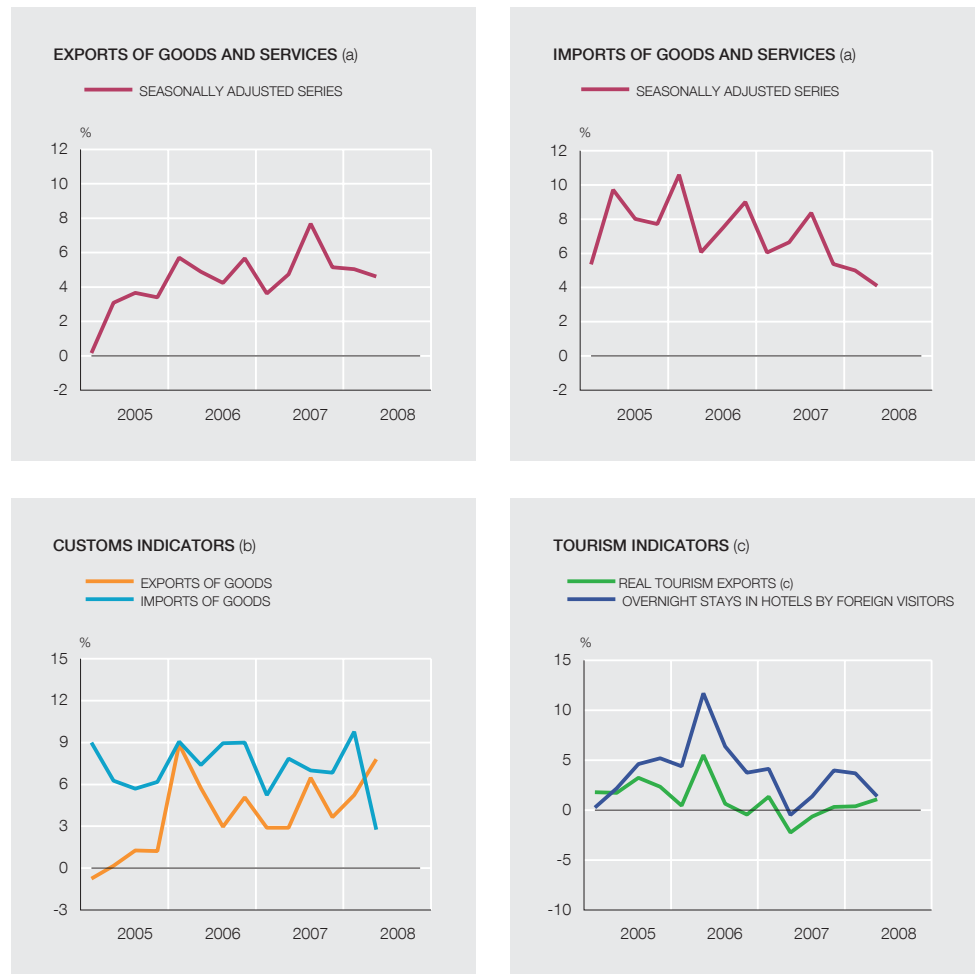
By type of building work, the adjustment of residential investment is expected to have stepped up in Q2, posting negative rates clearly higher than those at the start of the year. The notable

decline seen in approvals for new projects since mid-2007 means that a reduction in the number of housing starts in 2008 may be anticipated, and that residential investment will therefore trend unfavourably in the coming quarters. These developments are the result of the adjustment of supply to the rapid slowing in demand, the outcome of dearer financing and of the gloomier outlook for real estate wealth. The information on housing transactions and new mortgages, for which there are figures to April, is illustrative of the path the demand for housing has followed in recent months. It is also estimated that non-residential building will lose momentum in Q2, in step with the decline in approvals for new projects in the recent past. Finally, the procurement of civil engineering works has continued to grow at a sharp pace, although works executed might have slowed in the April-June period due to their being linked to the decline in official procurement in the second half of 2007.

On QNA data, the negative contribution of net external demand to output growth continued to decline in 2008 Q1, standing at 0.3 pp, 0.1 pp less than the previous quarter, set against the slight deceleration in foreign trade flows (of exports and imports alike). This came about against the background of the progressive slowdown in world trade which, after growing at a rate of 6% in 2007, slowed somewhat at the start of 2008 (to a rate of close to 5%). In particular, in the case of Spanish export markets, there was a weakening in the developed economies as a whole, including some of the main recipients of our exports, such as France and Italy. However, sales to the emerging countries continue to grow at double-figures rates. Most of the indicators of competitiveness have continued to worsen to date in 2008, this being due, above all, to the appreciation of the euro against the developed countries' basket of currencies and, to a lesser extent, to the widening of price and cost differentials. Nonetheless, the indicators compiled with export prices have trended favourably during 2008 Q1, thanks to the continued containment of export prices (with far lower growth rates than those of domestic production prices or unit labour costs). This would be showing the effort by exporting sectors to maintain their market shares against the backdrop of the appreciation of the euro and the slowdown in national demand.

The incomplete information for 2008 Q2 suggests exports will remain on a relatively favourable course, despite the continued strength of the euro. Imports, meanwhile, will continue to lose steam, in step with the moderation of private consumption and of investment in equipment. As a result of these developments in trade flows, the contribution of net external demand to growth is expected to have improved by 0.2 pp in 2008 Q2 to -0.1 pp of GDP.

On QNA figures, the year-on-year rate of real goods exports edged up in 2008 Q1 to 5.1% from 4.6% the previous quarter, interrupting the decelerating path onto which this variable moved in 2007 Q4 (see Chart 18). The Customs Department's foreign trade figures also reflected, in seasonally adjusted terms, a more favourable performance by exports in Q1, owing essentially to the dynamism of car sales and intermediate products. In terms of geographical areas, the improvement was concentrated in EU markets, while exports to third countries slowed, though they continued posting high growth rates in nominal terms. As to the latest figures, real exports rose in April and May to a year-on-year rate of 12.6%, although this figure may be biased upward by the effect of Easter falling earlier (in March) in 2008 as opposed to 2007 (April). However, in terms of the seasonally adjusted series, the increase was - at 8.9% - also notable, far higher than that recorded in Q1. By product group, the most dynamic components of exports in April and May were intermediate goods - both energy and, to a lesser extent, non-energy goods alike - and non-food consumer goods. Under non-energy intermediate goods, products intended for the transport and manufactured electrical equipment industries and for the metalworking sector rose forcefully. In the case of consumer goods exports, car sales contributed significantly. Capital goods exports, although they quickened in April and May, continued to grow at a moderate rate of 2.8% in real terms. This was



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

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

essentially due to the pick-up in sales of machinery and land transport equipment. By geographical area, exports to the Community in April and May quickened notably (to a real rate of increase of 12.2%, compared with the increase of 3.6% in 2008 Q1), boosted by the momentum of sales to some of our main markets, such as Germany, France and the United Kingdom. Non-Community exports also stepped up in these two months (to a year-on-year rate of 13.4%, compared with the decline of 1.1% in Q1), reflecting the dynamism of sales to Russia and the CIS countries, China and the OPEC countries, which contrasts with the fall in exports to Latin America. In the first five months of the year, exports thus posted a higher real growth rate than in 2007 (6.4% against 4.2%).

On QNA figures, real tourist services exports in 2008 Q1 maintained the moderation they had shown in the previous quarter, increasing by a year-on-year rate of 0.4% (0.3% in 2007 Q4) and abandoning the declining path on which they moved in the second and third quarters of 2007. Likewise, the main real indicators of tourism have so far in Q2 moved further along the improving path observed since late 2007. On figures to May, both inflows of foreign tourists and the number of overnight hotel stays show higher growth rates (3.5% and 4.2%, respectively) than the average for the previous year. EGATUR, the tourism expenditure survey, reveals a somewhat more expansionary performance by tourism receipts over the course of the first five

months of the year, with average increases of 6.7% in total nominal expenditure by tourists and of 3.2% in average spending per person. This is the result of the recovery, following the slackness of the previous years, in the markets that are the main suppliers of tourists for Spain, especially Germany (with an average increase of 3.3% in the January-May period) and, to a lesser extent, the United Kingdom and France (with respective growth rates of 2.9% and 2%).

Real exports of non-tourist services continued to slow during 2008 Q1, dipping to 9.2% from 11.7% the previous quarter. Drawing on Balance of Payments disaggregated information by type of service, the main contributing factor to the slowdown was transport services, since receipts from services provided to business recovered slightly, although they continued to grow at moderate rates, in contrast to the high increases they displayed for much of the previous year. On Balance of Payments figures for April, tourism receipts in Q2 may be expected to hold on the recovery path initiated late last year, while receipts from other services should moderate.

Turning to real goods imports, the growth rate of this variable in 2008 Q1 on QNA figures rose to 5.9% year-on-year, 1.2 pp up on the previous quarter, though similar to the average increase observed the previous year. This acceleration, which was sharper according to Customs figures (seasonally adjusted data<sup>1</sup>), was centred on the intermediate goods component, especially energy goods, since consumer goods imports slowed and capital goods imports fell. The latest figures, for April and May, show a significant slowdown in real imports to 4.4% year-on-year. Once adjusted for the Easter effect, this rate declines to 1.7%, clearly down on Q1. By product group, there was a marked fall-off in capital goods imports (which declined by 14.9% in real terms), this being essentially due to the notable fall in imports of maritime transport equipment and, to a lesser extent, of machinery, especially construction machinery. Likewise, consumer goods imports also posted a negative rate in this period (-1.8% in real terms), reflecting the unfavourable behaviour of imports of cars and other consumer durables, such as household electrical goods. Conversely, imports of non-energy intermediate goods retained their dynamism in April and May, growing at a rate of 9.9% as a result of the robustness shown by purchases of intermediate products intended for the electrical equipment, chemical and foodstuffs industries. After growing at a rate of 30% in Q1, real imports of energy intermediate goods eased in April and May, although they increased at a rate of 11.6%, despite their prices rising notably. In the five months to end-May, real goods imports grew by 5.9%, 1 pp less than the rate for the whole of 2007.

Lastly, in QNA terms, real services imports increased by scarcely 1.3% in Q1, with the slowdown initiated the previous quarter intensifying. This performance was the result of the slowdown both in real imports of non-tourist and tourist services (whose year-on-year rates dipped to 1.2% and 1.8%, respectively). Under non-tourist services, and drawing on Balance of Payments disaggregated data, there was a clear loss of momentum under its main component, namely business services, while payments for insurance and IT services fell. The Balance of Payments figures for April suggest that imports of services – tourism and other services alike – will continue on this declining trend during 2008 Q2.

## **4.2 Output and employment**

In 2008 Q1 the slowing profile shown by the market economy throughout 2007 steepened, meaning that the growth rate of its gross value added declined to a year-on-year rate of 2.5%, 0.8 pp down on the previous quarter. With the exception of agriculture and energy, all the productive sectors contributed to this loss of dynamism in activity, which was more acute in the case of manufacturing industry and of construction. The information available for 2008 Q2 points to a further moderation in market economy value added, which will likewise be more

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1. The different course shown since end-2007 by real goods imports in Customs terms and in QNA terms is due to the fact that in this period the imports UVI has increased by around 3 pp less than the imports deflator.

notable in these two branches (see Chart 19). Foreseeably, GVA in industry will show a more pronounced decline than that observed the previous quarter and the growth rate in construction, which was still positive at the start of the year, will turn negative in Q2. It is estimated that market services will slow, but to a lesser extent than the other sectors.

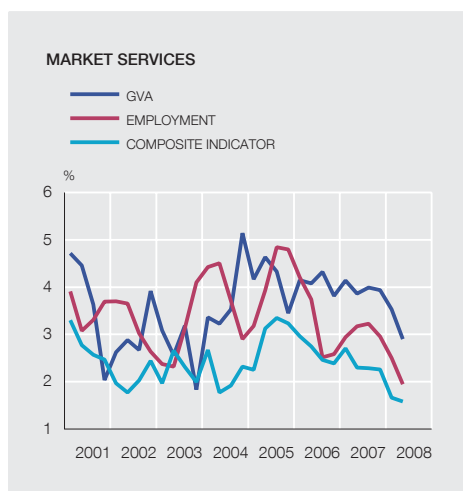
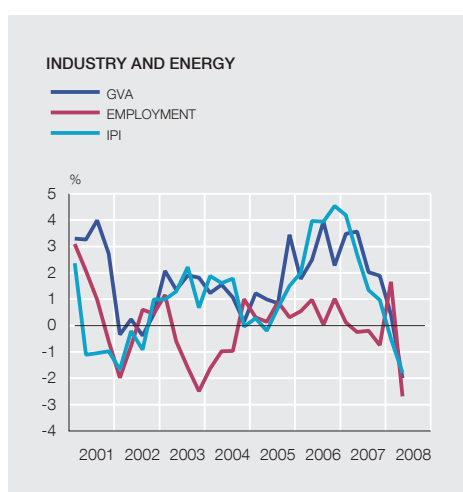
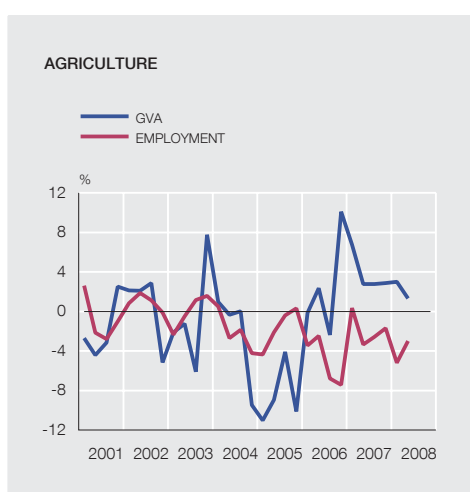
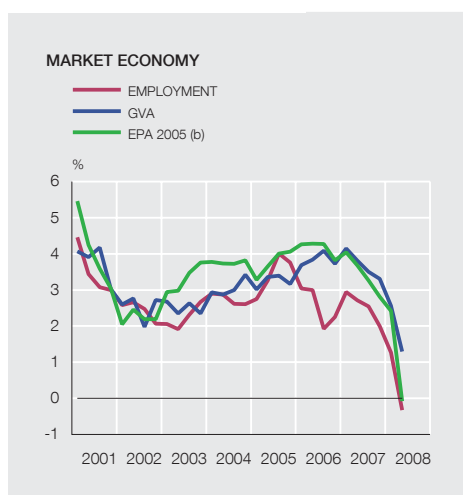
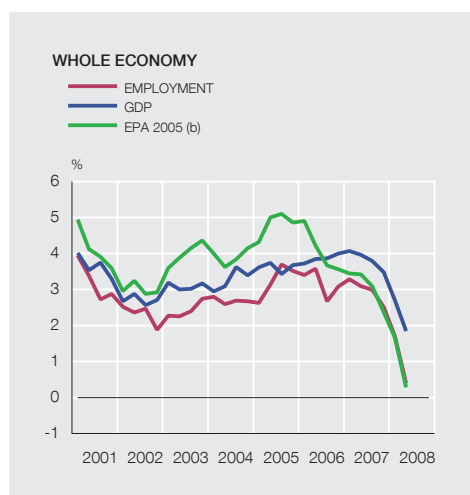
Activity in the agriculture and fisheries sectors grew in the period January-March 2008 at a rate of 3%, a very similar figure to the previous quarter. Nonetheless, GVA in this sector is expected to show a lesser pace in Q2, since the heavy rainfall recorded in April and May has been unable to offset the adverse effects of the scant winter rainfall on crop yields that account for a highly significant portion of the branch as a whole, as is the case of cereals and fruits.

Output in the industrial and energy sectors evidenced a notable loss of dynamism in Q1, accentuating the slowdown initiated in the second half of 2007. On QNA figures, the growth rate of GVA in these branches declined by 1.5 pp to a year-on-year rate of 0.4%. This slowdown essentially reflected the unfavourable course of industrial activity, whose GVA fell by 0.3% year-on-year in 2008 Q1, since value added in the energy sector continued to grow at a high rate (4%). The conjunctural indicators for Q2 point to a decline in industrial activity on a greater scale than in Q1, as a result of the fall-off in the demand for goods intended both for final household consumption and for use as inputs in market services and, above all, in construction. Notable among the quantitative indicators was the behaviour of the industrial production index; the year-on-year rate of fall in its non-energy component steepened in April and May relative to Q1, mirroring the trend of large corporations' domestic sales of industrial goods. Social Security registrations declined slightly in year-on-year terms in 2008 Q2 (having posted growth of 0.8% in Q1), while the rate of increase of the number of registered unemployed quickened to over 10%. Opinion-based surveys also point to a further worsening in industrial activity in Q2. Both the European Commission's confidence indicator and the manufacturing PMI presented a far lower value in Q2 than that recorded in Q1, with a significant decline in the assessment of order books.

Turning to construction activity, the slowdown already evident throughout 2007 intensified in 2008 Q1. GVA grew at a year-on-year rate of 1.4%, half the figure for the closing months of 2007. It is estimated that this trend has stepped up in Q2, judging by the decline observed (as indicated in the description of the outlook for investment in construction) in residential and non-residential building projects.

Finally, the growth rate in the services sector also eased in 2008 Q1, albeit less sharply than in industry and construction. Value added in services branches as a whole rose by 3.7% year-on-year, 0.5 pp below the related Q1 increase. This slowdown was more marked in non-market services (0.8 pp, to 4.2%), although they continued to show higher rates. As to market services, the growth rate of their value added declined by 0.4 pp to 3.5%. The conjunctural information available for Q2 suggests that the loss of momentum will have been somewhat sharper in this period. The average number of Social Security registrations in the sector increased at a year-on-year rate of 2.2% in the April-June period, 0.7 pp down on 2008 Q1, while the pace of large corporations' sales of services, in real and calendar-adjusted terms, fell in April and May compared with the growth in Q1. The European Commission's indicators of confidence in the services sector and in the retail trade worsened in Q2, as did the PMI index, reaching historical lows in some cases.

On QNA data, the slowing path of the rate of job creation economy-wide steepened in 2008 Q1. Specifically, the year-on-year growth rate of employment declined by 0.8 pp to 1.7%. This slowdown was approximately similar in the market economy, where employment increased by 1.3%. In the latter case, this diminished employment generation was accompanied by the lesser momentum of value added, meaning that productivity held unchanged at 1.3%.



SOURCES: INE, Ministerio de Fomento and Banco de España.

a. Year-on-year percentage rates based on seasonally adjusted series, except gross series in the EPA. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

b. Series linked by the Banco de España's DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

The indicators available point to job creation having adjusted sharply downwards during Q2. The growth in the number of Social Security registrations, calculated with average daily data, declined to 0.5%, compared with growth of 1.7% in Q1. However, registered hires drawing on INEM (National Public Employment Service) figures held at the same rate of decline in Q2 on average as in Q1 (-7.2% year-on-year).

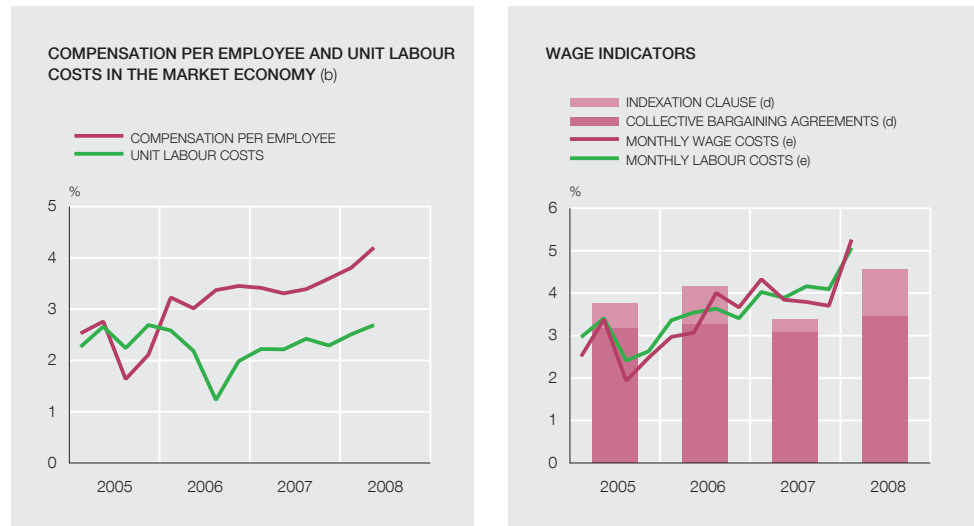
As regards the breakdown by productive branch of QNA data for 2008 Q1, job destruction in the construction sector – an event not witnessed since the early 90s – was notable. Specifically, the loss of equivalent jobs amounted to 1.1% year-on-year, a figure that contrasts with the positive growth of 3.3% in 2007 Q4. Likewise, as in the previous quarters there was further job destruction in agriculture, albeit on a much higher scale, where a negative year-on-year rate of -5.2% was recorded, compared with the end-2007 figure of -1.7%. Conversely, in the industry and energy branches, and contrary to what was observed throughout 2007, there was a pick-up in employment, which grew at a year-on-year rate of 1.7% compared with the decline of 0.7% in the previous quarter. Finally, the pace of job creation slowed both in market and non-market services alike, to 2.5% and 3.6%, respectively (these rates were 0.5 pp and 1.1 pp lower than those of the previous quarter). The indicators available for Q2 suggest job destruction has taken place both in industry and in construction, while job creation in services has slowed. In this respect, the EPA data for Q2 confirm a 7.9% decline in employment in construction, compared with the fall of 1.1% in Q1, and a slowdown in industry, albeit at a still-positive rate of 0.9%, against 1.7% the previous quarter. Employment in agriculture continued to fall at a rate of -4.4%, compared with -6.8% in Q1. Finally, the rate of job creation in market services declined by 2.4 pp to 2.6%.

According to QNA figures, the rate of increase of both dependent employment and self-employment eased in 2008 Q1, although the slowdown was sharper in the former category, as is habitual in phases of economic slowdown. Specifically, the respective rates of increase declined by 0.9 pp and 0.2 pp to 1.9% and 0.4% relative to the same period in 2007. On EPA data, however, the loss of steam in employment generation in 2008 Q1 was relatively similar among both categories, which meant that the proportion of dependent employees to total numbers employed in the economy held stable at 82.4%, scarcely 0.1 pp below the figure a year earlier.

The EPA data for Q2 infer that the slowdown in employment affected both Spanish and foreign workers, although the latter maintained a rate of net job creation of 6.9%, compared with -0.75% in the case of nationals. In terms of contractual duration, permanent employment retained the high momentum of 2008 Q1, with a year-on-year growth rate of 4.1%; nonetheless, this rate was 0.4 pp down on the previous quarter. The year-on-year rate of decline of temporary employment steepened to -7.4%. As a result, the ratio of temporary to permanent employees fell significantly during the quarter to 29.4%, 2.6 pp down on one year earlier. Lastly, both part- and full-time hires showed positive though lower growth of 0.37% and 0.27% in year-on-year terms, respectively. As a result, the ratio of part-time to full-time employees held at 12%.

The labour force grew at a rate of 3.1% in 2008 Q2 compared with the same period a year earlier, 0.1 pp up on the previous quarter. The participation rate rose by almost 1 pp in year-on-year terms to 59.8%. However, growth in the over-16 population stood at 1.5%, 0.1 pp less than three months earlier, and confirmed the process of deceleration evident in Q1. By sex, women continued to contribute more than men to the rise in the labour force in Q2 (4.6% against 2%). Specifically, the respective participation rates for women and men were 50.3% (1.4 pp more than a year ago) and 69.6% (0.3 pp up on a year ago). By nationality, the foreign labour force continued to show very high dynamism, despite the moderation observed in the related year-on-year increase (12.6%, 0.9 pp less than the rate one quarter earlier), while in the case of Spanish nationals growth was 1.5% (against 1.3% in 2008 Q1). The high participation rate of foreigners (76.7%) held up.





SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo e Inmigración and Banco de España.

- Percentage change on same quarter a year earlier.
- Rates based on QNA seasonally adjusted series.
- Information on collective bargaining agreements to June 2008.
- Previous year's indexation clause.
- ETCL (quarterly labour costs survey).

Finally, the result of the slowdown in the pace of job creation, combined with the continuing dynamism of the labour force, was the notable growth in unemployment in 2008 Q2 of the order of 621,000 people compared with the same period in 2007. This translated into a 35.3% year-on-year increase in joblessness, which took the unemployment rate to 10.4%, 0.8 pp up on the previous quarter.

### 4.3 Costs and prices

On QNA estimates, compensation per employee economy-wide posted year-on-year growth of 3.9% in 2008 Q1, 0.1 pp up on the previous quarter (see Chart 20). However, this wage rise is below that inferred by the quarterly labour costs survey, according to which the rate of change in average monthly wage costs increased by 1.1 pp to 5.1%, a pace more in keeping with the increase in wage settlements for 2008 and the estimated impact of the indexation clauses relating to 2007.

The information available indicates that compensation per employee is expected to have risen once again in Q2. Collective bargaining agreements signed in the period to June, which affect 7.2 million workers, show an average increase in wage rates of 3.5% for this year. This figure, which is almost 0.6 pp higher than the agreed increase in 2007 (without considering the impact of activation of the indexation clause), is above the guidelines agreed in the Inter-Confederal Agreement for Collective Bargaining for 2008. As usually occurs at times of worsening inflation, the wage settlements accorded in newly signed agreements have been higher than those incorporated into the revisions of agreements spanning several years (4.2% and 3.4%, respectively), although the proportion of workers availing themselves of the latter agreements is far higher, at close to 95% of the total. The estimate of the impact of the indexation clauses for 2007 (which affect around 74% of workers with an agreement in that year) on wage increases in 2008 is 1.1 pp, 0.8 pp up on the previous year, which is the result of the high inflation rate at end-2007. This highlights how the wage indexation mechanisms in place in Spain can contribute to transitory increases in inflation, such as that prompted by higher oil prices, influencing labour cost trends adversely, and hampering the adjustment of the economy when faced with a change in cycle as at present.





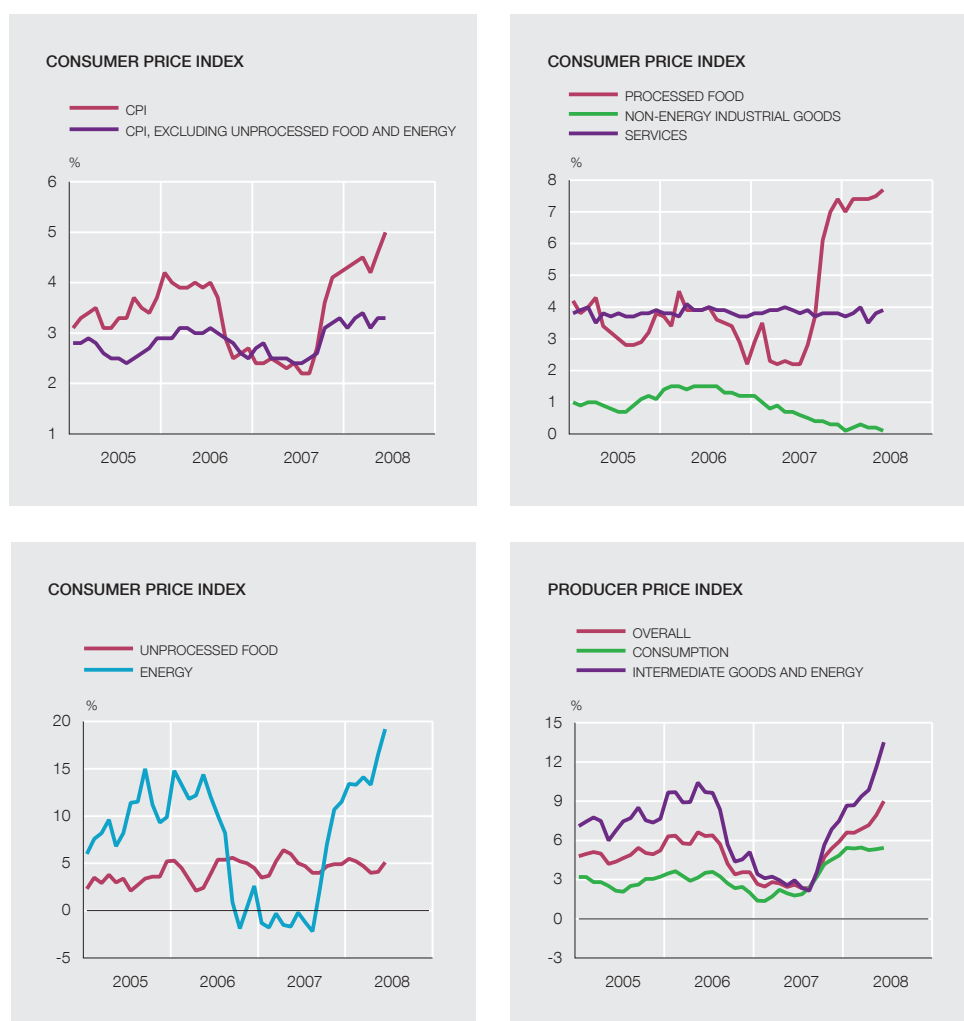
SOURCES: INE and Banco de España.

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

The acceleration in compensation per employee in Q1 was, according to QNA figures, similar across the economy to the rise in productivity, meaning that unit labour costs (ULCs) maintained a growth rate unchanged on end-2007, at 2.9% year-on-year. Nonetheless, in the market economy the growth rate of ULCs increased by 0.2 pp to 2.5%, as a result of the acceleration in compensation against a background of ongoing increases in productivity (see Chart 21). Compensation per employee is expected to rise to a greater extent than productivity in 2008 Q2, meaning that ULCs should quicken once again.

The rate of increase of the final demand deflator increased in 2008 Q1 to 3.6%. This rise reflected the 0.6 pp increase to 5.1% of the rate of expansion of the deflator of goods and services imports. The growth rate of the GDP deflator also stepped up in 2008 Q1, albeit more moderately, to 3.1%, 0.2 pp up on 2007 Q4. This increase continued to be higher than that recorded by ULCs, so margins continued to widen, despite the sluggishness of demand. On the expenditure side, the private consumption deflator accelerated by 0.4 pp to 3.1%, somewhat below the rise in the CPI.

According to the various indicators, the upward trend in prices initiated in the second half of 2007 has continued during Q2. The year-on-year rate of change in the CPI increased once more in this period, standing at 4.6% for the quarter as a whole, 0.2 pp up on Q1 (see Chart 22). This rise shows inflation to be on a rising path over the course of the quarter, and to have risen to 5% in

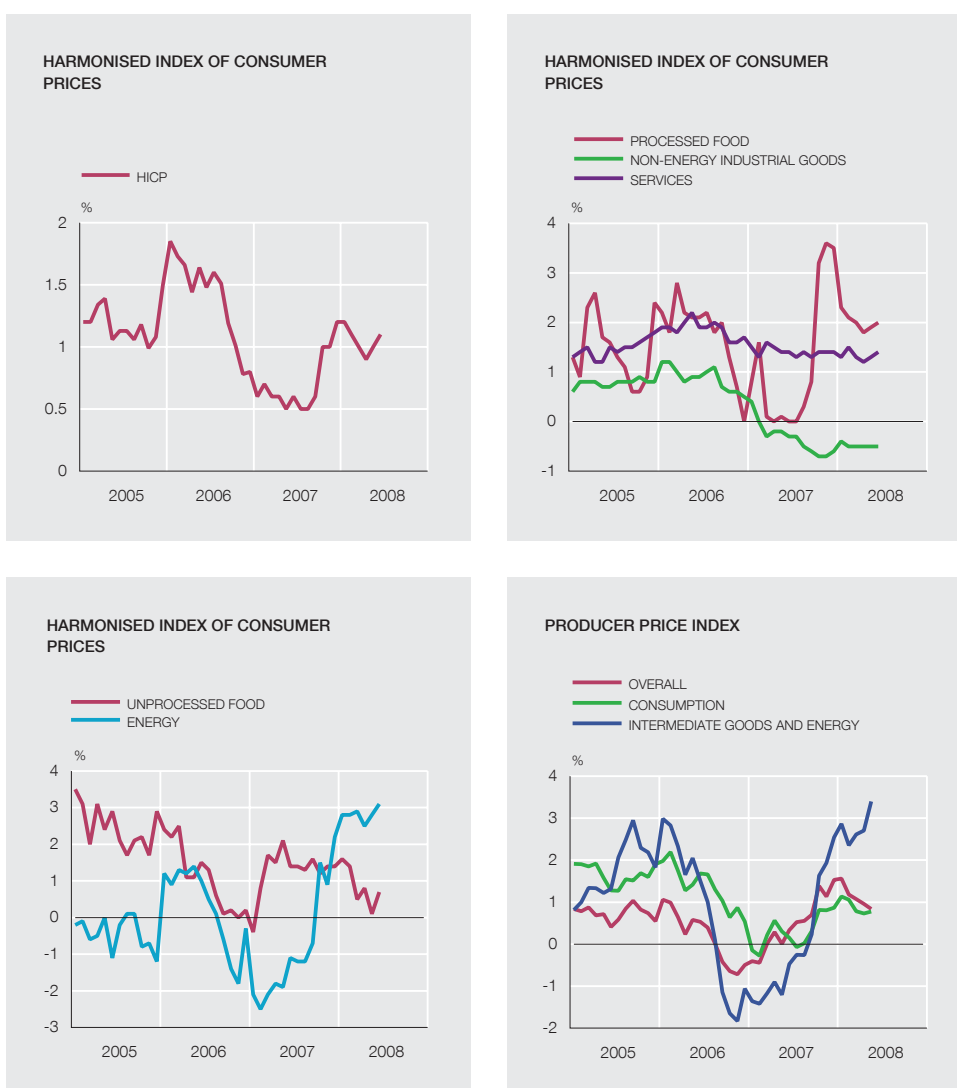


SOURCE: INE.

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

June, a rate not seen since July 1995. Behind these developments is the significant hike in energy prices and, to a lesser extent, in processed food prices. Indeed, for the third quarter running, energy prices accelerated significantly to a year-on-year rate of 16.8%, owing to the considerable rise in oil prices (the price of Brent oil exceeded \$130 per barrel in June). Processed food prices rose once again in the quarter, on this occasion by 0.2 pp, to 7.5%. While the year-on-year rate of increase of bread and cereal prices, and of alcoholic beverages, continued to increase in Q2, milk prices eased, although they continued to post very high year-on-year growth rates.

In contrast, the year-on-year growth rates of both unprocessed food and services prices eased in relation to the previous quarter (by 0.6 pp and 0.2 pp, respectively), although they continued to show very high rises (4.4% and 3.7%). The slowdown in the pace of unprocessed food prices interrupted the rising trend on which they had been moving since the second half of 2007. In June, however, there was a further rise in the price of certain products, as a result of the impact of the strike by fishermen and road hauliers. Turning to services prices, although their average year-on-year rate of change dipped in Q2, it showed a rising trend over the course of the quarter. This is partly the result of the pass-through of the increase in costs induced by dearer oil to the prices of specific services, such as air transport and package tours.



SOURCES: Eurostat and Banco de España.

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

Finally, non-energy industrial goods prices maintained in Q2 the moderate growth observed in the previous months (0.2% year-on-year). This variable continued to be favoured by the ongoing decline in the prices of cars and of electronic and IT equipment, and by the downward impact on the prices of specific articles (clothing and footwear) of special offers and promotions in the run-up to the official sales period. As a consequence of the developments in the various components, the average year-on-year rate of change of the CPI excluding unprocessed food and energy in Q2 held stable at the figure for Q1 (3.2%).

As in the case of the CPI, inflation measured by the harmonised index of consumer prices (HICP) rose by 0.2 pp over the course of Q2 to 4.7%, although in June this rate was even higher (5.1%). In the euro area as a whole, the average quarterly rate of inflation increased by 0.3 pp to 3.6% (and 4% in June), meaning that Spain's inflation differential with the euro area narrowed by 0.1 pp over the course of the quarter to stand at 1 pp (see Chart 23). Contributing to these developments was the significant correction in the differential in the case of processed and – especially – unprocessed food prices, due in this latter instance to the easing of inflation

in these goods in Spain. The services inflation differential also narrowed, albeit to a lesser extent, while that relating to energy goods held stable at around the figure for the preceding quarter. The inflation differential (in this case negative) for non-energy industrial goods also held steady.

Finally, the producer price index remained throughout 2008 Q2 on the path of high growth on which it embarked in late 2007, rising to an average year-on-year rate of 8%, 1.3 pp more than in Q1. The rise is due exclusively to the notable increase in the producer prices of energy goods, which grew by 21.1% in Q2, against 13.8% in Q1. In the remaining components, producer prices tended to hold stable, easing slightly in the case of consumer and capital goods, and edging up in intermediate goods. In the euro area as a whole, producer prices posted a year-on-year rate of increase of 7.1% in May, enabling the inflation differential with the euro area to narrow that month to 0.8 pp, 0.3 pp below the March figure. Export and import producer prices quickened somewhat in May to 2.8% and 9.3%, respectively, as a result of their energy component. Meanwhile, the remaining items broadly displayed much more moderate growth rates or even declines in prices, as was the case of consumer durables, in terms of both exports and imports.

#### **4.4 The State budget**

According to the National Accounts methodology, the figures published on the State budget outturn in the first half of the year show a marked contrast to the trend of recent years, having posted a deficit of €4,683 million (0.4% of GDP) in the six months to June 2008 compared with the surplus of €5,218 million (0.5% of GDP) in the same period in 2007. This result was essentially due to the 4.8% decline in resources, set against the 10% increase in uses. Admittedly, it should be borne in mind that, in seasonal terms, June is one of the months in which the State balance is lowest, whereby a recovery might be expected in the following months; but it should also be considered that the figures for this year do not yet reflect the impact of the new personal income tax credit for taxpayers of up to €400, which will only begin to be apparent from July onwards, reducing revenue for the second half of the year.

Along the same lines, the cash-basis outturn shows a deterioration in the budgetary situation. The State posted a deficit of €2,065 million in the first half of 2008, in contrast to the surplus of €4,168 million recorded in the same period in 2007 (see Table 3).<sup>2</sup> This change is due mainly to the ongoing decline in tax revenue, which reflects both the influence of the slowdown in the economy on takings and the impact of the measures approved by the government, some of which have already begun to be applied. Given the observed course of revenue and the outlook for the second half of the year, for 2008 as a whole there will foreseeably be significant deviations between actual and budgeted revenue. Conversely, the Social Security budget outturn shows a notable improvement, as described in Box 4.

For the analysis of revenue, information is available on total takings under the main taxes, both for the portion assigned to the State and that relating to the ordinary-regime Territorial Governments. According to this information, revenue declined by 0.9% in the first half of 2008 compared with the same period a year earlier, owing mainly to the negative course of VAT and corporate income tax takings. Conversely, personal income tax remained robust, with growth of 14.9%, underpinned mainly by revenue relating to withholdings on earned and unearned income, which increased by 9.8% and 36.8%, respectively. In the coming months, however, the aforementioned personal income tax credit will foreseeably prompt a notable slowdown in this

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2. The discrepancy between the balance in cash-basis terms and in National Accounts terms is mainly due to the adjustment for the different interest imputation criterion and for the change in receivables and payables.

The Social Security system posted a surplus of €11,301 million in the period January-April 2008, up 16.8% on the same period a year earlier. Revenue increased by 11.4% to April compared with the same period 12 months earlier, while the increase in expenditure amounted to 9.5% (see accompanying table).

Revenue from social security contributions rose by 7.7% to April, standing slightly above the budgeted increase for 2008 as a whole. The loss of dynamism in the labour market was manifest in the 0.9% reduction in the number of Social Security registrations in the first half of the year, the first such fall since 1994.

Turning to expenditure, the growth of that earmarked for contributory pensions grew by 7.8% to April, above the figure budgeted for the year as a whole. In the first six months of 2008 the number of contributory pensions has been running at a rate of 1.4%, similar to the

previous year's figure (1.3% for 2007 as a whole). The growth rate of expenditure on sickness benefits climbed by 7.1% to April, likewise above-budget for 2008.

As regards the SPEE (National Public Employment Service), the information on revenue for 2007 is not yet available. The growth of expenditure earmarked for unemployment benefits quickened markedly in the first five months of the year, increasing by 21.2% in year-on-year terms to May 2008. The coverage ratio in the same month stood at 70.4%, somewhat less than 4 pp above the rate recorded in the same month of 2007. On data to May, the number of beneficiaries increased by 28.1% compared with the same month in 2007, while registered unemployment grew at a year-on-year rate of 21.4% in the same period. The latest information available on registered unemployment shows a further acceleration to 23.9% in the first half of the year, in line with the loss of momentum in the labour market.

#### SOCIAL SECURITY SYSTEM (a)

##### Transfers to regional governments allocated (b)

##### Current and capital transactions, in terms of recognised entitlements and obligations

EUR m and %

	Budget			Outturn JAN-APR		
	2007	2008	% change	2007	2008	% change
	1	2	3 = 2/1	4	5	6 = 5/4
1 REVENUE	106,142	114,081	7.5	36,592	40,767	11.4
1.1 Social security contributions	97,942	105,107	7.3	33,680	36,262	7.7
1.2 Current transfers	5,963	6,796	14.0	2,041	3,322	62.8
1.3 Other	2,237	2,177	-2.7	870	1,182	35.8
2 EXPENDITURE	98,390	106,048	7.8	26,915	29,466	9.5
2.1 Wages and salaries	2,253	2,412	7.1	658	704	7.0
2.2 Goods and services	1,807	1,978	9.5	487	503	3.4
2.3 Current transfers	93,743	101,056	7.8	25,721	28,156	9.5
<i>Contributory pensions</i>	<i>80,099</i>	<i>86,041</i>	<i>7.4</i>	<i>22,098</i>	<i>23,820</i>	<i>7.8</i>
<i>Sickness</i>	<i>7,313</i>	<i>7,716</i>	<i>5.5</i>	<i>1,947</i>	<i>2,085</i>	<i>7.1</i>
<i>Other</i>	<i>6,331</i>	<i>7,300</i>	<i>15.3</i>	<i>1,677</i>	<i>2,251</i>	<i>34.3</i>
2.4 Other	588	601	2.2	49	103	111.0
3 BALANCE	7,752	8,033	3.6	9,677	11,301	16.8

SOURCES: Ministerio de Economía y Hacienda, Ministerio de Trabajo e Inmigración and Banco de España.

a. Only data relating to the system, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security funds will not be available until October 2008.

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.

EUR m and %

	Outturn							
	Outturn 2007	Percentage change 2006/2007	Initial Budget 2008	Percentage change 2008/2007	Outturn JAN-MAR Percentage change 2008/2007	2007 JAN-JUN	2008 JAN-JUN	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
<b>1 REVENUE</b>	159,840	12.7	158,757	-0.7	1.1	69,126	65,624	-5.1
Direct taxes	96,980	19.5	90,753	-6.4	9.6	32,003	33,398	4.4
<i>Personal income tax</i>	48,626	17.3	43,260	-11.0	8.7	21,445	24,378	13.7
<i>Corporate income tax</i>	44,823	20.5	44,420	-0.9	20.1	8,937	7,368	-17.6
Other (a)	3,531	42.8	3,073	-13.0	8.1	1,621	1,651	1.9
Indirect taxes	48,445	0.2	53,363	10.2	-7.2	30,515	24,989	-18.1
VAT	33,752	-4.7	38,205	13.2	-9.5	23,567	18,192	-22.8
<i>Excise duties</i>	11,468	15.9	11,661	1.7	2.5	5,386	5,243	-2.6
Other (b)	3,224	7.2	3,497	8.5	6.3	1,561	1,554	-0.5
Other net revenue	14,415	16.4	14,641	1.6	7.1	6,608	7,237	9.5
<b>2 EXPENDITURE</b>	139,704	7.2	152,331	9.0	4.1	64,958	67,689	4.2
Wages and salaries	23,678	6.6	25,378	7.2	2.7	11,722	12,601	7.5
Goods and services	4,454	17.2	3,563	-20.0	-1.2	1,956	1,906	-2.5
Interest payments	14,539	-6.9	16,631	14.4	14.6	6,521	7,519	15.3
Current transfers	77,680	7.6	83,372	7.3	3.0	36,467	38,111	4.5
Contingency fund and other unforeseen expenditure	—	—	3,100	—	—	—	—	—
Investment	10,106	11.8	10,588	4.8	0.0	4,601	4,452	-3.2
Capital transfers	9,248	23.5	9,699	4.9	-4.3	3,692	3,101	-16.0
<b>3 CASH-BASIS BALANCE (3 = 1 – 2)</b>	20,135	—	6,426	—	—	4,168	-2,065	—
<b>MEMORANDUM ITEM: NATIONAL ACCOUNTS</b>								
Resources	165,171	12.2	157,166	-4.8	1.3	70,332	66,934	-4.8
Uses	151,877	6.2	153,920	1.3	12.8	65,114	71,617	10.0
<b>NET LENDING (+) OR BORROWING (-)</b>	13,294	—	3,246	—	—	5,218	-4,683	—
(as a percentage of GDP)	1.3	—	0.3	—	—	0.5	-0.4	—

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.

revenue. Corporate income tax, following the first prepayment, declined strongly by 17.6%, owing both to the deterioration in taxable income and to the impact of the second phase of the reduction in the standard tax rate for large corporations (from 32.5% to 30%) and of the change in the means of calculating prepayments<sup>3</sup>. Under indirect tax, there was a decline in VAT takings, which posted a negative rate of -14.2% compared with the same six-month period in 2007. In this case, developments have been affected both by the impact of the economic slowdown and by the bringing forward of refunds and the change in the treatment of corporate groups, which enables them to offset balances payable by and refundable to the various group companies (which is tantamount to bringing forward refunds applied for). The items aggregated under "Other State revenue" (see Table 3) showed relatively high growth owing partly to the share in Banco de España profits and to the net difference between public debt redemptions and issues.

3. The aim of this measure is to postpone the tax effects of the accounting adjustments on these payments arising from the application of the new Spanish Chart of Accounts.

The growing internationalisation of economies has not only boosted global trade but has also wrought significant changes in its composition. Specifically, developing countries' exports to the industrialised economies have been on a rising trend throughout the past decade, in particular in the case of consumer goods (owing to lower price levels in the developing countries) and of non-energy intermediate goods (given the spatial fragmentation of production aimed at taking advantage of low-wage countries). Consequently, there has been a generalised increase in the degree of import penetration in the developed countries, to which Spain has been no exception.

On Spanish National Accounts data, the penetration of goods and services imports has increased to some extent from the late 90s to the present day (see panel 1). As a proportion of final demand, total imports in nominal terms accounted for 24.1% in 2007, around 3 pp above the related 1998 figure. This increase is far higher when the figures are considered in real terms; the percentage rises to 28.7% in 2007 compared with 21.9% in 1998.

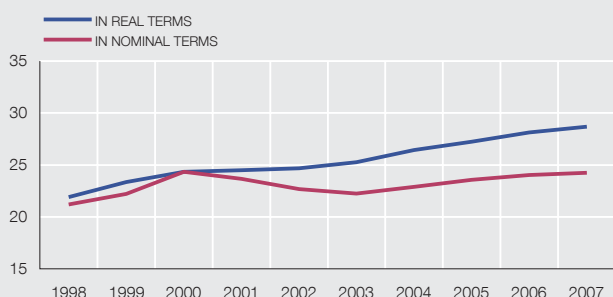
An initial approximation to the relevance of imports in each of the final demand components could be obtained from the Spanish Customs foreign trade figures, which provide information broken down by type of good (see panel 2). According to these figures, which should nonetheless be viewed with caution since they combine information from two different statistical sources, the weight of final consumer goods imports, in nominal terms,

increased by 3 pp from 1998 to 2007 to 13.1% (by 5.4 pp in real terms to 15.5%). The weight of capital goods imports also climbed in nominal terms relative to total investment in equipment, rising by 4 pp over the period considered to 40.7% in 2007 (by 12.7 pp in real terms to 49.3%).

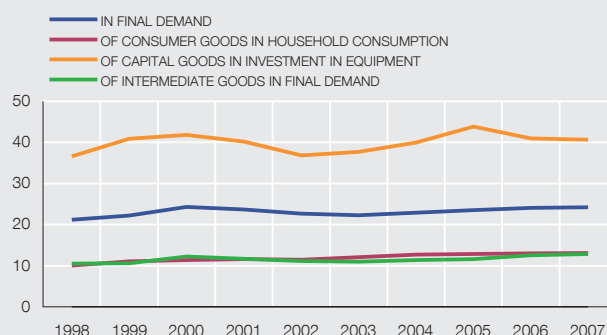
However, the foregoing data do not take into consideration the imported intermediate inputs used in domestic productive processes and which, once transformed, are recorded as part of national production; accordingly, this approximation, especially in a setting in which the fragmentation of production is of greater importance, would be underestimating the import content of each component of final demand. The weight of imported intermediate goods in total final demand is significant and, moreover, it has increased since 1998 by 2.4 pp, in nominal terms, to 12.9% (by 3.1 pp, to 13.8%, in real terms). In order to assign imported intermediate goods to the different components of final demand, it is necessary to resort to the Spanish National Accounts input-output tables. These provide information allowing the final destination of these imports to be estimated. The results drawn from this information for 1998, the last year for which the tables have been used to this end, are given in panel 3.<sup>1</sup>

1. These calculations are not made immediately, hence the use made of the input-output tables is with some delay. Recently, INE has published the input-output tables for 2004 and has revised those previously published for 2000 and 2001. The initial results obtained with this information did not differ substantially from those presented in this box.

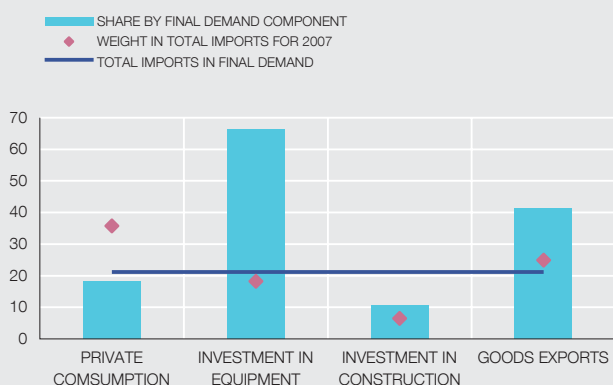
**1 IMPORT PENETRATION IN FINAL DEMAND**  
Goods and services



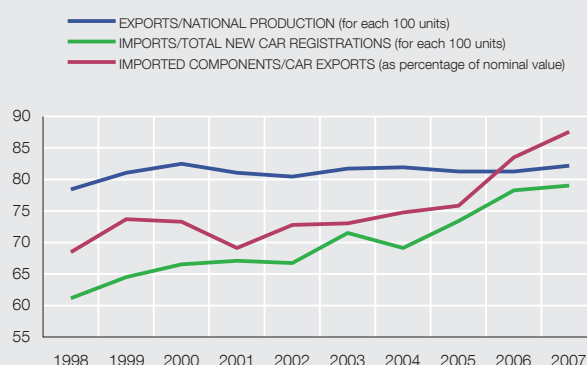
**2 IMPORT PENETRATION BY PRODUCT GROUP**  
In nominal terms



**3 SHARE OF IMPORTS IN MAIN COMPONENTS OF FINAL DEMAND**



**4 FOREIGN TRADE IN AUTOMOBILES**



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

As might be expected, by making this adjustment the import content of the various components of demand increases in comparison with that obtained directly from the Customs figures and from the National Accounts components. According to these figures, investment in equipment was the demand component that showed the highest import content (66.3%) in 1998, followed by goods exports (41.2%) – far higher in both cases than the weight of total imports in final demand (21.2%) – and, some distance back, by household final consumption (18.2%). Once the imported intermediate inputs have been redistributed among the final demand components and these weights have been applied to the 2007 figures, it is seen that in this year total imports were chiefly earmarked for private consumption (35.7%), to a lesser extent for goods exports (24.9%) and, finally, for investment in equipment (18.3%).

These data show that, when explaining the high import content of final demand in Spain, factors other than those mentioned in the introduction (mainly the penetration in the Spanish market of products from the emerging economies) come into play. These include the growing de-

mand for goods and services of higher value added content, the result of the higher level of household per capita income<sup>2</sup>, Spanish companies' dependence on imported technology and the importance of imported energy inputs. Finally, the weight in the export structure of sectors such as the car industry, which use a very high proportion of imported intermediate goods, should be taken into account. Panel 4 illustrates this point. It can be seen that imports of car components – intermediate inputs in the automobile industry – show a high and positive correlation with the industry's situation, as they have shown higher growth rates in recent years than those recorded by car exports (80% of domestic car production is for the foreign market). In sum, various factors relating to growing globalisation, which have affected all economies to differing degrees, along with other factors specific to Spain appear to explain the increase in the degree of import penetration in recent years.

2. Drawing on Spanish National Accounts figures for the period 2000-2005, the expenditure on household final consumption that most grew in real terms was on communications, audiovisual and IT equipment and accessories, drugs and travel expenditure abroad.

State cash-basis expenditure increased by 4.2% year-on-year to June, below the budgetary forecast, which points to growth of 9% for 2008 as a whole. While expenditure on wages and salaries and on interest payments grew at a higher-than-budgeted rate for the year as a whole, spending on current transfers (mainly directed to other general government) was more moderate. Nonetheless, given the figures budgeted, an acceleration in this expenditure may be expected in the coming months.

#### **4.5 The balance of payments and capital account**

The Spanish economy's net borrowing (i.e. the overall deficit on current and capital account) stood at €38,260 million in the first four months of 2008, 13% up on the same period a year earlier, a rate that is still high but below that observed in recent years. This widening of the external imbalance reflected the deterioration in the current account balance, whose deficit increased by 15.5% in year-on-year terms to €40,720 million. This widening in the current account imbalance was essentially due to the increases in the energy deficit and, to a lesser extent, in the current transfers deficit, which more than offset the improvement seen in the non-energy deficit, in the services surplus and in the income deficit. The surplus on capital account improved notably by 77.9% to €2,460 million.

In the first four months of 2008, the deficit on the trade balance widened by €4,865 million relative to the level recorded in the same period of 2007, rising to €31,653 million (18.2% up on the figure for the first four months of 2007). This rate, though similar to that observed in 2007 Q4, is appreciably higher than that recorded over the whole of the previous year. Despite the fact that the growth rate of real goods exports quickened between January and April 2008 according to Customs figures, imports continued to post higher growth rates, driven by purchasers of energy products. The worsening terms of trade contributed to widening the differential between the growth rates of exports and imports in nominal terms (9.9% and 12%, respectively) and, therefore, to the further deterioration of the trade balance. Unlike in 2007, the energy bill, which increased significantly in the first four months of 2008, accounted for the widening of the nominal trade deficit in its entirety, set against the significant rise in net imports



EUR m		ENERO-ABRIL	
		2007	2008
CREDITS	Current account	109,198	119,923
	<i>Goods</i>	61,519	67,652
	<i>Services</i>	26,010	28,334
	— Tourism	10,488	10,804
	— Other services	15,522	17,530
	<i>Income</i>	16,027	19,131
	<i>Current transfers</i>	5,642	4,806
	Capital account	2,212	2,884
	Current + capital accounts	111,410	122,807
DEBITS	Current account	144,443	160,643
	<i>Goods</i>	88,307	99,304
	<i>Services</i>	21,979	23,485
	— Tourism	4,208	4,401
	— Other services	17,771	19,085
	<i>Income</i>	24,912	27,812
	<i>Current transfers</i>	9,245	10,041
	Capital account	829	424
	Current + capital accounts	145,272	161,066
BALANCES	Current account	-35,245	-40,720
	<i>Goods</i>	-26,788	-31,653
	<i>Services</i>	4,031	4,849
	— Tourism	6,281	6,403
	— Other services	-2,249	-1,554
	<i>Income</i>	-8,885	-8,681
	<i>Current transfers</i>	-3,603	-5,235
	Capital account	1,383	2,460
	Current + capital accounts	-33,862	-38,260

SOURCE: Banco de España.

a. Provisional data.

of energy products in real terms. Conversely, the non-energy trade deficit declined in nominal terms.

In the first four months of 2008 the services balance posted a surplus of €4,849 million, 20.3% higher than the same period in 2007. The widening of the surplus was due to the modest 2% improvement in the tourism surplus, to €6,403 million, and, to a greater extent, to the 30.9% correction in the deficit on other services, placing it at €1,554 million. Nominal tourism receipts increased by 3% in this four-month period, a rate below both that in 2007 Q4 and that for 2007 as a whole (4.5% and 3.6%, respectively). Tourism expenditure slowed to a year-on-year rate of increase of 4.6%, in step with the development of its main determinants and, in particular, with the loss of momentum in household spending. As to other services, the buoyancy of receipts in the first four months was more pronounced than that of expenditure (the respective growth rates were 12.9% and 7.4%), which meant that the deficit on this heading narrowed considerably.

Unlike in recent years, the deficit on the income balance fell slightly – by 2.3% year-on-year – in the first four months of 2008 to stand at €8,681 million. This decline was due to receipts outperforming expenditure, although both flows posted notable growth (19.4% and 11.6%, re-

spectively). By type of investment, the notable improvement in the surplus on net direct investment income countered the widening of the deficits on other investment and, in particular, on portfolio investment. The increase in the surplus on foreign direct investment income reflected the favourable trend of dividend income received by other resident sectors and of the fall in related payments. In contrast, the deficit on current transfers widened by 45.3% year-on-year in the first four months of 2008 compared with the same period a year earlier to €5,235 million. This was due both to the fall-off in revenue (–14.8% year-on-year) and to the increase in payments (8.6% year-on-year). The former was particularly influenced by the decline under the Community EAGGF Fund and in the taxes received by general government. The growth of payments reflected the increase in those made by the public sector to the EU (especially those under the GNI resource, which countered the decline in traditional own resources), while migrants' remittance payments declined slightly (–1.5%).

## 5 Financial developments

### 5.1 Overview

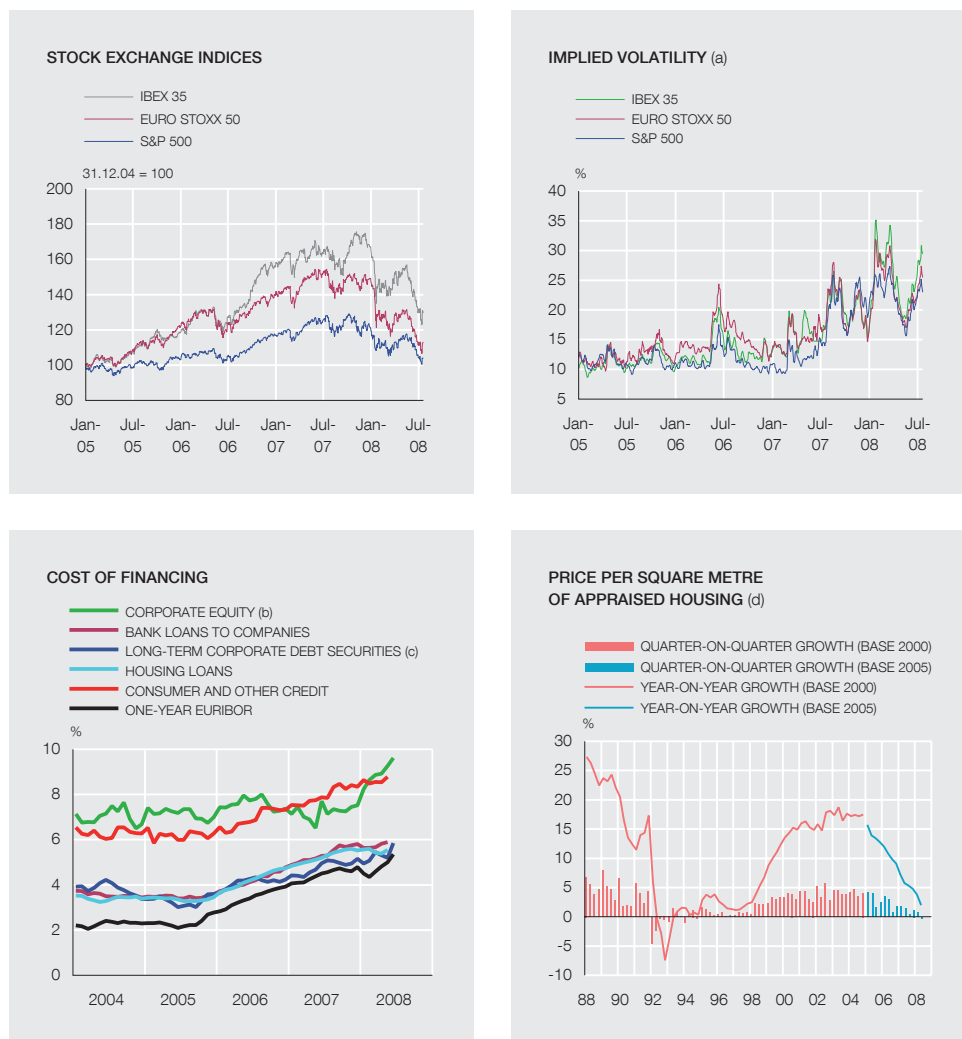
In 2008 Q2 interbank market interest rates again rose, and this trend was particularly marked at longer maturities. Thus 1-year Euribor stood at 5.4% at the end of June, up 0.7 pp on the rate three months earlier, and since then it has remained around that level until the cut-off date of this report. On this occasion the rise was linked to the upward revision of market expectations as to the future level of Eurosystem official interest rates (which rose by 25 bp at the beginning of July), and not to an intensification of the turmoil, since the difference with respect to secured transactions with the same time horizon (Eurepo) decreased slightly in this period to around 80 bp on 21 July, nearly 10 bp less than at the end of March.

The yield on government bonds also increased, most significantly in the case of five-year bonds (by more than 1 pp). Also, in April and the first fortnight of May the stock markets showed a certain recovery (higher prices and lower volatility) and a narrowing of credit spreads (see Chart 24). These trends, however, subsequently reversed. As a result, the Ibex-35 had lost 22% by 21 July this year, much more than the S&P 500 (14%) but somewhat less than the broad Euro Stoxx index (24%), and credit derivative premiums again rose above their end-2007 levels.

The latest information on private-sector financing conditions points to further tightening. Thus between March and May, the latest month on which information is available, the interest rates on new lending to households for consumer and other purposes and to non-financial corporations rose by somewhat more than 20 bp to 8.78% and 5.89%, respectively, while that on debt taken on for house purchases, which reflects with a certain lag the movements in interbank market interest rates, showed a smaller rise (up by 12 bp to 5.5%). In addition, it should be kept in mind that these figures do not take into account the June rise in Euribor rates. The cost for firms of raising funds through fixed-income securities and the cost of own funds also rose. Moreover, according to the April bank lending survey, credit institutions expected to apply tighter credit standards in the second quarter of the year.

In the real estate market, the latest data provided by the Ministry of Housing show that the slowing trend in unsubsidised housing prices continued between March and June, giving rise, for the first time in recent years, to a slight fall with respect to the previous quarter (down 0.3%). In year-on-year terms, the growth rate of the value of these assets continued to be positive (2%, down 1.8 pp on March).

Against this background, and in line with the observed behaviour of its determinants, the slowdown in private-sector debt apparent in previous quarters has continued in recent months. The year-on-year growth of households' liabilities in May was somewhat less than 10%, down nearly 1 pp on March. The growth rate of corporations' borrowing decreased more sharply (by more than 3 pp) to stand at around 12% in that same period. The annualised quarter-on-quarter rates point to smaller increases in the financing received by both sectors, of around 7% and 8%, respectively (see Box 6). The latest information on credit by productive purpose, which relates to Q1, shows that this slowdown was particularly marked in loans to the residential sector. Thus the rate of expansion of borrowing for real estate activities and construction decreased by nearly 7 pp and somewhat more than 2 pp, respectively, although continuing at high levels (around 18% and 12%). By contrast, the dynamism of borrowing by industry and by other services held steady.



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

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

The slowdown in household liabilities contributed to stabilising the sector's ratio of debt to gross disposable income (GDI) in the first few months of 2008, while the associated debt burden still shows an upward path as a result of the rising interest rates (see Chart 25). Meanwhile, household saving before debt service recovered slightly, while net wealth and net borrowing with respect to GDI and GDP, respectively, scarcely changed.

Nor did the debt ratio of corporations show significant changes in 2008 Q1. Rather, the associated debt burden increased, and this development contributed to reducing the return on capital (see Chart 26). These trends were also apparent in the corporations reporting to the CBQ, a high proportion of which are large. As result of these developments, the synthetic indicator of financial pressure on employment increased, while the corresponding indicator for investment decreased, this divergence reflecting the different weights of the variables used to calculate them. Further, the Financial Accounts information indicates that in this period the sector's net borrowing did not change significantly, standing near 12% of GDP. By contrast,

The financing received by the non-financial private sector is a highly significant variable in analysis of the economic conjuncture and in assessment of medium- and long-term growth prospects, since the movements of this indicator usually bear a certain relation to the course of spending by households and firms. This is because a significant part of these funds tends to be used for consumption and investment in real assets.

The availability of monthly information on financing enables both shorter-term (monthly or quarterly) and longer-term (annual) growth rates to be calculated. The main advantage of the first of these alternatives is that it uses only the most recent data, so that changes in profile tend to be detected more quickly. However, seasonality, calendar affects and the high variability of monthly flows hinder the extraction of signals about the trend in these series. Although there are statistical and econometric tools to deal with some of these problems, these procedures are subject to an error of estimation.

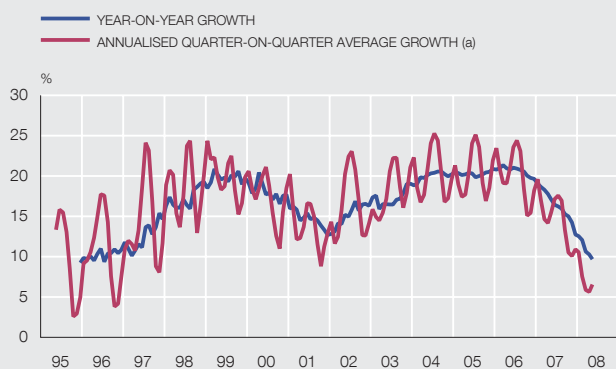
In view of the foregoing, the Banco de España bases its analysis of financing mainly on the year-on-year growth rate of this variable. The main advantage of this is that it avoids problems of seasonality and reduces calendar affects and the inconvenience of high volatility of series (since atypical movements in one direction in a month tend to be offset by others in the opposite direction in other periods). This allows much more stable measures to be obtained and minimises the risk of extracting erroneous signals or messages that change from one month to another. However, the drawback of this approach is that when changes of trend occur, the information contained in the longer-term rates is captured with a certain lag. Specifically, in periods in which borrowing by the private sector decelerates, the longer-

term rates tend to be higher than the shorter-term ones, and the opposite occurs at times of acceleration of this aggregate. In these situations, indicators based on quarterly or monthly changes can be a useful complement to those calculated from year-on-year movements, although their behaviour should be assessed with certain caution, given the problems associated with them.

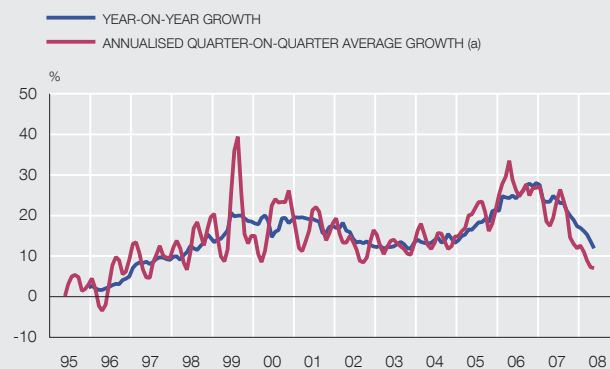
Charts 1 and 2 show, respectively, the growth rate of financing to households and firms, using both shorter-term rates (measures such as the annualised change in the average stock of financing in the last quarter with respect to that in the previous quarter) and longer-term rates (year-on-year growth). It is clearly discernible how the series based on longer-term rates are much more stable than those based on shorter-term rates, which is in line with the foregoing comments. Noticeable in both cases is a decelerating profile of the debt of households and firms which dates from mid-2006 in the first case and from early 2007 in the second. This moderation, which occurred after a long phase in which these variables had been growing at high rates (above 20%), seems to have been prompted by both demand-side and supply-side factors, as suggested by the bank lending surveys conducted in this period.

The most recent data show that the shorter-term rates are lower than the longer-term ones, which is consistent with the current stage of deceleration. Specifically, in May the year-on-year growth rate of financing was around 10% and 12% in the case of households and firms, respectively, as compared with an annualised quarter-on-quarter average growth rate of around 7% and 8%. These latter figures are already near the expansion of nominal GDP, meaning that the aggregate debt ratios of households and firms are stabilising, after a long phase of strong growth.

1 FINANCING TO HOUSEHOLDS. GROWTH RATES



2 FINANCING TO FIRMS. GROWTH RATES



SOURCE: Banco de España.

a. Calculated as the growth rate of the average stock in the last three months with respect to that in the preceding three months and annualised using the compound capitalisation formula.



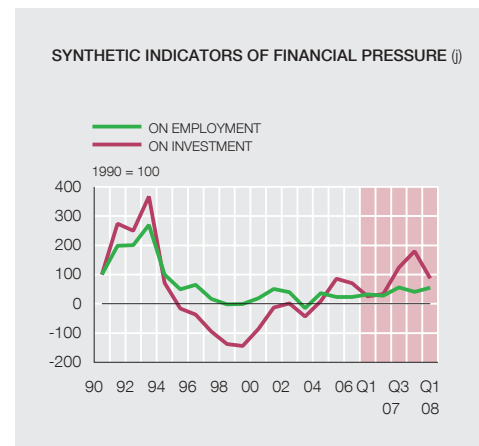
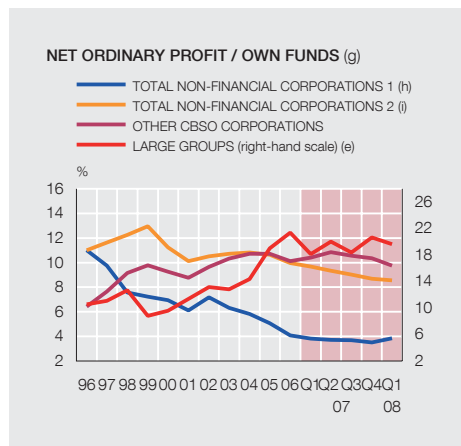
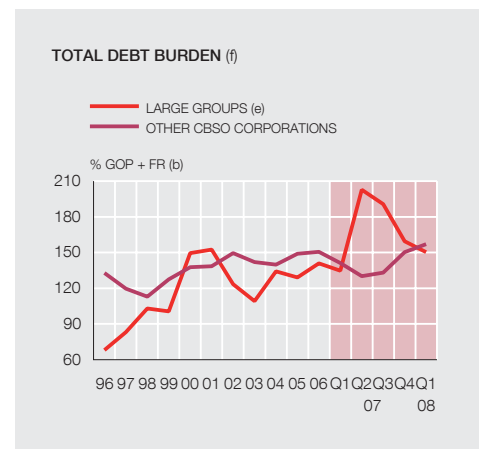
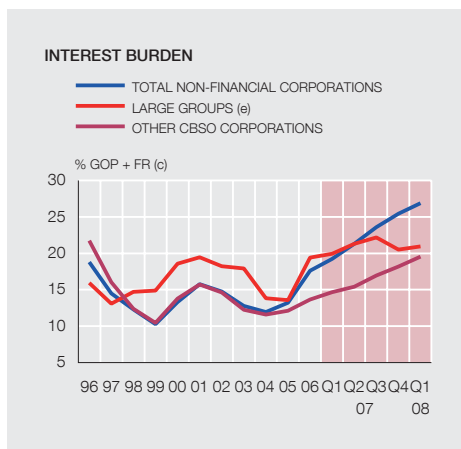
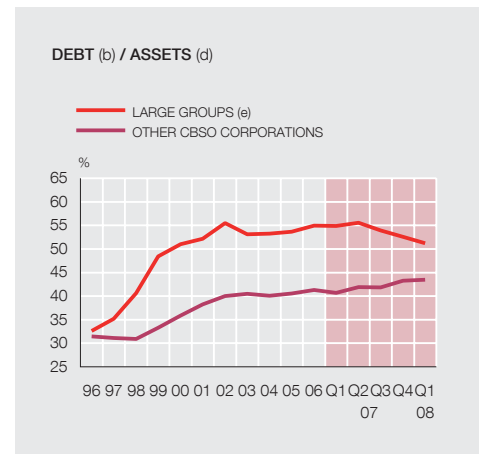
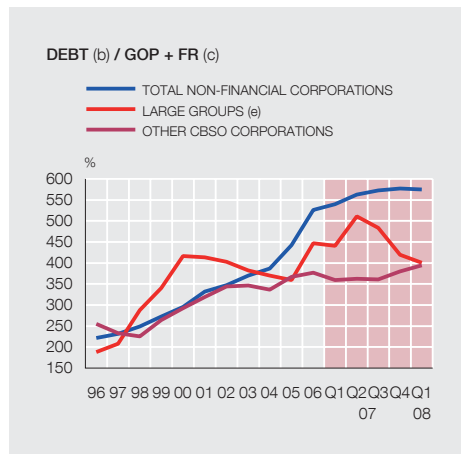
SOURCE: Banco de España.

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

the financing gap (which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment) widened slightly to nearly 18% of GDP, up 0.5 pp on end-2007.

The projections available for 2008 Q2 point to a continuation of the recent trends of the debt and debt-burden ratios of households and firms. Thus the former scarcely changed, while the latter continued to increase.

Although the shortfall in households' and corporations' funds held unchanged between December 2007 and March 2008, the lower saving of general government along with the scant change in the surplus of financial institutions led to an increase in the nation's net borrowing, which amounted 10% of GDP in cumulative year-on-year terms (see Table 5). Unlike what happened in the second half of 2007, in 2008 Q1 the net funds raised in the rest of the world by the sectors other than the Banco de España were sufficient to cover the external deficit.



SOURCE: Banco de España.

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

% GDP	2003	2004	2005	2006	2007				2008
					Q1	Q2	Q3	Q4	Q1
National economy	-2.9	-4.8	-6.5	-8.1	-8.3	-8.6	-8.9	-9.5	-10.0
Non-financial corporations and households and NPISHs	-3.8	-5.1	-8.2	-10.5	-11.1	-11.9	-12.9	-13.4	-13.4
<i>Non-financial corporations</i>	-3.9	-4.5	-6.9	-8.9	-8.8	-10.0	-11.0	-11.7	-11.9
<i>Households and NPISHs</i>	0.1	-0.6	-1.3	-1.7	-2.3	-1.9	-1.9	-1.6	-1.5
Financial institutions	1.0	0.6	0.7	0.6	0.8	1.2	1.4	1.6	1.7
General government	-0.2	-0.4	1.0	1.8	2.0	2.0	2.6	2.2	1.7
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.2	-8.7	-11.1	-16.1	-13.8	-15.6	-15.9	-17.4	-17.9

SOURCE: Banco de España.

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

However, in cumulative year-on-year terms, the capital inflows through this institution increased.

In sum, the latest data show that the financing conditions faced by households and firms tightened further in Q2, both through increases in the cost of funds and through the stricter credit standards applied by credit institutions. In line with this development and with the other basic determinants of liabilities, the borrowed funds raised by households and firms continued their progressive deceleration, and this will contribute to the more sustainable long-run course of the aggregate debt of these sectors. However, the high level of debt of some segments, along with the increase in financing costs and, in certain cases, the less favourable earnings performance, might be subjecting an increasing proportion of these agents to higher financial pressure. The increase in the doubtful assets ratio in recent months points in this direction. Between December 2007 and March 2008 this ratio increased by 0.3 pp both for households and for non-financial corporations, with a sharper rise in construction and real estate services (0.4 pp), although the level reached continues to be low both in historical terms and in comparison with other EU countries.

Although in 2008 Q1 the financing of the external deficit did not give rise to a decrease in the net position of the Banco de España vis-à-vis the rest of the world, and despite the fact that subsequent months have seen the incipient re-opening of some securities issuance markets, the persisting difficulty in raising funds on international markets continues to be a factor of risk, given the high net borrowing of the Spanish economy.

## 5.2 Households

2008 Q2 saw a further rise in households' financing costs. Between March and May the interest rates applied by credit institutions to new consumer credit and other lending increased by 23 bp to 8.78%, while that associated with funds for house purchase, which reflects with a certain lag the movements in interbank market interest rates, underwent a smaller rise (by 12 bp to 5.55%). The increase in Euribor rates in June points to a prolongation of the upward trend in the cost of credit to households. Moreover, according to the April bank lending survey, credit institutions anticipate applying tighter credit standards in both types of lending in Q2 compared with the preceding quarter.



Against this background, the decelerating path of household debt initiated in 2006 has continued in the last few months and the pace of year-on-year expansion decreased further to stand below 10% in May, down nearly 1 pp on March, a rate which is somewhat lower if measured in annualised quarter-on-quarter terms (around 7%). This development reflects the slower pace both of house purchase loans, the year-on-year growth rate of which stood at 10%, and of consumer credit and other lending, which was up by 8% with respect to the same period of 2007.

Regarding portfolio decisions, the most recent Financial Accounts information shows that purchases of financial assets by households again moderated in 2008 Q1. Hence, in cumulative annual terms, they stood at around 6% of GDP, nearly 1.5 pp below the end-2007 level. A large part of this decrease was concentrated in higher-risk instruments (shares and other equity and investment funds), in line with the greater volatility and downward trend of stock market prices in this period. Meanwhile, the heading other deposits and fixed-income securities continued to account for the bulk of fresh financial investment by households (it amounted to 7.7% of GDP) and was in fact the only heading, along with insurance technical reserves, to show positive flows in cumulative 12-month terms.

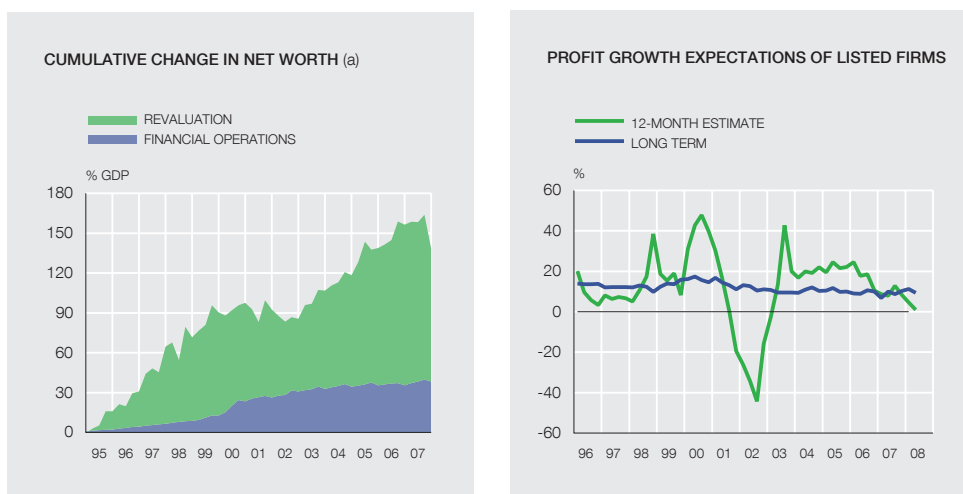
Thus in recent months the growth rate of household financing has moved progressively closer to that of household income. As a result, the debt ratio has tended to stabilise, and at the end of 2008 Q1 it stood at somewhat more than 130% of GDI. By contrast the associated interest burden continued to increase, driven by the rise in the component linked to interest payments. Despite this development, saving after debt service increased (by 0.4 pp with respect to GDI), basically as a result of the recovery of the sector's gross saving. Neither the net wealth of households with respect to their GDI, nor their net borrowing in terms of GDP showed significant changes.

### **5.3 Non-financial corporations**

The cost of corporate financing also increased in 2008 Q2. The breakdown into components shows that up to May, the date of the latest data available, the interest rate on credit increased by 22 pp to 5.9%. As in the case of households, these figures do not include the June rise in Euribor, which will foreseeably pass through to the price of bank financing. Also, between March and June the cost of equity rose by 75 pp and that of short- and long-term fixed-income securities issuance was up by 64 bp and 40 bp, respectively. Further, according to the April bank lending survey, between March and June credit institutions anticipate applying more stringent credit standards than in early 2008.

The progressive tightening of the credit conditions faced by firms, along with the developments in the other determinants of debt (in particular, the lower economic buoyancy), has contributed to the ongoing decline in the growth rate of firms' borrowed funds, which in many stood at around 12% in year-on-year terms (more than 3 pp below the March figure), and at around 8% according to the annualised quarter-on-quarter rates. Analysed by component, this development was a result of the deceleration in lending by resident credit institutions and in loans from non-residents, since fixed-income securities issuance showed greater vigour.

Analysis by loan purpose of the latest information, which relates to 2008 Q1, shows that the slowdown in credit granted by resident institutions was particularly marked in that to the real estate sector (its year-on-year growth rate fell by nearly 7 pp to stand somewhat below 18%), and more moderate in that for construction (the rate of expansion dropped by somewhat more than 2 pp). By contrast, despite the less vigorous activity, the funds raised by industry and the other services branches retained their notable dynamism, with year-on-year growth of around 19% and 22%, respectively.



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.

The Financial Accounts information for 2008 Q1 shows few changes in the sector's net borrowing, which held at levels around 12% of GDP. However, the financing gap, the indicator which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, increased to nearly 18% of GDP, up 0.5 pp on end-2007.

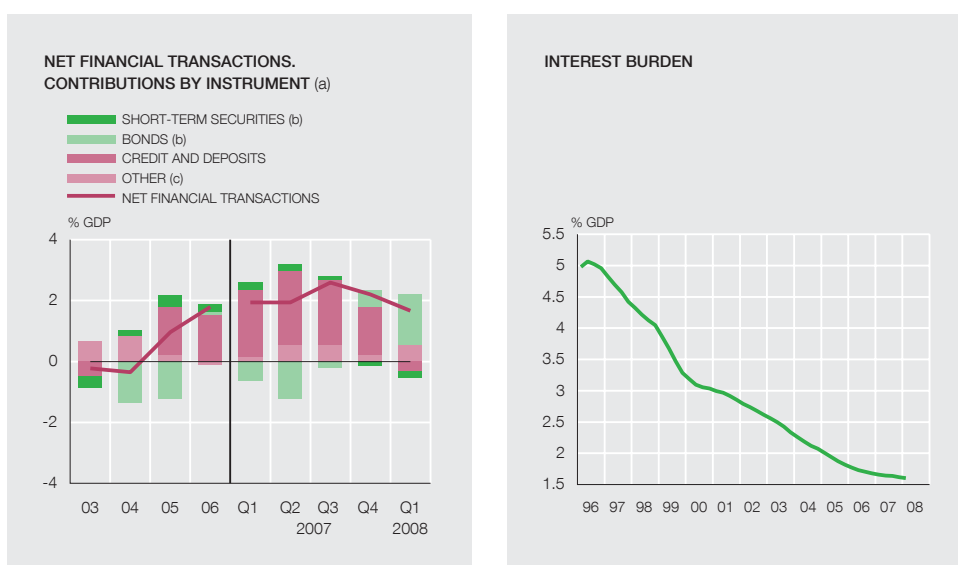
In line with the progressive deceleration of borrowing, the level of corporate debt has tended to stabilise lately, standing in Q1 at around 575% of the funds raised by this sector (see Chart 26). This, together with the increased financing costs, led the debt burden ratio to move upwards once again to reflect the fact that financial costs absorbed 27% of gross operating profit plus financial revenue. This increase contributed to the contraction of firms' ordinary net profit, which led to a certain decrease in the return on capital.

The latest available information from firms reporting to the CBQ, which relates to 2008 Q1, shows a picture similar to that reflected by aggregate sector data. There was an increase in the proportion of revenue used for debt service, more marked in the case of firms not belonging to large corporate groups, while the debt ratio did not undergo significant changes. Profitability decreased slightly with respect to the same period of the previous year, and this trend was fairly general across the various branches of activity. As result of the overall effect of these developments, the synthetic indicator of financial pressure on employment increased slightly, while that for investment decreased. These divergences result from the different weighting of the variables used to calculate the indicators.

Analysts' projections of the increase in the profits of listed non-financial corporations for the next 12 months were again revised downwards in 2008 Q2, to practically zero. Those for longer time horizons were also down, albeit to a lesser extent, and so still remain at comfortable levels (see Chart 27).

#### 5.4 General government

From December 2007 to March 2008, general government net lending in cumulative 12-month terms stood at 1.7% of GDP, down 0.5 pp on end-2007 (see Chart 28). Analysis by instrument shows some significant changes compared with the recent past. Thus the balance of general



SOURCE: Banco de España.

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

government deposits (net of credits) declined with respect to the same period of the previous year, in contrast with the pattern of growth of this heading in the preceding period. Also, net placements of short-term securities increased. These changes were basically offset by the cut-back in the outstanding volume of long-term securities. As in previous quarters, the decrease in the debt ratio meant that, despite the rise in the average cost of funds, interest payments as a proportion of GDP held stable at around 1.6%.

## 5.5 The rest of the world

In 2008 Q1 the debit balance of the nation's financial transactions increased further to stand, in cumulative 12-month terms, at 10% of GDP, up 0.5 pp on 2007. Sectorally speaking, this result was basically a consequence of less saving by general government, since net borrowing by the other sectors scarcely changed (see Table 5).

In cumulative four-quarter terms, the net capital inflows channelled through the financial system (excluding the Banco de España and institutional investors) continued to decrease with respect to GDP between December 2007 and March 2008. Nevertheless, the reduction was much more moderate than in the preceding months and, moreover, was accompanied by a significant change in the composition of these flows. Thus, as a result of the persistent issuance difficulties in the securitisation markets, the funds raised through financial institutions other than institutional investors (which include issues by financial vehicle corporations) contracted again significantly (by 4.6 pp with respect to GDP). By contrast, the funds raised directly by credit institutions increased notably (by 4.3 pp with respect to GDP), a development which manifested itself basically in an increase in interbank financing vis-à-vis the rest of the world. Net purchases of foreign assets by institutional investors and by the Banco de España were again negative, amounting to 2.9% and 1.7% of GDP, respectively, compared with 1.9% and 1.4% at end-2007. Finally, the flows channelled through general government continued to show a net credit balance, which is consistent with the decrease in the volume of outstanding debt, whereas the opposite occurred in those corresponding to the non-financial private sector.

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

TABLE 6

% GDP	2004	2005	2006	2007		2008
				Q3	Q4	Q1
<b>HOUSEHOLDS AND NPISHs:</b>						
Financial transactions (assets)	9.5	10.4	10.9	8.4	7.2	5.8
Cash and cash equivalents	3.9	4.0	3.1	0.6	-1.0	-1.0
Other deposits and fixed-income securities (a)	1.2	1.6	5.6	6.8	7.7	7.7
Shares and other equity (b)	0.3	0.2	-1.1	-0.2	0.4	-0.3
Investment funds	1.6	1.9	0.2	-1.0	-1.2	-1.6
Insurance technical reserves	1.9	2.0	1.8	1.6	1.0	0.9
<i>Of which:</i>						
Life assurance	0.7	0.8	0.6	0.6	0.3	0.3
Retirement	0.9	1.0	0.9	0.8	0.6	0.5
Other	0.7	0.7	1.3	0.5	0.4	0.1
Financial transactions (liabilities)	10.1	11.8	12.6	10.3	8.8	7.4
Credit from resident financial institutions (c)	10.8	12.3	13.0	10.9	9.4	8.0
House purchase credit (c)	8.7	10.2	9.9	8.5	7.2	6.2
Consumer and other credit (c)	2.1	2.2	3.1	2.5	2.2	1.8
Other	-0.7	-0.5	-0.4	-0.6	-0.6	-0.6
<b>NON-FINANCIAL CORPORATIONS:</b>						
Financial transactions (assets)	14.4	18.2	22.8	17.7	13.8	11.6
Cash and cash equivalents	1.0	2.0	2.3	0.4	-0.4	-1.1
Other deposits and fixed-income securities (a)	0.3	1.2	2.0	2.8	2.5	2.8
Shares and other equity	6.3	7.2	10.9	8.5	7.2	5.7
<i>Of which:</i>						
Vis-à-vis the rest of the world	3.8	3.9	7.7	5.1	5.3	5.3
Other	6.8	7.7	7.5	5.9	4.5	4.1
Financial transactions (liabilities)	18.9	25.1	31.6	28.7	25.6	23.4
Credit from resident financial institutions (c)	8.3	12.9	17.7	16.9	13.9	12.4
Foreign loans	0.7	2.1	3.4	2.1	2.6	2.8
Fixed-income securities (d)	0.0	0.3	1.8	0.8	0.5	0.3
Shares and other equity	4.4	3.7	2.5	4.1	5.0	5.0
Other	5.5	6.1	6.4	4.9	3.5	3.0
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (e)	16.3	21.2	24.2	18.6	15.3	13.3
Households and NPISHs	20.2	20.9	19.6	15.3	12.7	10.6
Non-financial corporations	13.2	21.4	28.0	21.1	17.3	15.3

SOURCE: Banco de España.

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

In 2008 Q1 the volume of capital inflows again fell, and, in cumulative four-quarter terms, stood at 19% of GDP, down 3.7 pp on end-2007 (see Table 7). Analysis by instrument disclosed the same trends as at the end of the previous year. Thus, against a background of paralysis of the international securitisation markets and of notable tightening of financing conditions on other debt markets, there was a sharp contraction (of 8 pp with respect to GDP) in the funds associated with securities other than shares (the amount of which actually turned negative). This significant decrease reflected the lesser funds raised by this means, basically by financial institutions, and also, albeit to a lesser extent, by general government, in line with the decrease in the outstanding stock of assets of this type. By contrast, the funds raised through shares and

% GDP	2004	2005	2006	2007		2008
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-4.8	-6.5	-8.1	-8.9	-9.5	-10.0
FINANCIAL TRANSACTIONS (ASSETS)	13.3	18.7	17.9	16.5	13.2	9.0
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.2	2.2	5.5	5.7	2.2	-0.7
<i>Of which:</i>						
<i>Interbank (a)</i>	0.7	3.1	3.4	5.9	4.2	1.6
Securities other than shares	1.8	8.8	-1.2	2.7	1.6	1.3
<i>Of which:</i>						
<i>Credit institutions</i>	1.0	6.6	-2.1	2.3	1.8	1.9
<i>Institutional investors (b)</i>	0.3	2.3	0.6	0.5	-0.1	-0.7
Shares and other equity	6.8	5.1	10.2	6.6	7.6	6.0
<i>Of which:</i>						
<i>Non-financial corporations</i>	3.8	3.9	7.7	5.1	5.3	5.3
<i>Institutional investors (b)</i>	0.8	0.9	1.2	-0.4	-1.0	-1.9
Loans	0.8	1.1	1.8	0.4	1.1	1.4
FINANCIAL TRANSACTIONS (LIABILITIES)	18.2	25.2	26.0	25.4	22.7	19.0
Deposits	1.7	5.6	0.3	5.4	7.3	11.2
<i>Of which:</i>						
<i>Interbank (a)</i>	5.0	7.2	0.6	5.3	6.7	10.9
Securities other than shares	12.4	15.8	21.7	15.0	7.9	-0.3
<i>Of which:</i>						
<i>General government</i>	2.7	0.2	1.3	-0.5	-1.5	-2.3
<i>Credit institutions</i>	4.6	6.3	8.0	5.8	3.5	0.8
<i>Other non-monetary financial institutions</i>	5.1	9.3	12.4	9.7	5.9	1.2
Shares and other equity	2.7	0.9	-0.1	2.1	4.3	4.8
<i>Of which:</i>						
<i>Non-financial corporations</i>	1.7	1.0	-0.5	2.1	4.5	4.8
Loans	1.3	2.3	3.6	2.4	2.8	3.0
Other, net (c)	-0.6	-0.9	-1.0	-0.6	-0.4	-0.7
MEMORANDUM ITEMS						
Spanish direct investment abroad	5.8	3.7	8.1	6.4	8.7	8.6
Foreign direct investment in Spain	2.4	2.2	2.2	1.6	4.0	5.4

SOURCE: Banco de España.

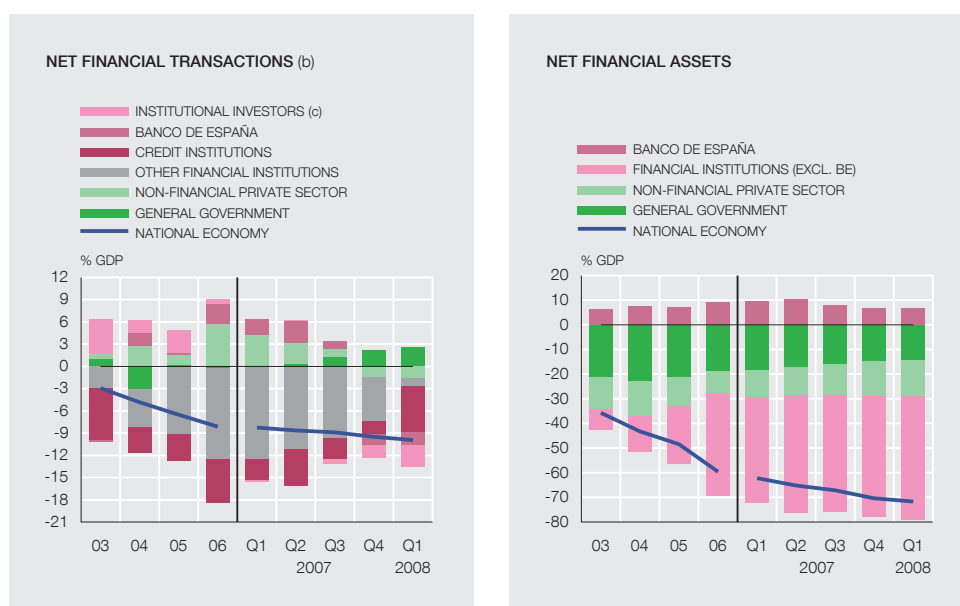
a. Correspond only to credit institutions and include repos.

b. Insurance corporations and collective investment institutions.

c. Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

other equity increased, in line with the rise in foreign direct investment in Spain and, in particular, in interbank financing, which accounted for more than half the funds received from the rest of the world.

The volume of capital outflows also decreased, standing at 9% of GDP, down 4.2 pp on 2007. This decline was fairly general across instruments, with the exception of loans. The largest contractions were in the heading cash and deposits (specifically in interbank market deposits) and in investment in shares and other equity, basically as a result of smaller purchases by credit institutions and institutional investors. Spanish direct investment abroad as a proportion of GDP scarcely changed, standing at 8.6%.



SOURCE: Banco de España.

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

As a result of the changes in cross-border financial flows, asset prices and the exchange rate, the value of the accumulated net liabilities to the rest of the world increased slightly (see Chart 29). Sectorally, this was due to an increase in the debit balance of financial institutions (excluding the Banco de España) and of the non-financial private sector, which exceeded the decrease attributable to general government.

24.7.2008