

QUARTERLY REPORT ON THE SPANISH ECONOMY

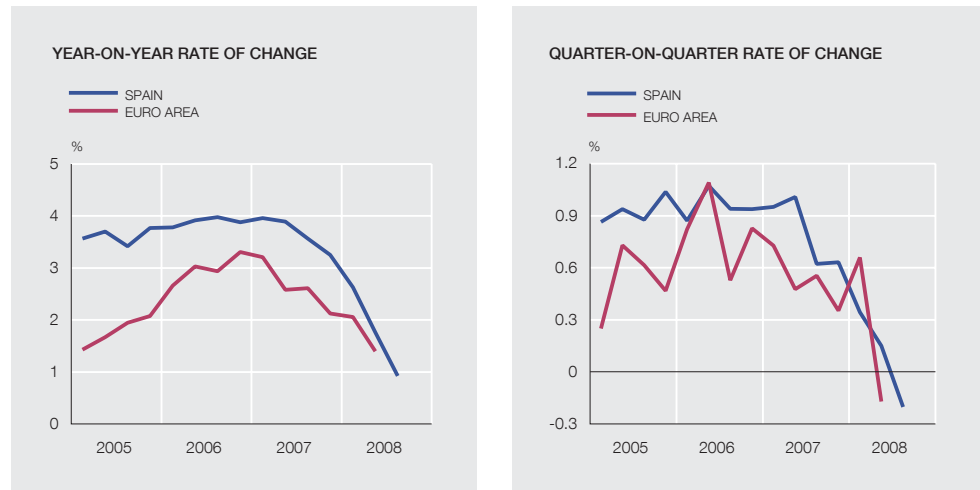
1 Overview

In 2008 to date, the adjustment of the Spanish economy that began last year has continued intensifying in a climate of heightened international financial instability, which has come to a head in October. In Q2 the year-on-year growth rate of GDP declined by 0.8 pp to 1.8% (0.1% in quarter-on-quarter terms). This was due to slower national demand, which grew at a year-on-year rate of 1.4% (2.7% the previous quarter), partially offset by an improvement in the contribution of net external demand which, for the first time since 2001, was positive and added 0.3 pp to GDP growth.

The indicators for 2008 Q3 show an intensification of the adjustment, in a setting in which the marked deterioration of international financial markets since mid-September has exacerbated the prevailing uncertainty – with significant effects on agents' confidence – and has given rise to a further tightening of financing conditions. Under these circumstances, the estimates made drawing on available information suggest that the year-on-year growth rate of GDP in Q3 declined by 0.9 pp to 0.9%, a figure representing a slightly negative quarter-on-quarter rate of –0.2%. Behind this further deceleration in output is the significant fall in the rate of increase of national demand to 0.3% year-on-year, to which all its components contributed, especially residential investment and household consumption. Conversely, the contribution of net external demand to growth increased once again in the July-September period to 0.6 pp, as a result of the appreciable reduction in the growth rate of imports and some continuing momentum in exports. On the supply side, the sharp correction of activity in the construction sector and the decline in value added in manufacturing continued, while a process of job destruction began that spread to the various productive branches, except services. EPA (Labour Force Survey) data for Q3 place the decline in employment in this period at 0.8% in year-on-year terms, and raise the unemployment rate to 11.3%. Turning to prices, the inflation rate improved somewhat from August, chiefly as a result of the heavy fall in oil prices that began in mid-July. The HICP posted a year-on-year rate of change of 4.6% in September (compared with its peak of 5.3% two months earlier), and the differential with the euro area stood at 1 pp, slightly down on the previous quarter.

On the international economic front, the deterioration in the financial situation from the second half of September, following more than a year of persistent instability, resulted in a serious crisis of confidence and began to spread to the emerging economies, whose financial markets had remained relatively insulated from the turmoil in the previous phase. Under these conditions, there was a new and substantial deterioration of the growth outlook for the main industrialised countries. In parallel, oil prices declined substantially from their mid-July peak, and the inflation outlook improved. All these events mean that the world economy faces the coming quarters against a backdrop of extreme uncertainty, with a heightened risk that the cyclical downturn will be more pronounced and lasting.

The instability on international financial markets worsened in the face of the deterioration in the position of certain financial institutions of great importance from a systemic standpoint. The outcome was the bankruptcy of a major US investment bank, and a wave of banking consolidation and government bail-outs of financial institutions, both in the United States and in Europe. These events severely worsened the situation on the financial markets: the interbank markets were blocked, as were other key wholesale markets (see Box 1), such as that for commercial paper; credit risk premia increased; and stock market prices plummeted, with heightened volatility and declines of over 15% in the main stock market indices since June.

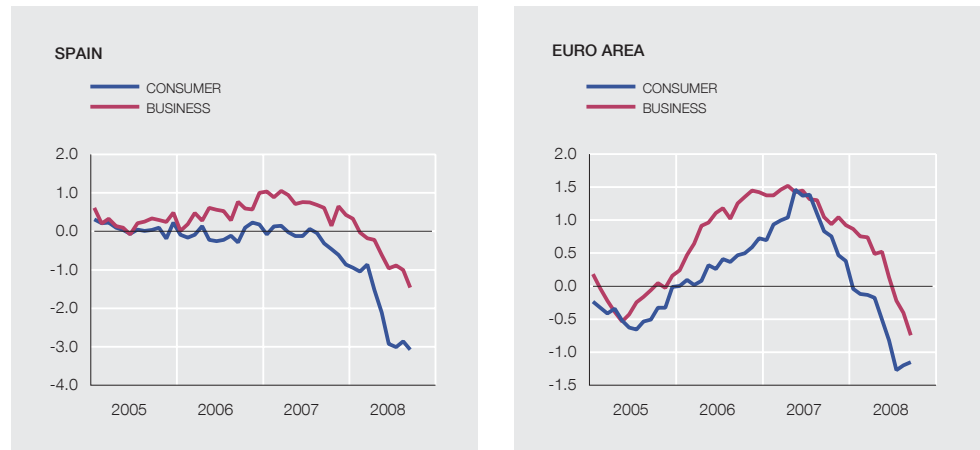


SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

Given the seriousness of the situation, the central banks and governments of the main developed countries deployed a wide range of measures. Their threefold aim was to restore confidence, to stabilise financial markets and to prevent potential systemic risks from materialising. To guarantee the liquidity demanded by financial institutions, in a setting of malfunctioning interbank markets, the main central banks adopted a raft of exceptional liquidity-supplying measures, including both changes in the terms of their loans and a widening of the range of eligible collateral, in addition to a significant increase in volumes lent. The ECB undertook to provide unlimited quantities of liquidity at terms ranging from one week to six months while the current circumstances persist and, at least, until January 2009. Further, on 8 October the Federal Reserve, the ECB and the Bank of England agreed to a concerted 50 bp reduction in intervention rates, a decision which was followed by the monetary authorities of some emerging economies.

Some governments, at first unilaterally, adopted measures in support of the banking system. These included most notably the plan to purchase financial institutions' troubled assets, announced by the US Treasury on 19 September, which was followed by Ireland's deposit guarantee extension and the British plan, whose central plank involves the recapitalisation of banks by the Treasury. However, the exceptional nature of the situation called for concerted action by the governments affected by the crisis, which took shape on a global level during the G8 summit in Washington. In Europe, the ECOFIN meeting on 4 October, along with the subsequent joint declaration by the EU, marked the start of coordination, which culminated on 12 October with the launch of a joint action plan by the Eurogroup Heads of State and Government (see Box 2). This action plan is an exceptional measure on the part of the Member States to ensure the stability of the financial system and to restore confidence. To this end, the resolutions adopted are structured around three major areas: the raising of the guarantee limits of national deposit guarantee funds; the adoption of measures aimed at preventing the interruption of credit flows, including both the possibility of acquiring or exchanging banks' assets and the setting in place of temporary arrangements guaranteeing new issues of bank debt; and, lastly, the possibility for banks to improve their capital ratios by means of recapitalisation operations by the respective national Treasuries. All these measures are intended to be temporary; they must observe the functioning of the single market, must ensure that shareholders and managers assume their responsibilities and must safeguard taxpayers' interests. The measures



SOURCE: European Commission.

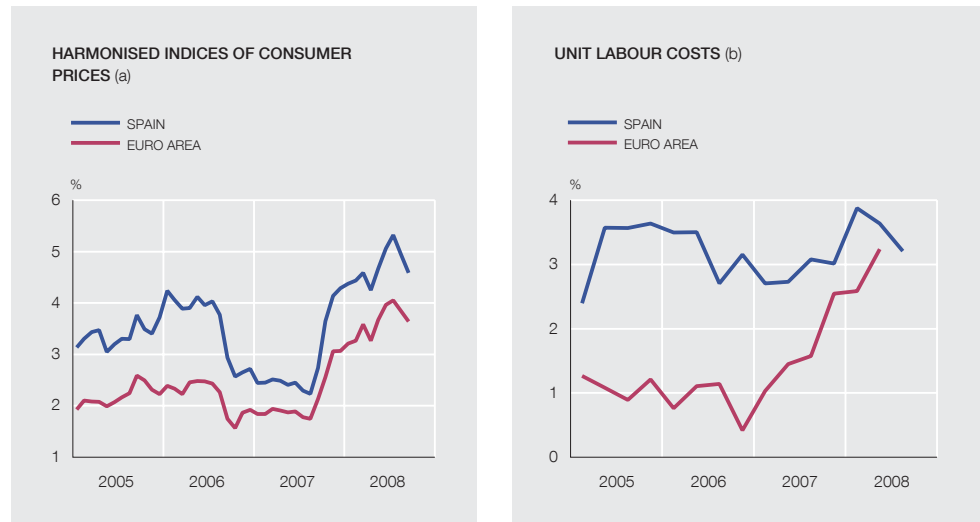
a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

adopted by the Spanish government on 10 and 13 October conform to these requirements. Specifically, it was decided on 10 October to raise the deposit guarantee limit to €100,000 and to set up a fund, financed by the Treasury, with an initial contribution of €30 billion extendable to €50 billion, for the acquisition of Spanish assets of the highest quality. Subsequently, on 13 October, authorisation was given to the granting of State guarantees to new lending by credit institutions in Spain, up to a maximum amount of €100 billion in 2008, and, exceptionally, to the acquisition of securities to shore up credit institutions' capital.

Against this background of instability, global economic activity continued to worsen during the summer months after zero or negative growth rates were posted in Q2 in the euro area, the United Kingdom and Japan. Growth was slightly higher in the United States in Q2, although in this case it was supported by the tax package to reactivate the economy. In the emerging economies, activity remained robust throughout the quarter, although it generally slowed moderately, amid growing tensions on their financial markets.

Turning to economic developments in the euro area, after a sharper-than-expected decline in quarter-on-quarter GDP growth in Q2, the conjunctural indicators available are generally notably slack. On the prices front, upward pressures have slackened, in step with the slide in commodities prices since mid-July. Combined with weakening activity, that has lessened the risk of possible upward drift in wages. Against this background, the ECB lowered its key interest rates on 8 October, in the above-mentioned concerted action. The interest rate on the main refinancing operations was cut by 50 bp to 3.75%, and the corridor of standing facilities was reduced from 200 bp to 100 bp, so that the deposit facility and marginal lending facility rates now stand at 3.25% and 4.25%, respectively (see Box 3).

Under these circumstances, the external environment of the Spanish economy in recent months has continued to weaken and has been subject to significant financial turbulence. Against this backdrop, financing conditions for Spanish households and firms became tighter as a result of further increases in the cost of funds and tighter bank lending standards. In addition, the fall in stock prices, along with the moderate decline in property prices, which fell in Q3 at a quarter-on-quarter rate of 1.3% according to information provided by the Spanish Ministry of Housing, adversely affected household wealth.



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

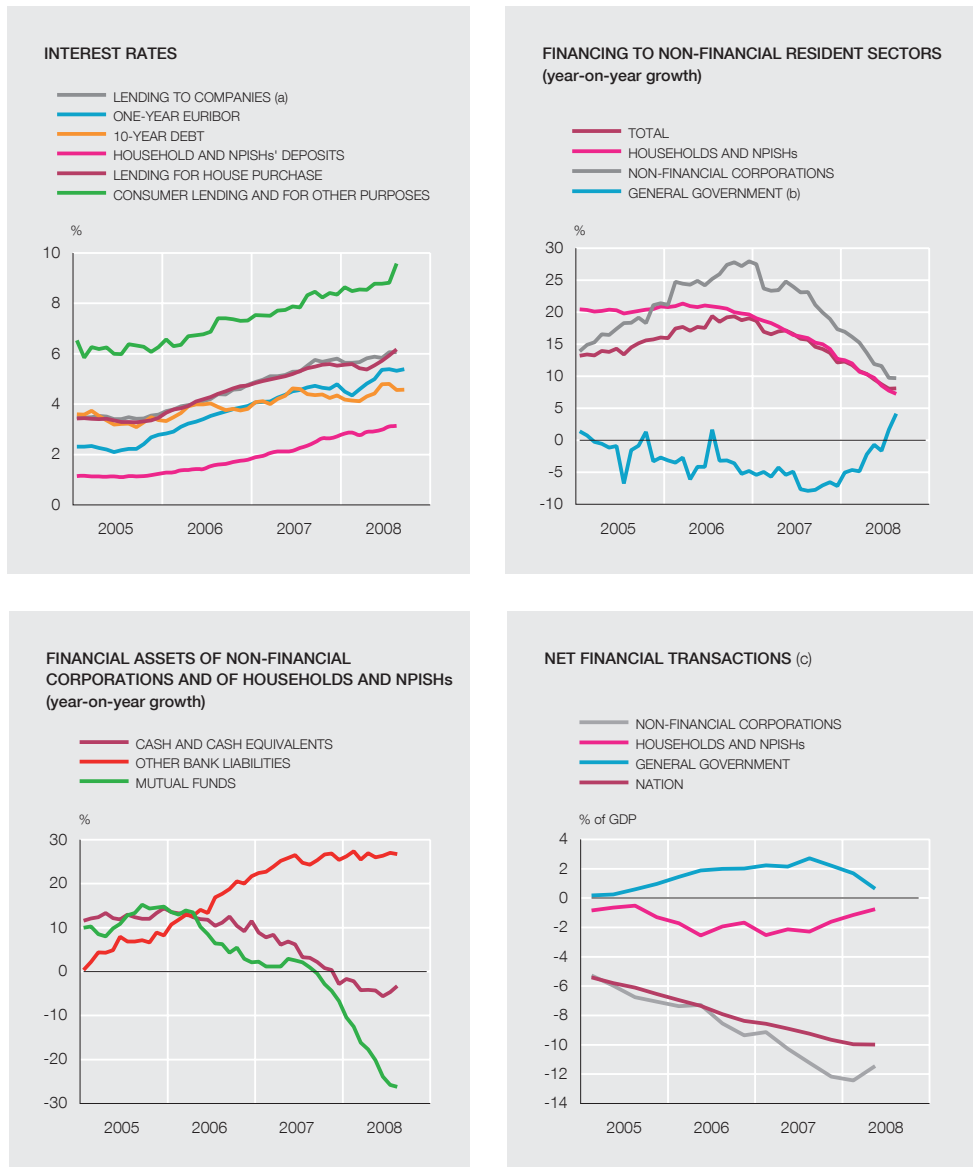
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

Household spending slowed further under these conditions. The rate of change of consumption dipped to below 1% in year-on-year terms, greatly affected by the deterioration in agents' confidence (which stood at a historical low according to the usual indicators), the slowdown in disposable income (given the poor behaviour of employment and the rise in the inflation rate) and diminished wealth. All these factors dampened the expansionary effect that might have been exerted in less uncertain circumstances by the personal income tax reduction, which came into effect in late June, and the rise in wages, which are rapidly reflecting the deterioration in the inflation outlook, despite the weakening labour market. This setting of uncertainty is proving conducive to a recovery in the household saving rate, which ended a nine-quarter decline in Q2, rising to 10.7% of disposable income in cumulative four-quarter terms.

Turning to residential investment, the available indicators point to a reduction in activity which is becoming more pronounced as the year unfolds. This is a result of the significant contractionary effect that the climate of uncertainty is exerting on house-purchase decisions. The change in price expectations and the tightening of financing conditions continue to discourage residential investment. And that has triggered the restructuring of real estate companies, severely compounding the adjustment of the sector.

The corollary of this decline in household investment and the increase in the saving rate is the reduction in household net borrowing, which dipped to a four-quarter average of 1.9% of GDP in Q2, and has possibly continued falling in the latest period. In this setting, the rate of increase of household debt slowed once more to a year-on-year rate of change of close to 7% in August (prior, in any event, to the most intense phase of the recent tensions), 1 pp down on June, which affected loans for house purchase as well as consumer loans and those for other purposes. This slowing trajectory may have steepened since September further to the worsening situation on financial markets.

Business investment is also being affected by the prevailing climate of uncertainty, both in its equipment component and in that of other construction, and it has undergone a sharp adjustment in response to the change in the macroeconomic environment. Investment thus showed



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.

signs of marked weakness, in line with the profile of final demand, the strong deterioration in business confidence and the slowdown in corporate earnings. Indeed, it is only the fact that exports are holding up that might be providing some support for business spending plans. Tighter financing conditions, along with the slowdown in activity, are prompting non-financial corporations to resort less to borrowed funds, which grew in August at a year-on-year rate of close to 10%, 2 pp below the June rate, although this trend can also be expected to intensify in September and October. Across the productive activities, the latest information – for June – shows a very sharp slowdown in borrowing to finance real estate activities and a more moderate slowdown in funds raised by the construction and industrial branches. Conversely, borrowing to finance other services held at a high rate, similar to that of previous quarters.

In line with the progressive loss of momentum in credit, the corporate debt ratio is expected to have fallen slightly in Q3, although the interest burden will have continued to increase given the rising trend of financing costs. Overall, profit ratios turned down slightly in Q2 while doubtful assets ratios continued to increase, especially at construction and real estate service companies.

This progressive weakening in domestic spending is in contrast to the greater dynamism of net external demand, for which a positive contribution of 0.6 pp to GDP growth in Q3 is estimated. Behind this development lies the continuing and relatively positive performance of goods exports, but also, and above all, the sluggishness of imports which, as in previous cycles, are swiftly mirroring the downward adjustment of final demand. In the case of exports, the increases in Q3 were somewhat lower than in the first half of the year but, in any event, they continue to grow at a somewhat higher rate than our export markets. The depreciation of the euro since mid-August has enabled the price-competitiveness indicators to behave more favourably in recent months, mitigating the losses accumulated in the first half of the year in most such indicators. On the available indicators, tourist service exports and imports performed worse. The rate of increase of foreign trade in non-tourist services dipped in Q3.

The correction of the contribution of net external demand to GDP growth has not yet fed through to the nation's net borrowing, which reached 10% of GDP in the first two quarters of 2008 in cumulative 12-month terms. The dynamic of the income balance and the rises in oil prices, which substantially raised the energy deficit in the first half of the year, lie behind this result. However, the balance of payments data for July appear to mark a turning point, as they show an appreciable reduction of 27% in the year-on-year rate of change in the nation's net borrowing, chiefly as a result of the reduction in the trade deficit.

On the supply side, the loss of momentum of activity in all market-economy productive branches continued in Q3, with declines in value-added in industry and construction, very moderate increases in agriculture and more substantial rises in market services, where year-on-year growth was still close to 3%. Against this background, a sharp adjustment continued in employment; for the first time in the last 14 years, total economy-wide employment fell relative to the same quarter a year earlier, more markedly in the market economy and, above all, in construction. Only services continued to generate employment, although at increasingly slacker rates. The dynamism of the labour force means that the rise in the number of unemployed is being accompanied by very swift increases in the unemployment rate, which rose to 11.3% in Q3 on EPA figures. Overall, the decline in employment was more marked than the slowdown in activity, so that productivity rose further.

In the course of the year labour costs have proven highly sensitive to the deterioration in inflation in the closing months of 2007 and in the first half of 2008, despite the slackness of the labour market. As a result, growth in compensation per employee is rising significantly, to a rate of close to 4.5% for the market economy (and of 5% for the whole economy), more than 1.5 pp above the increases recorded the previous year. In terms of unit labour costs, the increase is expected to have been somewhat less, owing to the productivity gains being observed. But the increase is in any event excessive, both from the standpoint of the necessary revitalisation of the labour market and of labour cost developments in the economies competing with Spain, both of which are closely linked.

Commodities costs, in particular oil prices, began to turn down in mid-July, and more decidedly so further to the deterioration in financial tensions, which helped bring inflation down to more contained rates over the course of Q3. Against this backdrop, the year-on-year growth

rate of the HICP fell from its annual high in July of 5.3% to 4.6% in September, although average inflation in the July-September period was higher than in the previous quarter. There was, however, no decline in core inflation, which held close to 3.5%. This was due to the small rise in non-energy industrial goods prices, probably as a result of the tailing off of the beneficial effects of the appreciation of the euro, and to the increase in services inflation. The traditional downward stickiness of services inflation is likely to have been compounded in the recent period by the rise in transport services prices, in response to the increase in energy costs. Foreseeably, this slowing trajectory of the CPI will continue in the coming months, driven by the stripping out of the energy and processed food price rises that took place in the closing months of 2007 and by cyclical weakening. But it is important to ensure that the containment of prices passes fully through also to core inflation, so that the price differential with the euro area countries can be reduced on a lasting basis (to below the average differential of 1.1 pp observed since the start of EMU), and that social agents' conduct should conform more closely to the patterns of macroeconomic stability required in a situation – as at present – of sharp adjustment.

Public finances are deteriorating rapidly. This is associated first with the grinding to a halt of the economy, which is prompting a rapid decline in tax revenues and, in the case of expenditure, the activation of the automatic stabilisers, mainly in the form of increases in unemployment benefit expenditure. Adding to this is the impact on tax revenue of the expansionary measures adopted during the year. As a result, with the unveiling of the draft State budget for 2009, the government has revised the year-end figures for the general government account for 2008, projecting a deficit of 1.5% of GDP, and a somewhat higher deficit in 2009, of 1.9% of GDP. The draft budget also projects an increase in the public debt ratio of around 2 pp of GDP. This figure might be higher given that it does not incorporate the impact of the creation of the fund of up to €50 billion for the acquisition of Spanish assets. These official estimates are subject, moreover, to significant risks, derived above all from the uncertainty clouding the macroeconomic scenario. In a situation such as the present one, fiscal policy must continue to allow the automatic stabilisers to deploy their counter-cyclical effects, while preserving room for manoeuvre should situations of greater weakness arise.

It is also crucial to push through structural measures on the supply side that allow for greater flexibility in the adjustment of margins and wages to macroeconomic conditions. In this respect, the draft bill on the freedom to take up and pursue services activities has recently been published. The content and, above all, the implementation of this legislation should aim to lower entry barriers and increase competition in this sector, which is so vital for making the economy more dynamic.

2 The external environment of the Spanish economy

In the past quarter, developments in the external financial environment of the Spanish economy were characterised by the difficulties of numerous key institutions in the United States which finally resulted in a situation of extreme financial instability on a global scale from the second half of September (see Box 1). This deterioration has occurred at a time when activity has been weakening across an increasing number of economies and, particularly sharply, in advanced economies. Negative economic and financial developments and the way in which they have fed on each other triggered a notable worsening of the economic outlook against a backdrop of high uncertainty. Both factors sparked a strong and swift correction of commodity prices which has eased the inflationary tensions seen in previous months.

Over the last quarter, and especially in September and October, the deterioration of credit and stock markets intensified. At the beginning of September US authorities were forced to intervene in Fannie Mae and Freddie Mac (the mortgage securitisation agencies), in view of their delicate financial position. However, it was following the bankruptcy of Lehman Brothers, the investment bank, half-way through September, that the bouts of instability increased sharply and public intervention of financial firms, including the world's leading insurance company (AIG in the US), mushroomed as did the number of mergers between financial institutions in the US and Europe. In this scenario, the authorities in many countries took different action which included, most notably, a very strong increase in injections of liquidity. At the same time, publication of various plans for rescuing and supporting the financial sector began (most notably in the United States and the United Kingdom) and the major central banks (excluding Japan) coordinated a 50 bp cut in intervention rates on 8 October. Nevertheless, these initiatives did not manage to restore confidence and avoid steep declines on most developed and emerging stock markets which by mid-October were more than 30% lower than at the end of July (according to the MSCI world index). Faced with this situation, and coinciding with the annual meetings of the IMF and the World Bank (the second weekend in October), the communiqués of meetings held by the G7 and by the Heads of State in the euro area presented the outline of a shared global approach to tackle the situation in order to maintain the stability of the financial system and to re-establish operations on credit markets (see Box 1). This outline was firmed up in subsequent weeks in the action plans of a growing number of countries which contributed to stabilising markets.

The resilience, which had characterised developments on emerging markets since the beginning of the turbulence, came to an end in 2008 Q3. As early as mid-June their financial indicators had begun to weaken, but it was further to heightened difficulties in advanced economies that sovereign spreads hit levels that had not been seen since the beginning of 2003, while stock markets posted substantial losses, which even surpassed those recorded on the stock markets of developed countries. On foreign exchange markets the dollar appreciated considerably against the euro and, in particular, the yen rose against the main currencies, while emerging currencies posted strong downward corrections which in some cases, such as Brazil, Mexico, Chile and South Korea, were more than 20%. Lastly, the steep drop in oil prices since July (approximately 50% down) led the downward adjustment in the commodity price index (20%), although precious metals fell to a lesser extent because of their role as a safe haven at times of high volatility.

In the US, the final GDP estimate for 2008 Q2 confirmed an annualised quarterly growth rate of 2.8%, thanks to the contribution from external demand and the impact of the fiscal impulse

The financial turmoil which began in summer 2007 resulted in a crisis of confidence in the global financial system. In September 2008 there were bouts of extreme financial instability which, *a priori*, were highly improbable. They occurred at great speed, covered a broad spectrum of financial institutions (some with systemic importance), affected key markets and became global, spreading from the United States to a growing number of countries, particularly in Europe, but also to many emerging economies.

Although, as early as the beginning of September, tension had grown in the financial system, the bankruptcy of Lehman Brothers on 15 September arguably precipitated the situation. Firstly, this is because until then, the counterparty risks with financial institutions considered systemic had been mitigated with public interventions; secondly, because the bankruptcy generated uncertainty about which institutions were considered systemic by the authorities (and, consequently, were going to be protected from bankruptcy) and which were not; and, thirdly, the disappearance of this institution gave rise to unthinkable ramifications owing to a lack of information about the situation of financial intermediaries' balance sheets and the fact that these entities are highly inter-

linked. Thereafter the lack of confidence snowballed, triggering the gradual blocking of key financing markets, including the interbank and commercial paper markets (see Panels 1 and 2), and causing the widespread collapse of world stock markets.

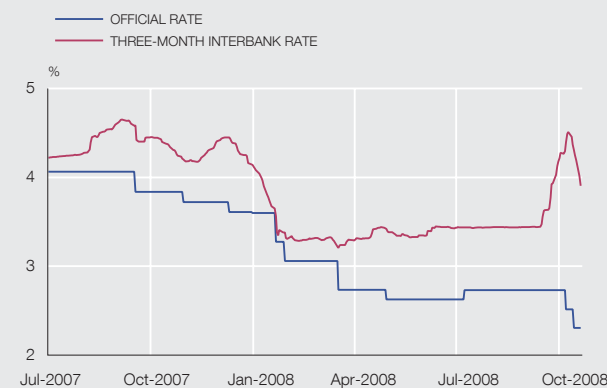
At the beginning of the financial turmoil two inter-related problems clearly emerged: liquidity and perceived solvency. As a result of the persistence of the turmoil during the last year they fed on each other, accentuating solvency problems and entrenching liquidity problems. A key element in these developments has been the unknown exposure of financial institutions to complex structured products, which is very difficult to evaluate. These problems gradually spread to new segments and affected a growing number of entities, and in an increasingly sizeable proportion on global financial markets (see Panel 3), until last month's situation was reached.

The authorities' responses to the worsening of the crisis have been increasingly far-reaching, covering a larger geographical area. Until summer, the strategy adopted was, broadly speaking, to provide markets with liquidity and give temporary support to certain ailing

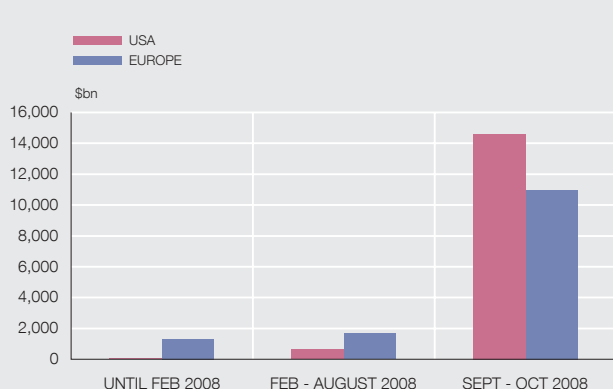
1 CREDIT RISK INDEXES. SPREADS



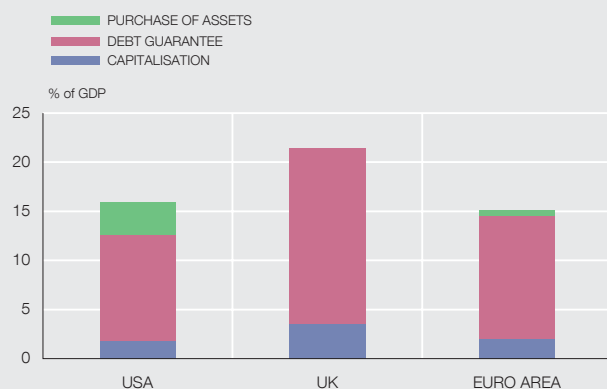
2 OFFICIAL INTEREST AND THREE-MONTH INTERBANK RATES (a)



3 ASSETS OF AFFECTED ENTITIES (b)



4 AMOUNT COMMITTED IN PUBLIC AID PLANS (c)



SOURCES: Datastream, Bloomberg and Banco de España.

- a. Average data of United States, Japan and the euro area weighted by GDP.
- b. Entities which are bankrupt, have been intervened or persuaded to merge.
- c. Data as a percentage of GDP.

entities, pending the disclosure of the losses associated with problematic assets and the implementation of the necessary adjustments in accordance with market mechanisms, while waiting for market conditions to normalise. However, the swift succession of events gave way in the last month to a sudden change towards much more exhaustive, determined and finally, well-structured strategies which also tended to converge among the countries affected. Concerted mechanisms also improved substantially as was demonstrated by the simultaneous interest rate cut undertaken by the major central banks on 8 October and the relative similarity between the strategies adopted, both in terms of time and content.

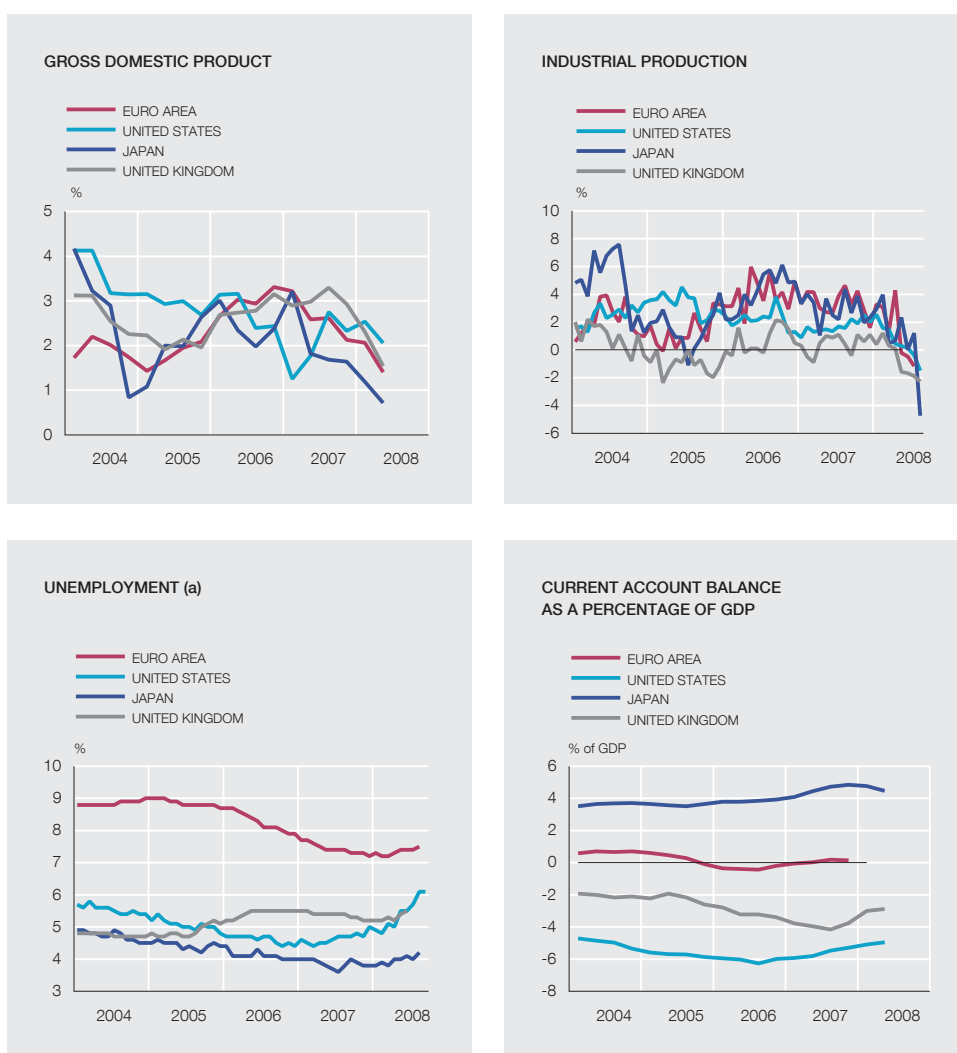
The authorities' strategy is based on four fundamental pillars. Each is aimed at tackling one of the above-mentioned key elements: liquidity, valuation, (perceived or actual) solvency and (lack of) confidence. In practice, however, many of the measures are targeted at mitigating problems in several areas: i) providing *liquidity and financing* to the banking system and other segments of the financing markets in view of the market blockage; the provision of liquidity has been instrumented by central banks through increasingly broad credit facilities, also in foreign currency, while financing financial institutions and even ailing non-financial corporations has been the responsibility of governments, although on occasions it has been instrumented through central banks, either as an agent in financing bail-outs (the case of AIG, for example), or, directly financed as the ultimate borrowers (purchase of commercial paper); ii) *pricing of financial instruments*, which is specifically addressed by the US troubled asset relief program

(TARP), together with other plans; iii) reinforcement of (actual or perceived) solvency, which has resulted in the strengthening of the capital base through several types of initiatives (injections of public capital, encouragement of M&As, nationalisation of banks, etc.), and iv) restoring confidence, which is the ultimate objective of the above-mentioned measures and, also, of the other measures adopted, such as public guarantees of debt, deposits and other banking assets and liabilities. This return of confidence and unclogging of wholesale financing markets are the basic ingredients for making financial markets function normally again.

In short, the deterioration of the global financial situation has crystallised into a determined, convergent and coordinated response between countries. The magnitude of the response can be measured by the amount committed in capital injections, bank debt guarantees and asset purchase programmes and other forms of financing which are approximately 15% or more of GDP in numerous advanced economies (see Panel 4). It must be underlined that this amount does not represent the effective tax cost of the measures, which would be much less, or could even be zero or could generate net revenue in the medium term, if they achieve their objective of market stabilisation. The reason is that the corollary for these actions is the acquisition of assets or capital of the firms which are supported and the guarantees are contingent and entail revenue for tax authorities. The breadth, intensity and complementarity of the measures adopted must lay the foundations for the gradual recovery of confidence and for market normalisation, although it will be a long and complex process.

approved at the beginning of 2008. However, indicators for Q3 showed a notable weakening of activity which was accentuated in September. Consumer confidence indices, after the temporary effect of the fiscal stimulus, held at historically low levels. Housing market indicators continued to reflect the deep adjustment in the residential sector (housing starts, construction permits and house sales all fell in Q3) and the construction sector confidence index hit a new record low in October. The manufacturing ISM index dropped in Q3 to levels associated with a contraction in activity at the same time as industrial production fell strongly in September. Nevertheless, the non-manufacturing ISM index stood slightly above the threshold of expansion of activity. The labour market weakened sharply with a rise in the unemployment rate to 6.1% in September and the net destruction of nearly 300,000 jobs during the quarter. CPI inflation rose steeply in July, although this rise was corrected in August and September due to the moderation in oil prices, to 4.9% year-on-year in September, while core inflation posted a year-on-year rate of 2.5%. The Federal Reserve cut the interest rate on federal funds by 50 bp to 1.5%, as part of the above-mentioned coordinated action. Also, a financial rescue plan was finally approved which includes asset purchases and recapitalisations totalling US\$ 700 bn, a programme to buy commercial paper and a public guarantee of bank debt (for an estimated value of US\$ 1.4 trillion) and of corporate deposits.

In Japan, following the contraction of GDP by 3% in annualised quarterly terms in Q2, the latest indicators point to a scenario of a notable weakening of the economy, which could be more protracted and severe than initially envisaged. Private consumption and external demand

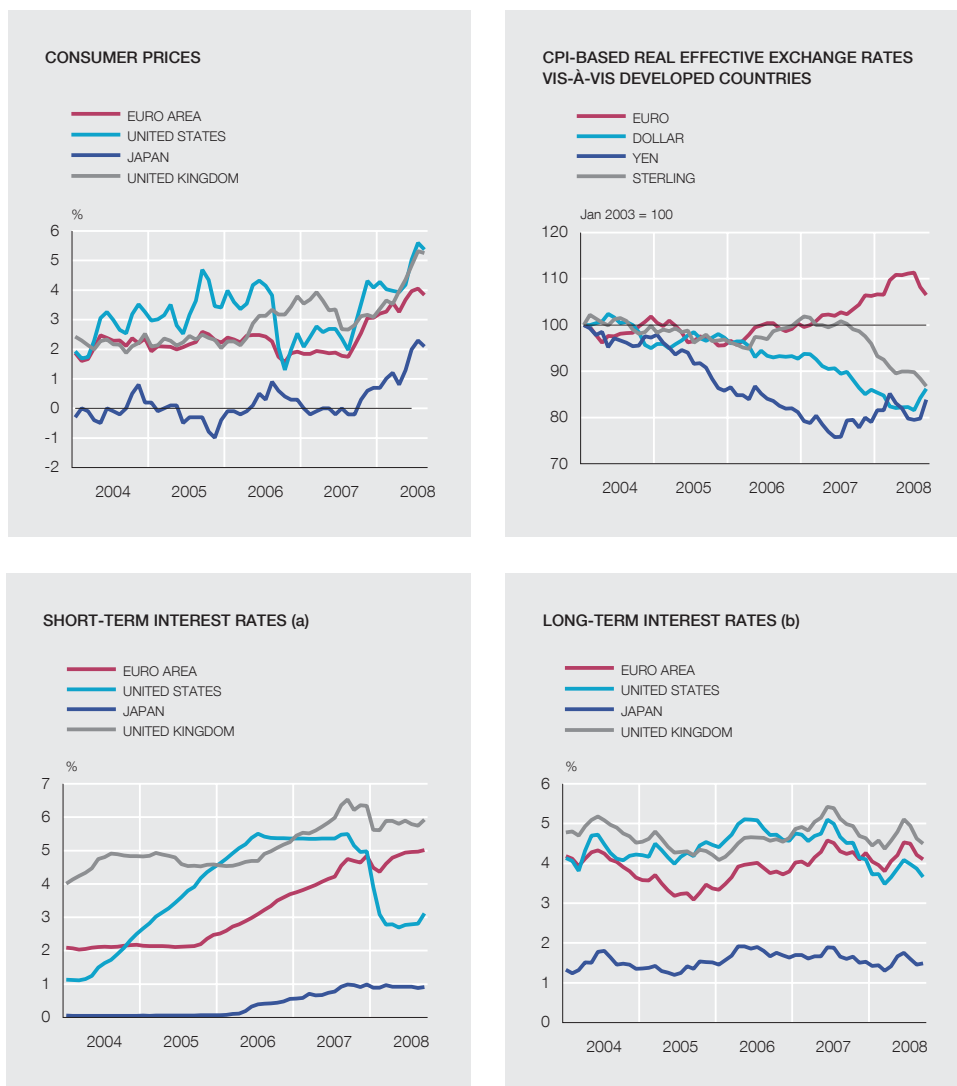


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

showed no signs of improvement and expenditure on investment remained contained against a backdrop of high uncertainty. Industrial production, the PMI manufacturing index, the Tankan business survey and the poor performance of the construction sector indicate a contraction of activity in Q3. The unfavourable trend in private consumption can be attributed to the continuing slide in household purchasing power and a weak labour market. The unemployment rate increased to 4.2% in August, while the ratio of vacancies to job-seekers and real salaries experienced further declines. On the external front, the slight trade deficit in August is worth mentioning which was due to the continuing weakness of exports and an increase in the price of imports. As for prices, inflation dropped 0.3 pp to 2.1% in August. The Bank of Japan did not join in with the coordinated reduction of official rates due to their low level (0.5%). However, the monetary authority stepped up operations to inject liquidity for banking institutions which, nonetheless, are slowing down their credit expansion.

In the United Kingdom, the downward trends in activity and employment intensified sharply: GDP growth was zero in Q2 and negative in Q3, a period in which the most important activity indicators once again fell sharply. The manufacturing PMI reached a new low in September.



SOURCE: Banco de España.

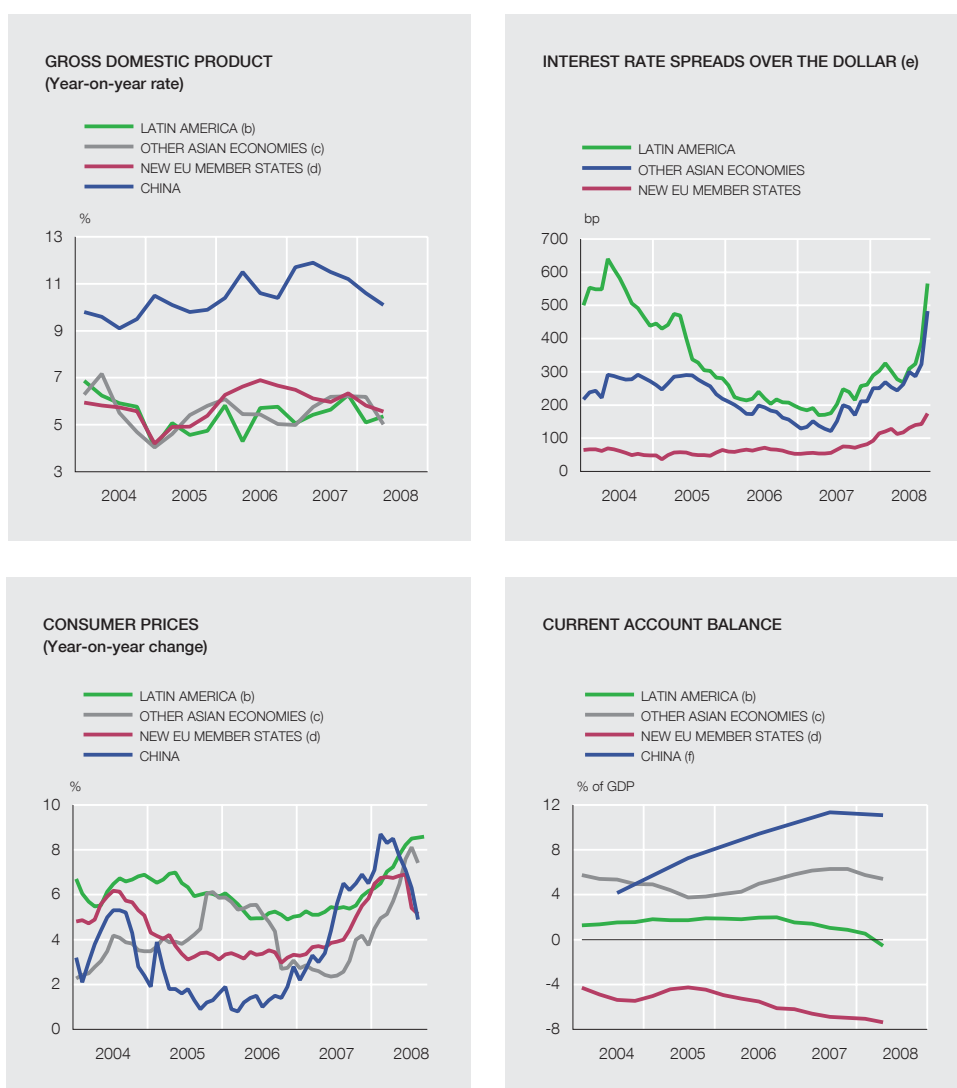
- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

Property prices posted a year-on-year decline of 13% in September. In spite of weak and lower commodity prices, inflation rose in September to 5.2%, due to higher food prices and the pass-through to final prices of previous increases in the price of oil. In this scenario, the Bank of England took part in the coordinated rate cut, reducing its interest rate to 4.5%. In the first week of October the Treasury announced its proposal for recapitalising banks (following talks with the major UK banks) -for which purpose it created a £50 billion fund- guaranteeing new bank debt and extending liquidity facilities.

In the new EU Member States not belonging to the euro area, GDP in Q2 slowed 0.3 pp on average to a year-on-year rate of 5.6%. However, economic activity underwent a strong adjustment in the Baltic states owing to the sharp deceleration in domestic demand, against a background of slowing credit and a high level of net external borrowing. In contrast, activity in Slovakia, Romania and Bulgaria remained highly buoyant, in Hungary it continued to recover gradually and in the rest of the region the moderation of growth was more gradual. Nevertheless, the high frequency indicators generally show a slowdown in activity and exports owing to lower demand in the euro area. Inflation decreased in most countries over the quarter, al-

**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.

though in September it remained at rates above 10% in the Baltic states and in Bulgaria. Monetary policy was tightened in Romania, while the Czech Republic cut the official interest rate by 25 bp. In the institutional sphere, the Polish government announced its intention to join the euro area in 2012, which would involve the entry of the Polish zloty in ERM II in the first half of 2009. More recently, the worsening of financial tension has notably affected certain countries which rely heavily on external financing (in particular, Hungary, a country with which the ECB arranged a swap line in mid-October to alleviate its position). The financial difficulties of other European countries are worth noting, in particular Iceland (which led to the nationalisation of its major banks and the collapse of its currency), Russia (where the government injected substantial resources into its financial system) and Ukraine.

In China, GDP grew 9% in 2008 Q3, down from 10.1% in Q2. This lower growth was in line with the trend in industrial production during the quarter which continued to moderate its year-on-year rate of increase, while consumption indicators (like retail sales) continued to grow strongly. The trade surplus widened in Q3 with respect to the same period in 2007 and international reserves rose to \$1.9 trillion in September, in a scenario in which the appreciation of the renminbi against the dollar was interrupted. Consumer prices grew at a year-on-year rate of 5.3% in Q3, continuing to moderate after peaking in Q1. The money and credit supply grew at year-on-year rates which were similar or lower than those in 2007 and the monetary authorities cut interest rates, for the first time since 2002, and also, on two occasions, the bank reserve requirement. The latest move coincided with the concerted action to cut official interest rates undertaken by some of the main developed economies. During the quarter, the Chinese authorities adopted certain measures which were interpreted as a sign of bias towards growth and support for the stock market. In the rest of Asia, GDP slowed in most countries in Q2, as did industrial production, and the latest data for which continued to point to moderation. The fall in oil prices triggered a decline in inflation, following the highs posted in July and August in most countries in the region. Broadly speaking, monetary policy changed from restrictive in July and August, with interest rate hikes in most countries and an increase in the reserve requirement in India, to more accommodative from September, when official interest rates were cut in Hong Kong, South Korea and India. The financial difficulties spread through nearly all the countries in the region, the strength of the decline in South Korea was particularly noteworthy and a package of measures was adopted to offset its effects.

In Latin America, the indicators published in 2008 Q3 partly include the tightening of external financing conditions and the deterioration of the international situation, in the form of weaker industrial activity and more moderate exports, but the demand indicators continued to show noticeable strength, which would be indicative of only a slight moderation in growth in that quarter. The fall in commodity prices in recent months, however, was reflected in a reduction of trade balance surpluses and in the moderation of government receipts. The region experienced a sharper adjustment in financial asset prices than in other emerging regions, especially, in September and October, in the same way as it recorded a relatively better performance than in the previous year. One reason behind this differentiated behaviour was the correction of commodity prices in itself. Similarly, the withdrawal of external investors triggered the unwinding of positions in local currency and the repositioning of local investors towards dollars which generated notable financing difficulties in this currency and an abrupt depreciation of exchange rates in the region against a backdrop of extreme volatility. Faced with this situation in recent weeks many countries in the region have implemented extraordinary measures geared towards restoring liquidity on markets, particularly in dollars, including the sale of reserves which is also aimed at stabilising exchange rates. In this scenario, certain central banks (Chile and Peru) interrupted the process of tightening their monetary policies which was implemented during recent months, despite the persistence of inflation which stood at 8.6% for the region as a whole in September, in comparison with 8.2% posted in June. By contrast, the Central Bank of Argentina raised its official interest rates to enhance the appeal of its currency.

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

Since mid-September, global and euro area economic developments have been marked by worsening financial market tensions. They began in the United States with the bankruptcy of Lehman Brothers and have now spread to European banks. The escalation of tensions manifested itself in sharp falls in stock market indices against a background of extreme volatility and in pronounced rises in risk premiums, while the gap between key ECB interest rates and those prevailing on the money markets widened to historical highs. On the foreign exchange markets, the euro continued to depreciate and its exchange rate against the dollar stood near \$1.2/euro at the end of October, a level not seen since 2006.

The seriousness of the situation obliged the economic authorities to take diverse extraordinary measures to stabilise the financial markets, restore confidence and prevent potential systemic risks from materialising (see Box 2). The amounts and maturities of the diverse liquidity providing transactions carried out by the monetary authorities exceeded those usually seen and, on 8 October, the European Central Bank, the Federal Reserve, the Bank of England and other central banks decided to relax monetary conditions simultaneously. The decrease in upside risks to price stability allowed the ECB to cut the interest rate on its main refinancing operations by 50 bp to 3.75%. As well as this concerted action, the ECB made significant changes in the implementation of its monetary policy decisions in order to keep interbank market interest rates more in line with the key ECB interest rate (see Box 3).

This action detained the sharp deterioration which the usual indicators of financial strain had suffered in the preceding weeks, although it is highly uncertain how they will behave in the immediate future. There is still not enough information to assess the impact of recent developments on the main macroeconomic aggregates. The National Accounts figures available to 2008 Q2 show a higher-than-expected decrease in quarterly GDP growth and the economic activity indicators available for Q3 generally reflect a notable sluggishness. The deepening of the global economic crisis brought an additional tightening of financial conditions and a notable fall-off in the confidence of agents, which the most recent forecasts of different public and private agencies interpret as signalling the prolongation of the weak economic activity. In any event, the exceptionality of the situation adds extra uncertainty. Any recovery during 2009 will depend, among other factors, on the result of the extraordinary measures taken by the economic authorities to re-establish financial market confidence and functioning and thus prevent the possibility of perverse feedback between financial instability and economic activity.

The upward pressure on prices is easing in consonance with the fall-off in commodity prices since mid-July. These include most notably oil prices, which stood at nearly \$60/barrel at the end of October, after touching \$150 in July. This price movement and the weakness of activity led to a downward revision of the inflation outlook reflected by the usual indicators, although care still has to be taken to avoid the risk of slipping into an upward wage spiral.

The slowdown in activity is also affecting the behaviour of fiscal balances which, according to the information available on the budget outturn and the draft budgets of various countries (currently in the process of approval), are deteriorating more sharply and rapidly than was anticipated some months ago. This is a consequence of the operation of automatic stabilisers and of the introduction of discretionary measures in some countries. What is most noteworthy, however, is the slowdown in the collection of certain taxes linked to the real estate market's

From the onset of the financial turmoil, the European economic authorities have been working on a joint response co-ordinated with other international initiatives, particularly with the recommendations of the Financial Stability Forum (FSF).¹ The work programme is in-

cluded in the roadmap approved by the ECOFIN Council in October 2007. Its objectives are to improve the functioning of markets (including the operation of credit rating agencies), enhance transparency, improve asset valuation and strengthen supervision, risk management and co-operation between supervisors.

1. The FSF was set up following the Asian crisis to coordinate global efforts to strengthen the financial system. In April 2008 the FSF issued recommendations to deal with the current situation. A follow-up report on their implementation is available at http://www.fsforum.org/press/pr_081009f.pdf.

The sharp turn for the worse in the global financial crisis from mid-September, with the concomitant risks to financial stability and harmful effects even on solvent banks, required resolute action by

NATIONAL PLANS TO SUPPORT THE FINANCIAL SYSTEM IN THE EURO AREA (a)

	Financing				Assets	Total amount		
	Recapitalisation	Guarantee		Other forms of financing		Purchase/exchange of assets	In € billion (b)	% of GDP
Of debt		Of deposits						
DE	Yes €70 billion (increasable to an additional €10 billion)	Yes Max. €400 billion. Loan loss provision of 5%	Political commitment to 100% coverage	Only if necessary	Yes. Allocation of funds combined with recapitalisation measures	480	19.8	6.3
FR	Yes Max. €40 billion	In special circumstances. Yes for Dexia	Remains at €70,000	Yes Refinancing fund €320 billion		360	18.0	5.4
IT	Yes No allocation of funds	Yes No allocation of funds	Remains at €103,291.38		Yes Exchange of public debt Up to €40 billion	40	2.6	1.2
ES	Yes No allocation of funds	Yes Máx. 100 mm €	Raised to €100,000		Yes Fund initially set at €30 billion, increasable to €50	150	14.3	5.1
NL	Yes Total allocation of funds unspecified. €20 billion immediately	Yes Máx. 200 mm €	Raised to €100,000	The Dutch central bank will grant credit to financial institutions		220	38.8	10.0
BE	Yes No allocation of funds	Yes No allocation of funds	Raised to €100,000					
AT	Yes Max. €15 billion	Yes. Up to €85 billion, including other forms of financing	100% coverage with effect from 1.10.2008	Yes A private entity with State guarantee will act as intermediary in the interbank market		100	36.9	11.2
GR	Yes €5 billion	Yes €15 billion	Raised to €100,000		Yes. €8 billion. Exchange of public debt	28	12.2	7.3
IE		Yes No allocation of funds	100% coverage					
FI	Yes €4 billion	Yes €50 billion	Raised to €50,000			54	30.1	18.8
PT		Yes Max. €20 billion	Raised to €100,000			20	12.3	4.5

SOURCES: European Central Bank and national central banks and finance ministries.

a. Measures announced up to 24 October, in many cases lacking specificity and legislative approval.

b. For the euro area as a whole, the total figure amounts to €1,412 billion.

c. Assets of credit institutions in 2007, taken from the October 2008 ECB publication *EU banking structures*.

governments. The summit of the European G8 countries on 4 October and the subsequent joint declaration of the EU heads of state and government manifested the initial political commitment to act coordinately and resolutely to ensure financial system stability. Subsequently, on 7 October the EU ministers of economy and finance decided to take all the action needed to re-establish the confidence and proper functioning of markets. The ministers decided to raise the minimum coverage of the deposit guarantee fund to €50,000 and established common principles on which the national initiatives should pivot: protection of taxpayers' interests, liability of shareholders and managers, and observance of single market and competition rules.²

Following this commitment, on 12 October the EU heads of state and government launched a concerted action plan. Whereas the ECB's measures are designed to support very short-term liquidity conditions (see Box 3), the governments' plan aims to support medium-term funding and restore institutions' capital ratios so that they continue to play their role as intermediaries in the economy. The member countries immediately made known some features of the national plans, which in certain cases supplemented previously announced or approved measures. As illustrated in the accompanying box, the plans of the euro area countries envisage various types of measures which, according to the information released so far, amount to more than €1,400 billion.

First, to enable credit markets to function normally again and so banks can obtain medium-term funding, the euro area governments propose a system to temporarily guarantee new bank issues of senior debt (with maturities of up to five years). Moreover, some countries,

2. Subsequently, the European Commission released a communication detailing the characteristics required of national guarantee and recapitalisation systems so as to comply with the general principles and with EU law.

such as France and Austria, offer guaranteed loans to their banking system, while others, such as Spain and Italy, have opted to purchase or exchange high-quality assets enabling institutions to be refinanced. The plan also helps institutions to restore their capital ratios. To this end, various governments have announced that they will provide (tier 1) capital to solvent institutions and, where necessary, emergency capital to prevent possible systemic risk. All these actions must comply with certain requirements, namely that they must be of a temporary nature and take place at market prices, among others.

Finally, the action plan agreed in the euro area also seeks to improve the mechanisms of cooperation between countries³ and make accounting criteria more flexible. In regard to this latter task, the European Commission has already issued a regulation so that the diminution in asset values does not continue to put additional pressure on European institutions.

In short, the measures referred to above aim to restore confidence and mitigate short-term liquidity and medium-term funding pressures, thereby helping the banking system to keep channelling savers' funds efficiently to the individuals and firms that need them and thus reducing the impact of the financial strain on economic growth.

In any event, in the medium term, it is also necessary to set in train the reforms identified in the roadmap approved by the ECOFIN Council in October 2007, which continues to be a priority. Also, the global nature of this crisis and the growing cross-border interrelationship of markets and institutions will require close international cooperation of governments, regulators, supervisory authorities and central banks.

3. In this respect, on 15 and 16 October the European Council announced it was setting up a financial crisis cell to act as a warning, information-exchange and evaluation mechanism.

performance and to business profits, which in recent years had contributed extraordinarily to improving fiscal balances. All this demonstrates the scant room for manoeuvre in the budgetary policy of some euro area countries. Further, the size of the financial institution recapitalisation and rescue plans being carried out by governments may have a significant impact on the behaviour of fiscal aggregates.

3.1 Economic developments

According to the second National Accounts estimate, after rapid growth in the first quarter of the year, euro area GDP posted a quarter-on-quarter decrease of 0.2% in Q2 (see Table 1 and Chart 8). This fall partly reflected a technical offsetting of the extraordinary factors which drove GDP at the beginning of the year, but its larger-than-expected size was a clear sign that the combined negative impact of various shocks was starting to have a bearing on euro area activity. Notable among these shocks are the rise in commodity prices, the appreciation of the euro, the loss of dynamism of the international environment and the turmoil in financial markets since mid-2007, which are being reflected in a tightening of financial conditions and in a decline in wealth associated with the fall in financial and real asset prices.

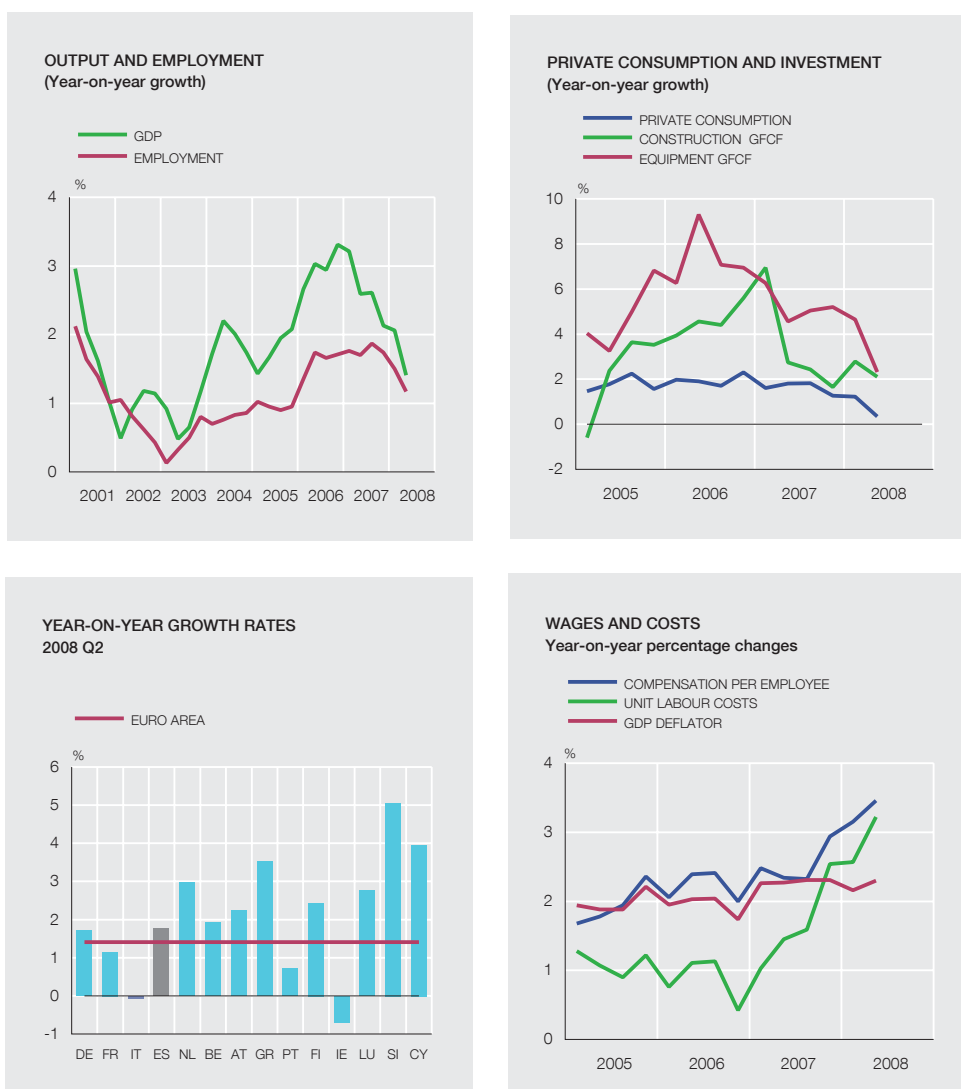
	2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NATIONAL ACCOUNTS (Quarter-on-quarter growth, except as indicated)								
GDP	0.7	0.5	0.6	0.4	0.7	-0.2		
Private consumption	0.0	0.7	0.4	0.2	-0.1	-0.2		
Public consumption	1.0	0.2	0.5	0.3	0.3	0.5		
GFCF	0.9	0.2	0.9	1.1	1.4	-1.0		
Imports	1.2	0.8	2.2	-0.4	1.8	-0.5		
Exports	0.5	1.3	1.8	0.3	1.8	-0.2		
Contribution to quarter-on-quarter GDP growth (pp)								
<i>Domestic demand (excl. inventories)</i>	<i>0.4</i>	<i>0.5</i>	<i>0.5</i>	<i>0.4</i>	<i>0.3</i>	<i>-0.2</i>		
<i>Changes in inventories</i>	<i>0.6</i>	<i>-0.2</i>	<i>0.2</i>	<i>-0.3</i>	<i>0.3</i>	<i>0.0</i>		
<i>Net foreign demand</i>	<i>-0.3</i>	<i>0.2</i>	<i>-0.2</i>	<i>0.3</i>	<i>0.0</i>	<i>0.1</i>		
GDP (annual growth)	3.2	2.6	2.6	2.1	2.1	1.4		
ACTIVITY INDICATORS (quarterly average)								
IPI, working-day adjusted (annual growth)	3.9	2.8	3.9	2.9	2.6	1.2	-0.9	
Economic sentiment	109.4	111.0	108.7	104.3	100.5	96.5	88.6	
Composite PMI	57.5	57.2	56.5	54.0	52.1	50.8	47.6	44.6
Employment (annual growth)	1.8	1.7	1.9	1.7	1.5	1.2		
Unemployment rate	7.6	7.4	7.4	7.3	7.2	7.3	7.4	
PRICE INDICATORS (end-period data)								
HICP (annual growth)	1.9	1.9	2.1	3.1	3.6	4.0	3.6	
PPI (annual growth)	2.8	2.3	2.7	4.4	5.8	8.1	8.5	
Oil price in USD	62.3	71.8	78.2	91.5	104.3	132.0	98.1	75.0
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year government bond yield	4.1	4.7	4.4	4.4	4.2	4.9	4.5	4.4
US-euro area ten-year government bond spread	0.58	0.46	0.15	-0.36	-0.69	-0.88	-0.88	-0.49
Dollar/euro exchange rate	1.332	1.351	1.418	1.472	1.581	1.576	1.430	1.260
Appreciation/depreciation of the EER-22 (b)	0.9	1.5	3.7	6.3	3.6	3.4	-0.7	-6.2
Dow Jones EURO STOXX 50 index (b)	1.5	9.0	6.4	6.8	-17.5	-23.8	-30.9	-47.0

SOURCES: European Commission, Eurostat, Markit Economics, ECB and Banco de España.

- a. Information available up to 24 October 2008. The information in italics does not cover a full quarter.
b. Percentage change over the year.

Most notable among the components was the decrease in spending on investment and on consumption. The former was particularly sharp, especially in the case of construction, which in the previous quarter had been stimulated to very high levels by the favourable weather conditions. The fall in private consumption was because of the contractionary impact of inflation on agents' incomes and the tighter financial conditions which, in a climate of uncertainty about the economic outlook and of deterioration in confidence, has pushed up the household saving rate. In year-on-year terms, euro area GDP growth decreased by 0.7 pp to 1.4%. The slowdown in activity spread to the main euro area economies. In the case of Germany, the quarter-on-quarter decline in GDP was 0.5% and was of a general nature, and the most notable feature was the weakness of private consumption, which fell for the third consecutive quarter. The fall in private consumption and investment in France and Italy was not as sharp as in Germany, but to this should be added a negative contribution from external demand, which left the quarter-on-quarter decrease in GDP in both economies at 0.3%.

Despite the fall-off in activity, employment increased in 2008 Q2, albeit more slowly than in the preceding months, prolonging the slowing trend initiated in the second half of 2007. Given that the slowdown in employment was smaller than in output, as is usual in cyclical downturns, labour productivity rose very moderately. This cyclical slowdown in productivity, in conjunction with the acceleration in compensation per employee, meant that unit labour costs grew rap-

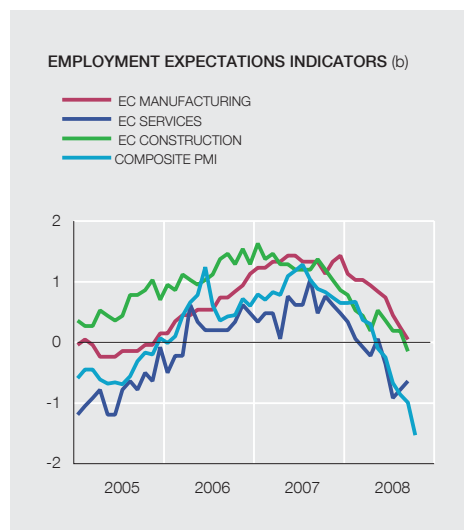
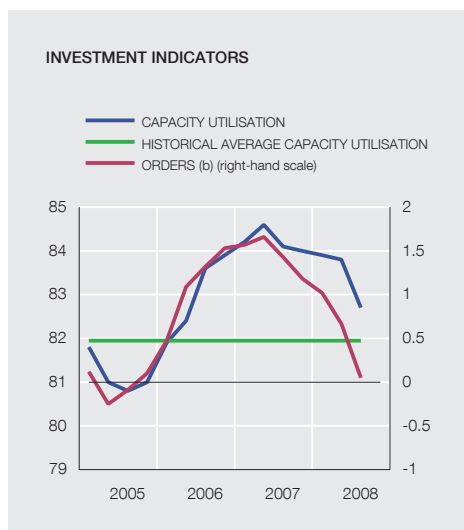
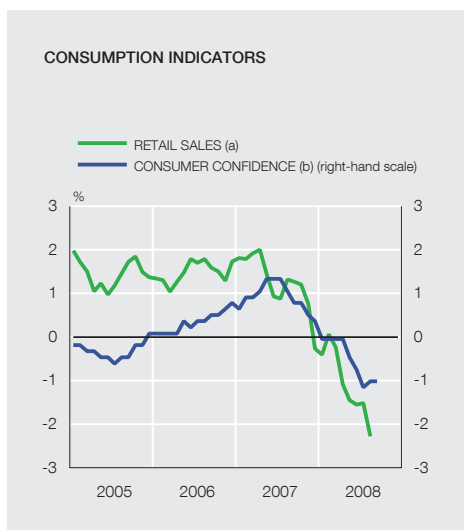
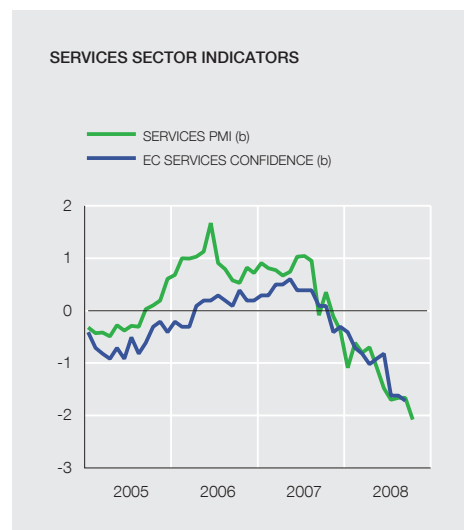


Sources: Eurostat and national statistics.

idly at more than 3%. Nevertheless, the contraction in operating margins partly cushioned the effect of the higher labour costs on final prices.

In 2008 Q3 the conjunctural indicators of activity deteriorated further (see Chart 9). Thus the decline in the industrial production index steepened in July and August and the business surveys showed a notable fall-off up to September which extended throughout all sectors and most of their components (current situation, expectations, etc). Further, the indices based on surveys of purchasing managers (PMIs) were down by 50 points on average for the quarter, pointing to a contraction of activity both in industry and in services. Meanwhile, the indicators of job creation expectations prolonged the deceleration initiated in the previous quarter, while the unemployment rate continued to rise slowly, standing at 7.5% in July.

The demand-side information available also reflects a weak growth rate of the main macroeconomic aggregates in Q3. Among the household spending indicators, retail sales and new car registrations showed very subdued month-on-month rates of change in July and August, following a decline in Q2. Meanwhile, the deceleration of consumer confidence and retail sales indices steepened in the quarter as a whole and there was a notable worsening of sentiment as to the employment trend, the household financial position and the general economic situa-



SOURCES: European Commission, Eurostat and Markit Economics.

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.

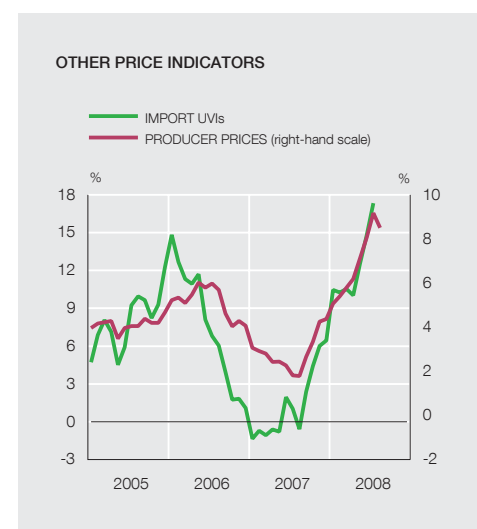
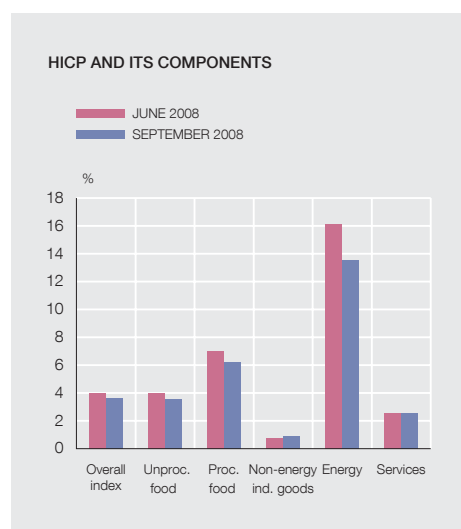
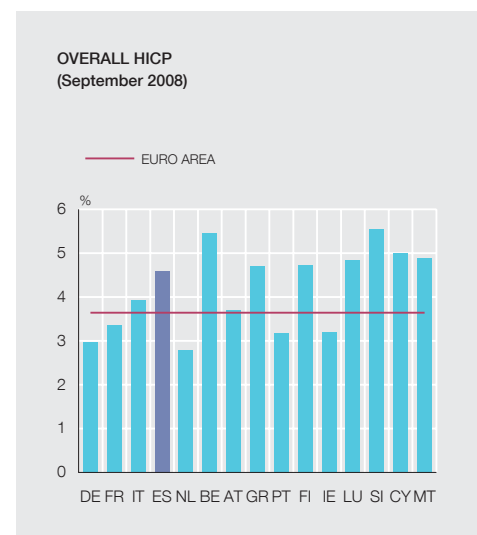
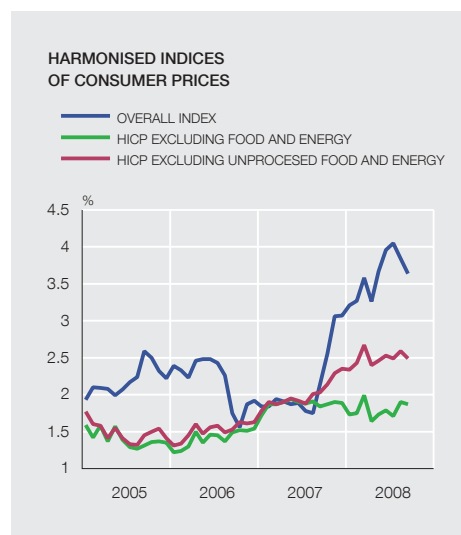
	2008		2009	
	GDP	HICP	GDP	HICP
Eurosystem (September 2008)	1.1-1.7	3.4-3.6	0.6-1.8	2.3-2.9
European Commission (April 2008)	1.7	3.2	1.5	2.2
<i>Interim update (September 2008)</i>	1.3	3.6		
IMF (October 2008)	1.3	3.5	0.2	1.9
OECD (June 2008)	1.7	3.4	1.4	2.4
<i>Interim update (September 2008)</i>	1.3			
Consensus Forecast (October 2008)	1.2	3.4	0.5	2.2
Eurobarometer (October 2008)	1.2	3.5	0.3	2.3

SOURCES: European Commission, Consensus Forecast, Eurosystem, IMF, MJ Economics and OECD.

a. Annual growth rate.

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

CHART 10



SOURCES: Eurostat and European Central Bank.

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

TABLE 3

	% of GDP					
	BUDGET BALANCES (a)					
	2006	2007		2008		2009
	Stab.Prog. (b)	EC (c)	Stab.Prog. (b)	EC (c)	EC (c)	
Belgium	0.3	-0.2	-0.2	0.0	-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 and national stability programmes..

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

tion. Noteworthy in regard to investment in capital goods is the rapid fall-off in the level of capacity utilisation in industry, although it is still above its long-term average. Finally, as regards external demand, exports performed very weakly in July, since there was a fresh fall in export order books and in export expectations, in line with the weakening of external demand.

In short, the available information for Q3 points to a prolongation in this period of the economic weakness seen in the previous quarter. The worsening of the financial crisis since mid-September makes it less likely that there will be a prompt end to the period of financial instability initiated in summer last year and has notably heightened the uncertainty over the prospects for growth. The most recent forecasts by international and private agencies delay the onset of improvement until the second half of 2009, so they envisage very low average growth for next year (see Table 2). Moreover, this scenario is subject to notable downside risks derived from possible feedback between the deterioration in financial and real conditions.

Euro area inflation decreased in Q3 to stand at 3.6% in September, from a high of 4% in June and July. As in previous months, this behaviour is largely linked to energy price developments and, to a lesser extent, to the slowdown in food prices (see Chart 10). The slight acceleration in the prices of services and non-energy industrial goods contrasts with the gradual weakening of demand. Core inflation (measured by the year-on-year rate of change of the HICP excluding unprocessed food and energy) held steady at 2.5% between June and September.

The intensification of the financial crisis and its foreseeable effects on the real economy, along with the moderation of food and energy commodity prices (at the end of October the price of Brent oil was approximately \$60), lends support to the downward revision now under way of inflation expectations in the short and medium term. A similar picture is offered by the selling price indicators based on confidence surveys and the inflation expectations indicators drawn from the financial markets. Nevertheless, foreseeably wages will remain at high levels, since they are the result of negotiations conducted several months ago, when the economic outlook was more favourable and the labour market had little slack. It can therefore be expected that the weakening of demand and of job creation prospects will help to hold wage demands in check, as the risk diminishes that energy price rises will produce widespread second-round effects on wages.

According to the information published by the ECB, the euro area current account balance posted a deficit of €39.8 billion (0.6% of GDP) up to August 2008, in contrast to the surplus of €8.9 billion recorded in the same period last year. This change of sign largely reflects the decrease in the goods surplus and the increase in the current transfers deficit. The performance of the goods balance is a result of the moderation of export sales in line with the weakening world trade and, in particular, with the deterioration in real terms of trade linked to sharp import price growth up to July. In the financial account, the direct and portfolio investment aggregate recorded net outflows of €95 billion between January and August, compared with €188 billion of inflows in the same period of last year. This was because direct investment posted a net capital outflow far higher than that in the same period of the previous year, while net capital inflows arising from portfolio investment decreased notably.

In the fiscal policy realm, the information available on the budget outturn points to a deterioration in the general government budget balance higher than that envisaged in the Commission's spring 2008 economic forecast. This result reveals mainly a sharp deceleration of revenue, which reflects both the introduction of discretionary measures (notable among these are the lowering of social contributions in France and Germany, the reduction of corporate income tax in Spain and Germany and the direct tax cuts in Spain) and the worsening of macroeconomic conditions. Also noteworthy is the absence of the extraordinary revenue recorded in the previous two years in some countries, linked to the boom in the real estate sector and to the increase in corporate profits.

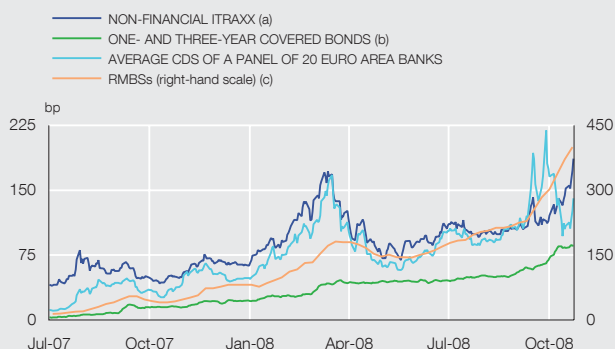
In these circumstances, when they prepare their budgets for the coming years, most countries are revising the objectives set in their updated stability programmes at the end of 2007 (see Table 3). The revision is especially significant in the cases of Ireland, which estimates that it will end 2008 with a deficit of more than 5%, and Spain. The governments of France and Italy have also revised upwards their deficit estimates for 2008, to 2.7% and 2.5% of GDP, respectively. In addition, France has postponed to 2013 its medium-term objective of achieving a balanced budget, while Italy has approved a package of fiscal measures intended to achieve balance in 2011. Only in Germany were the budget deficit estimates for 2008 revised downwards, leaving the general government budget nearly balanced in that year, compared with the previously estimated deficit of 0.5 pp.

What has been said so far highlights the scant room for manoeuvre available to some countries (with deficits already close to 3% of GDP in 2008) when it comes to allowing automatic stabilisers to act freely or to establishing discretionary anticyclical policies. To this should be added the fiscal cost which the financial institution recapitalisation and rescue plans undertaken by various governments will foreseeably have. Given this situation, in the coming months some governments will foreseeably invoke the "exceptional circumstances" clause of the Stability and Growth Pact.

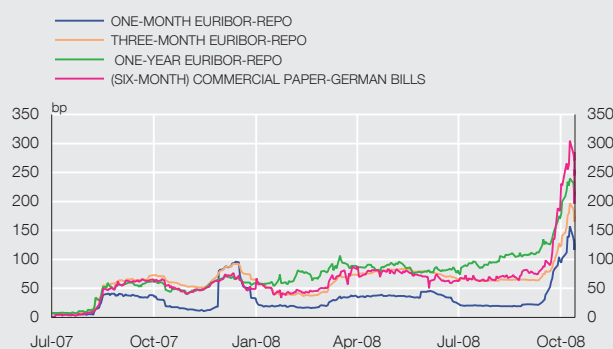
In the euro area, as elsewhere, the deterioration of the international financial markets affected the whole of the banking sector, including highly solvent institutions without any direct exposure to the products that have come to be known as “toxic”. The concerns over the solvency of banks reached extreme levels, with the premiums on credit default swaps rising extraordinarily (see Chart 1). In the money markets, term financing in the unsecured segment was practically inexistent

and the lack of confidence between institutions was reflected in EURIBOR levels which incorporated premiums of more than 200 bp at the beginning of October (see Chart 2). Also, in the markets of highest credit quality, such as covered bonds, rates also rose. Meanwhile, stock exchange indices fell sharply amidst extreme volatility affecting all sectors, with the EUROSTOXX 50 undergoing a correction of nearly 30% from mid-September (see Chart 3).

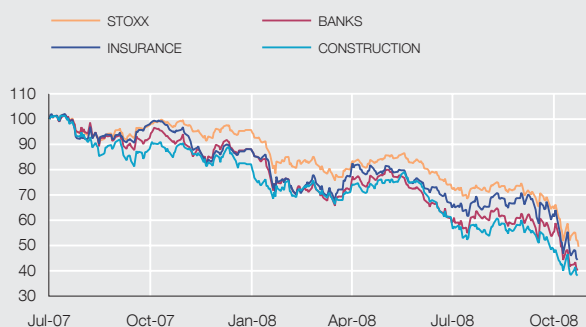
1 RISK INDICATORS



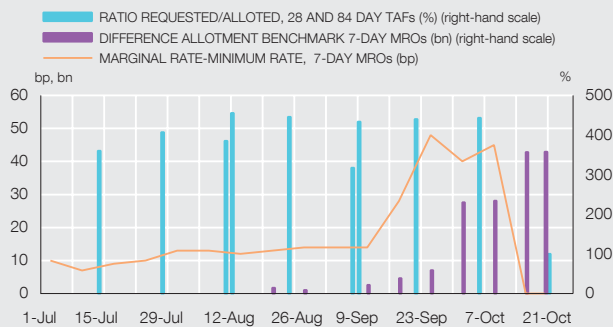
2 MONEY MARKET SPREADS



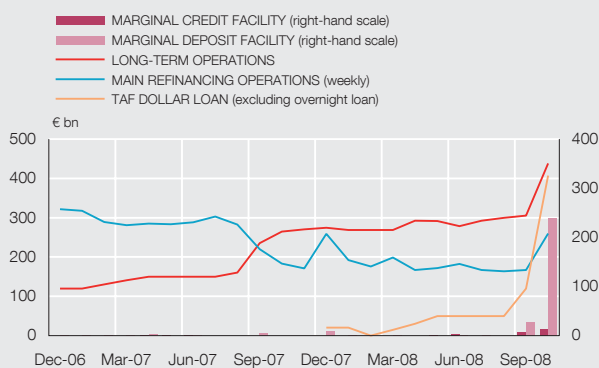
3 BROAD EURO STOXX AND SECTORAL INDICES



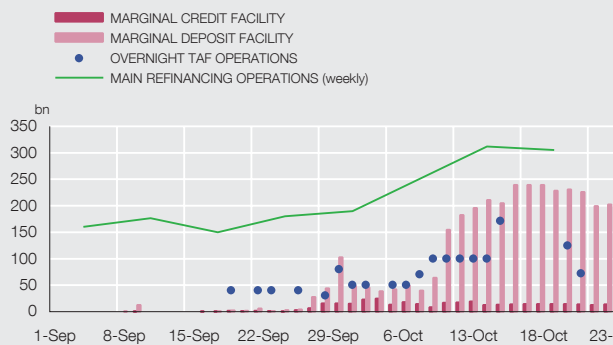
4 ECB OPERATIONS. DAILY DATA



5 VOLUMES OF ECB OPEN MARKET OPERATIONS (d)



6 VOLUMES OF ECB OPERATIONS. DAILY DATA



SOURCES: European Central Bank, Bloomberg, Datastream and JP Morgan.

- a. Quoted indices of a basket composed of different credit default swaps.
- b. Spread with respect to swaps. Five-day moving averages.
- c. AAA-rated euro-denominated mortgage-backed securities. Spread over three-month EURIBOR. Unweighted average of indices available for countries.
- d. Plot of average monthly net loan in each type of operation, except for TAFs and standing credit and deposit facilities, for which the month-end volumes are shown. October figures are up to the 24th.

Faced with the risks which this situation posed for the activity of financial intermediation, governments and central banks of numerous countries, including those of the euro area, undertook extraordinary measures to support the financial system (see Box 2 for more details on the initiatives of euro area governments).

However the escalation of the financial strain also strongly affected the implementation of single monetary policy. Thus, from mid-September the marginal rate in the weekly tenders reached notably high levels, despite the fact that the ECB continued to provide liquidity above what, *ex ante*, was considered neutral (see Chart 4). At the same time, however, institutions increasingly resorted to the deposit facility, indicating that liquidity was not being distributed efficiently in the system (see Chart 5). In addition, the US dollar liquidity needs of European banks increased.

The monetary authority responded to this additional strain by renewing the long-term supplementary financing transactions with three- and six-month maturities that it had entered into before summer and increasing the amounts supplied in the latter. One-off transactions were also conducted, such as, for example, that entered into on 29 September to provide €120 billion for 38 days with a renewal commitment until the beginning of 2009. As a result, the longer-term lending operations are providing the bulk of financing (see Chart 5), since the average net loan in September amounted to €305 billion, against €167 billion through the weekly tenders. In October to date these amounts were even higher (see Chart 6).

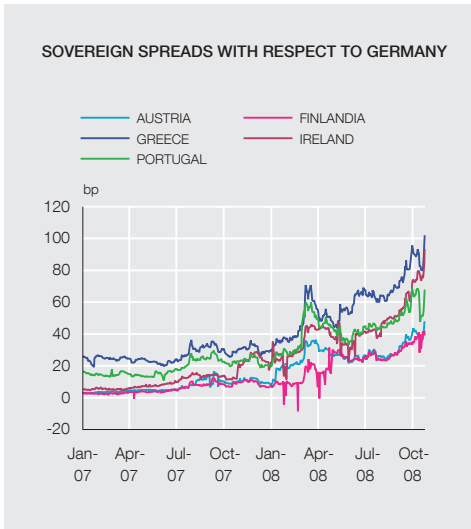
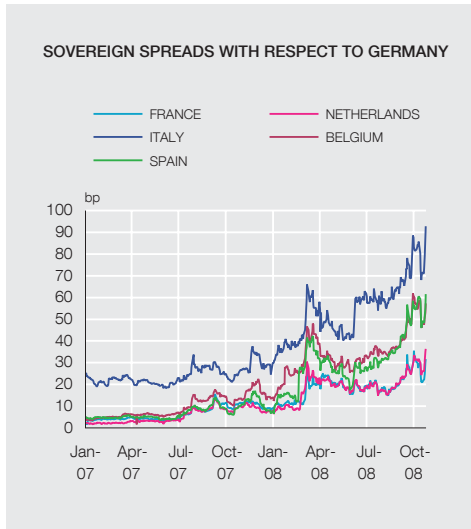
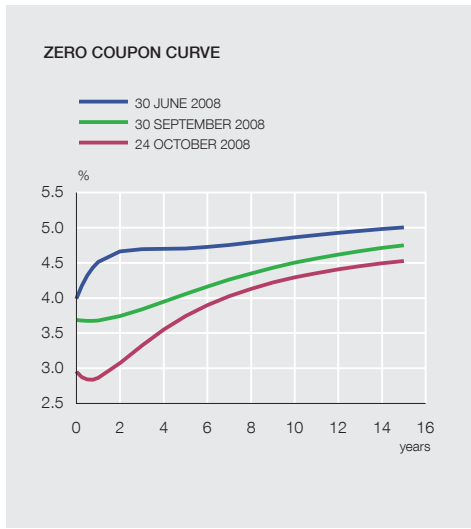
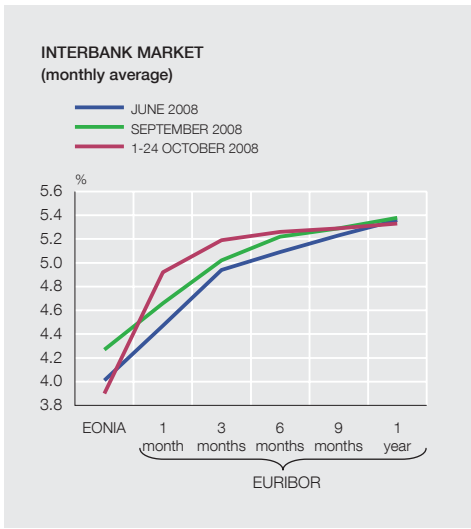
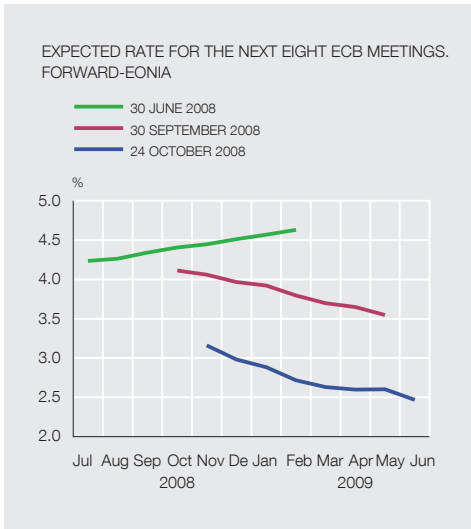
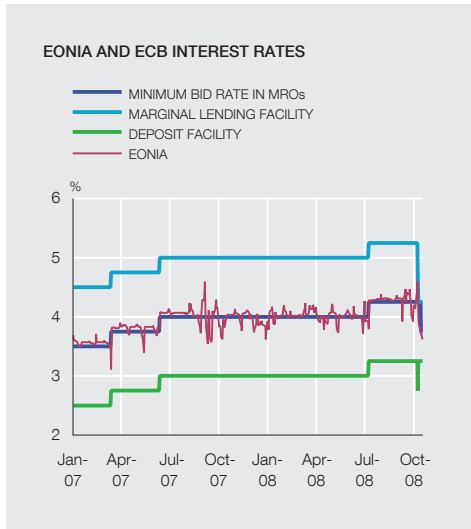
Nonetheless, in October the ECB Governing Council decided to undertake more radical changes in view of the prolongation of the crisis and the realisation that the interbank market was unlikely to be able to resume its normal functioning in the short term. First, it

was decided that the weekly main refinancing operations would be carried out through a tender procedure at a fixed rate (the minimum rate in the weekly tenders), with full allotment of the requested amounts, which gave rise to a significant increase in this type of financing (€310 billion in the 15 October tender). This tender procedure was subsequently extended to other longer-term operations. Second, the corridor of standing facilities was reduced from 200 bp to 100 bp around the interest rate on the main refinancing operation. Lastly, the Governing Council decided to significantly broaden the range of assets acceptable as collateral. Simultaneously, the ECB, in coordination with other central banks, widened the agreements with the Federal Reserve to increase the dollar loan. Hence new one-week dollar operations and daily tenders for overnight loans were introduced. Also, on various occasions the amount of the term auction facilities was increased and on 13 October the central banks decided to grant the total funds requested in fixed-rate term auction facilities (except in the daily ones). This measure will remain in place until at least January 2009. The ECB also reached an agreement with the Swiss National Bank to provide financing in Swiss francs.

The wide range of measures adopted in recent weeks have led the ECB to take on a role of liquidity distribution normally carried out by the market. As is well known, the financial markets have to function normally before the main channels used by the monetary policy transmission mechanism can operate. Moreover, in circumstances like those prevailing at present, there is an increased risk that liquidity problems may rapidly turn into bouts of financial instability. From this standpoint, the decisions taken by the ECB Governing Council, within the scope of the independent exercise of its powers, supplement the measures, also extraordinary, taken recently by the governments of the euro area countries.

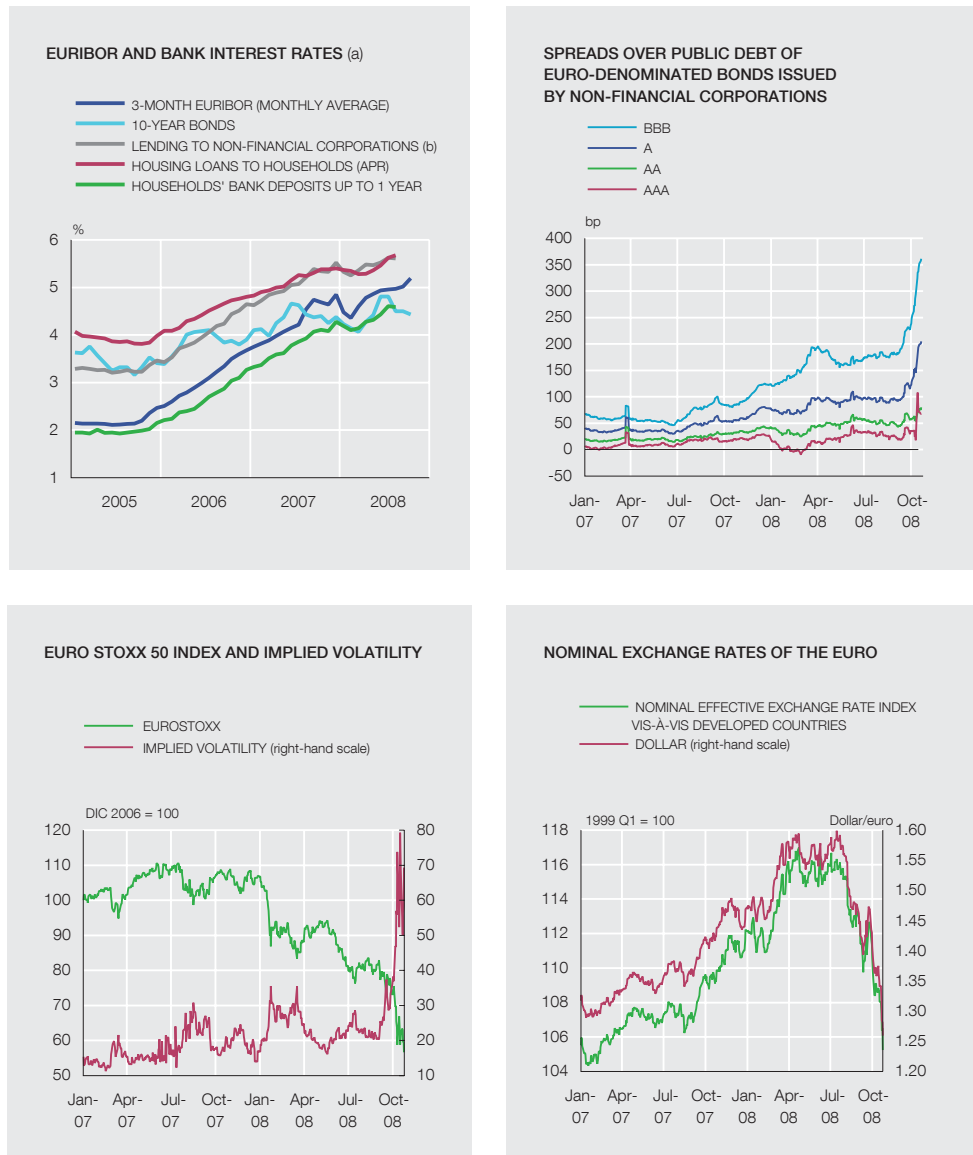
3.2 Monetary and financial developments

In the euro area the extraordinary worsening of the financial tensions seen in mid-September was manifested in the further tightening of financial conditions. As shown by Table 3, the difficulty in obtaining liquidity on the monetary markets prompted a large increase in the spreads between interest rates on the interbank market and those on assets without counterparty risk. Risk premiums and the spreads on corporate bonds also increased notably, and stock market indices, amidst extreme volatility, recorded sharp falls (see Charts 11 and 12). The deterioration in the financial situation of some institutions and the growing difficulties in obtaining financing have given rise to corporate movements which are producing a restructuring of the European banking sector and, on occasions, have required the intervention of governments in troubled institutions to prevent possible systemic risk. Apart from this action in respect of specific institutions, as described in Box 2, the euro area governments acted in coordination to take exceptional measures to support the financial system so that it could satisfactorily continue its task of intermediation in the economy. Against this background, the ECB has taken numerous decisions to mitigate the effects of the deepening crisis on financial conditions, restore confidence to the markets and meet the abundant demand for liquidity.



SOURCES: European Central Bank and Banco de España.

a. Estimated by the ECB using swaps market data.

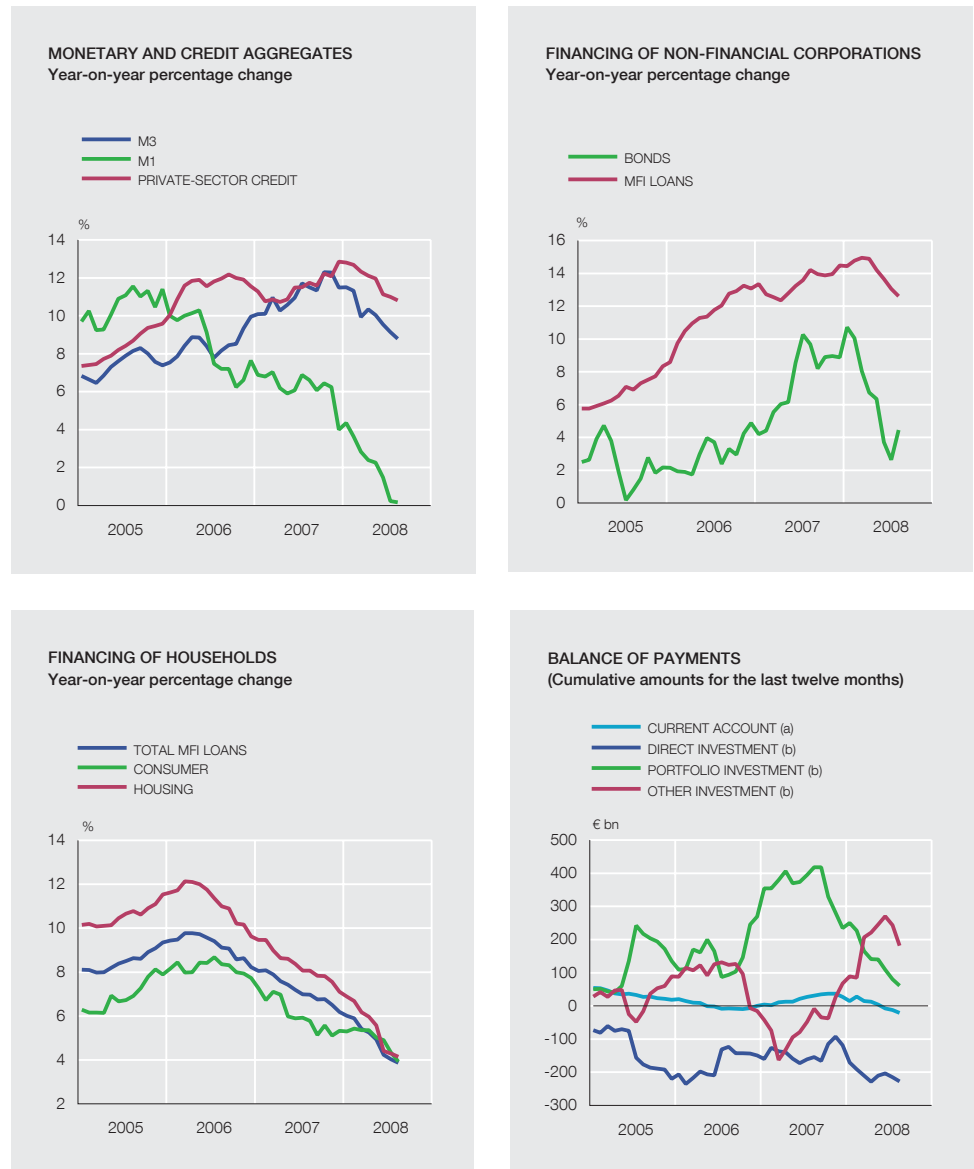


SOURCES: European Central Bank and Banco de España.

- a. For new operations.
- b. Floating interest rates and up to 1 year initial rate fixation.

On 2 October the ECB Governing Council discussed at length the intensification of the financial turmoil and its impact on activity and prices. At that time it considered that the weaker activity had reduced the risks to the objective of price stability, although they had not totally dissipated. In the ensuing days, however, there was a spate of negative news about the course of the financial crisis and its possible effects on the growth and inflation outlook. On 8 October the ECB Governing Council decided, in concerted action with other central banks, to lower interest rates on main refinancing operations (MROs) by 50 bp to 3.75%. This measure was accompanied by significant changes in its policy on the provision of liquidity, which are analysed in Box 3.

As noted above, the uncertainty at the time of this article going to press is very high, but it seems that the action taken by the economic authorities to ameliorate the adverse effects of the escalating financial turmoil have at least halted the rapid deterioration being recorded by



SOURCES: European Central Bank and Banco de España.

- a. A positive (negative) sign indicates a current account surplus (deficit).
- b. Capital inflows less capital outflows. A positive (negative) sign indicates a net capital inflow (outflow).

most financial variables. Nonetheless, the worsening in most of the indicators of financial tensions since mid-September has not been fully corrected and, in any event, they continue to stand at high levels.

Thus EURIBOR interest rates, after peaking at the start of October, have been falling since the measures were announced. However, on 24 October the one-month rate remained above the levels before the intensification of the turmoil, while one-year EURIBOR stood at 5.04%, a level not seen since May. Meanwhile, at the date of this bulletin going to press, the long-term yields on government debt were slightly above 4%, somewhat down on those in June, reflecting a higher flow of savings to insurance assets and the possible impact of the deteriorating economic outlook and the easing inflationary pressure. The yield spread with respect to 10-year US bonds was around 50 bp. The yield spreads between German sovereign bonds and their equivalents in other euro area countries were higher than in June, standing above 90 bp

in the case of Italy, Greece and Ireland, above 50 bp in Spain and Belgium, and around 30 bp in France, the Netherlands and Finland. Finally, the yield spreads of private debt over public debt have also increased notably, especially in the case of lower-rated securities.

European stock market prices were clearly penalised by the recent tensions and, as said above, have still not recovered the lost ground. Volatility increased significantly and, on 24 October, the EURO STOXX 50 had dropped by 47% from the beginning of the year and by nearly 30% since mid-September, with losses in most sectors, the sharpest being in the financial sector. The euro exchange rate stood at \$1.26 per euro, with a depreciation of somewhat more than 14% in the year to date. In nominal effective terms, the cumulative depreciation was 6.2%. Additionally, against this background of financial tensions, there was downward pressure on some of the currencies participating in ERM II.

The latest information available on monetary and credit aggregates relates to August and therefore does not include the possible effects of the recent deepening of the financial turmoil (see Chart 13). The information available up to that month reflects a progressive slowdown in M3 growth to 8.8% year-on-year in August, with practically zero growth rates of its most liquid component, i.e. M1, which includes cash in circulation and overnight deposits. From the standpoint of counterparties, lending to the private sector held on a smoothly moderating trend apparent in all countries and which was somewhat more pronounced in lending to households than in that to non-financial corporations. Overall, the slowdown in lending to firms and households up to August was in line with the slackening dynamism of activity and the deteriorating economic outlook and with the persistent rise in financing costs. On the supply side, the bank lending survey reflected an additional tightening of credit standards in 2008 Q2, and institutions expect that this process will continue in Q3.

4 The Spanish economy

On QNA estimates, GDP slowed sharply in 2008 Q2, posting year-on-year growth of 1.8%, 0.8 pp below the estimated rate for the previous quarter. In quarter-on-quarter terms, the rate of increase in output stood at 0.1%, 0.2 pp down on Q1. This loss of momentum in activity reflected the diminished dynamism of national demand, in particular of residential investment. In contrast, the contribution of the external sector to GDP growth improved by 0.5 pp and turned positive, set against the sharper slowdown in imports than in exports. On the supply side, with the exception of energy, the rate of expansion of all branches of activity eased off, particularly construction and industry. The deceleration in activity was mirrored in the pace of job creation which, on QNA figures, slowed significantly in 2008 Q2 to 0.4% in year-on-year terms, 1 pp less than in the previous quarter. Consequently, given the rate of expansion of output, the pace of productivity increased by 0.2 pp to 1.4%.

On the information available, activity in the Spanish economy continued to weaken in 2008 Q3. The persistence of the instability on international financial markets and its consequences for financing conditions and agents' confidence have amplified the correction begun in the preceding quarters, contributing to check the increase in activity. The most acute episodes of the financial crisis seen in recent weeks might further have inhibited economic growth. Against this background, the year-on-year rate of change of GDP is expected to have stood at 0.9% in Q3, 0.9 pp below that observed the previous quarter. In quarter-on-quarter terms, it is estimated output will have fallen off, posting a rate of -0.2%. This would be attributable to the ongoing loss of momentum of national demand, whose year-on-year growth rate is expected to have fallen to 0.3%, while the positive contribution of the external sector is forecast to have continued improving to 0.6 pp (see Chart 14).

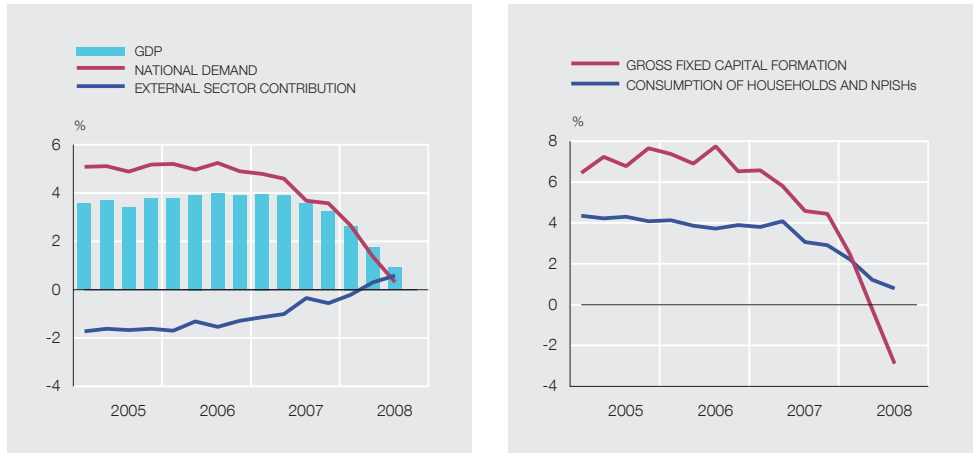
On the supply side, the slowdown in value added in the market economy in Q3 is estimated to have been across the board, bearing chiefly on the industry and construction branches. As to the labour market, the indicators available point to an intensification of the process of job destruction. Compensation per employee is estimated to continue growing at a high rate, similar to that observed in recent quarters, whereby the growth of unit labour costs is expected to slow slightly in Q3. As regards consumer prices, the year-on-year rate of change of the CPI increased over Q3 as a whole to an average rate of 4.9%, 0.3 pp more than the previous quarter, although it moderated appreciably from August. This trajectory was largely influenced by the path of oil prices which, after peaking in July, fell heavily subsequently. For the quarter on average, core inflation rose by the same amount as the overall index, to 3.5%, as a result of the acceleration of prices in services and in non-energy industrial goods.

4.1 Demand

Final consumption spending by households and NPISHs continued in Q3 on the markedly slowing path witnessed since the start of the year, according to the latest conjunctural information (see Chart 15). Consumer confidence and that of retailers slipped further, reaching a new historical low in the first instance and standing very close to it in the second. Among the quantitative indicators, the Tax Agency's figures on large corporations for July and August revealed year-on-year declines in domestic sales of consumer goods and services that were somewhat greater than in Q2 on average. Along these same lines, the retail trade index in real terms fell in the July-August period at a rate which was also higher than that seen in the spring. The deterioration was greater in the case of consumer durables. In Q3 there was a year-on-year fall of more than 30% in new car registrations.

MAIN DEMAND AGGREGATES (a)

CHART 14

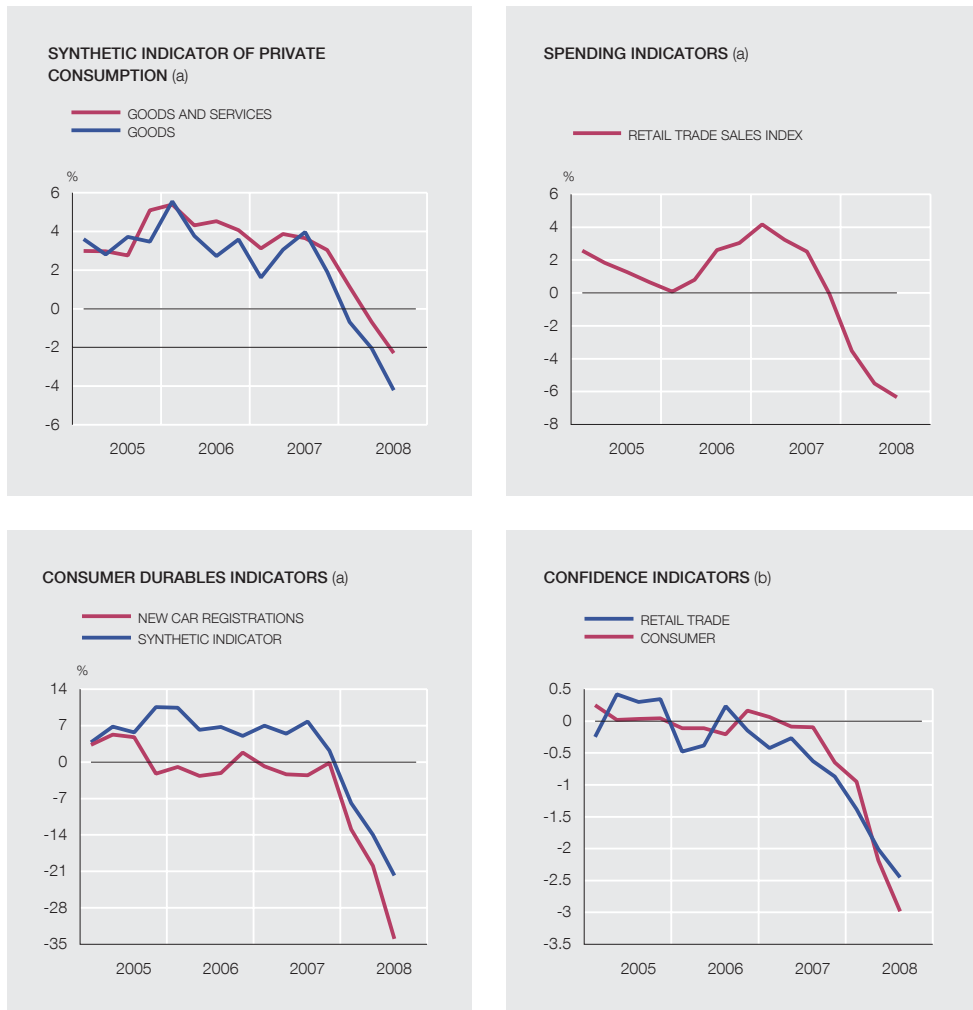


SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION INDICATORS

CHART 15



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).

Behind this weakening in household consumption is both the aforementioned loss of confidence, generated by the delicate situation of international financial markets and by the gloomier macroeconomic outlook, and the more unfavourable trend of the attendant determinants. Hence job destruction and the high rate of inflation have eased the real rate of increase of household gross disposable income, despite high wage growth. Furthermore, the fall in stock market prices and the marked slowdown in house prices are exerting an unfavourable effect on household wealth. In turn, tighter financial conditions might be contributing to households deferring certain consumer durables spending decisions. All these factors are leading to a pick-up in the household saving ratio which, on the latest data from the non-financial accounts of the institutional sectors, increased to 10.7% of disposable income in the four-quarter period to 2008 Q2. That said, certain factors of a more structural nature might help support consumption to some extent in this sluggish phase, as is analysed in Box 4.

Final general government consumption is expected to post a similar rate in Q3 to that recorded the previous quarter (3.8%), although the State budget outturn data suggest a somewhat more moderate increase in civil servants' compensation.

Gross fixed capital formation continued to slide in 2008 Q3, according to the conjunctural information available (see Chart 16). In the case of capital goods, the related indicators of apparent investment, though incomplete, point in Q3 to some contraction, while the confidence indicators signal greater slackness, with declines in the business climate indicator in respect of capital goods and of industry as a whole, along with a deterioration in orders. These developments are in keeping with the weakness of domestic demand and of world trade, and with the moderation of business profits. Further, the recent tightening of bank financing conditions and the greater difficulties in raising financing from banks and through other channels are adversely affecting non-financial corporations' spending decisions. This set of factors is, according to the non-financial accounts of the institutional sectors, translating into a decline in the overall sector's net borrowing which, in the four quarters to 2008 Q2, stood at 10.3% of GDP (0.8 pp less than over the four previous quarters).

The contractionary behaviour of investment in construction became more acute in Q3. The indicators of inputs – such as the domestic production of construction materials and the apparent consumption of cement – saw their rate of decline step up over the July-August period. The labour market indicators also followed this course, with a year-on-year decline of 12% in the average number of Social Security registrations in this sector during Q3. Further, the related confidence indicator for construction entrepreneurs fell more sharply in Q3 than in Q2. With regard to the different types of works, investment in residential building is expected to have fallen at a higher rate than that in the preceding quarter, owing to the significant decline in housing starts, according to the information drawn from figures for project approvals and from the gradual completion of the high volume of projects begun in 2006 and 2007. Uncertainty over the economic outlook – in particular employment – and over house price developments has affected residential demand by households, and this in turn has tended to discourage new projects from being launched. Approvals for non-residential building also showed an appreciable loss of momentum in Q3.

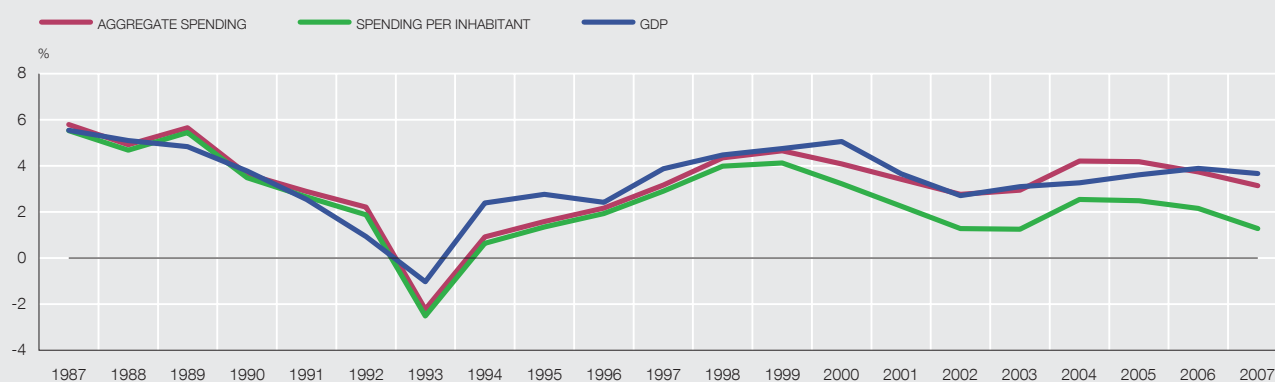
The information available indicates that the contribution of net external demand to GDP growth is expected to have continued increasing in Q3 to 0.6 pp, as a result of the continuing loss of steam in imports (see Chart 17). This slowdown in imports is in line with the trajectory described for final consumption demand and investment in equipment. Exports are estimated to have lost some momentum, in a setting of slowing world trade. This loss is essentially concentrated in the developed economies, and in particular in some of our main European partners.

Household consumption is closely related to output, employment and income, which determine household income, and to the value of household assets and to the expected real interest rate. However, in addition there are certain demographic and social factors which may

also significantly affect the fluctuations in consumption.

First, population growth affects aggregate consumption because the minimum level of spending per person on consumer goods and serv-

1 HOUSEHOLD FINAL CONSUMPTION (percentage change)



1 POPULATION AND HOUSEHOLD COMPOSITION AND SPENDING

	1992	1995	1998	2000	2002	2005
Total population (annual growth)	0.3	0.2	0.4	0.8	1.5	1.7
Household formation (thousands) (a)	170.6	117.0	221.2	309.5	377.0	477.9
Average household size (a)	3.3	3.2	3.1	3.0	2.9	2.8
Distribution (% of households) (a)						
One member	11.3	12.2	13.0	14.0	14.9	16.3
Two members	22.1	22.9	24.0	25.2	26.3	27.6
Three members	21.2	21.9	22.9	22.9	23.5	23.8
Four members	24.8	25.3	25.4	24.9	24.1	22.8
Five or more members	20.6	17.7	14.7	12.9	11.2	9.6
Average spending per person (euro) (b)			5,481.0	6,425.4	7,159.5	8,651.1
Average spending index (three members) (b)						
One member			141.4	149.2	154.5	158.4
Two members			110.1	114.5	119.9	112.9
Three members			100.0	100.0	100.0	100.0
Four members			88.7	86.3	90.2	86.3
Five members			76.4	78.8	80.6	74.1

2 STRUCTURE OF HOUSEHOLD FINAL CONSUMPTION (COICOP)

%	1993	2006
Food and non-alcoholic beverages	19.5	13.0
Alcoholic beverages, tobacco and narcotics	2.4	2.6
Clothing and footwear	8.1	5.7
Housing, water, electricity, gas and other fuels	13.1	15.7
Furnishings, household equipment and routine household maintenance	6.9	5.7
Health	5.2	3.6
Transport	13.5	11.6
Communication	1.1	3.5
Recreation and culture	5.8	9.8
Education	1.8	1.4
Restaurants and hotels	16.1	17.2
Miscellaneous goods and services	6.6	10.1
FINAL CONSUMPTION SPENDING	100.0	100.0

SOURCE: INE.

a. Spanish Labour Force Survey (social indicators).

b. Spanish Household Expenditure Survey.

ices is only reduced in highly exceptional circumstances. This implies that certain types of goods, such as food, for instance, exhibit a smooth cyclical pattern and average spending per inhabitant tends to fluctuate less than aggregate spending in periods of strong demographic expansion. This has been the case in Spain in the last 15 years, when the population has increased notably and the average consumption per person has followed a more moderate growth pattern than aggregate spending (see Figure 1).

Second, certain social factors have given rise to changes in the structure and composition of households and reduced their average size. The average number of children Spanish couples have had has trended downward in the past three decades. Also, the increase in the number of separations and in longevity has prompted the growth of households with a small number of individuals and, as a result, family units with a single member, which accounted for 11% of the total in 1992, made up 16% in 2005 (see first accompanying table). There was a similar increase in households with two individuals, while the proportion of households with five or more individuals fell by 11 pp. The outcome of all this was that the number of members per household, which averaged 3.3 at the beginning of the 1990s, dropped to 2.8 in 2005. At the same time there was a notable rise in the creation of new households, a trend which, according to the latest information, has continued in recent years. The fixed costs of households (for example, those relating to house rental and current expenses) and the resulting economies of scale give rise to an inverse relationship between average spending per person and the number of members in the family unit. Moreover, this relationship is non-linear,

as shown by the Household Expenditure Survey. The decrease in average household size in Spain has thus led to a rise in average consumption per person.

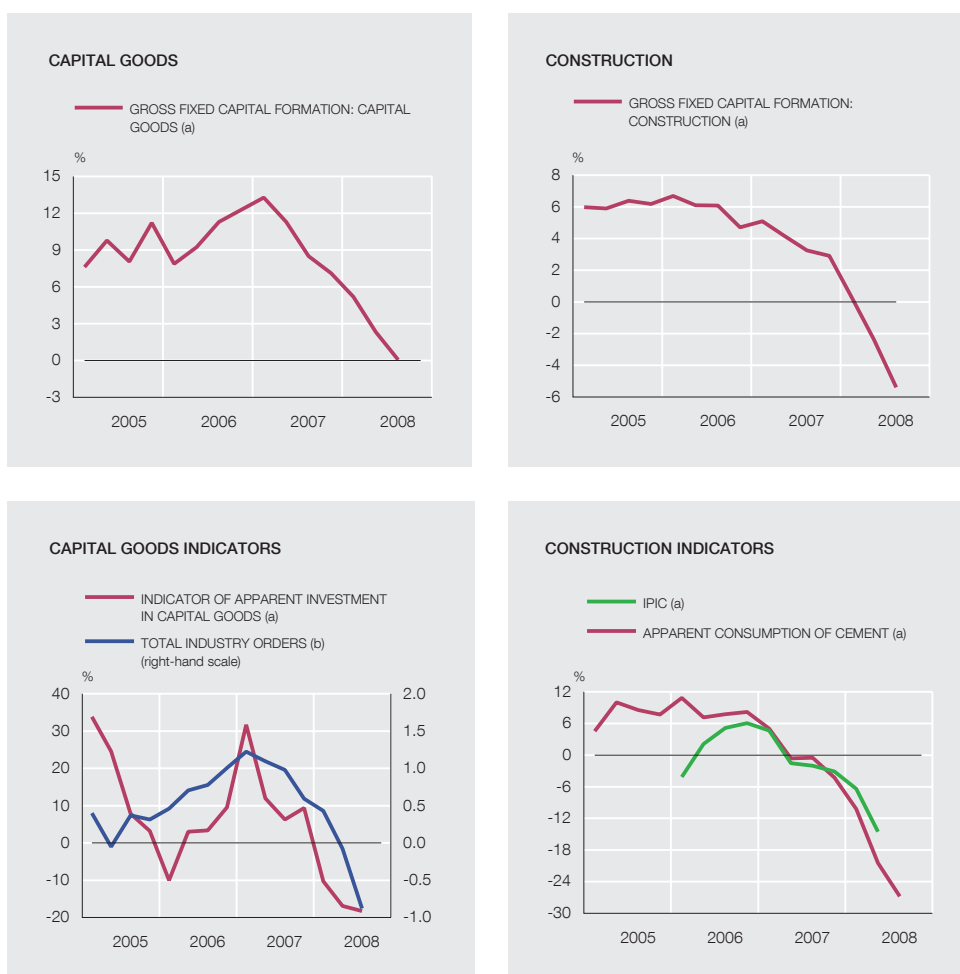
One last factor affecting average spending per person is the shift in the consumption structure towards goods and services, the demand for which tends to rise with increasing economic development and per capita income level. Thus the decline in the relative weight of food and the increase in spending on communications, leisure and cultural services and personal care (the latter are included under the other goods and services heading) are some examples of how these social changes tend to raise average consumption growth, since per capita spending on food is growing more slowly than the average, while the goods and services that are gaining relative weight in the spending structure are doing so at a faster pace (see second accompanying table). If the growth in consumption by type of good had been the same as at the beginning of the 1990s, the aforementioned change in composition would have led to a present growth in average consumption per person estimated at somewhat more than 0.5 pp higher than it actually is.

Consequently, strong population growth and higher new household creation seem to have spurred aggregate consumption growth since the end of the 20th century. Furthermore, diverse structural factors relating to the decrease in family unit size and to the composition of spending (linked in turn to the higher levels of income) have contributed to raising average spending per person over the past two decades. These factors may to some extent support the growth of private consumption in the current economic downturn.

The information available signals that the depreciation of the euro in Q3 translated into a more favourable performance of the price-competitiveness indicators, although over the course of the year to date these indicators have shown a deterioration.

On Customs data, real goods exports slowed in July and August, growing at a year-on-year rate of 4.1%, compared with 6.6% in Q2. However, in the period to August real goods exports grew by 4.4%, a very similar rate to that in 2007. By product group, the most dynamic components of exports in July and August were energy products and capital goods, although the latter have fallen off in 2008 to date, while sales of consumer goods other than food were those that showed most slackness. In terms of geographical areas, for which the information is presented in nominal terms, non-Community exports rose strongly in July and August. There were notably high growth rates in exports to Japan, Russia and the OPEC countries. The pace of sales to the EU was much more moderate, with declines in nominal exports for the euro area as a whole, which is in step with the weakness of demand in these markets.

Turning to real exports of tourist services, Balance of Payments figures suggest their rate of decline has steepened in Q3. In this period numbers of inbound tourists into Spain fell by 5.2%, although overnight stays in hotels increased (by 0.7%), as did the average stay in Spain. According to the Tourism Expenditure Survey (EGATUR), nominal spending by foreign visitors declined by 0.3% in July and August, although average spending per tourist rose notably



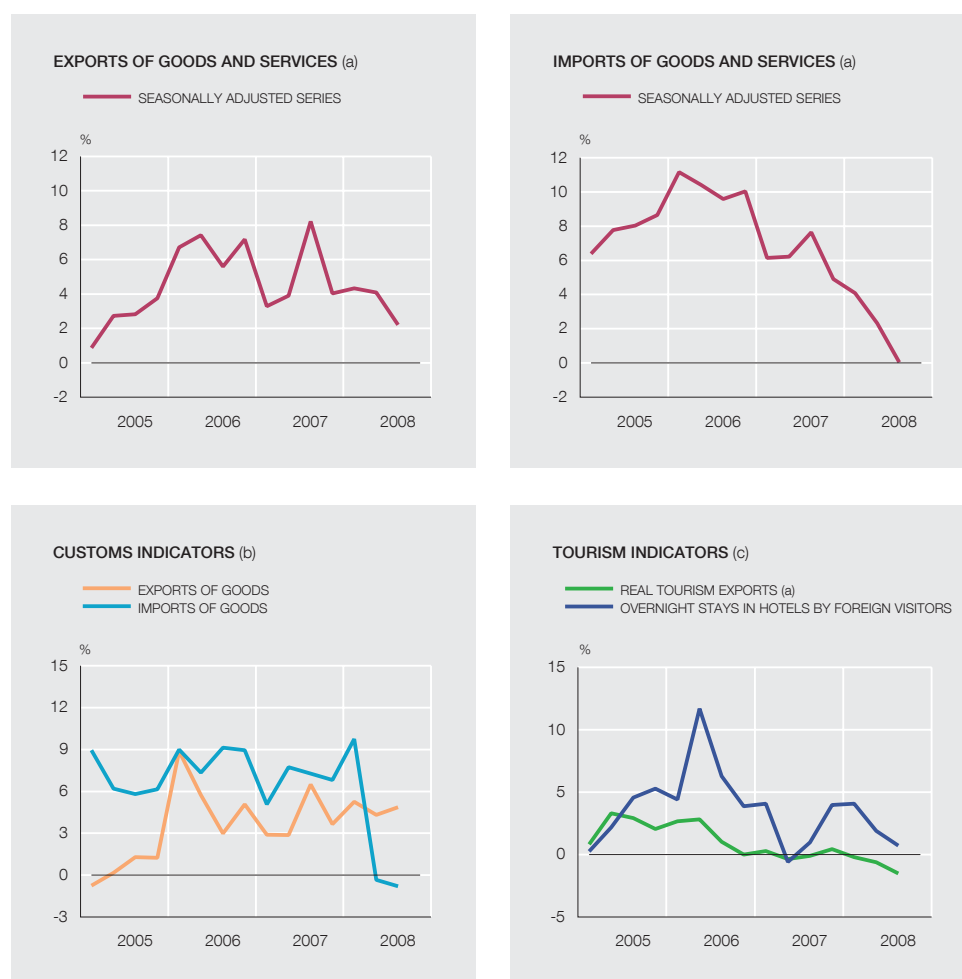
SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN and Banco de España.

- 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.

(5.8%). The breakdown by country of origin shows that the decline in incoming tourists in Q3 affected the main markets from which tourists to Spain are drawn, especially France. The Balance of Payments figures suggest that the slowdown in real exports of non-tourist services will have stepped up in Q3. The disaggregated Balance of Payments data highlight the declines in royalties and income from intangible assets and in revenues from insurance services, while the dynamism of receipts from transport and, in particular, from construction services continued.

On the information available, it is estimated that real goods imports eased off most considerably in Q3. Customs figures show that purchases of goods abroad in real terms declined by 3.6% in July and August, compared with the 1.4% increase recorded in Q2. In the first eight months of the year, real imports grew by 2.3%, one-third of their growth in 2007. By product group, there was a strong reduction in July and August in foreign purchases of capital goods and of non-food consumer goods, while real imports of intermediate energy goods maintained high growth rates (13.4%), due partly to the significant increase in exports of refined products (petrol in particular).

Finally, real imports of services are estimated to have slowed in Q3, owing both to the behaviour of expenditure relating to non-tourist services and, especially, to the trend of tourist im-



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

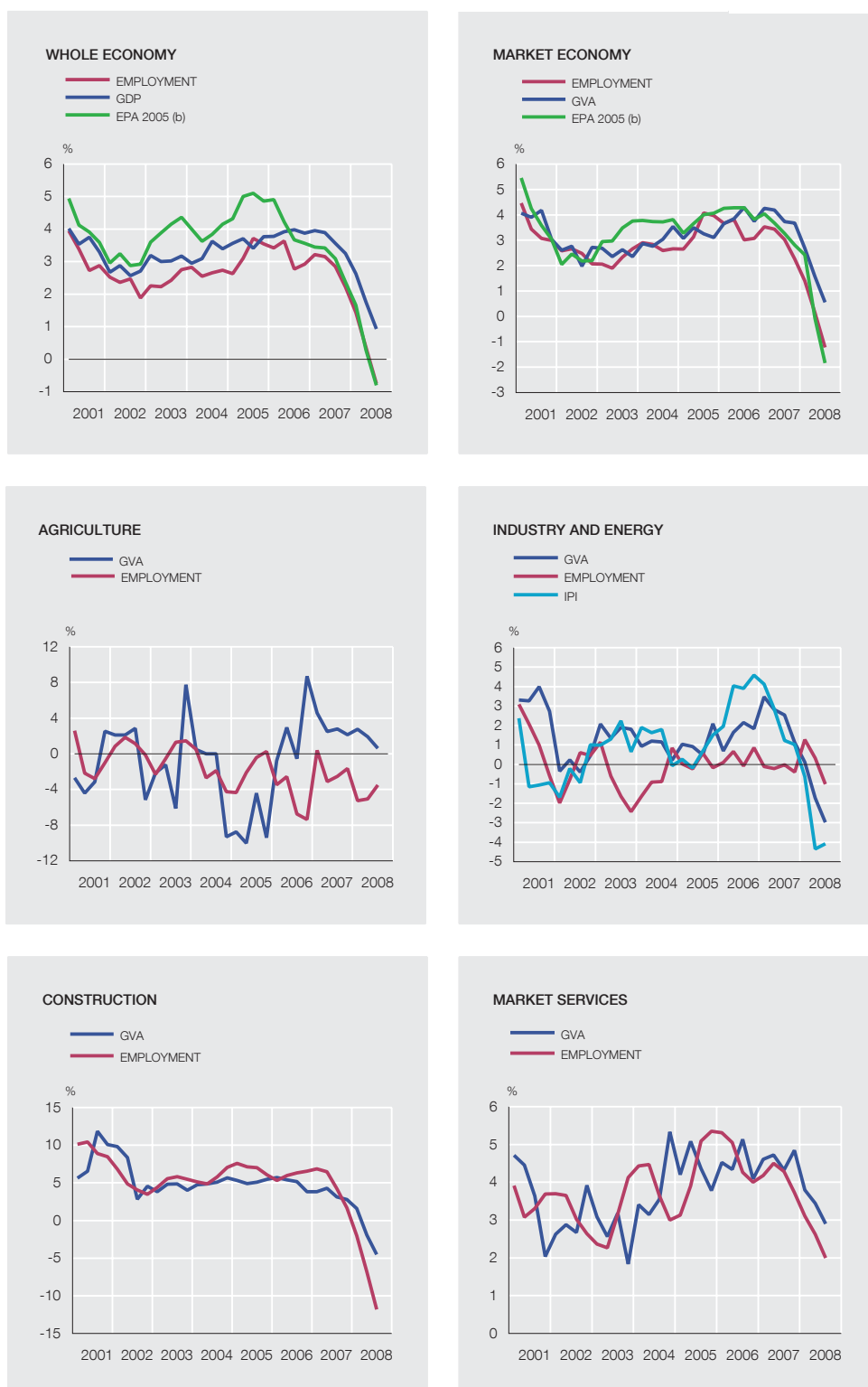
- a. QNA data at constant prices.
- b. Deflated seasonally adjusted series.
- c. Seasonally adjusted series.

ports. In the first instance, with disaggregated data from the July Balance of Payments, there were notable declines in nominal payments linked to financial services and to royalties and income from intangible assets. Conversely, construction and transport services continued to perform dynamically.

4.2 Output and employment

In line with the analysis of demand, value added in the market economy is expected to have eased substantially in Q3 as a result of the intensification of the adjustment in the industrial branch and, particularly, in construction, while the slowdown in market services is estimated to have been comparatively less (see Chart 18).

Output in the industry and energy branch is estimated to have declined in Q3 as a result of the slowdown in energy and the contraction in industry. In line with the behaviour of large corporations' goods sales, the rate of decline of the non-energy component of the industrial production index steepened in July and August, especially in the case of capital goods and non-food consumer goods. Labour market-based indicators, such as the average number of Social Security registrations, confirm this ongoing adjustment. Moreover, surveys also point to a further deterioration in industrial activity in Q3. Hence both the European Commission's industrial



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 DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

confidence indicator and the PMI for the manufacturing sector fell in the July-September period in relation to the previous quarter, with a significant decline in the assessment of order books and of production expectations. The contraction in construction is also expected to have intensified in Q3 judging by the fall which, as earlier indicated on describing the outlook for investment in construction, has been seen in the related main indicators.

On the conjunctural information available, the services branch is expected to have weakened somewhat more sharply in 2008 Q3 compared with Q2. Indeed, large corporations' sales, in real terms and adjusted for calendar effects, fell considerably once again in July and August, while the growth rate of the average number of Social Security registrations in this sector dipped in Q3 to 1.4%, compared with 2.2% the previous quarter. Finally, the European Commission's confidence indicators for services and retail trade and the activity index of the PMI for the services sector deteriorated further in Q3, reaching historically low levels in some cases.

As regards labour market developments, the indicators available coincide in that the downward adjustment in employment became more acute in Q3. Indeed, employment is estimated to have begun to fall across the whole economy. Specifically, the growth in the number of Social Security registrations, calculated using average daily data, fell by 0.9%, compared with the 0.5% increase in Q2. Likewise, the year-on-year decline in INEM (National Public Employment Service) registered hires was more marked in Q3 than in Q2 (-9.9% against -7.2%, respectively). Finally, the recently published EPA figures estimated a year-on-year decline in employment - of 0.8% - for the first time since 1994, following the 0.3% increase in Q2.

Across the productive branches, employment is expected to have fallen in all the market economy sectors - with the exception of services - and, especially, in construction. The EPA figures for Q3 confirm a decline in employment in the market economy of 1.8%. During this period job destruction stepped up (-13%, compared with -7.9% in Q2), and the numbers employed in industry fell to -1% (against 0.2% in the previous quarter). Employment in agriculture continued to decline at a similar rate to that of the previous quarter (-4.1%). Finally, the rate of job creation in market services fell by 0.9 pp to 1.7%.

On EPA figures, the decline in employment affected both dependent employees, with a fall of 0.7%, and the self-employed (-1.3%). That said, dependent employees as a proportion of total numbers employed stood at 82.3%, scarcely 0.1 pp more than the related rate a year earlier. Job destruction was concentrated among Spanish nationals (-1.5%), while employment among foreign nationals held at a positive rate (3.6%), albeit slowing in relation to the previous quarter (6.9%). As regards contract duration, the year-on-year rate of decline in temporary wage-earners increased to -8.2%, at the forefront of the adjustment in employment, since permanent employment continued to increase appreciably (2.8% against 4.1% the previous quarter). As a result, the temporary employment ratio stood at 29.5%, 2.4 pp down on a year earlier. Lastly, part-time hires showed positive growth, raising the part-time employment ratio to 11.4%, compared with 11.1% one year earlier.

The labour force grew in 2008 Q2 by 2.9%, 0.2 pp down on the previous quarter, while the slowdown in the population aged over 16 continued, with a rate of increase of 1.4% (0.1 pp less than in the previous quarter). Further to these figures, the participation rate rose to 60%, which maintains the year-on-year increases at almost 1 pp. In terms of the breakdown by gender, the increase in the labour force was due mainly to women (4.5%), since in the case of men the rise was more moderate (1.7%). Specifically, the female participation rate climbed by 1.5 pp in year-on-year terms to 50.5%, while the male rate edged up by 0.2 pp to 69.8%. By nationality, the dynamism of foreign nationals in the workforce remained very high, although more moderate (10.7%

against 12.6% in Q2), reflecting a slowdown in the growth of this population (10.4%, compared with 11.5% the previous quarter) and a somewhat lower increase in their participation rate. In the case of Spanish nationals in the workforce, growth of 1.6% was recorded (1.5% in Q1).

Finally, the decline in employment, combined with the continuing high dynamism of the labour force, resulted in marked growth in unemployment in 2008 Q3 of the order of 800,000 people compared with the same period the previous year. This made for a year-on-year increase in unemployment of 45%, and for a rise in the unemployment rate to 11.3%, 0.9 pp up on the previous quarter and more than 3 pp higher than a year earlier.

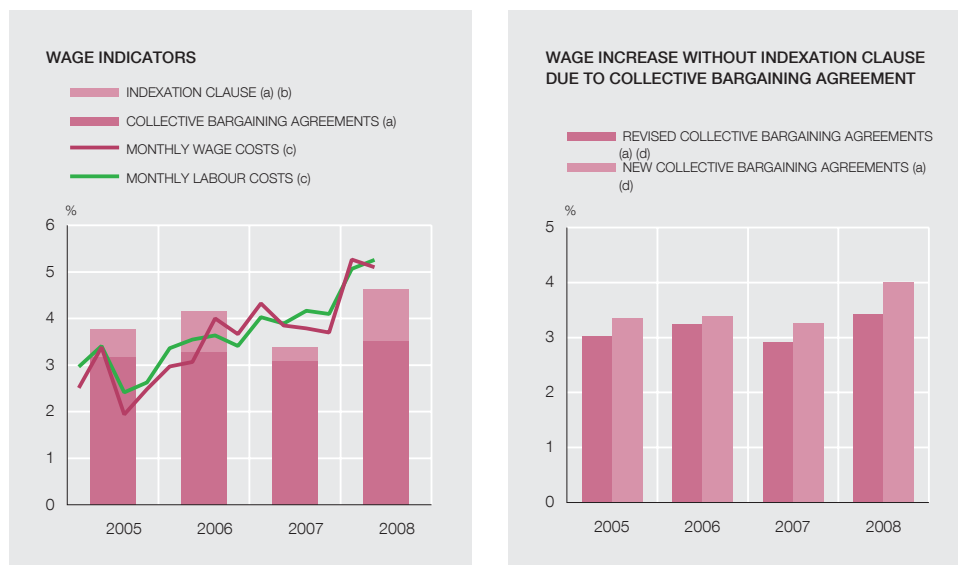
4.3 Costs and prices

Wage developments in 2008 have been marked by the collective bargaining agreements entered into in the period to September, which affect close to 8 million workers, and which incorporate an average increase in wage rates of over 3.5% for this year (see Chart 19). This figure is more than 0.4 pp up on the agreed increase in 2007 (without considering the impact of the activation of the indexation clauses) and lies above the guidelines agreed in the Interconfederal Collective Bargaining Agreement for 2008. As is habitual in rising-inflation situations, wage settlements in newly signed agreements have been higher than those in revised agreements spanning several years (4% and 3.4%, respectively), although the proportion of employees covered by the latter is far higher, approaching 87% of the total. The estimated impact of the indexation clauses for 2007 (which affect around 74% of workers with an agreement that year) on wage increases for 2008 is 1.1 pp, 0.8 pp up on the figure calculated for last year, as a result of the high inflation rate as at end-2007. This illustrates how the wage indexation mechanisms in place in Spain contribute adversely to labour cost developments in economic settings marked by a temporary increase in inflation, such as that prompted by dearer oil, which hampers the adjustment of the economy to a cyclical turnaround such as that at present.

The latest QNA figures for 2008 Q2 are in step with this information, since they show economy-wide year-on-year growth in compensation per employee of 5.1%, and a somewhat lower figure in the case of the market economy (see Chart 20). In the same period, according to the quarterly labour costs survey, the rate of change of average monthly wage costs in the non-farm market economy increased by 0.2 pp to 5.3%. The rate of increase of compensation per employee is expected to hold up in 2008 Q3, and this, combined with the rise in productivity, should lead to some slowing in unit labour costs.

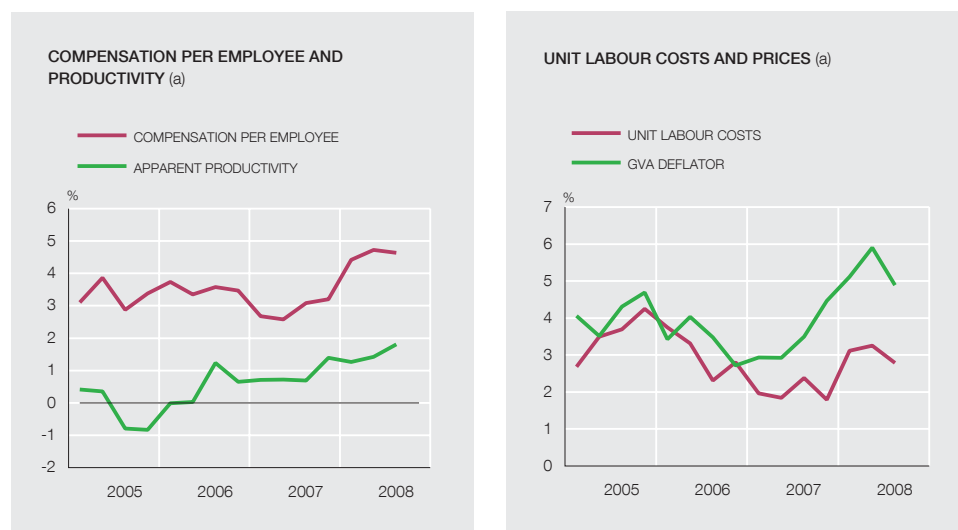
The consumer price indicators rose over Q3 as a whole, although they declined gradually from August. While the year-on-year rate of the CPI increased over the whole of Q3 to 4.9%, 0.3 pp up on the previous quarter, its pace eased appreciably following the high in July (5.3%), taking the rate to 4.5% in September (see Chart 21). These developments were influenced by the trend of energy prices which, over the quarter on average, grew by 17.9%, further to the rise in electricity charges in July and to the course of fuel prices, which maintained a high growth rate over the course of the quarter. Nonetheless, since July oil prices have diminished significantly in dollars, a decline which has only been partially offset by the depreciation of the euro against the dollar. The growth rate of unprocessed food prices fell by 0.2 pp to 4.2%, thanks to the sound behaviour of the prices of fish, pulses and fresh vegetables, and to the slowdown in fresh fruit prices.

As regards the components of the CPI excluding energy and unprocessed food prices, services and non-energy industrial goods prices also contributed to the average rise in inflation for the quarter. In the case of services, average year-on-year growth stood at 4.1%, 0.3 pp up on the previous quarter, in a setting of highly dynamic prices of transport services, tourism, and hotels and restaurants. Non-energy industrial goods prices rose by 0.2 pp to 0.4%, influenced by the less marked decline in car prices. There was a break in the upward path of the inflation rate for proc-



SOURCES: INE and Ministerio de Trabajo e Inmigración.

- a. The last year with partial information on collective bargaining agreements (until September).
- b. Previous year's indexation clause.
- c. ETCL (quarterly labour costs survey). Year-on-year rates of change.
- d. Revised: collective bargaining agreements with economic effects in the year but which were signed in previous years and are in force for more than one year. New: collective bargaining agreements with economic effects in the year, this being the first or only year they are in force.

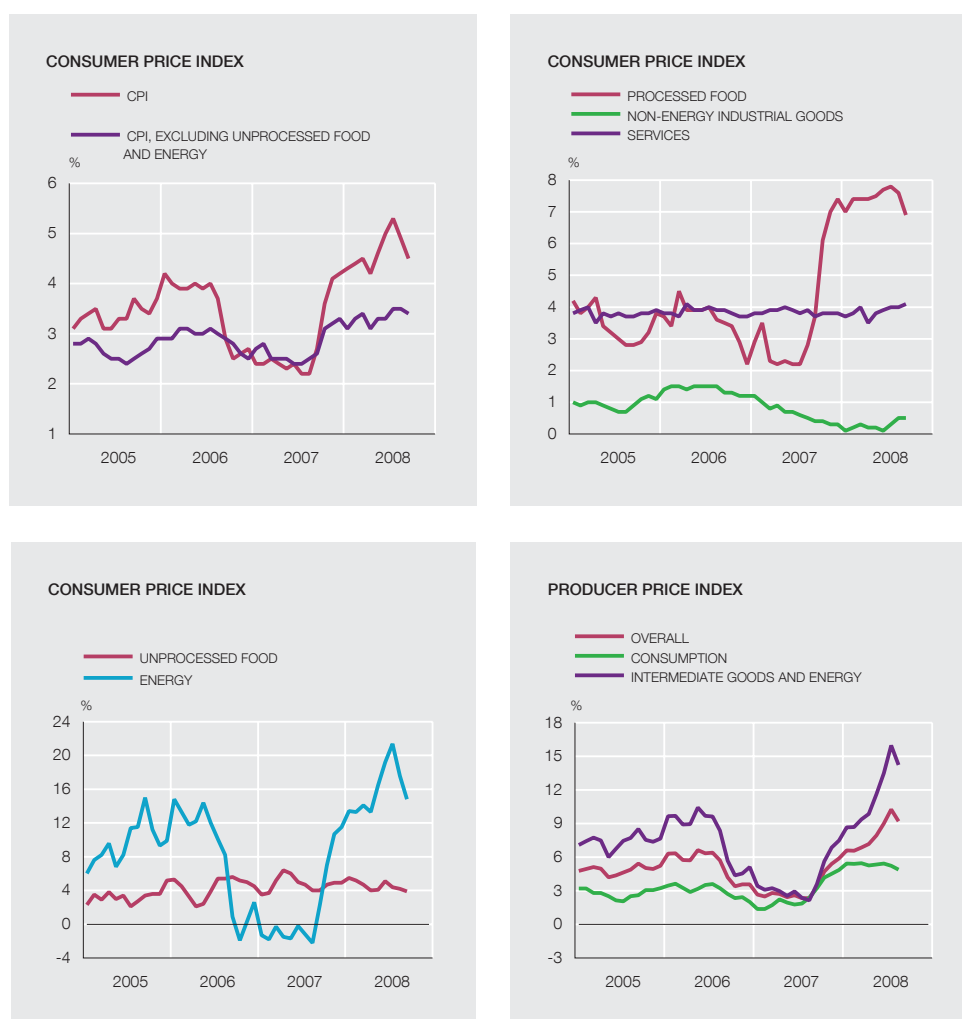


SOURCES: INE and Banco de España.

a. Year-on-year rates of change based on QNA seasonally-adjusted series.

essed food that had begun in mid-2007; this item fell by 0.1 pp to 7.4%, owing to the slight easing in the rate of increase of the price of milk, against a background in which the upward trajectory of prices of cereals and related products, milk products and non-alcoholic beverages remained unchanged. As a result of the performance of its various components, the average year-on-year rate of change of the CPI excluding energy and unprocessed food prices rose by 0.3 pp to 3.5%.

As in the case of the CPI, inflation measured by the harmonised index of consumer prices (HICP) increased by 0.3 pp over the course of Q3 to 5%, although its growth rate slowed from

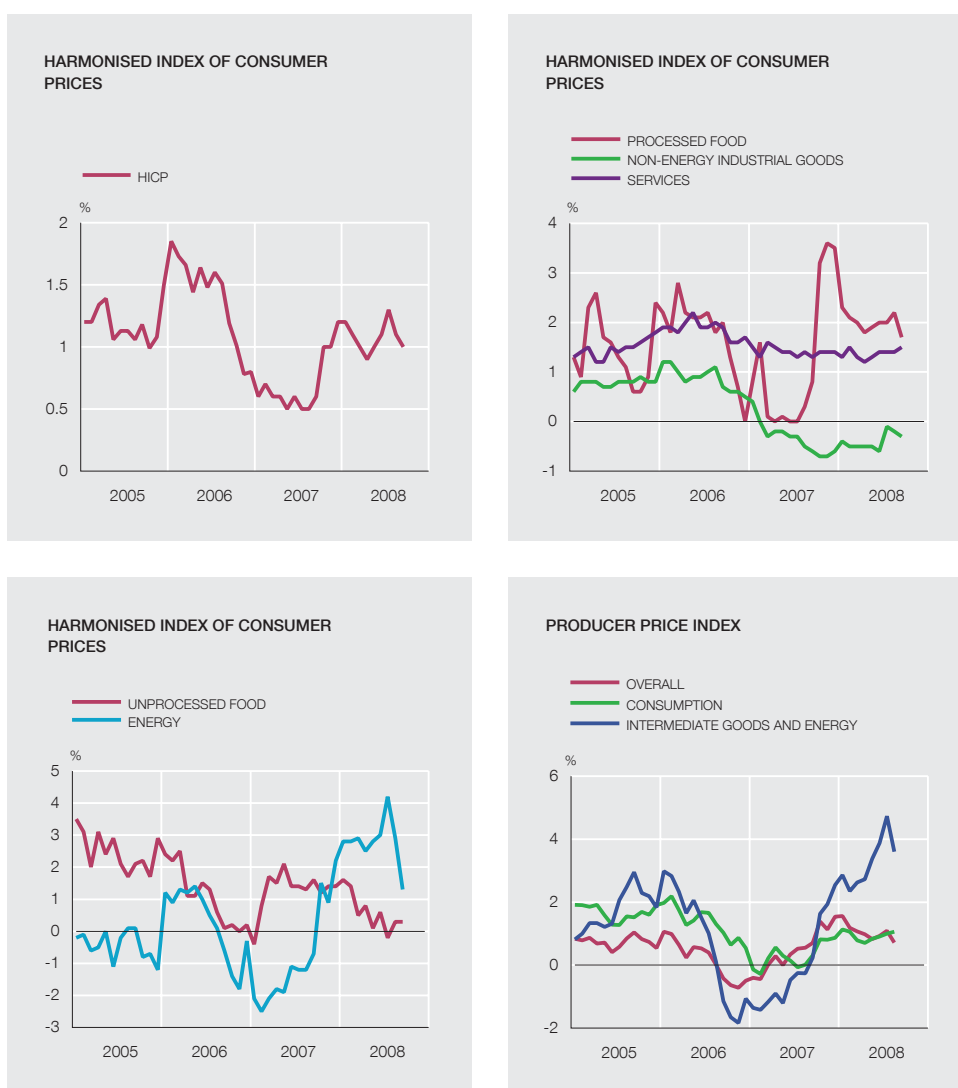


SOURCE: INE.

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

August. In the euro area as a whole, the increase in average quarterly inflation was 0.2 pp, taking the rate to 3.8%; accordingly, for the July-September period, Spain's inflation differential with the euro area rose by 0.1 pp to 1.1 pp, although after the high reached in July it narrowed to 1 pp in September (see Chart 22). The increase in Q3 was due to the widening of the differentials for the services headings and, particularly, energy, along with the narrowing of Spain's negative differential in non-energy industrial goods, although both this latter item and that of energy trended favourably from August. Only the positive differential of food prices relative to the euro area narrowed on average in Q3.

Oil price oscillations also affected the producer price index, the year-on-year rate of which rose in July, slowing in August and September to 8.1% in the latter month, a similar growth rate to that recorded in Q2. The components showing the highest rate of increase in their prices continued to be energy and intermediate goods. In the euro area as a whole, producer prices rose in August by 8.5%, which allowed the differential with the euro area to narrow to 0.7 pp, 0.2 pp less than in Q2. The import and export prices of industrial products decelerated in August to 8.6% and 3.9%, respectively, as a result of the easing in energy prices and, in the case of exports, of the slowdown in consumer goods prices.



SOURCES: Eurostat and Banco de España.

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

4.4 The State budget

At the Council of Ministers meeting on 26 September the government approved the draft State budget for 2009, setting an overall general government deficit target of 1.9% of GDP. This target includes the deficit allowed under the Budgetary Stability Law for investment by the regional (autonomous) governments (0.25% of GDP), the State (0.20%) and local governments (0.05%) in 2009. The draft budget projects a National Accounts general government deficit of 1.5% of GDP for 2008, deviating from the initial forecast of a surplus of 0.9% of GDP. Across the sub-sectors, central government is estimated to post a deficit of 1.6% of GDP in 2008, while the regional and local governments are expected to close the year with deficits of 0.5% and 0.2% of GDP, respectively. Finally, the Social Security system is expected to run a surplus of 0.8% of GDP this year (Box 5 analyses the Social Security budget outturn in 2008 to date).

In cash-basis terms, the State deficit in 2008 will rise to €8,042 million according to the outturn projection, compared with the surplus of €6,426 million projected in the initial budget document. This difference reflects the strong deterioration in the main tax revenue headings, as a result of the effects of the tax-reduction measures adopted, on one hand, and of the slowdown in activity, on the other.

The Social Security system posted a surplus of €10,916 million in the period January-July 2008, up 1.1% on the same period a year earlier, which was a less favourable outturn than in the period to April. Revenue growth slowed in the last few months to 8.3%, while expenditure gained momentum, rising by 9.7%.

Revenue from social security contributions rose by 6.6% to July, against an increase of 7.7% to April. The marked loss of dynamism in the labour market was also reflected in the 2.4% reduction in the number of Social Security registrations to September 2008, in sharp contrast to the increases posted the previous year.

Turning to expenditure, there was mild quickening in that earmarked for contributory pensions, since it rose by 8% to July, compared with a 7.8% increase to April, which in both cases was above the 7.4% budgeted for the year as a whole. The number of contributory pensions has stabilised at a growth rate of around 1.5%, slightly higher than the average for the whole of the previous year (1.3%). The growth rate of expenditure on sickness benefits quick-

ened notably to 15.7% in July to stand well above the budgeted increase.

As regards the SPEE (National Public Employment Service), the data for which are not shown in the adjoining table, the contributions received were up by 6.3% to June, while rebates on contributions in respect of employment-promoting contracts decreased by 9.2% in the same period.

The growth of expenditure earmarked for unemployment benefits has accelerated sharply in the year to date, increasing by 22.7% year-on-year to June 2008. The coverage ratio in that month stood at 71.4%, up nearly 4 pp on that recorded in the same period of 2007. On data to June, the number of beneficiaries increased by 30.7% compared with the same month a year earlier, while registered unemployment grew by 23.9% year-on-year in that period. The latest information available, i.e. to September, for expenditure on unemployment benefits and for registered unemployment continued to show fresh increases, to 27.1% and to 32.4%, respectively.

SOCIAL SECURITY SYSTEM (a)

Transfers to regional governments allocated (b)

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

€m and %

	Budget		% change	Outturn		% change	% change
	2007	2008		JAN-APR	Outturn JAN-JUL		
	1	2	3=2/1	4	5	6	7=6/5
1 REVENUE	106,142	114,081	7.5	11.4	65,008	70,401	8.3
1.1 Social security contributions	97,942	105,107	7.3	7.7	59,738	63,668	6.6
1.2 Current transfers	5,963	6,796	14.0	62.8	3,588	4,865	35.6
Other	2,237	2,177	-2.7	35.8	1,682	1,868	11.0
2 EXPENDITURE	98,390	106,048	7.8	9.5	54,208	59,485	9.7
2.1 Wages and salaries	2,253	2,412	7.1	7.0	1,252	1,345	7.5
2.2 Goods and services	1,807	1,978	9.5	3.4	990	1,067	7.7
2.3 Current transfers	93,743	101,056	7.8	9.5	51,551	56,491	9.6
Contributory pensions	80,099	86,041	7.4	7.8	44,301	47,852	8.0
Sickness	7,313	7,716	5.5	7.1	3,741	4,327	15.7
Other	6,330	7,298	15.3	34.2	3,508	4,311	22.9
2.4 Other	588	601	2.2	111.0	416	583	40.2
3 BALANCE	7,752	8,033	3.6	16.8	10,800	10,916	1.1

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.

	€m and %								
	Outturn 2007	Percentage change 2007/2006	Outturn Projection 2008	Percentage change 2008/2007	Outturn JAN-JUN Percentage change 2008/2007	Outturn			
						2007 JAN-SEP	2008 JAN-SEP	Percentage change	
1	2	3	4 = 3/1	5	6	7	8 = 7/6		
1 REVENUE	159,840	12.7	142,247	-11.0	-5.1	111,524	93,566	-16.1	
Direct taxes	96,980	19.5	83,624	-13.8	4.4	65,957	53,912	-18.3	
<i>Personal income tax</i>	48,626	17.3	44,645	-8.2	13.7	33,978	30,582	-10.0	
<i>Corporate income tax</i>	44,823	20.5	35,445	-20.9	-17.6	29,372	20,703	-29.5	
<i>Other (a)</i>	3,531	42.8	3,534	0.1	1.9	2,606	2,627	0.8	
Indirect taxes	48,445	0.2	42,423	-12.4	-18.1	35,950	29,258	-18.6	
VAT	33,752	-4.7	27,791	-17.7	-22.8	24,940	18,380	-26.3	
<i>Excise duties</i>	11,468	15.9	11,458	-0.1	-2.6	8,588	8,520	-0.8	
<i>Other (b)</i>	3,224	7.2	3,174	-1.6	-0.5	2,422	2,358	-2.7	
Other net revenue	14,415	16.4	16,200	12.4	9.5	9,617	10,395	8.1	
2 EXPENDITURE	139,704	7.2	150,289	7.6	4.2	101,354	106,575	5.2	
Wages and salaries	23,678	6.6	25,425	7.4	7.5	16,937	18,078	6.7	
Goods and services	4,454	17.2	4,212	-5.4	-2.5	2,788	2,857	2.5	
Interest payments	14,539	-6.9	16,094	10.7	15.3	12,182	13,914	14.2	
Current transfers	77,680	7.6	83,661	7.7	4.5	57,581	60,154	4.5	
Investment	10,106	11.8	10,575	4.6	-3.2	6,314	6,738	6.7	
Capital transfers	9,248	23.5	10,321	11.6	-16.0	5,552	4,835	-12.9	
3 CASH-BASIS BALANCE (3=1-2)	20,135	—	-8,042	—	—	10,169	-13,009	—	
MEMORANDUM ITEM: NATIONAL ACCOUNTS									
Resources	165,179	12.2	146,640	-11.2	-4.8	114,152	96,730	-15.3	
Uses	151,683	6.7	164,280	8.3	10.0	101,899	110,306	8.3	
NET LENDING (+) OR BORROWING (-)									
	13,496	—	-17,640	—	—	12,253	-13,576	—	
(as a percentage of GDP)	1.3	—	-1.6	—	—	1.2	-1.2	—	

SOURCE: Ministerio de Economía y Hacienda.

- a. Includes revenue from the tax on the income of non-residents.
b. Includes taxes on insurance premiums and tariffs.

Turning to the budget outturn to September, on National Accounts methodology State finances posted a deficit of €13,576 million (-1.2% of GDP), which contrasts with the surplus of €12,253 million (1.2% of GDP) in the same period of 2007 (see Table 4). This result stemmed from a 15.3% decline in resources, while uses increased by 8.3%. As regards the outturn in cash-basis terms, the State budget to September posted a deficit of €13,009 million, against a surplus of €10,169 million in the same period a year earlier. The decline in revenue steepened in Q3 to -16.1%, while expenditure quickened, increasing by 5.2%. These results augur a State deficit for the year as a whole of 1.6% of GDP.

For the analysis of revenue, information is available on takings under the main taxes, both for the portion assigned to the State (the only portion reflected in Table 4) and that relating to the ordinary-regime regional governments. This aggregate information is more illustrative for assessing developments in tax receipts. The figures indicate that tax revenue contracted significantly during Q3 as a result of the behaviour of direct taxes, while the decline in indirect taxes slackened slightly. Other revenue eased off marginally relative to its high growth rates in the first half of the year. Both personal income tax, with a reduction of 0.1% to September, and

corporate income tax, with a decline of 29.5%, saw their respective growth rates worsen in this quarter compared with the first half of the year. In the first instance, the reduction in revenue was due essentially to the impact of the new €400 deduction for taxpayers who earn income from work or returns on economic activities, and, to a lesser extent, to the impact of the reform on final tax payable. The marked decline in corporate income tax is attributable, first, to a cluster of regulatory changes to this tax (the influence of the tax reform on final tax payable for 2007, the change in the method for calculating payments on account and the second rebate on the partial payments rate) and, further, to the deterioration in corporate profits because of the increase in wage, financial and energy costs. As far as indirect taxes are concerned, the fall-off in VAT revenue eased slightly, although it remained pronounced (-13.4%). VAT developments in 2008 to date are influenced, firstly, by the negative effect on revenue derived from the new special arrangements for offsetting VAT balances payable and refundable among the different institutions in a single group, which is proving greater than initially expected by the tax authorities. In any event, this is a temporary effect given that it adversely affects VAT revenue in cash-basis terms throughout the whole of 2008 as it produces fewer receipts, but it will also give rise to fewer applications for refunds in 2009. Secondly, the impact of the increase in energy costs on the balances payable by and refundable to corporations, combined with the lesser momentum of economic activity, is weighing down VAT revenue.

With regard to State expenditure, the acceleration in Q3 was marked by that of capital expenditure, which recovered somewhat, especially in the case of investment. Current expenditure grew at a similar rate to that of the previous quarter, as a result of opposing moves by wages and salaries and by interest payments, which slowed, and by goods and services, which gained momentum. The initial budget projects a significant acceleration in total expenditure in the second half of the year, linked to current and capital transfers.

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 €62,010 million in the first seven months of 2008, equivalent to a year-on-year increase of 5%, a significantly lower rate than that in 2007 (see Table 5). This widening of the external deficit reflected an 8.2% increase in the current account deficit, which was the outcome of the rise in the energy deficit and, to a lesser extent, of the respective deficits on the income and current transfers balances, which the improved surplus on the services balances was unable to offset. The surplus on the capital account doubled to €4,016 million.

In the first seven months of 2008, the deficit on the trade balance increased by 9.2% to €53,916 million. This rate of increase is somewhat higher than that seen over the course of 2007, although it has evidenced a slowing profile in recent months. Furthermore, the greater increase in nominal imports as opposed to exports (7.9% and 7.3%, respectively) is due to the deterioration in the terms of trade brought about by oil prices, since, according to Customs data, goods exports in real terms outpaced imports. Unlike in 2007, the energy bill, which increased significantly between January and July 2008, was the determining factor behind the rise in the nominal trade deficit, since the non-energy deficit was moderately corrected.

The services balance posted a surplus of €13,343 million in the first seven months of 2008, 12.2% up on the same period in 2007. This increase in the surplus was due to the modest improvement in the surplus on tourism, up 3.1% to €15,734 million, and, to a greater extent, to the correction to the deficit on other services (29.1%), which took it to €2,391 million. Nominal tourist receipts grew by 2.4% over the course of the first seven months of 2008, down on the rate for the whole of 2007 (3.6%). Tourism expenditure slowed, increasing by 1.2% year-on-year, in step with the performance of its main determinants, and in particular with the loss of momentum of household spending. As to other services, the buoyancy of re-

		JANUARY-JULY		RATE OF CHANGE 08/07 (b)
		2007	2008	
€m				
CREDITS	Current account	203,203	217,875	7.2
	Goods	110,484	118,514	7.3
	Services	52,260	55,604	6.4
	Tourism	23,014	23,574	2.4
	Other services	29,247	32,030	9.5
	Income	31,118	35,209	13.1
	Current transfers	9,340	8,549	-8.5
	Capital account	3,196	4,802	50.2
	Current + capital accounts	206,399	222,677	7.9
	DEBITS	Current account	264,230	283,901
Goods		159,862	172,430	7.9
Services		40,366	42,261	4.7
Tourism		7,747	7,840	1.2
Other services		32,619	34,421	5.5
Income		49,381	54,245	9.9
Current transfers		14,622	14,964	2.3
Capital account		1,217	786	-35.4
Current + capital accounts		265,447	284,687	7.2
BALANCES		Current account	-61,027	-66,026
	Goods	-49,378	-53,916	-4,539
	Services	11,895	13,343	1,448
	Tourism	15,266	15,734	467
	Other services	-3,372	-2,391	981
	Income	-18,263	-19,037	-774
	Current transfers	-5,281	-6,415	-1,134
	Capital account	1,979	4,016	2,037
	Current + capital accounts	-59,049	-62,010	-2,961

SOURCE: Banco de España.

- a. Provisional data.
b. Absolute changes for balances.

ceipts in the first seven months of the year was more marked than that of expenditure (with growth rates of 9.5% and 5.5%, respectively), which enabled the deficit on this item to fall considerably.

The deficit on the income balance grew by 4.2% in the first seven months of 2008, entailing a slowdown in comparison with recent years. This moderation is due to a more marked increase in receipts than in expenditure (13.1% and 9.9%, respectively). Conversely, the rate of expansion of the deficit on current transfers in the first seven months of the year (21.4%) was more pronounced than in the whole of 2007. This was the result both of the 8.5% reduction in receipts and of the 2.3% increase in expenditure. The decline in receipts was centred on those from the EU, particularly those relating to the agricultural funds and, to a lesser extent, on the European Social Fund. The increase in expenditure was in response to the behaviour of payments to the EU, driven above all by those relating to the GNI resource. Likewise under current transfers, remittances sent abroad fell by 5.3% in the first seven months of 2008, in contrast to their buoyancy during the recent expansionary phase of the Spanish economy.

5 Financial developments

5.1 Overview

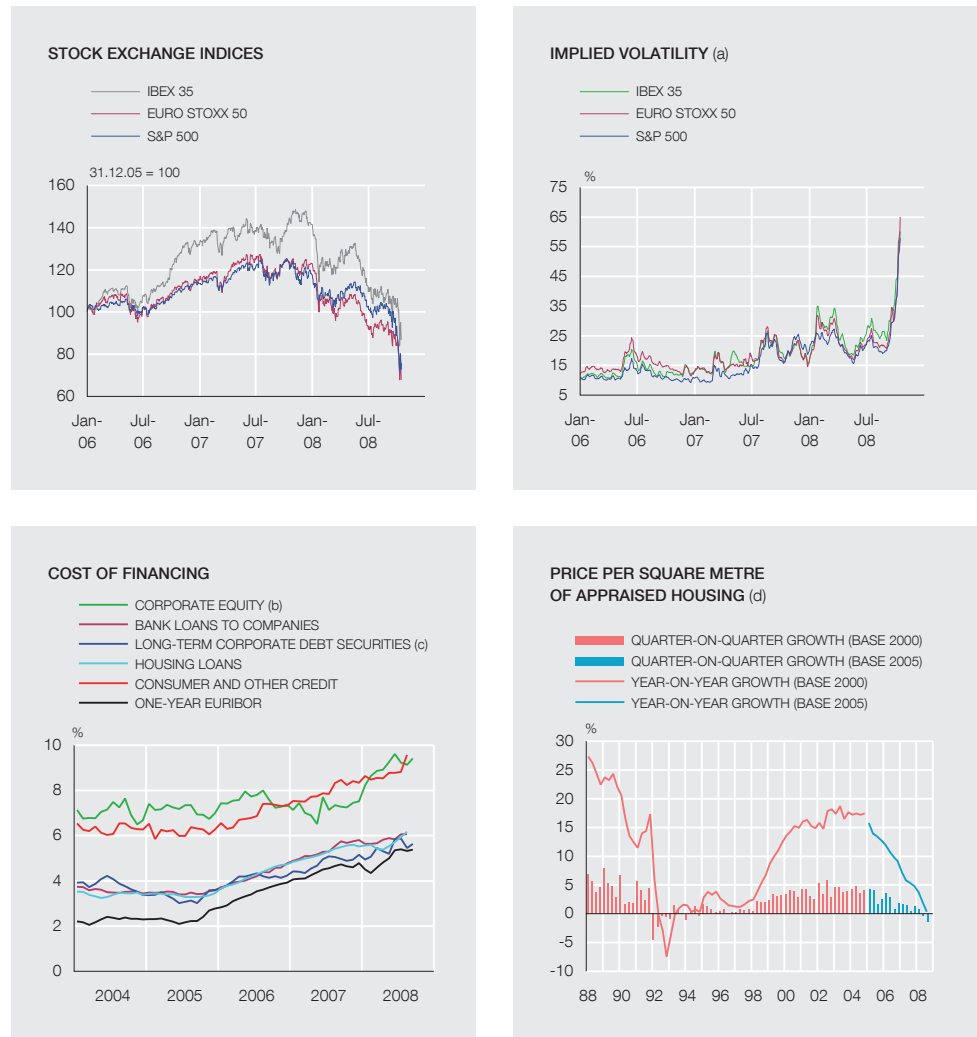
Financial developments in 2008 Q3 and the early weeks of Q4 were conditioned by new bouts of instability associated with the sharp deterioration of the equity position of certain systemically important US and European financial institutions, which led to bankruptcies in some cases, and public rescues and bank consolidation processes in others. These events triggered growing concern about international financial stability which led to a significant worsening of tension on international financial markets during September and at the beginning of October. The determined action of central banks (which implemented a coordinated 50-bp cut of intervention rates) and of governments (which announced various plans to help the financial sector) contributed somewhat to normalising market conditions in recent days, although it is still early to evaluate their final effect. In any event, except for in the case of financial markets, the information used in this section to analyse recent financial developments refers to a period prior to the time of greatest turmoil and, consequently, data are not available to study the impact of these developments on the main variables discussed.

On stock markets, the tension resulted in lower share prices and a notable rise in their volatility (see Chart 23). By mid-October, the IBEX 35 was 23% down on its end-June level, falling less than the EURO STOXX 50 (28%) and the S&P 500 (26%). Following these movements, the losses posted by the Spanish index in the year to date increased to 39% (45% and 36%, for the above-mentioned European and US indexes, respectively). Throughout this period the risk premiums on credit markets rose, while on public debt markets the yields traded fell as a result of greater investor preference for safer assets and the downward revision of future expectations of official interest rates. Within the euro area this move was sharper for German bonds, which resulted in a widening of the spread against these assets which reached 45 bp in the case of Spanish ten-year government bonds. There were no significant changes in prices on interbank markets in Q3, with the result that one-year EURIBOR averaged 5.4% in September, practically the same as in June. During the first few days of October this interest rate climbed above 5.5%, 225 bp higher than the rate for secured transactions at the same maturity (145 bp up on end-June). Nevertheless, following the Eurogroup's approval of the plan including measures to assist the financial sector, the return on interbank term deposits dropped somewhat.

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 July and September, giving rise to a fall with respect to the previous quarter (down 1.3%), which put the year-on-year growth rate at 0.4% (1.6 pp less than in June). An important new development regarding information on the value of property is the new index which the INE published for the first time at the beginning of October. This series measures changes in the price of homes acquired in each period, adjusted for changes in quality and in geographical breakdown. The most recent data for 2008 Q2 shows a decline of 0.3% in relation to June 2007.

The latest available information on private-sector financing conditions, which refers to a period prior to the most acute phase of recent market tension, continues to point to further tightening, through an increase in the cost of borrowing and more demanding credit supply conditions, as can be deduced from institutions' expectations for Q3 in the July Bank Lending Survey (BLS).

The most recent information from private-sector balance sheets, which also refers to the period before the phase of greatest market tension, shows that in the first two months of Q3 the



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.

slowdown in private-sector debt continued. The year-on-year growth of lending to households stood as approximately 7% in August, just over 1 pp down on the June data, while the quarter-on-quarter rates indicate an increase of slightly less than 5% in annual terms. The growth rate of corporations' borrowing decreased to a greater extent by approximately 2 pp to slightly below 10% in comparison with the same period of the previous year and by around 5% in annualised quarter-on-quarter terms. The latest information on lending by purpose, for June, shows that there was a slowdown in this variable in most branches, although it was sharper in real estate services than in construction and industry. By contrast, the growth rate of borrowing by other services remained high, similar to that of previous months.

In 2008 Q2 household and corporate debt-to-income ratios remained the same but the debt burden increased once again as a result of the rising cost of financing (see Charts 24 and 25). The latest advance data indicate slight declines for the former and a continuation of the rising trend for the latter. According to the Financial Accounts, in Spring the net borrowing of these

sectors fell. In line with these developments, household saving after debt service recovered, a path which it followed during the summer. In parallel, between April and June household net wealth in terms of gross disposable income (GDI) dropped somewhat, a trend which could have lasted during subsequent months judging by changes in asset prices. Corporate earnings have begun to show less buoyancy during the first half of the year and analysts have revised downwards their projections for next year for listed companies (see Chart 26). Also, judging by various surveys, in recent quarters financial developments have had a negative impact on corporate activity (see Box 6).

The degree of financial pressure borne by certain segments of these sectors increased during recent months, especially among the most indebted agents that are more exposed to unfavourable developments in asset prices and which operate in branches that have been harder hit by the economic slowdown. In keeping with this, the corporate and household aggregate ratio of doubtful assets continued to increase and in August stood at 2.5% in comparison with 0.9% at end-2007.

The most recent Financial Accounts data for June 2008 shows that the nation's net borrowing as a percentage of GDP held at the same levels as in Q1 (10%, in cumulative twelve-month terms) as a result of the shortfall in households' and companies' funds, which was offset by a decrease in the general government's and, to a lesser degree, financial institutions' surplus of funds (see Table 6). Unlike what happened in the first three months of the year, between April and June the net funds obtained from the rest of the world by sectors other than the Banco de España were not enough to cover the external deficit, with the result that the Banco de España's net asset flow vis-à-vis non-residents was negative to the tune of the equivalent of just over 1% of GDP.

In short, the most recent data indicate that private-sector financing conditions continued to move in a more restrictive direction. Thus, the gradual deceleration in household and corporate borrowing kept up, a trend which is expected to have been in line with the higher proportion of agents subject to increased financial pressure. Lastly, the continuation and worsening of tension on international financial markets in recent weeks have tended to make it more difficult, than up until now, to raise funds in the rest of the world, a risk which is particularly important in those economies, like Spain's with a high external deficit.

Against this backdrop, it is important to underline the joint efforts of central banks and governments in the principal developed countries to restore the normal functioning of financial markets. Central banks have modified their operational frameworks and daily operations to ensure that institutions' complex liquidity requirements in this highly tense situation do not contribute to making matters worse. Governments, after an initial phase of prominently individual action, designed a concerted framework for joint action, with a three-fold objective: to increase depositors' confidence by raising the guarantee threshold of national deposit guarantee funds; to prevent the interruption of credit flows by enabling the acquisition (or swap) by the Treasuries of certain assets of institutions and introducing public guarantee systems for new bank debt issues; and enabling institutions to increase capital with contributions from the State. This is the framework for the measures adopted at the beginning of this month by the Spanish government: the raising of the deposit guarantee threshold to €100,000; the creation of a fund from an initial contribution from the Treasury of €30 bn (extendable to €50 bn) to acquire top quality Spanish assets held by institutions, the granting of State guarantees for new operations performed by credit institutions in Spain up to a maximum of €100 bn in 2008; and the authorisation for the purchase by the State of securities to strengthen credit institutions' capital.

Recent quarters have seen a notable change in the economic and financial context in which firms have been operating. Thus, aggregate demand has weakened substantially amid a bout of financial turmoil, which has worsened notably in recent weeks. These developments could result in greater financial difficulties for firms (in terms of their financial position and access to external financing) which could ultimately have a negative impact on their activity.

In this setting, this box analyses firms' perceptions of the influence of financial factors on their activity during the recent period. Surveys are used to approximate this concept. The results of the Business Confidence Indicator are used specifically. This indicator is compiled quarterly by the Chambers of Commerce from the responses of approximately 5,000 firms, located throughout Spain, to a questionnaire including a series of questions on their activity and the factors which restrict it. Those factors include possible financing or cash difficulties. Panel 1 shows the percentage of firms which, on average, according to this survey stated that they had this type of problems in two periods: between 2003 (the first year this indicator was compiled) and 2007, and in 2008 to date (up to Q3, the quarter to which the latest available data refers).

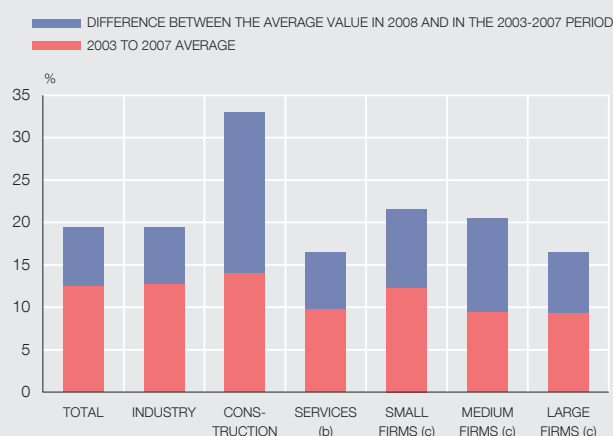
Panel 1 shows firstly certain sectoral differences in the percentage of firms which stated that financial factors have a negative influence on their business performance. Thus, the breakdown by productive branch indicates that this proportion is somewhat lower in the services sector than in industry and construction, while in terms of business size, there is an inverse relationship between this variable and the perception of financing and cash difficulties as a constraint on activity.

Secondly, it can be seen that during recent quarters the proportion of firms which perceive that financial factors have exercised a negative influence on their activity has increased. Specifically, the indicator has risen by 7 pp for the sample as a whole. The increase was sharpest in construction, climbing by nearly 20 pp to more than 30%, in line with less buoyant activity in this sector. In other productive branches, although a rise also occurred, it was much more moderate. In contrast, no significant differences were detected in the changes in the most recent period on the basis of company size.

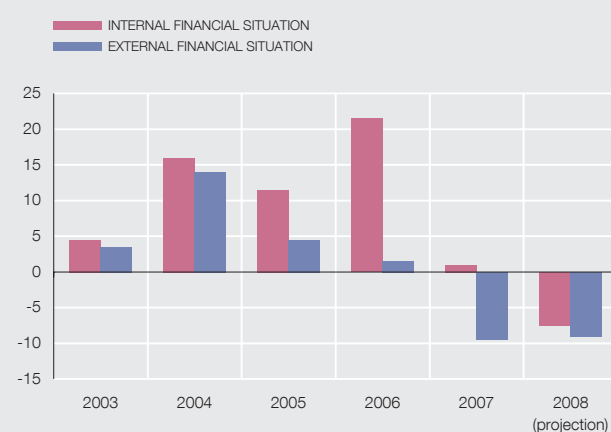
The rise in the percentage of firms which perceive a negative influence of financial factors on their performance may reflect a less favourable trend in the funds generated internally, against a backdrop of a less buoyant economy, and greater difficulty in accessing external financing. The Industrial Investment Survey, compiled by the Ministry of Industry, Tourism and Commerce, from a sample of approximately 2,000 firms in the industrial sector, provides useful information about this aspect since it gives a breakdown which approximates these two components. Specifically, it distinguishes between the internal financing situation and the external one. Panel 2 includes the developments in recent years in an index (ranging from 100 to -100) summarising the impact of these two aspects on investment for the sample firms. Positive values indicate a positive effect, while negative ones indicate a negative impact.

As can be seen in Panel 2, according to the Spring 2008 survey (the latest available survey), industrial firms (excluding construction firms) envisaged that, for the first time in the last six years, their internal financial situation would have a negative impact on their investment

1 PERCENTAGE OF FIRMS REPORTING FINANCIAL OR CASH DIFFICULTIES AS A CONSTRAINT ON THEIR ACTIVITY (a)



2 INDICATOR OF THE IMPACT OF FINANCIAL FACTORS ON THE INDUSTRIAL SECTOR'S BUSINESS INVESTMENT (d)



SOURCE: Chambers of Commerce (Panel 1) and Ministerio de Industria, Turismo y Comercio (Panel 2).

a. Averages from quarterly observations in the period considered.

b. Calculated as the average of the percentages observed for the wholesale and retail trade, hotels and restaurants and other services.

c. Small, medium and large firms are defined as those with less than 50 employees, between 50 and 249 employees, and more than 250 employees, respectively. The percentage relating to small firms is the average of those relating to firms with less than 10 employees and firms with between 10 and 49 employees.

d. Indicator calculated weighting with values 1, 0.5, -0.5 and -1, the percentage of firms which indicated that their financial situation has a very favourable, favourable, constraining or very constraining impact, respectively, on their investment decisions.

this year. The positive influence associated with external financial factors declined in recent years (specifically since 2005, a period in which the cost of borrowing embarked on a rising path), and would have turned negative in 2007 and 2008, in line with the results of the Bank Lending Survey, which indicate that institutions have tightened their credit standards during the same period.

In short, the most recent data from alternative business surveys seem to indicate a more negative influence of financial factors on the firms' performance, which was linked to fewer internal funds being available against a background of a less buoyant economy and more restrictive credit standards. By productive branch, the most notable chang-

es were recorded in those like construction, which have been affected by the switch in economic cycle, while in other sectors the variations were more moderate.

It must be taken into account, nonetheless, that the information used in this box is based on data collected before the episodes of greatest tension on international financial markets at the beginning of October. Accordingly, these developments can be expected to have resulted in a greater negative perception by firms of the influence of financial factors on their performance, although the announcement of plans to assist the financial sector by economic authorities may have been able to mitigate this impact.

5.2 Households

In Q3 2008 a further rise was posted in households' financing costs. Thus, interest rates on new loans for house purchase and consumer and other credit rose in July and August by around 45 bp and 80 bp, respectively. Also, according to the July BLS, financial institutions were expecting credit standards to be more demanding between June and September than in the three preceding months.

The tightening of credit standards and lower household confidence contributed to the ongoing slowdown in their debt, with the result that the year-on-year growth rate dropped by more than 1 pp to approximately 7% in August. The quarter-on-quarter annualised rates show slightly more moderate growth (of around 5%). By purpose, the lower buoyancy of liabilities was seen in house purchase loans and in consumer credit and other lending, whose pace of advance decreased to 7% and 8%, respectively, in relation to the same period in 2007.

The most recent Financial Accounts information shows that investment in financial assets moderated again in 2008 Q2 (see Table 7). Hence, in cumulative annual terms, it stood at around 6% of GDP, more than 1 pp below the March level. These developments were accompanied by the ongoing portfolio reallocation process with the result that time deposits, which are included under other deposits and fixed-income securities, continued to increase their share, while net purchases of mutual fund shares and cash and cash equivalents were negative.

In Q2 the household debt ratio held at around 130% of GDI, the same level as three months earlier (see Chart 24). By contrast, the rise in interest rates led to a further increase, albeit modest, in the related debt burden with the result that as at the same date it stood at approximately 18% of GDI. However, households' saving, after deducting the expenses associated with their liabilities, recovered during this period, in line with the drop in this sector's net borrowing to 0.7% of GDP in cumulative four-quarter terms (in comparison with 1.2% in March). In parallel, the net wealth of these agents slipped slightly in relation to their GDI between March and June.

Doubtful assets ratios for households continued to increase in Q2. The rise was sharper for unsecured rather than mortgage loans which stood in June at 3.6% and 1.3%, respectively, in comparison with 3% and 1% in March.

% GDP	2003	2004	2005	2006	2007			2008	
					Q2	Q3	Q4	Q1	Q2
					National economy	-2.9	-4.8	-6.5	-8.4
Non-financial corporations and households and NPISHs	-3.8	-5.1	-8.4	-11.0	-12.4	-13.5	-13.8	-13.6	-12.2
<i>Non-financial corporations</i>	-3.9	-4.5	-7.1	-9.4	-10.3	-11.2	-12.2	-12.4	-11.4
<i>Households and NPISHs</i>	0.1	-0.6	-1.3	-1.7	-2.1	-2.3	-1.6	-1.2	-0.7
Financial institutions	1.0	0.6	0.9	0.6	1.3	1.6	1.9	1.9	1.6
General government	-0.2	-0.4	1.0	2.0	2.2	2.7	2.2	1.7	0.7
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.2	-8.7	-11.4	-17.0	-16.3	-16.4	-18.1	-18.7	-16.1

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.

5.3 Non-financial corporations

The cost of bank borrowing for corporations also increased in 2008 Q3. Thus, interest rates on bank loans up to €1 million rose by 18 bp in July and August, while those for a higher amount climbed 24 bp. Furthermore, according to the July BLS, credit institutions anticipated applying more stringent credit standards than during the three previous months.

The tightening of bank credit conditions and the worsening economic outlook continued to dampen the buoyancy of borrowed funds and, consequently, the latter grew by approximately 10% in year-on-year terms in August, almost 2 pp below the figure for June. The annualised quarter-on-quarter rates held at lower levels (around 5%). By instrument, these developments were in particular the result of the moderation of lending by resident institutions, which is the largest item. Also noteworthy is the fact that the fixed-income securities component has slowed considerably during recent months (the quarter-on-quarter rate fell by almost 8 pp), although its relative importance is very low. In any event, the bulk of funds obtained through this channel was in short-term securities, which may be linked to the difficulties of raising long-term funds on markets.

The latest data on the breakdown by productive activity of lending, for June, show that funds earmarked for real estate services slowed significantly (their year-on-year growth rate dropped by more than 6 pp to 11%) and those raised by construction and industry decelerated less sharply. Conversely, bank borrowing obtained by other services continued to advance at a high rate (22%), similar to that of previous quarters.

The Financial Accounts information for 2008 Q2 shows a 1 pp drop in the sector's net borrowing, which stood at around 11% of GDP in cumulative twelve-month terms. Similarly, the *financing gap*, the indicator which approximates the funds required to bridge the difference between gross capital formation plus permanent foreign investment and gross corporate saving, fell to 16% of GDP, down more than 2 pp on its value in March.

In line with the progressive deceleration of borrowing, in 2008 Q2 the rise in the corporate debt ratio came to a halt, standing at 570% of the funds raised by the sector, practically the same level observed three months earlier (see Chart 25). However, the debt burden continued to increase, nearing 28% of the sector's gross operating profit plus financial revenue, under-

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

TABLE 7

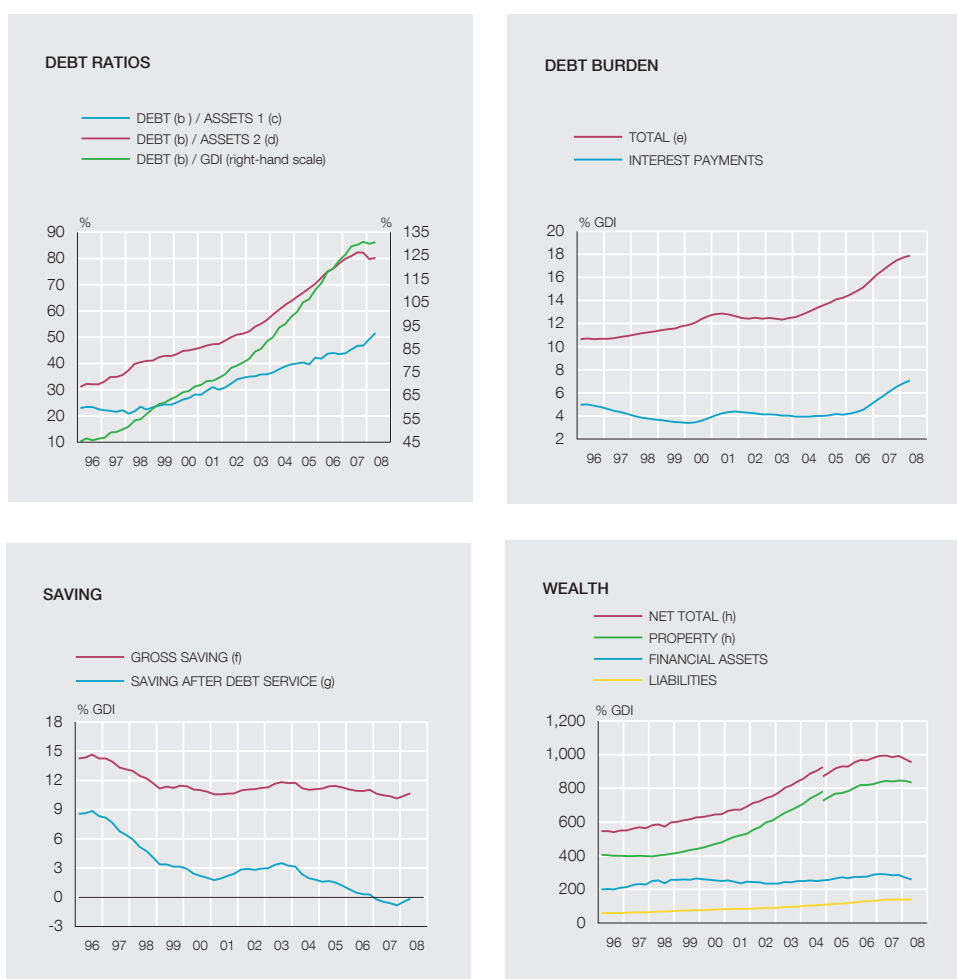
% GDP	2004	2005	2006	2007			2008	
				Q4		Q1		Q2
				Q4	Q1	Q2	Q1	Q2
HOUSEHOLDS AND NPISHs								
Financial transactions (assets)	9.5	10.4	10.9	7.7	6.8	5.6		
Cash and cash equivalents	3.9	4.0	3.1	-1.0	-1.0	-1.7		
Other deposits and fixed-income securities (a)	1.2	1.6	5.8	7.8	7.9	8.3		
Shares and other equity (b)	0.3	0.2	-1.1	0.7	0.5	0.9		
Investment funds	1.6	1.9	0.2	-1.2	-1.5	-2.8		
Insurance technical reserves	1.9	2.0	1.8	1.0	0.9	0.9		
<i>Of which:</i>								
<i>Life assurance</i>	0.7	0.7	0.6	0.3	0.2	0.2		
<i>Retirement</i>	0.9	1.0	0.9	0.6	0.5	0.5		
<i>Other</i>	0.7	0.7	1.2	0.4	0.1	0.1		
Financial transactions (liabilities)	10.1	11.7	12.6	9.3	8.0	6.4		
Credit from resident financial institutions (c)	10.8	12.3	13.0	9.4	8.0	6.6		
<i>House purchase credit (c)</i>	8.7	10.2	9.9	7.2	6.2	4.7		
<i>Consumer and other credit (c)</i>	2.1	2.2	3.1	2.2	1.8	1.8		
<i>Other</i>	-0.7	-0.6	-0.4	-0.1	0.0	-0.2		
NON-FINANCIAL CORPORATIONS:								
Financial transactions (assets)	14.4	18.2	22.5	12.9	10.2	5.6		
Cash and cash equivalents	1.0	2.0	2.3	-0.4	-1.1	-1.1		
Other deposits and fixed-income securities (a)	0.3	1.2	1.6	2.4	2.7	2.3		
Shares and other equity	6.3	7.2	10.9	6.7	5.3	2.5		
<i>Of which:</i>								
<i>Vis-à-vis the rest of the world</i>	3.8	3.9	7.7	5.5	5.6	3.5		
<i>Other</i>	6.8	7.7	7.7	4.2	3.2	1.8		
Financial transactions (liabilities)	18.9	25.2	31.8	25.0	22.6	17.0		
Credit from resident financial institutions (c)	8.3	12.9	17.6	13.9	12.4	9.3		
Foreign loans	0.7	2.1	3.4	2.6	2.7	2.4		
Fixed-income securities (d)	0.0	0.3	1.8	0.5	0.3	0.5		
Shares and other equity	4.4	3.7	2.5	5.0	5.0	4.4		
<i>Other</i>	5.5	6.2	6.6	3.0	2.2	0.4		
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):								
Financing (e)	16.3	21.2	24.2	15.3	13.3	10.3		
Households and NPISHs	20.2	20.9	19.6	12.7	10.7	8.5		
Non-financial corporations	13.2	21.4	28.0	17.3	15.3	11.6		

SOURCE: Banco de España.

- a. Not including unpaid accrued interest, which is included under "other".
- b. Excluding investment funds.
- c. Including off-balance-sheet 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.

pinned by the rising cost of borrowing. This increase contributed to the stagnation of firms' ordinary net profit, which led to a certain decrease in the return on capital in the first half of the year. The doubtful assets ratios of firms continued to grow between March and June, especially in the branch of construction and real estate services (up from 1% to 2%), while in the other productive activities the rise was more moderate (up from 1% to 1.2%).

The latest Central Balance Sheet Data Office Quarterly Survey (CBQ) information, based on a sample in which large corporations predominate, shows a decline in their debt ratio in 2008 Q2, as a result of the decrease at large groups, which offset the increase posted for other



SOURCE: Banco de España.

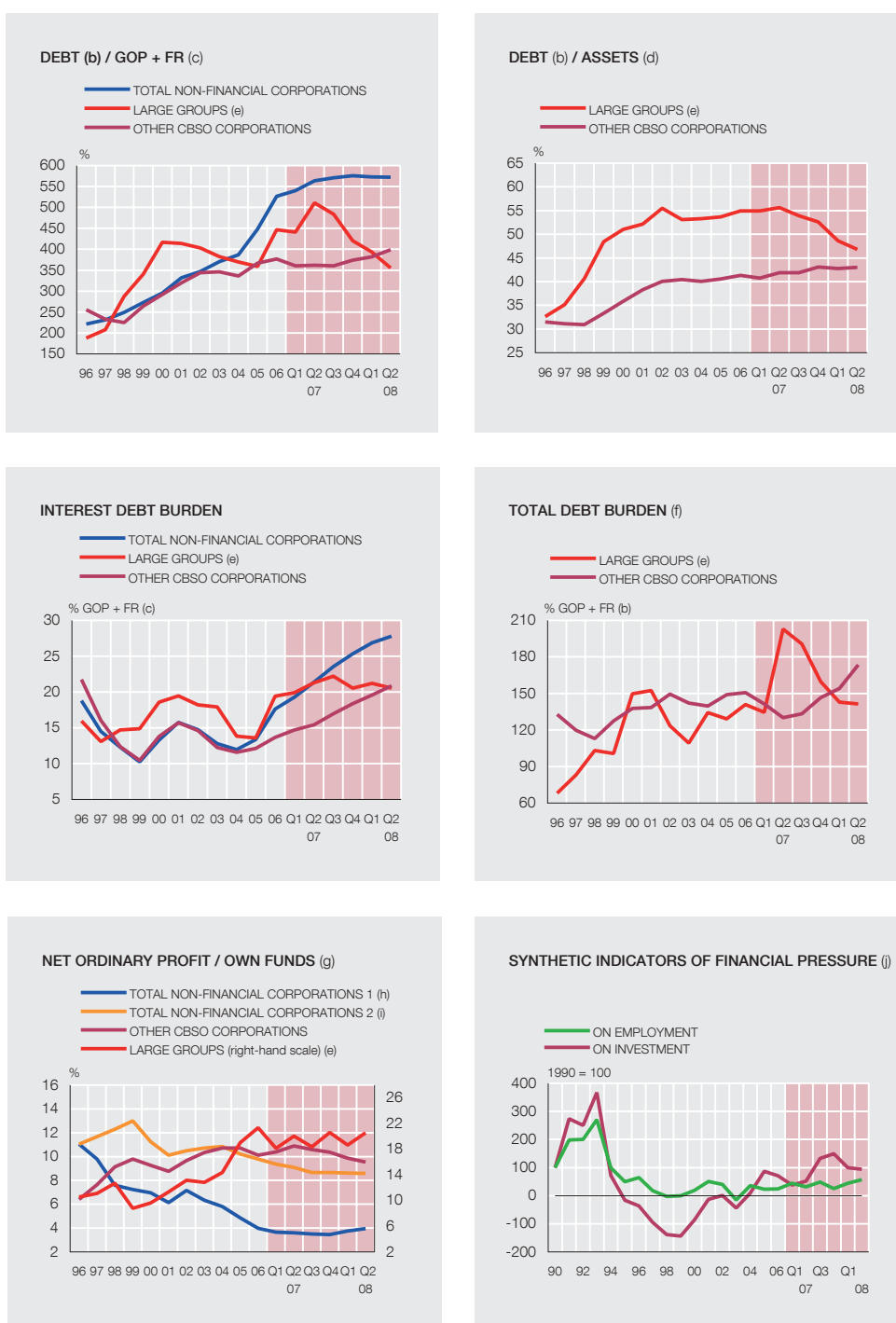
- a. From 1999, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
- b. Includes bank credit and off-balance-sheet securitised loans.
- c. Assets 1 = total financial assets - "other".
- d. Assets 2 = assets 1 - shares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

firms, while the debt burden recorded a slight rise. The profitability of the sample firms decreased slightly. As a result of the overall effect of these variables, the synthetic indicator of financial pressure on employment increased slightly, while that for investment held steady.

Lastly, analysts anticipate lower growth in the profits of listed non-financial corporations, both for the next few months, reaching negative growth rates, and in the longer term, although in this case the drop will be more moderate (see Chart 26).

5.4 General government

General government net lending in cumulative four-quarter terms stood in June at 0.7% of GDP, down 1 pp on end-March (see Chart 27). The breakdown by instrument shows that in the last twelve months the volume of medium and long-term securities issued by these institutions which are held by the other sectors has declined. These developments have been accompanied by a decrease in the balance of deposits net of lending and the positive issuance



SOURCE: Banco de España.

a. Based on CBSO annual and quarterly survey data, except in the case of the "total non-financial corporations" series, which is based on the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is used.

b. Interest-bearing borrowed funds.

c. Gross operating profit plus financial revenue.

d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

e. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.

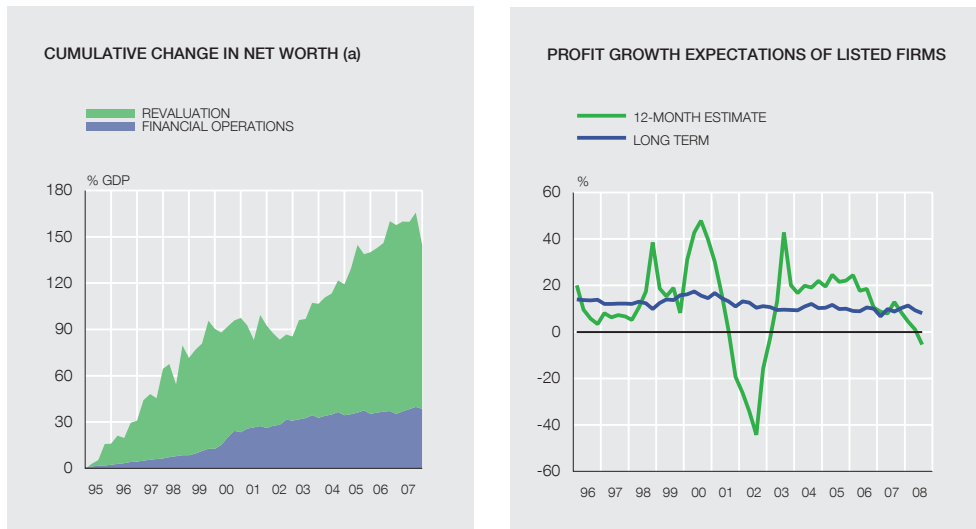
f. Includes interest plus interest-bearing short-term debt.

g. For total non-financial corporations, NOP = GOS + interest and dividends received – interest paid – fixed capital consumption.

h. Own funds valued at market prices.

i. Own funds calculated by accumulating flows from the 1996 stock onwards.

j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.



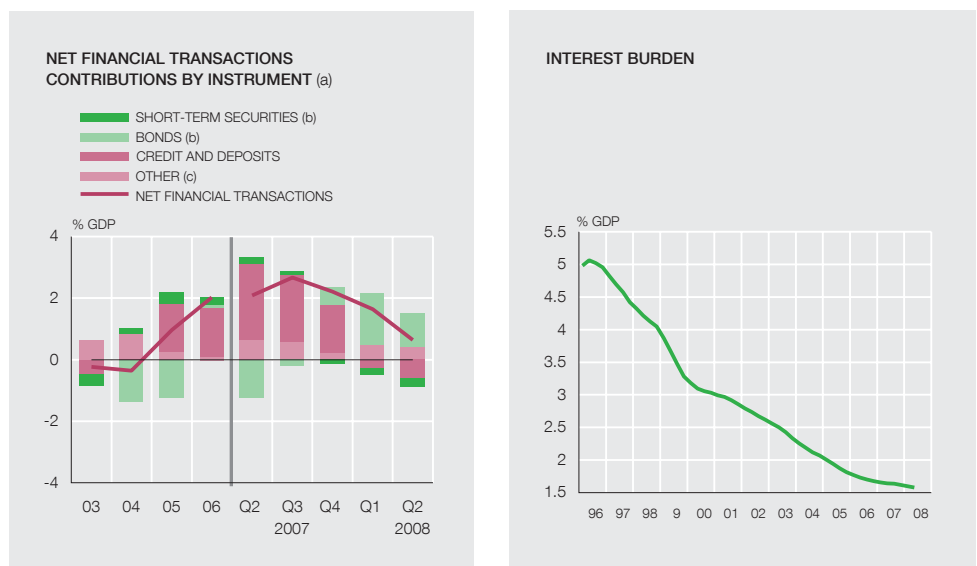
SOURCES: I/B/E/S and Banco de España.

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

GENERAL GOVERNMENT

Four-quarter data

CHART 27



SOURCE: Banco de España.

a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.

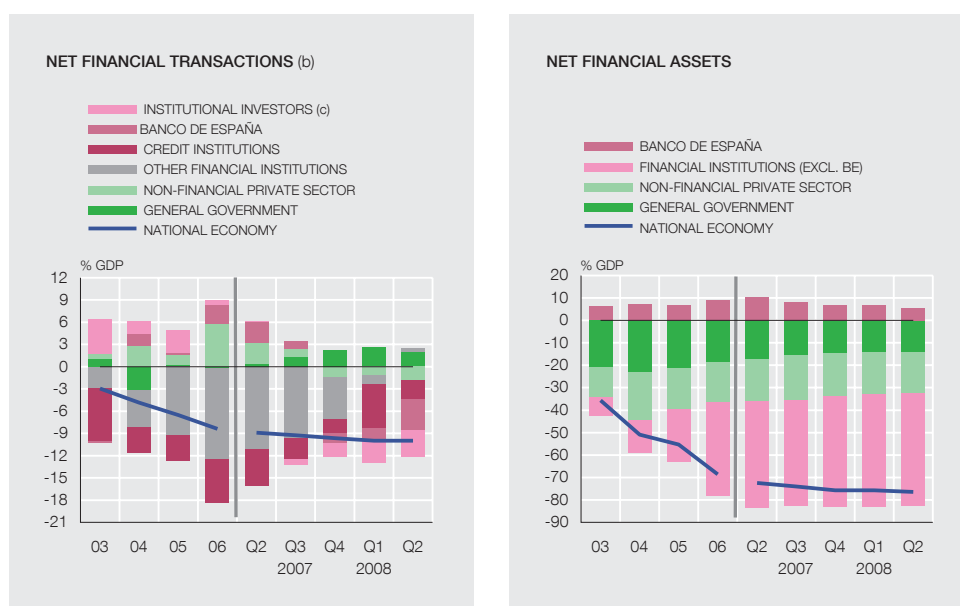
b. Includes only liabilities transactions.

c. Unpaid accrued interest on bonds and net investment of Social Security funds in assets issued by the rest of general government.

of short-term instruments. The contraction of the debt ratio, together with the unchanged average cost of funds, resulted in interest payments decreasing somewhat as a proportion of GDP to 1.6%.

5.5 The rest of the world

In 2008 Q2 the debit balance of the nation's financial transactions stood, in cumulative twelve-month terms, at 10% of GDP, the same level as in March. The breakdown by sector reveals that these developments were the result of a drop in the shortfall in corporations' and,



SOURCE: Banco de España.

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

to a lesser extent, households' funds, which was offset by the contraction of the surplus of financial institutions and, more markedly, by that of general government (see Table 6).

The sectoral breakdown of financial transactions vis-à-vis the rest of the world shows that in Q2 net inflows of funds were recorded, which were channelled through institutional investors (divestments), corresponding to the non-financial private sector and general government. However, these funds were insufficient to cover the nation's overspending relative to the revenue and financing granted by financial institutions other than the Banco de España (which was positive in net terms). Consequently, Banco de España's net flows of assets vis-à-vis the rest of the world turned negative again and, in cumulative twelve-month terms, stood at 4.2% of GDP (see Chart 28).

On the liability-instruments side, in 2008 Q2 the volume of financial flows vis-à-vis the rest of the world increased, a development which was accompanied by a net inflow of funds channelled through fixed-income securities issued by general government and financial institutions. Nevertheless, in cumulative four-quarter terms, capital inflows fell back again to 17% of GDP, nearly 2 pp below the March figure (see Table 8). By instrument, the principal financing vehicle related to interbank deposits (including collateralised deposits), which represented a gross inflow of funds of approximately 11% of GDP and nearly 6%, if asset-side transactions are stripped out. Transactions channelled through debt resulted in a capital outflow equivalent to 3% of GDP, while the amount raised through shares and other equity held at around the same levels as in the first three months of the year, in spite of more buoyant foreign direct investment in Spain.

The volume of asset flows vis-à-vis the rest of the world also recovered, the bulk of these funds were in the form of interbank loans. However, in cumulative four-quarter terms, the amount decreased to 7% of GDP, 2 pp lower than in March. Most of the capital outflows were chan-

% GDP	2004	2005	2006	2007		2008	
				Q4	Q1	Q2	
NET FINANCIAL TRANSACTIONS	-4.8	-6.5	-8.4	-9.7	-10.0	-10.0	
FINANCIAL TRANSACTIONS (ASSETS)	13.3	18.7	17.6	13.0	9.0	7.0	
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	
Cash and deposits	3.2	2.2	5.2	2.1	-0.7	1.6	
<i>Of which:</i>							
<i>Interbank (a)</i>	0.7	3.1	3.4	4.2	1.6	4.6	
Securities other than shares	1.8	8.7	-1.2	1.6	1.5	0.9	
<i>Of which:</i>							
<i>Credit institutions</i>	1.0	6.6	-2.1	1.8	2.1	1.7	
<i>Institutional investors (b)</i>	0.3	2.3	0.6	-0.1	-0.7	-0.8	
Shares and other equity	6.8	5.1	10.2	7.8	6.3	3.1	
<i>Of which:</i>							
<i>Non-financial corporations</i>	3.8	3.9	7.7	5.5	5.6	3.5	
<i>Institutional investors (b)</i>	0.8	0.9	1.2	-1.0	-1.9	-2.6	
Loans	0.8	1.1	2.1	1.2	1.3	1.7	
FINANCIAL TRANSACTIONS (LIABILITIES)	18.2	25.2	26.0	22.7	18.9	17.0	
Deposits	1.7	5.6	0.3	7.3	11.2	13.0	
<i>Of which:</i>							
<i>Interbank (a)</i>	5.0	7.2	0.6	6.7	10.9	10.7	
Securities other than shares	12.4	15.8	21.7	7.9	-0.2	-3.2	
<i>Of which:</i>							
<i>General government</i>	2.7	0.2	1.3	-1.5	-2.3	-1.7	
<i>Credit institutions</i>	4.6	6.3	8.0	3.5	0.8	-1.1	
<i>Other non-monetary financial institutions</i>	5.1	9.3	12.4	5.9	1.2	-0.4	
Shares and other equity	2.7	0.9	-0.1	4.3	4.7	4.6	
<i>Of which:</i>							
<i>Non-financial corporations</i>	1.7	1.0	-0.5	4.5	4.7	4.2	
Loans	1.3	2.3	3.6	2.8	3.0	2.4	
Other, net (c)	-0.6	-0.8	-0.8	0.0	-0.3	0.4	
MEMORANDUM ITEMS							
Spanish direct investment abroad	5.8	3.7	8.1	8.7	8.9	7.0	
Foreign direct investment in Spain	2.4	2.2	2.2	4.0	5.6	6.1	

nelled through the cash and deposits heading which includes most notably interbank deposits. There was a drop in investment in fixed-income securities abroad by residents and, in particular, by institutional investors, which disposed of part of their portfolio. Lastly, partly as a consequence of the decrease in Spanish direct investment abroad, purchases of shares and other equity also contracted.

As a result of the changes in cross-border financial flows, asset prices and the exchange rate, the value of the accumulated net debt vis-à-vis the rest of the world increased slightly (see Chart 28). Sectorally, this was due to an increase in the debit balance of financial institutions and a decrease in the credit balance of the Banco de España, which amply offset the moderate decline in the net liabilities of the non-financial private sector and of general government.

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