

QUARTERLY REPORT ON THE SPANISH ECONOMY

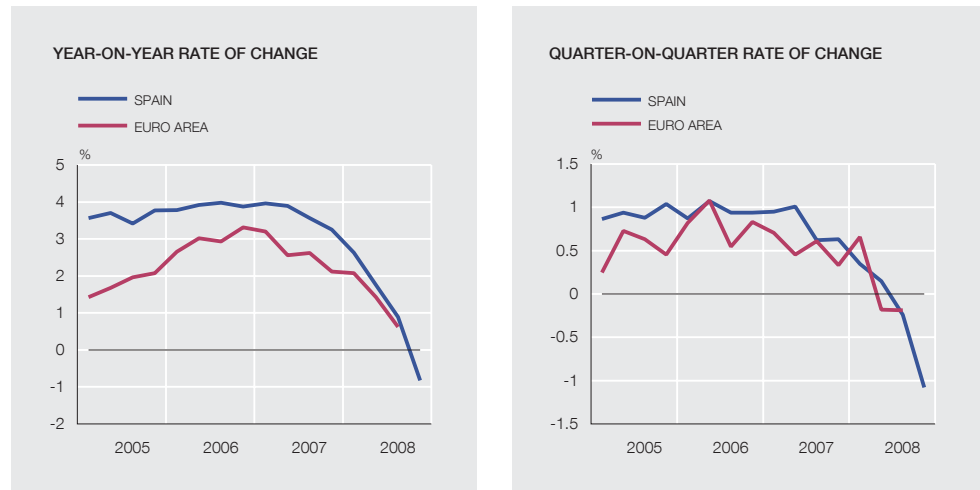
## 1 Overview

During the first three quarters of 2008, there was a continual loss of momentum in the Spanish economy. This was the result of the dynamic of the internal adjustment that had begun the previous year and of the impact of the prolonged episode of financial instability. On the information available this pattern is expected to have stepped up in Q4, following the worsening of the international financial crisis, which considerably dented agents' confidence and further tightened financing conditions. The annual rate of GDP is estimated to have declined by 0.8% (–1.1% in quarter-on-quarter terms). Behind these developments lies a reduction in national demand of 2.4%, in terms of its year-on-year rate, which was not offset by net external demand, whose positive contribution to GDP growth increased by 0.9 pp to 1.7 pp.

On these estimates, the growth rate of GDP for 2008 as a whole is expected to stand at 1.1%, a substantial slowdown on the previous year's rate (3.7%). The pronounced decline in the pace of growth during 2008 came about as a result of the sharp slowdown in national demand, which posted an average rate of increase of 0.4%, compared with 4.2% in 2007. This stemmed from the general weakening across all its components, except government consumption, which held at a similar rate to that of 2007. There was, however, a notably strong correction in residential investment, whose rate declined over the course of the year as a whole to close to 10%, and a rapid adjustment of consumption, which posted practically zero or even negative growth in the second half of the year. The contribution of net external demand to GDP growth was positive for the first time since 1997, at 0.7 pp, compared with a negative contribution of 0.8 pp in 2007. Underpinning this, in particular, was the swift loss of steam by imports, which slowed more sharply than exports.

On the supply side, the sudden halt in spending impacted all the productive branches, especially industry and construction. It also bore on the rate of employment generation, which worsened markedly to the point of moving into a phase of net job losses in Q3, which intensified in the closing months of the year. As a result, employment fell by 0.5% in 2008 (compared with an increase of 3.1% in 2007) and the unemployment rate climbed substantially to 11.3% for the year on average (13.9% in Q4), on EPA (Labour Force Survey) figures, against a background in which labour supply remained strongly dynamic. Turning to inflation, the growth rate of the CPI stood at 4.1% for the year on average, above the related figure for the previous year (2.8%), although in the second half of the year it moved on a rapidly slowing path, to reach an annual rate of change of 1.4% in December, the lowest figure since 1998. Accordingly, the inflation differential with the euro area, in terms of the HICP, narrowed in December and ended the year negative – for the first time since the start of EMU – at –0.1 pp.

The international economic outlook in Q4 was marked by the episode of exceptional instability of the global financial system in September and October, and by the forceful response of governments and central banks. The latter, given the seriousness of the situation, urgently adopted fiscal and financial support plans, proceeded to extend liquidity-providing mechanisms and made unprecedented cuts to their key interest rates. Notwithstanding, the tensions on international financial markets persisted and financing conditions remained restrictive. These circumstances saw a further and substantial worsening across the board in world economic activity in the final months of 2008, and a deterioration in the growth outlook for the coming quarters. At the same time, the declining course on which oil prices had embarked in the summer intensified and there were fresh falls in other commodities prices, prompting widespread falls in inflation rates and a further improvement in the inflation outlook.



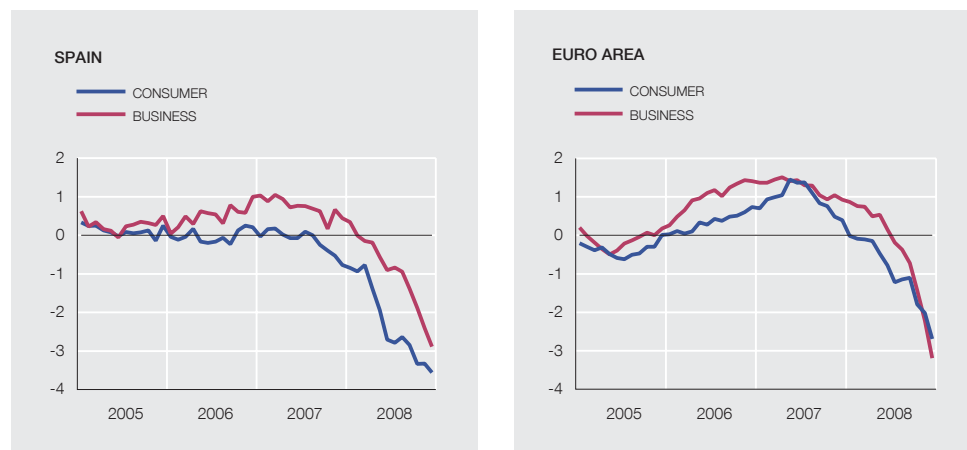
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

As indicated in the preceding “Quarterly Report on the Spanish Economy”, the economic authorities reacted to the severe deterioration in financial markets in September and October with a wide range of measures geared to restoring confidence, stabilising the financial markets and preventing potential systemic risks. These measures included raising the amounts covered by national deposit guarantee schemes, the adoption of measures aimed at preventing the interruption of credit flows and, finally, the possibility for banks to improve their capital ratios through re-capitalisation. Against this background, the Spanish government increased the deposit guarantee limit to €100,000, created the Treasury-funded FAAF (a fund for the acquisition of high-quality Spanish assets) and approved the granting of State guarantees for new lending by credit institutions in Spain. It also authorised the purchasing of securities to shore up credit institutions’ capital (for more details of these measures, see Box 2 in the above-mentioned Report).

The efforts to achieve a coordinated solution for the international situation during the quarter culminated in the meeting of Heads of State and of Government of the main developed and emerging economies in Washington in November. The meeting concluded with an agreement to support the financial system, basic guiding principles for its reform and a commitment not to succumb to protectionist pressures. In this setting, on 12 December the European Council approved the plan for European economic recovery, the immediate aim of which is to allocate an amount equivalent to 1.5% of EU GDP to boost public investment and corporate spending (see Box 3 of this Report). Along the same lines is the Spanish government’s initiative, approved in late November, to set up a State fund for local investment (endowed with €8 billion), dedicated to funding employment-generating investment at the municipal level, and the creation of a special State fund to reinvigorate the economy and employment (endowed with €3 billion) for sectors considered strategic to be able to pursue projects that also have an impact on employment.

Central banks, in turn, cut intervention rates considerably and continued to offer unlimited liquidity, under the procedures introduced in previous months. The Federal Reserve reduced its official rates in October, November and December, when the federal funds rate stood in a target range of 0% to 0.25%, while formalising a change in strategy in its monetary policy, which is now geared to safeguarding financial stability (see Box 2); and the Bank of England, which followed a similar sequence, lowered its official rate to 1.5% in January. The ECB Gov-



SOURCE: European Commission.

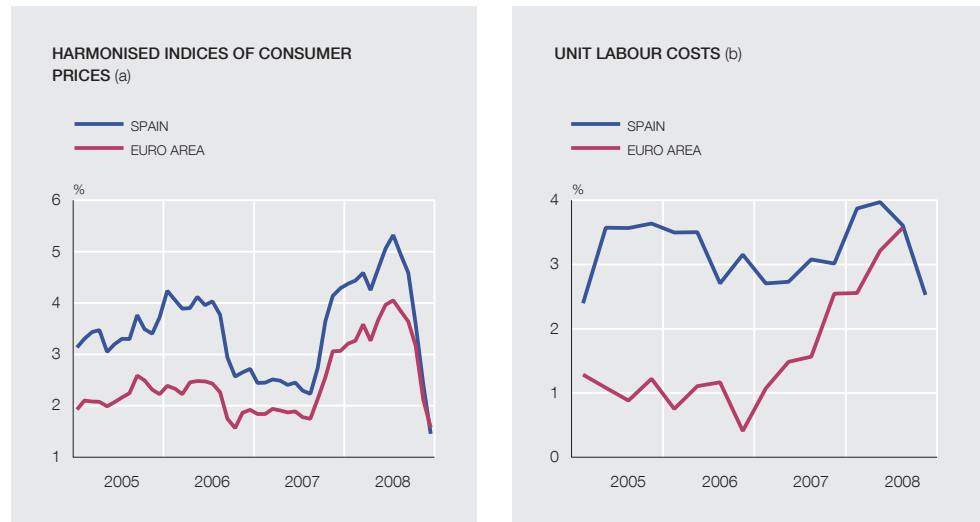
a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

erning Council decided to make four consecutive cuts to interest rates between October and January, which took the main refinancing operations rate to 2%, 225 bp below the level observed in September, while it continued to provide all the liquidity applied for by financial institutions at maturities ranging from one week to six months, having undertaken to maintain this stance as long as it remains necessary.

The adoption of this raft of measures contributed to checking the deterioration in the main financial stress indicators. However, the great fragility that continues to prevail has not been overcome, and the setting is still dominated by uncertainty, market volatility and high risk aversion, which are keeping financing conditions tight. Since mid-October, interest rates on inter-bank deposits have fallen considerably, and this has continued into January to date. But levels are still above those of guaranteed bank transactions, denoting the persistence of pressures on money markets. Government debt yields also fell, especially at shorter dates, with discrepancies of some significance within the euro area in the extent of the decline, so that most countries' spreads over the German bund widened. In the case of Spanish ten-year government bonds, the spread over the German bund was 120 bp in the third week of January (having been virtually zero until the start of the financial turmoil). On 19 January Standard & Poor's downgraded Spanish debt by a notch (from AAA to AA+). Non-financial corporations' credit risk premiums widened once again in Q4, although they narrowed to some extent in January, and there were heavy falls in prices on equity markets, against a backdrop of high volatility, which have continued in January.

In this environment of instability, world economic activity continued to worsen in Q4 after negative growth was posted in Q3 in the United States, the United Kingdom, Japan and the euro area. In the emerging economies, which had remained resilient until the second half of the year, there was a strong slowdown in activity in Q4. This was very marked in the Central and Eastern European countries which are, to date, proving the most vulnerable to the international financial crisis.

Following a decline in GDP in Q3, for the second consecutive quarter, the conjunctural indicators available in the euro area for 2008 Q4 point to a further deterioration in activity, which was affected by the impact of the financial crisis, the climate of heightened uncertainty and the decline in foreign demand. At the same time, inflation eased considerably in Q4, placing the



SOURCES: Eurostat, ECB and INE.

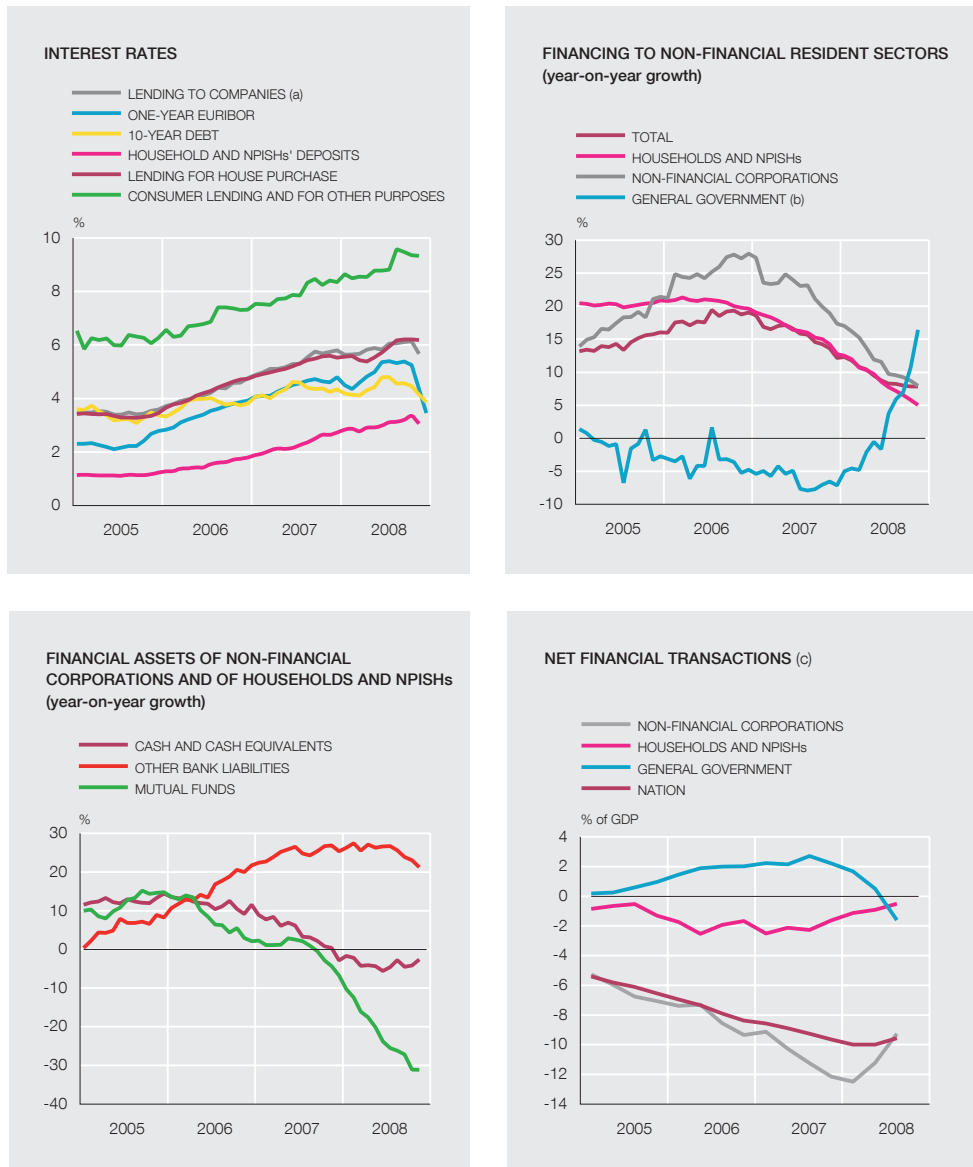
a. Year-on-year rate of change.

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

annual growth rate of the HICP at 1.6% in December. This outturn, as in other geographical areas, was closely linked to energy price developments, since the rate of increase of the other components scarcely eased. The substantial abatement of inflationary pressures, set against the marked deterioration in the economic outlook, lay at the basis of the above-mentioned substantial change in monetary policy stance.

Under these circumstances, the external environment of the Spanish economy continued to weaken and financing conditions for households and firms remained restrictive, despite the fact that the cost of bank funding has begun to fall in response to the developments described on money markets. The sizeable declines in money market yields observed since November will foreseeably tend to lessen the cost of private-sector financing and the interest burden borne by indebted households and firms in the coming months. Further, the initiatives adopted by the national and international economic authorities to restore the normal workings of financial markets might help soften the credit standards applied to the private sector. Moreover, private-sector wealth was adversely affected first, by the significant decline in stock markets in Q4, which raised cumulative losses in 2008 to close to 40% on the various securities markets; and further, by the fall in property prices, which according to the Spanish Ministry of Housing was of the order of 3.2% in Q3 compared with the same period a year earlier, meaning the year-end figure was of average growth of 0.7% (down from 5.8% in 2007).

Against this background, household expenditure contracted more sharply than in the previous quarter. In particular, household consumption fell at a year-on-year rate of somewhat over 1.5% in 2008 Q4, meaning that for the year as a whole it was the domestic demand component which most contributed to the slowdown in GDP, even exceeding residential investment. Consumption was affected by the climate of mistrust brought on by the financial market convulsions during the quarter and by the deterioration in the general macroeconomic outlook. But job destruction and the tightening of financing conditions also contributed to the scaling back by consumers of their spending decisions, dampening the expansionary effects on disposable income stemming from the rise in wages, lower inflation and the fiscal impulse linked to the personal income tax deduction applied in June. All these factors, along with the reduc-



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. Four-quarter cumulated data.

tion in the real value of household wealth, are prompting a rapid recovery in the household saving ratio, which rose in Q3 to 11.9% of disposable income in cumulative four-quarter terms, compared with 10.2% on average in 2007.

Residential investment was particularly influenced by the contractionary effect exerted by the tightening of financing conditions and the climate of uncertainty surrounding the economic outlook. And compounding this in particular is the declining course on which house prices have embarked. Real estate supply progressively adjusted during the year to the decline in residential demand, while the ongoing restructuring of the sector continued, which made for a further contraction in residential construction activity. It is estimated that residential investment may have fallen at a year-on-year rate of 20% in Q4.

Naturally, faced with the downward revision in household spending plans, the demand for financing posted lower growth. And this, combined with the tightening of credit supply conditions, meant that the slowing trajectory of household debt continued in the closing months of the year, to reach a year-on-year growth rate of 5% in November, almost 8 pp down on the December 2007 figure. The mildly declining path of the debt ratio, which started during Q3, when it stood at 128% of GDI, also continued.

The slide in corporate investment also steepened in Q4, as a result of the worsening economic outlook, the sluggishness of demand and the heightening of uncertainty, against the backdrop of financing conditions not conducive to new business projects. Investment in equipment fell off markedly, by more than 7% year-on-year, and investment in other construction began to show equally negative signs. Non-financial corporations' external borrowing also continued to slow, reaching a year-on-year growth rate of close to 8% in November, compared with 17% in December 2007. That made for a slight reduction in the sector's debt ratio during the closing months of the year.

The general government sector contributed in 2008 to sustaining spending, mainly by means of government consumption, which increased at a rate of 5% over the year a whole, since investment increased only moderately, at a far slower pace than in the two previous years. In addition, however, the deterioration in activity activated the automatic stabilisers in 2008 in the form of increases in unemployment benefits and declines in tax revenue, softening the impact of the cyclical change on household disposable income. Lastly, the government adopted a series of measures that reduced the tax burden on households and firms by an estimated amount of almost 2 pp of GDP. As a result of these factors, and of the forgone revenue entailed by the disappearance of the extraordinary proceeds linked to the real estate boom, public finances deteriorated rapidly in 2008: from a surplus of 2.2% of GDP in 2007, they are running a deficit that might rise to 3.4% of GDP in 2008, according to the latest Stability Programme update. The public debt ratio departed from the declining course of the last 11 years, rising by 3.3 pp in 2008 to 39.5% of GDP. For 2009, the government envisages a further increase in the deficit, which might stand close to 6% of GDP, although a portion of this deterioration can be explained by the launching of the above-mentioned funds for municipal investment and for reinvigorating the economy.

The progressive weakening of domestic spending was tempered by the greater buoyancy of net external demand, which is estimated to have made a positive contribution to GDP growth of 1.7pp in Q4. This was primarily a result of the weakness of imports, which are rapidly reflecting the downward adjustment in final consumption demand and equipment investment. As for exports, their growth rate declined significantly, against the background of a steeper slowdown in world trade, although both the depreciation of the euro and the performance of relative prices in Q4 saw price competitiveness indices behave more favourably, helping reduce the losses accumulated in the first half of the year. With regard to tourism services, the available indicators point to a step-up in their decline in Q4, a pattern that appears also to have been followed by imports of non-tourism services, although not by the exports of such goods, which picked up slightly.

The correction of the contribution of net external demand to GDP growth has begun to be passed through to the nation's net borrowing, which stood at 9.6% of GDP in Q3, in cumulative four-quarter terms, as against 10% in the first two quarters of the year. According to balance of payments data this correction continued in October, with the additional support of the lower energy bill during the final quarter.

On the supply side, value added declined in Q4 in all the productive branches of the market economy, except market services (although growth rates still fell significantly in this sector), with particularly sizeable declines in industry and in construction. Against this backdrop, the adjustment in employment seen in previous quarters intensified, with an estimated decline of around 3%. By productive branch, there was once more a very heavy fall in employment in construction, but high negative rates were also recorded in industry and, for the first time in this adjustment phase, employment also fell in market services, a sector that had been creating employment until Q3, albeit more moderately as the year elapsed. Meanwhile, the temporary employment ratio fell to 27.9% in Q4, reflecting the greater impact of workforce restructuring on temporary employment. Overall, employment fell at a higher rate than value added, so that productivity growth increased in the market economy from 0.9% in 2007 to 1.7% in 2008.

Despite the deterioration in the labour market during 2008, there was a significant increase in labour costs (which appear to have eased slightly only in the final quarter). This was a result of somewhat higher average wage settlements than in the previous year and, in particular, of the impact of indexation clauses, which added an additional percentage point to wage settlements. Compensation per employee is estimated to have grown on average during the year at a rate of 4.7% in the market economy (and 5% in the economy as a whole), up more than 1.5 pp on the previous year. In terms of unit labour costs, the increase would have been smaller, owing to the productivity gains being observed, although it would still have been larger than those of our competitors.

As a result of the declines in commodity and oil prices in the second half of 2008, CPI inflation fell from a high for the year of 5.3% in July to 1.4% in December. This gave rise – for the first time since the start of EMU – to a negative price differential vis-à-vis the euro area, in terms of the HICP, of 0.1 pp. Inflation excluding energy and unprocessed food prices was more stable, but fell in December to an annual rate of 2.6%. The inflation outlook for the coming months is one of more moderate growth until mid-2009, when the base effects of the oil price rises in the first half of 2008 drop out of the index, as part of a general trend towards price containment, based on slack demand.

The Spanish economy has over the past year undergone a very severe adjustment, exacerbated by the prolonged instability on international financial markets, which is giving rise to a severe weakening of world economic activity, a marked loss of confidence and a tightening of private-sector financing conditions. A large part of the deterioration in activity is rapidly being passed through to employment, and this is one of the main channels through which the adjustment is being spread to the rest of the economy, magnifying its effects on spending plans. The pass-through of interest rate reductions, cheaper oil, the decline in inflation, the effect of the expansionary measures taken and a possible end to the financial turmoil may help to alleviate the contractionary tendencies. However, given the recessionary climate in the world economy, it is hard to believe that the external sector can significantly reduce the scale of the adjustment of domestic demand. Since the fiscal policy leeway available is limited following the rapid deterioration in public finances over the past year, it is particularly important that progress be made in implementing the appropriate measures and economic reforms so as to improve the labour market situation, to foster the necessary shifting of resources among productive branches, to increase long-term productivity and to resume growth in potential output.

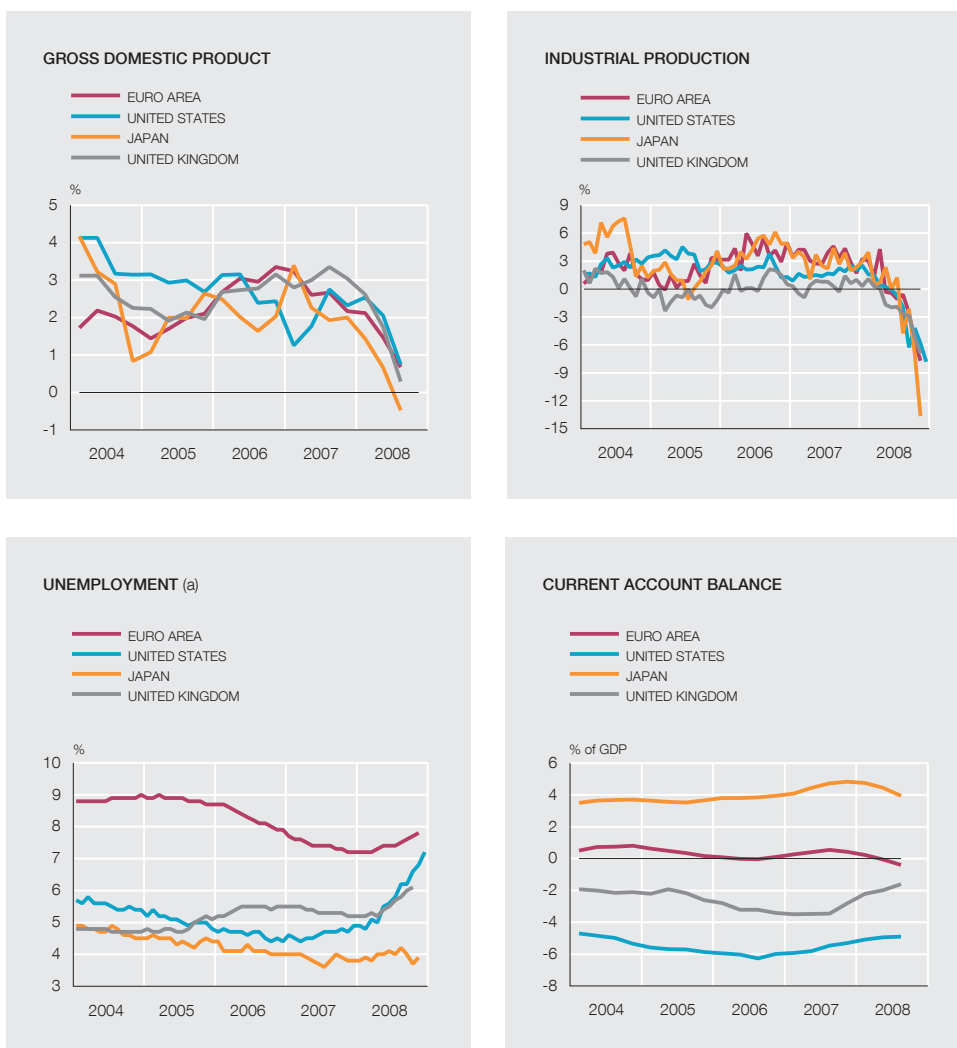


## 2 The external environment of the Spanish economy

In the last two months, the situation on international financial markets has stabilised slightly following the acute strains in the weeks after the bankruptcy of Lehman Brothers, an investment bank. This stabilisation has been seen in a moderate reduction of volatility on the major markets from the highs posted in November. Thus, although the situation is far from back on a normal footing, certain segments of the financial system have been reactivated, thanks to the effect of the support measures implemented by the authorities. Worth noting among these measures are: the increase in the provision of liquidity and financing to the banking system by central banks, together with lower borrowing costs arising from further very sharp drops in official interest rates; capital injections and guarantees given to bank debt by many governments to strengthen entities' solvency, and specific rescue plans for certain ailing institutions such as Citigroup and, more recently, Bank of America in the US. Additionally, the aid has been extended to other sectors, in particular the automobile industry in the US. However, the effect of these measures has been lessened by the strong deterioration of most macroeconomic indicators and unfavourable corporate earnings, along with the uncertain knock-on effect on the market of the Madoff hedge fund financial fraud in December. Against this background, the authorities' economic policy response through support for the financial sector and fiscal plans of increasing amounts, is key for restoring agents' confidence, safeguarding financial stability and supporting economic activity. On the monetary front, in particular, the loosening of monetary policy, which has been unprecedented in terms of its breadth and scope, has been facilitated by the substantial across-the-board reduction in inflation rates and short and medium-term expectations.

In the last three months, advanced economies' stock markets tended to moderate their losses. On foreign exchange markets the dollar reached a low against the euro mid-December (just before official rates were cut by the Federal Reserve) and, since then, it has continued to appreciate. The yen appreciated strongly, while the depreciation of sterling against the major currencies intensified. Long-term interest rates on government debt dropped significantly, due to weak activity, lower inflation expectations and reduced appetite for risk, in spite of expectations of a substantial rise in government debt issues worldwide aimed at financing rescue and fiscal plans. Trends in emerging markets have continued in parallel to those in developed markets and international investor sentiment has improved. Dollar-denominated liquidity assistance to certain emerging countries provided by the Federal Reserve and the announcement of a new emergency facility by the IMF at the end of October had a positive effect. Against a backdrop of weak global economic activity the price of Brent oil fell more than 40% over the last quarter (in spite of the cut in output announced by OPEC and geopolitical tension in certain producing regions) and currently stands at around \$45/barrel, although futures are factoring in a rise. Similarly, commodities prices dropped notably, with the exception of gold, which once more acted as a safe haven in times of turmoil.

In the US, GDP in 2008 Q3 contracted at an annualised quarterly rate of 0.5%, due to the fall in consumption and fixed investment, and the lower contribution from external demand. Q4 indicators are pointing to greater weakness of activity, indicating a sharper rate of decline, and of the labour market. Consumer confidence indices stood at record lows and, likewise, retail sales and real consumer spending point to a strong contraction of private consumption in Q4. The deep adjustment in the residential sector continued, as shown by the fall in the number of housing starts, construction permits and house sales during the quarter. House prices also underwent a strong downward adjustment in November. The worsening of activ-



SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

ity was confirmed by the declines in the ISM Purchasing Managers' indices to levels indicating a strong contraction and the reduction in industrial production in Q4. In the labour market, net job destruction affected 1.5 million people in Q4, raising the number of jobs destroyed in 2008 to nearly 2,600,000 (1.8% of the total), while the unemployment rate rose to 7.2% in December. CPI inflation plummeted in Q4 to an annualised rate of 0.1% in December, nearly 5 pp less than in September due to the fall in oil prices, while core inflation stood at an annualised rate of 1.8%. The worsening of the outlook for activity and the abatement in inflationary pressure led the Federal Reserve to cut the federal funds interest rate further and to determine for the first time ever a target range of 0% – 0.25% in mid-December. This target is commensurate with the low values reached by the effective interest rate on federal funds in the first half of that month. Also, the Federal Reserve's balance sheet has increased 150% since October and there has been an important change of strategy in its monetary policy (see Box 1). In terms of fiscal and financial policy, the Treasury substantially increased the funds committed to guarantees, financing, bank recapitalisation and fiscal aid, which will mean a drastic increase in the deficit and public debt over the next few years. Also noteworthy was the change in tack of TARP (the Troubled Assets Relief Program) from the purchase of toxic



SOURCE: Banco de España.

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

assets to earmarking its funds (of \$350 bn, extendable to \$700 bn) to the recapitalisation of ailing banks.

In 2008 Q3 Japan's economy contracted at an annualised quarterly rate of 1.8%, and Q4 indicators point to a sharp recession. Industrial production and the manufacturing PMI posted abrupt falls in November and December. On the demand side, private consumption is expected to deteriorate more due to the decline in disposable income and the flagging labour market. As for the business sector, it is expected that the fall in external and internal demand, the strong reduction in earnings and tighter credit conditions will have a negative effect on investment and recruitment plans over the coming months. The sharp fall in exports in December triggered a trade deficit for the third consecutive month, with the result that the surplus in 2008 narrowed by 80% on the previous year. Headline and core inflation in November fell to 1%, from 1.7% and 1.9%, respectively, in October. The Bank of Japan cut the official interest rate to 0.1% in December (and left it unchanged in January) and adopted measures to smooth business financing and the expansion of its balance sheet. As part of these measures it increased its purchases of government debt and approved the direct purchase of commercial

The loosening of monetary policy by the Federal Reserve since mid-2007 has reduced the official interest rate from 5.25% to very close to 0%. At its meeting in December 2008 the Federal Open Market Committee decided to set a target range for the federal funds interest rate of between 0 and 25 bp, instead of setting a specific figure. The proximity of official interest rates to 0% has revived the debate on whether monetary policy can continue to be effective in the easing of monetary and financial conditions. The monetary policy options available, when the possibility of reducing official interest rates has been exhausted, are analysed in this box. Furthermore, the box shows how some of these options have been used in the United States since early 2008, in conjunction with interest rate cuts, in order to mitigate the effects of the financial and credit crisis.

One initial alternative (and, in certain cases, complementary) measure to reducing official interest rates is changing the composition of the assets in a central bank's balance sheet, without altering its size. As can be seen in Panel 1, since early 2008 the Federal Reserve has been shedding its highly liquid, low-risk assets (in particular, US Treasury bonds) to include an increasing amount of other higher-risk, less liquid private, public or government-backed assets. This type of intervention was aimed at improving liquidity and helping restructure private entities' balance sheets through the transfer of part of their risk to the Federal Reserve, at the same time as it supported the price of certain assets. The corresponding reduction – until September – in US Treasury bond holdings was essential for maintaining the size of the Federal Reserve's balance sheet constant in this first stage and, in this way, avoiding compromising the target set for the federal funds interest rate.

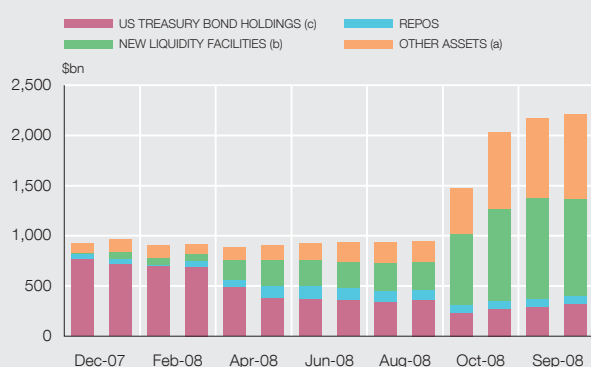
As an alternative to changing the composition of its balance sheet, a central bank may choose to increase its size. In the Fed's case, the fact that the reserves (deposits) of depository institutions (which are

part of the Fed's liabilities) were not remunerated limited the use of this possibility insofar as the Fed wanted to maintain the federal funds interest rate close to its target. The new authority granted to the Federal Reserve to remunerate bank reserves from October 2008 has enabled it to almost triple its balance sheet (Panels 1 and 2), without compromising the target for the federal funds interest rate. This policy has been compared with that of the Bank of Japan at the beginning of the decade, which was known as "quantitative easing".

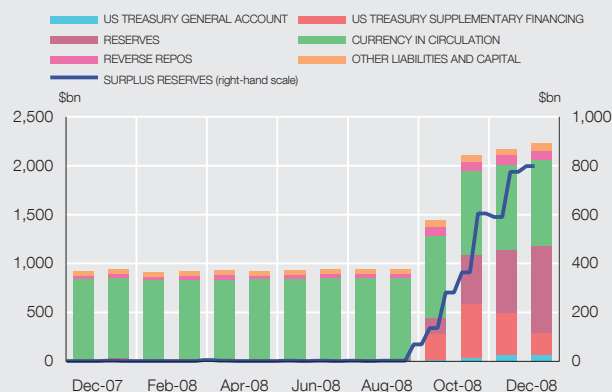
In Japan, from 2001 to 2006, official interest rates reached the limit of 0% and the economy faced sluggish activity and deflationary pressures. In that period, the Bank of Japan set a specific operating target of increasing banks' excess reserves above those required to hold the official interest rate at zero. At the same time it committed itself to continuing this policy until core inflation turned positive again. The main counterpoint to this increase in reserves was, on the asset side, the rise in purchases of Treasury bonds. The ultimate aim of this type of policy was to stimulate economic activity and take the country out of deflation through three inter-related mechanisms: (i) reducing long-term interest rates; (ii) stimulating credit to the private sector, and (iii) resolving the banks' liquidity problem. Although the evidence is not conclusive, purportedly this type of policy should have marginally reduced long-term interest rates. But it does not seem to have been as successful as the authorities expected in terms of the increase in credit to the private sector. Admittedly, this policy contributed to the stabilisation of the financial system by providing ample liquidity to banks, but it also helped the weakest banks in particular and may therefore have delayed the necessary reform of the banking system in Japan.

However, there are important differences between the Federal Reserve's recent actions and those of the Bank of Japan at the beginning of this decade. Firstly, the Federal Reserve still formally maintains

## 1 ASSETS



## 2 LIABILITIES



SOURCE: Banco de España.

- a. Other assets include credit lines for Bear Stearns and AIG, Treasury bonds loaned through SOMA and dollar swaps with other central banks.  
 b. The new liquidity facilities include the TAF, PDCF, TSFL, Commercial Paper Funding Facility programmes and measures to support money markets.  
 c. Excluding bonds loaned through TSFL.

the official interest rate target – within a range – and there is no explicit objective of increasing bank reserves. Secondly, and more importantly, the Federal Reserve has focused on the asset side of its balance sheet by expanding it to support the price and liquidity of certain assets in order: to facilitate the restructuring of private-sector balance sheets; to attempt to reduce the yield spreads on these assets over low-risk assets, such as Treasury bonds; and, in short, to keep credit flowing in the economy and maintain financial stability. In a recent speech, the Chairman of the Federal Reserve defined this strategy as “credit easing”, emphasising the differences with the case of Japan.<sup>1</sup> As an example of direct price support for certain assets, the Federal Reserve has begun to buy mortgage-backed securities directly, which had an immediate effect reducing mortgage market interest rates. Similarly, the Federal Reserve has announced the purchase of securities backed by consumer and small-business loans. Although the Bank of Japan also supported certain specific assets, its main objective was to expand the monetary base in order to help lift the economy out of deflation and to reduce long-term interest rates.

1. “The crisis and the policy response” speech given by Ben S. Bernanke at the London School of Economics on 13 January.

In the case of the United States, the expansion of excess reserves and of the Federal Reserve's liabilities (see Panel 2) is more a knock-on effect of its policy to support certain types of financial assets and not an objective in itself.

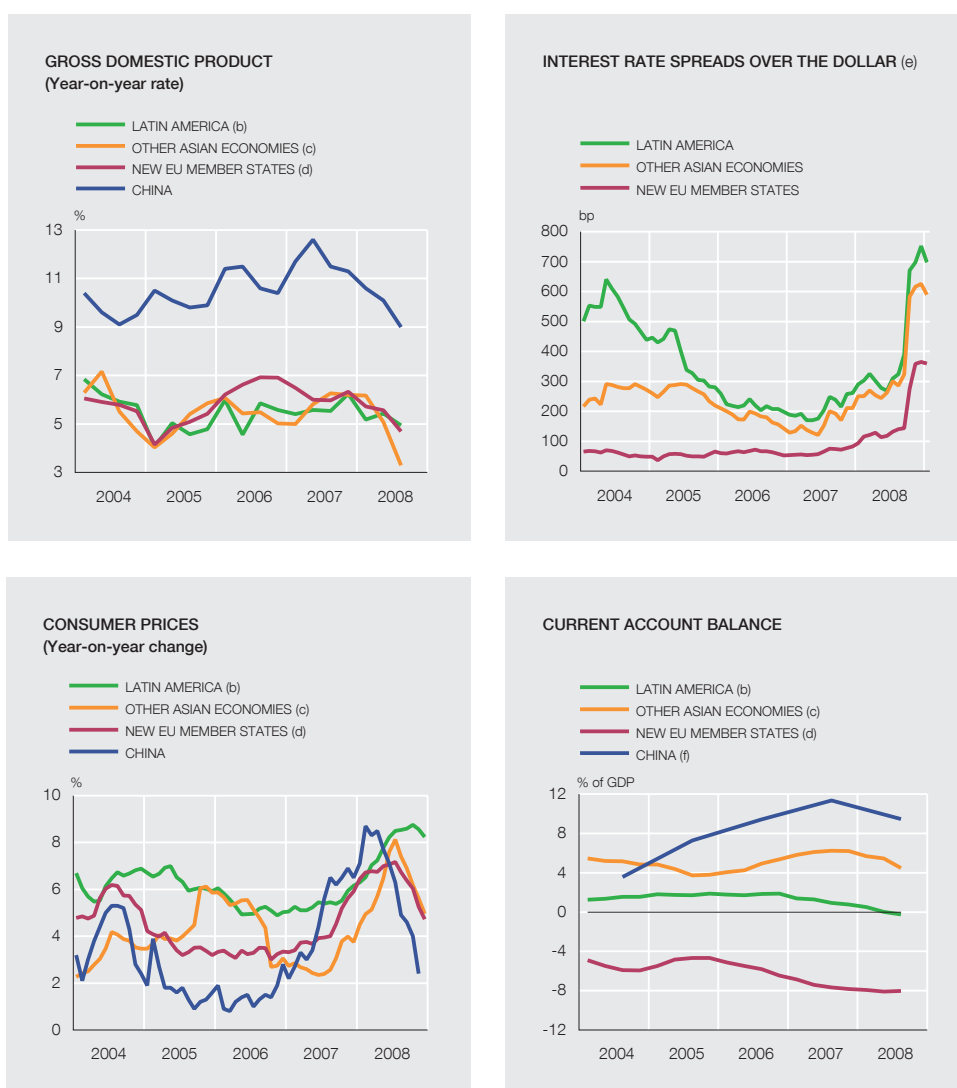
In short, even if official interest rates approach the lower bound of 0%, central banks can modify the composition and size of their balance sheets to exert their influence on interest rates other than short-term ones (for example, the interest rate on long-term bonds or the yield on other private or government assets). In fact, the Federal Reserve has already used the first of these options since the beginning of 2008 to provide greater liquidity to certain financial markets. Furthermore, since October it has strongly expanded its balance sheet, while the leeway for further reducing official interest rates has practically been exhausted. Significantly, however, in addition to the shortcomings seen in the case of Japan – for example, the delay in the necessary restructuring of the banking system – and the greater credit risk being assumed by the Federal Reserve, the formal maintenance of a target interest rate, while using the composition and size of its balance sheet as an instrument, may give rise to problems in clearly and effectively communicating the course of its monetary policy.

paper and accepted corporate debt as eligible assets in its open market operations. The Government announced two new economic stimulus plans which, together with the plan at the end of August, amounted to 75 billion yen (approximately 14.5% of GDP). These plans essentially include financial measures (12.5% of GDP) to support SMEs and financial institutions, and are supplemented by fiscal measures such as tax cuts, aid for households and employment promotion. Lastly, the budget for fiscal year 2009 includes a 9% rise in current expenses together with a 14% drop in tax receipts.

In the United Kingdom, GDP in Q3 contracted at an annualised quarterly rate of 2.6% due to the falls in private consumption and in investment. According to the advance estimate, GDP in Q4 declined at an annualised quarterly rate of 5.9%, in line with the indicators. The PMI indices in December fell to historically low levels. The growth in credit extended to households and non-financial corporations continued to slow in the quarter. Similarly, the adjustment in the property market continued: house prices fell at an annualised rate of more than 15% in December. Inflation dropped 1 pp in December to an annualised rate of 3.1%, in line with expectations expressed in the letter sent by the Governor of the Bank of England to the Exchequer in December and in the Bank of England news release in January, which reflected expectations of a steep decline in inflation – even below 1% – in 2009. The sharp weakening of activity and poor economic outlook prompted the Bank of England to drastically cut the official interest rate from 4.5% at the beginning of October to 1.5% – an all-time low – at its meeting on January 8. The Government implemented a fiscal stimulus plan of approximately 1.5% of GDP which includes, among other measures, a reduction in VAT, aid for refinancing mortgages and finance for SMEs, and extending unemployment benefits. The financial rescue plan announced in October, which is based on bank recapitalisation and guarantees for new debt issues, was strengthened mid-January to include guarantees for losses and purchases of troubled assets.

**EMERGING ECONOMIES:  
MAIN MACROECONOMIC INDICATORS (a)**

CHART 7



SOURCES: National statistics and JP Morgan.

- a. The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d. Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, 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.

In Q3, GDP slowed in all new EU Member States not belonging to the euro area, and on average grew at an annualised rate of 4.7%, down on the growth rate of 5.6% posted in Q2. There was a pronounced decline in Latvia and Estonia, where GDP fell at an annualised rate of 4.6% and 3.5%, respectively, due to the profound slowdown in domestic demand, against a background of high external financing requirements and credit restrictions. In the rest of the region the moderation in activity was more gradual. However, Q4 indicators show signs of a greater weakness in activity and demand – in particular, consumption – and exports, because of weak demand in euro area countries. Inflation followed a downward path and in December the average annualised rate stood at 4.4%. Against this backdrop, official interest rates were cut in nearly all countries and Romania and Poland announced fiscal plans to stimulate employment and investment. The worsening of financial strains and external vulnerability led to the down-

grading of ratings in all countries with a negative outlook. Hungary and Latvia received financial aid from the IMF, the World Bank and the EU, totalling €20 bn and €7.5 bn, respectively, and the ECB arranged a repo loan facility with Poland for €10 bn. On the institutional front, Slovakia joined the euro area on 1 January 2009.

In China, GDP slowed from 9% to 6.8% year-on-year in Q4, making for annual growth of 9% in 2008 (13% in 2007). This deceleration is essentially due to the abrupt adjustment in the property sector and the marked deterioration in exports. Q4 production and demand indicators confirm the prevailing weakness. In short, industrial production decreased significantly and, to a lesser extent, fixed-asset investment and retail sales. The trade surplus widened in Q4 in year-on-year terms since the fall in exports was accompanied by an even greater slump in imports. In 2008, the trade surplus amounted to \$295 bn and widened 12% on the previous year. Inflation fell to 1.2% in December, while the money supply and credit grew at slightly higher annualised rates than those of the previous quarter. In this setting, the Chinese authorities adopted numerous measures to support economic growth. These comprised further reductions in interest rates and in the reserve requirement, and a fiscal stimulus plan, whose impact is estimated at between 2% and 4% of GDP, and includes aid for certain sectors, among others the property sector. In the rest of Asia, GDP slowed across the board in Q3 – though differing from country to country – and, on average, fell from an annualised rate of 6.6% to 6%. There was a strong deceleration in industrial production and exports in Q4, presaging the poor performance of activity at year-end. Inflation rates decreased as a result of the ongoing decline in energy and commodity prices. In this setting, there was a widespread easing of monetary policies through increasingly deep cuts in official interest rates and in the reserve requirement, and several countries adopted supplementary measures to stimulate credit. Likewise, fiscal policies adopted a clearly expansive stance in many countries through plans to increase public spending.

In Latin America, GDP grew at an annualised rate of 4.9%, in comparison with 5.4% in the previous quarter. This deceleration essentially stemmed from a lower contribution from domestic demand – especially in Argentina and Venezuela, and to a lesser degree in Peru – together with a more negative contribution from external demand in all countries. Q4 indicators point to a greater slowdown of activity for the region and a widespread deterioration of the growth outlook for this year. At the same time, inflation rates began to ease, albeit at a lower rate than in other emerging areas. Thus, after the annualised rate for the region peaked at 8.7% in October, it decreased to 8.2% in December, although the inflation targets for the year were only met in Brazil. On the monetary policy front, Colombia was the first country in the region to cut the official interest rate in December (by 50 bp), followed in January by Chile (100 bp to 7.25%), Mexico (50 bp to 7.75%) and Brazil (100 bp to 12.75%). Other countries such as Peru confined themselves to reducing reserve requirements. As for fiscal policy, several countries adopted various stimulus measures and two new plans were announced in Mexico and Chile, for a higher amount than the earlier ones. Mexico, in December, and Brazil and Colombia, at the beginning of January, were able under the difficult circumstances to issue dollar-denominated sovereign debt on international markets on favourable terms. Lastly, Fitch downgraded the sovereign debt ratings of Venezuela, from BB– to B+, and for Argentina, from B to B–, while Moody's upgraded Uruguay's rating from Baa1 to Ba3.



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

The information available on economic developments in the euro area in 2008 Q4 points to a very notable deterioration in activity, which had already been showing signs of sluggishness from Q2. On top of the contractionary effects arising from the global financial crisis and from the low levels of business and consumer confidence, world trade was extremely weak during these months, presaging a deeper and longer-lasting recession in the euro area than anticipated. This is reflected in surveys of private analysts, who have revised their growth predictions for 2009 and 2010 substantially downwards, and put back the outlook of a recovery until the end of this year or the beginning of next. Also, the main international organisations have revised (or are in the process of revising) their predictions, in some cases outside the normal publication timetable for these exercises.

In the area of prices, the outlook also changed significantly in 2008 Q4, when inflation slowed sharply to reach very moderate levels in December. This process was largely the result of commodity price developments, especially those of energy, which are expected to continue to rein in inflation during the coming months. This may stand at rates of close to zero at around mid-2009, before increasing in 2009 H2. More in the medium term, the inflation outlook is determined by the effects of the fall in demand which will tend to moderate the growth of mark-ups and wages. Therefore, everything seems to indicate that the inflationary pressures that were being discerned until summer have disappeared from the immediate horizon. Against this backdrop, the Governing Council of the ECB decided to make four consecutive cuts in rates between October and January, reducing them by a total of 225 bp from their September level to 2%. The Council also reiterated the importance of inflation expectations remaining anchored around rates of below, but close to, 2% in the medium term.

The urgent action of European governments following the bout of exceptional instability that took the global financial system to the brink of collapse in September and October 2008 has helped, along with the Eurosystem's policy of supplying generous liquidity, to stemming the deterioration in the main indicators of financial tension. Nevertheless, the situation continues to be characterised by great uncertainty and great market volatility, and risk aversion remains high, with the result that financing conditions are still restrictive (see Box 2). More recently, EU governments have focused their efforts on developing economic recovery plans to counteract the risks of a negative feedback loop between the real economy and the financial strains (see Box 3). The effectiveness of these plans, beyond their capacity to stimulate short-term demand, will largely depend on the authorities – when using the room for manoeuvre in some countries and the flexibility provided by the Stability and Growth Pact- not losing sight of the fact that it remains essential to guarantee the sustainability of public finances over the medium term.

On 1 January 2009 Slovakia joined the Monetary Union. The adoption of the euro, to replace the Slovak koruna, was successfully completed in January.

#### **3.1 Economic developments**

According to the second National Accounts estimate, in Q3 euro area GDP contracted, for the second consecutive quarter, by 0.2% quarter-on-quarter (see Table 1 and Chart 8). This fall confirms the negative impact of the financial turmoil on the international environment and euro area activity. In year-on-year terms, euro area GDP grew by 0.6%, down 0.8 pp from the previous quarter.



In 2008, the prolongation and worsening of the financial crisis triggered a substantial drop in activity on credit markets and a strong increase in the risk premia demanded by investors. That resulted in notably tighter financial conditions than those official rates would suggest, which contributed to aggravating the economic downturn in the euro area and other regions of the world (see Chart 1). Thus, although the central bank has the ability to control very short-term interest rates, it is the financial markets which pass on the impulses of monetary policy and determine the borrowing costs of firms and households, conditioning, through this channel, the spending decisions in an economy. Within the monetary policy transmission mechanism, the interbank market is an essential link in EMU, since banks channel the bulk of financing. In this way, the EURIBOR (which includes the yield on unsecured interbank transactions) approximates the marginal cost of bank liabilities and is used as an anchor for the price of new loans and for the interest burden of a high number of borrowers.

In the case of non-financial corporations (NFCs), it is estimated that the nominal cost of financing approximated by an aggregate indicator—which weights the importance of various components in corporate liabilities—reached levels of approximately 8% in November (see Chart 2). During 2008, deteriorating prices on capital markets caused financing via securities (fixed-income and equity) to become more expensive in comparison with bank loans. However, the upward trend was discontinued in November when the ECB began to aggressively loosen monetary policy, which was immediately reflected in the EURIBOR. The interest rate on NFCs' new loan transactions dropped in November to 4.9% for contracts of more than one million euro and to 6% for contracts of less than one million euro, down from 5.5% and 6.4%, respectively, in October. For large transactions, whose volume represents more than 75% of the total granted to corporations, the cost was below that recorded in July 2007. Conversely, the price of loans for a smaller amount was still approximately 50 bp higher, although on the recent trend in the EURIBOR it is estimated that euro area bank rates were substantially lower in December and January. It should also be noted that contractually, interest rate revisions are usually on an annual or more frequent basis and, consequently, the

financial burden on outstanding debt in corporate balance sheets can also be expected to fall (see Chart 3).

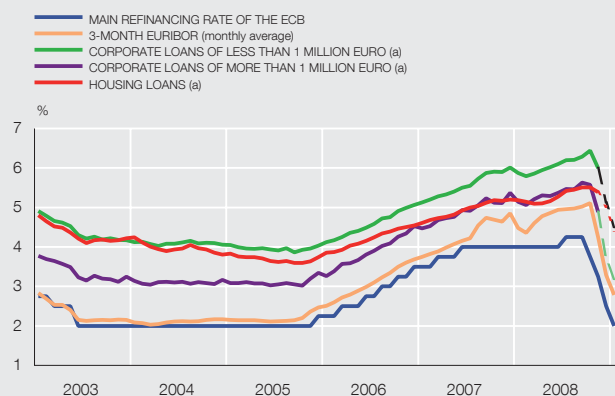
The cost of household loans also moved on an upward trend in 2008. In spite of the monetary easing which began in October, the cost of consumer credit continued to rise until November, when one-year contracts required remuneration of 9%, 1 pp higher than in July 2007 (see Chart 4). In contrast, the trend in the cost of housing loans changed in November, falling slightly to 5.4% in the euro area as a whole (see Chart 5). Floating rate contracts were the most sensitive to market conditions and are currently the most sensitive to the change in monetary policy stance, although their cost remains higher than in mid-2007. Also, there has been a trend towards less floating-rate housing credit and its volume represents less than 35% of new transactions in the euro area, in comparison with 55% at end-2005. This trend is not common to all countries in the area (it has only been observed in Greece, Italy, the Netherlands, Belgium and France) and the differences in the predominant type of contract are still very pronounced. Germany, Belgium, France and the Netherlands use contracts with fixed rates for more than five years, while Spain, Portugal and Finland are at the other extreme.

As inferred by the Bank Lending Survey, financing conditions were also tightened through aspects not linked to price (see Chart 6). The supply of bank credit became more restrictive as a consequence of the worsening economic situation and the impact of the financial turmoil, with fewer funds available and higher collateral requirements.

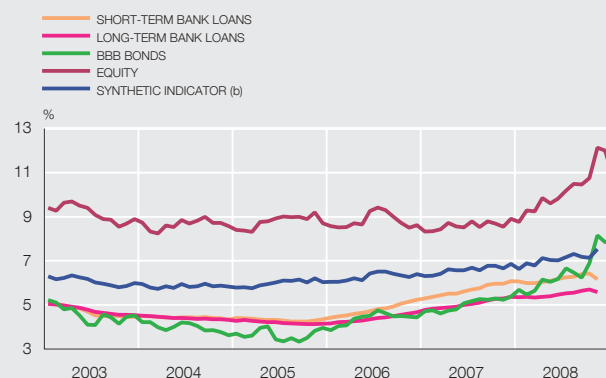
Therefore, the premiums required on credit markets in the last year and the procyclicality of credit supply prompted an increase in the cost of financing in 2008, which also affects non-price related aspects. The change in monetary policy stance since October has begun to be manifest in a gradual easing of financial conditions, although this has not been reflected in all instruments to the same degree. Nevertheless, there is still room for recent monetary policy impulses to be transmitted to financing costs and that the lack of confidence prevailing on credit markets can be overcome.

The breakdown of GDP by branch of activity reveals the unfavourable situation of industry and construction, which posted negative growth rates for the second consecutive quarter, while market services grew very moderately. Notable by spending components was the zero contribution of domestic demand, excluding inventories, as a result of highly disparate behaviour across its main items. Private consumption was unchanged, following the decline of the previous quarter, possibly as a consequence of the tightening of financial conditions and the deterioration in confidence against a backdrop of lower employment creation. Gross fixed capital formation (GFCF) declined again as did construction. The equipment component of GFCF was severely affected by the poor economic outlook and fell especially sharply. Lastly, government consumption retained its relative strength. The contribution of net external demand to GDP was very negative, as exports stagnated (for the second consecutive quarter) and imports increased by over 1%, and was partly offset by the positive contribution of the change in inventories.

## 1 INTEREST RATES IN THE EURO AREA

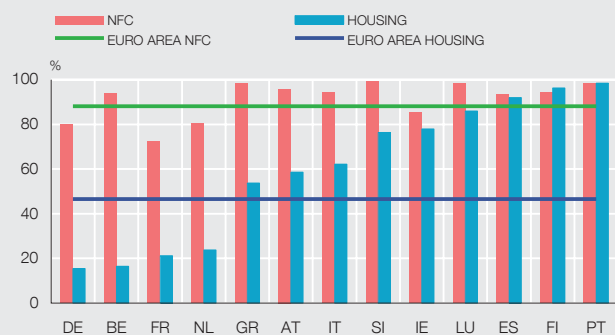


## 2 NOMINAL FINANCING COSTS FOR NON-FINANCIAL CORPORATIONS

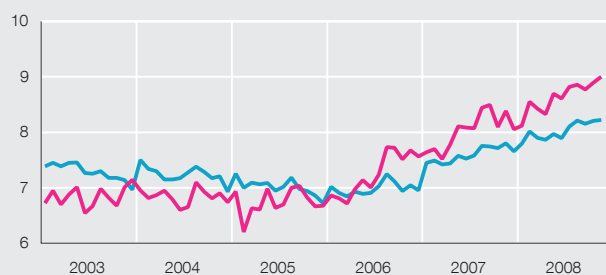


## 3 PERCENTAGE OF FLOATING-RATE LOAN OPERATIONS (c)

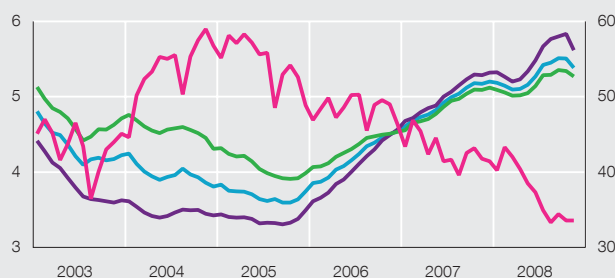
Average since 2005



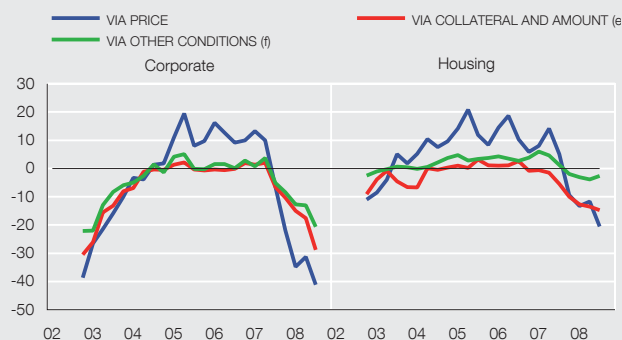
## 4 COST OF CONSUMER LOANS

CONSUMER LOANS  
1-YEAR CONSUMER LOANS

## 5 COST OF HOUSEHOLD FINANCING TO ACQUIRE HOUSING

HOUSING LOANS  
FLOATING-RATE CONTRACTS (c)  
OTHER CONTRACTS  
% FLOATING-RATE HOUSING LOAN (right-hand scale)

## 6 CHANGES IN LOAN SUPPLY CONDITIONS (d)



SOURCES: European Central Bank and Banco de España.

a. Weighted average by volume of new transactions. Data observed to November. In December and January a projection was used based on the trend of the EURIBOR.

b. Weighted average of the interest rate on loans (linked to the loan stock), the yield of fixed-income securities for BBB-rated firms and the cost of equity approximated by a dividend discount model. Weights are the relative significance of each source of financing in terms of stocks.

c. New loan transactions with a fixed-interest rate for one year or less.

d. Indicator = % of institutions which considerably loosen credit standards + % of institutions which show a slight loosening of credit standards  $\times 1/2$  - % of institutions which show a slight tightening of credit standards  $\times 1/2$  - % of institutions which considerably tighten credit standards. Data to 2008 Q3.

e. For corporations it includes the collateral required and the amount of the loan or credit line. In terms of housing loans, it refers to the collateral required and the ratio between the principal and the value of the collateral.

f. Refers to term and expenses, excluding interest. For corporations it also includes the commitments associated with loan contracts.

The serious deterioration in economic activity in recent months has led international authorities to adopt, in coordination, exceptional fiscal measures as part of a broader economic policy response, which was initially directed at stabilising financial markets and is currently attempting to prevent a negative feedback loop between the real economy and financial strains. In the European arena, on 12 December 2008, the European Council (comprising the Heads of Government of EU Member States) adopted the European Economic Recovery Plan, whose immediate objective is to earmark approximately €200 billion, equivalent to 1.5% of EU GDP, to boost public investment and short-term corporate and household spending. The Plan also contains a set of recommendations for structural reform grounded in the Lisbon Strategy.

This Plan is conceived as a joint framework of action, specifying the steps that will be taken by European institutions and the basic principles which should be satisfied by the measures adopted by the different Member States.

Specifically, EU action amounts to €30 billion (0.3% of EU GDP), which will be targeted at increasing the financial capacity of the European Investment Bank in 2009 and 2010, to finance (in partnership with private enterprise) investment projects in energy, transport and telecommunications infrastructures in EU Member States.

As for national measures, the European Council agreed that the national plans as a whole should amount to approximately €170 billion, equivalent to 1.2% of EU GDP. Aside from this overall aggregate, the plan points out that it is appropriate for each country's fiscal impulse to take into consideration the situation of its public finances. Also, measures must be designed which are timely, temporary and targeted at the sectors and segments of the population which are affected most by the crisis, where fiscal multipliers are higher. The objective is to attempt to ensure that the fiscal impulse is swiftly and sharply passed through to agents' spending decisions without compromising the sustainability of public finances.

At present, most Member States have approved or announced a fiscal stimulus plan. These plans are varied in nature on the basis of

their magnitude and the instruments they use. The plans envisage a wide range of measures targeted at stimulating household expenditure such as VAT cuts, lower social contributions, a reduction in taxes for families with mortgages and lower-income households, and direct aid. The measures for companies are principally geared at SMEs and the automobile and construction sectors. As for public investment, projects aimed at the development of transport infrastructures and the use of environmentally-friendly energies are prioritised.

Lastly, the plans envisage another type of measures with no direct budgetary impact. Among them is an instrument included in most plans, which is the provision of funds to guarantee loans granted to SMEs or companies in strategic sectors which, in the current climate have seen their access to credit restricted. They also generally include initiatives aimed at easing the transition of the unemployed to new jobs and to improve the functioning of the labour market.

The accompanying table attempts to summarise the most important characteristics of the plans approved in the major EU countries between September and 19 January using the information from the stability programmes submitted by countries to the European Commission and other national sources. This assessment has only taken into account those measures with a direct impact on budget balances in 2009 (consequently, the German plan, which earmarks most of the impulse for 2010, appears to be so small in comparison with the news published in the press). Projects financed with European funds are also excluded.

In short, it is estimated that the amount of the measures adopted to date is close to 1% of GDP in the area as a whole. These funds are distributed among households, companies and the public investment impulse, although by country there are notable differences as regards the intensity of the impulse and its breakdown. Thus, in the United Kingdom, Germany and Italy, the core of the measures is directed at stimulating household spending (although Germany's January plan places greater emphasis on public investment). In contrast, other Member States such as Spain, France and the Netherlands have had to focus the fiscal response on stimulating business activity and public investment.

#### MAIN CHARACTERISTICS OF MEASURES TO SUPPORT THE REAL ECONOMY ADOPTED IN EURO AREA COUNTRIES (a)

	TOTAL AMOUNT		DISTRIBUTION OF FUNDS (%)			OTHER MEASURES	
	€	% of GDP	Households	Companies and sectors	Public investment	Credit facilities and/or guarantees for companies	Employment Policies
EURO AREA	97 €	1.0	35	33	32	Yes	Yes
Germany	35 €	1.4	56	15	29	Yes	Yes
France	26 €	1.3	8	52	40	—	Yes
Italy (b)	6 €	0.3	63	25	12	—	—
Spain	20 €	1.9	17	44	39	Yes	Yes
Netherlands	1 €	0.2	18	82	0	Yes	Yes
United Kingdom	£20	1.0	80	4%	16	Yes	Yes

SOURCE: Banco de España.

a. The estimated amount shows the budget impact of the measures announced for 2009. Only measures announced until 19 January 2009, for which an amount based on official sources is available, are included.

b. Including measures approved in the Decree Law of 29 November 2008, although their impact on the budget will be limited since they are financed with increases in taxes or improvements in collection.

	2007			2008			2009
	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NATIONAL ACCOUNTS (Quarter-on-quarter growth, except as indicated)							
GDP	0.5	0.6	0.3	0.7	-0.2	-0.2	
Private consumption	0.7	0.4	0.2	0.0	-0.2	0.0	
Public consumption	0.2	0.5	0.3	0.3	0.8	0.7	
GFCF	0.2	1.0	1.0	1.4	-0.9	-0.6	
Imports	0.8	2.2	-0.3	1.5	-0.4	1.4	
Exports	1.2	1.9	0.4	1.6	-0.1	0.0	
Contributions to quarter-on-quarter GDP growth (pp)							
<i>Domestic demand (excl. inventories)</i>	<i>0.5</i>	<i>0.6</i>	<i>0.4</i>	<i>0.4</i>	<i>-0.1</i>	<i>0.0</i>	
<i>Changes in inventories</i>	<i>-0.2</i>	<i>0.1</i>	<i>-0.3</i>	<i>0.2</i>	<i>-0.2</i>	<i>0.4</i>	
<i>Net foreign demand</i>	<i>0.2</i>	<i>-0.1</i>	<i>0.3</i>	<i>0.1</i>	<i>0.1</i>	<i>-0.6</i>	
GDP (annual growth)	2.6	2.6	2.1	2.1	1.4	0.6	
ACTIVITY INDICATORS (quarterly average)							
IPI seasonally and working-day adjusted	0.4	1.3	1.1	-0.2	-1.1	-1.5	-3.3
Economic sentiment	111.0	108.7	104.3	100.5	96.5	88.5	74.0
Composite PMI	57.2	56.5	54.0	52.1	50.8	47.6	40.2
Employment	0.5	0.4	0.3	0.3	0.2	-0.1	
Unemployment rate	7.4	7.4	7.2	7.2	7.4	7.5	7.7
PRICE INDICATORS (annual growth of end-period data)							
HICP	1.9	2.1	3.1	3.6	4.0	3.6	1.6
PPI	2.3	2.7	4.4	5.8	8.0	7.9	3.3
Oil price (USD value)	71.8	78.2	91.5	104.3	132.0	98.1	40.5
FINANCIAL INDICATORS (end-period data)							
Euro area ten-year government bond yield	4.7	4.4	4.4	4.2	4.9	4.5	3.9
US-euro area ten-year government bond spread	0.46	0.15	-0.36	-0.69	-0.88	-0.88	-1.80
Dollar/euro exchange rate	1.351	1.418	1.472	1.581	1.576	1.430	1.392
Appreciation/ depreciation of the EER-22 (b)	1.5	3.7	6.3	3.7	3.5	-0.6	2.7
Dow Jones EURO STOXX 50 index (b)	9.0	6.4	6.8	-17.5	-23.8	-30.9	-44.3

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

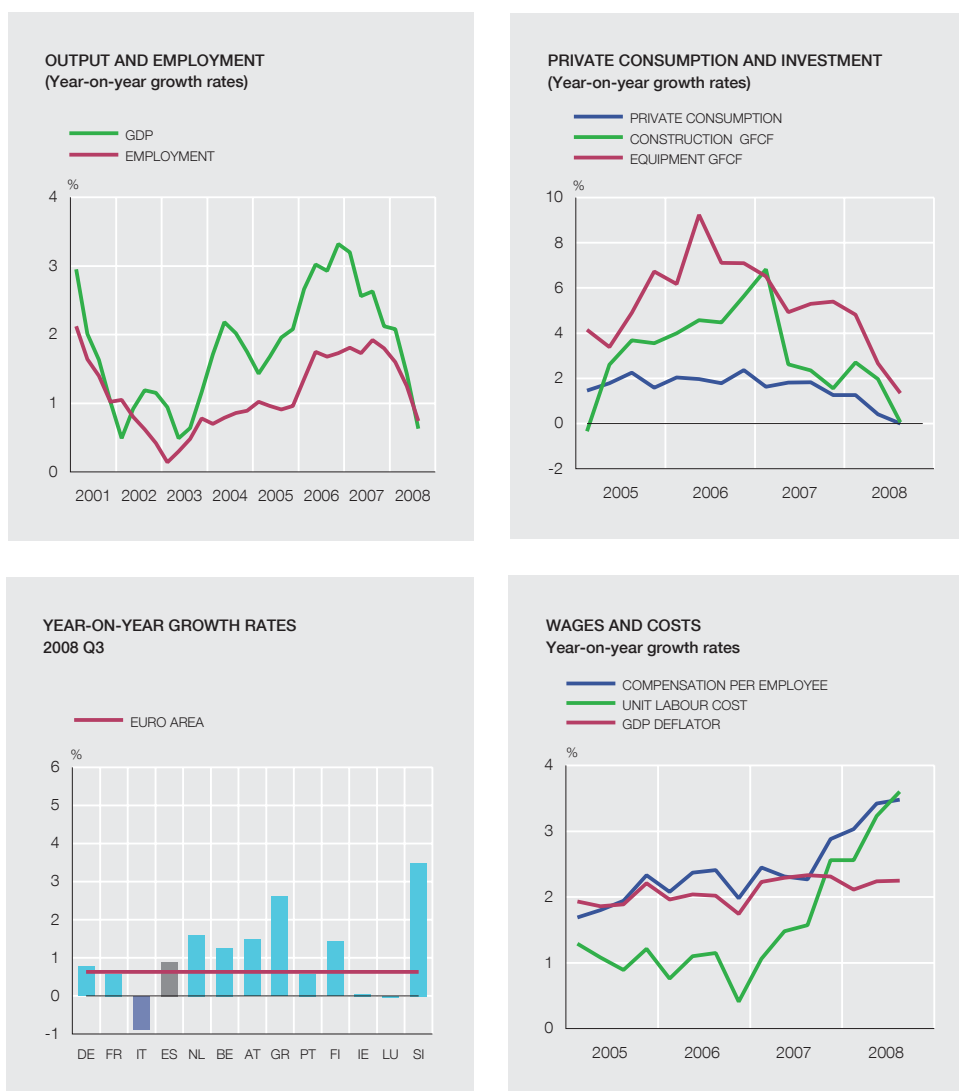
a. Information available up to 22 January 2009. The information in italics does not cover a full quarter.

b. Percentage change over the year.

The feebleness of GDP in Q3 spread to the largest economies of the euro area, except France. In Germany and Italy, the quarter-on-quarter GDP increase was  $-0.5\%$ , following the fall of  $0.4\%$  in the preceding period, and was attributable, in both cases, to the poor performance of the external sector, owing to the strong contraction in exports and equipment investment. Private consumption and investment in construction remained weak. In France, GDP grew  $0.1\%$ , buoyed by higher exports and, to a lesser degree, consumption, since investment declined.

Employment grew in 2008 Q3 at a negative rate of  $-0.1\%$ , the lowest rate recorded since 1995. As this decline was smaller than that in GDP, labour productivity decreased, as is usual at the beginning of cyclical downturns. The combination of the behaviour of productivity with a slight acceleration in compensation per employee caused the unit labour cost to grow at high rates of over  $3.6\%$ , although its effect on final prices was partly offset by a further contraction in operating margins.

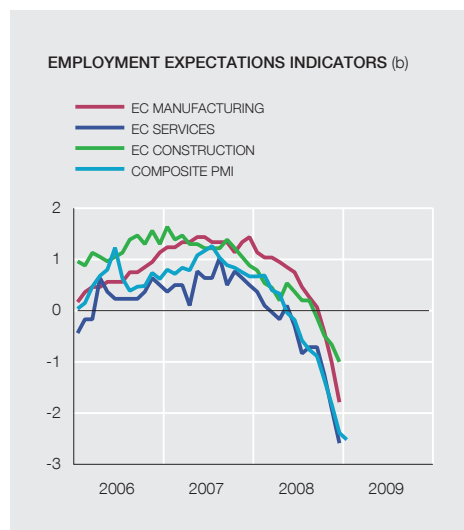
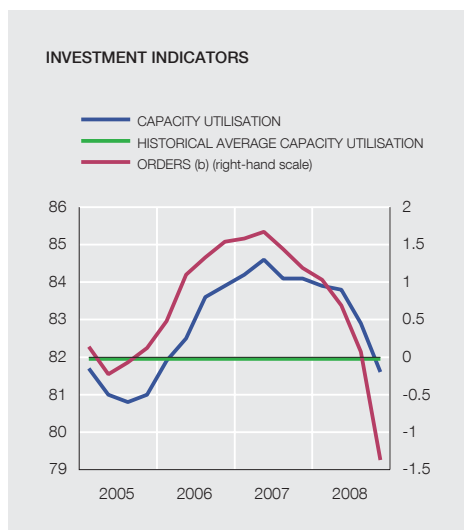
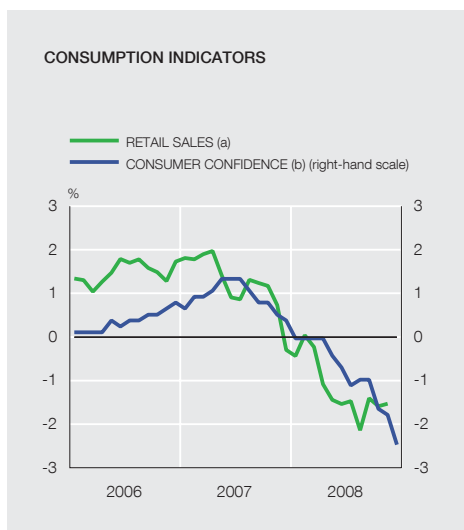
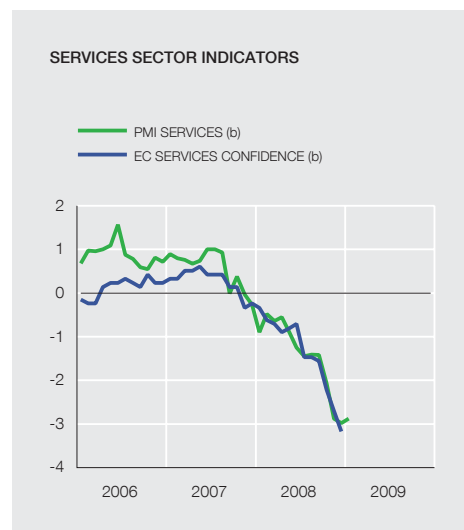
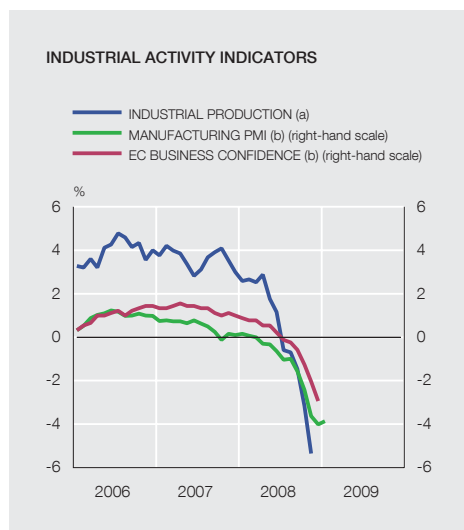
The latest conjunctural information shows a substantial deterioration in activity in 2008 Q4 and points to clearly negative output growth in that period (see Table 1 and Chart 9). On the supply side, the industrial production index and industrial orders (on data to November) slowed with respect to the preceding quarter. Confidence survey indicators also fell in Q4, more sharply so



Sources: Eurostat and national statistics.

in the industrial than in the services sector. In fact, these indices currently stand at historical lows, indicating the gravity of the current situation. Lastly, the decline in the indicators of employment creation expectations steepened in Q4, while the unemployment rate continued to rise slowly to stand at 7.8% in November.

The short-term spending indicators also worsened notably in 2008 Q4. On data to November, average growth of retail sales and, especially, new car registrations declined with respect to Q3. Likewise, consumer and retail confidence indicators published by the European Commission fell significantly in Q4 and the former is at its lowest level since the start of the series in 1985. The downward path of investment indicators such as the assessment of order books and, to a lesser extent, capacity utilisation, steepened in 2008 Q4. If the difficulties involved in gaining access to external financing are considered, the outlook for corporate spending is very bleak. Finally, according to trade balance data, extra-euro area goods exports and imports fell in the period October-November relative to Q3. The qualitative export indicators point in the same direction, since the external order books and export expectations of the quarterly European Commission survey declined in 2008 Q4.



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 (December 2008)	0,8-1,2	3,4-3,5	-1,0-0,0	1,4-2,2
European Commission (January 2009)	0.9	3.3	-1.9	1.0
IMF (November 2008)	1.2	3.5	-0.5	1.9
OECD (November 2008)	1.1	3.4	-0.6	1.4
Consensus Forecast (January 2009)	1.0	3.3	-1.4	1.0
Eurobarometer (January 2009)	0.9	3.3	-1.5	1.0

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

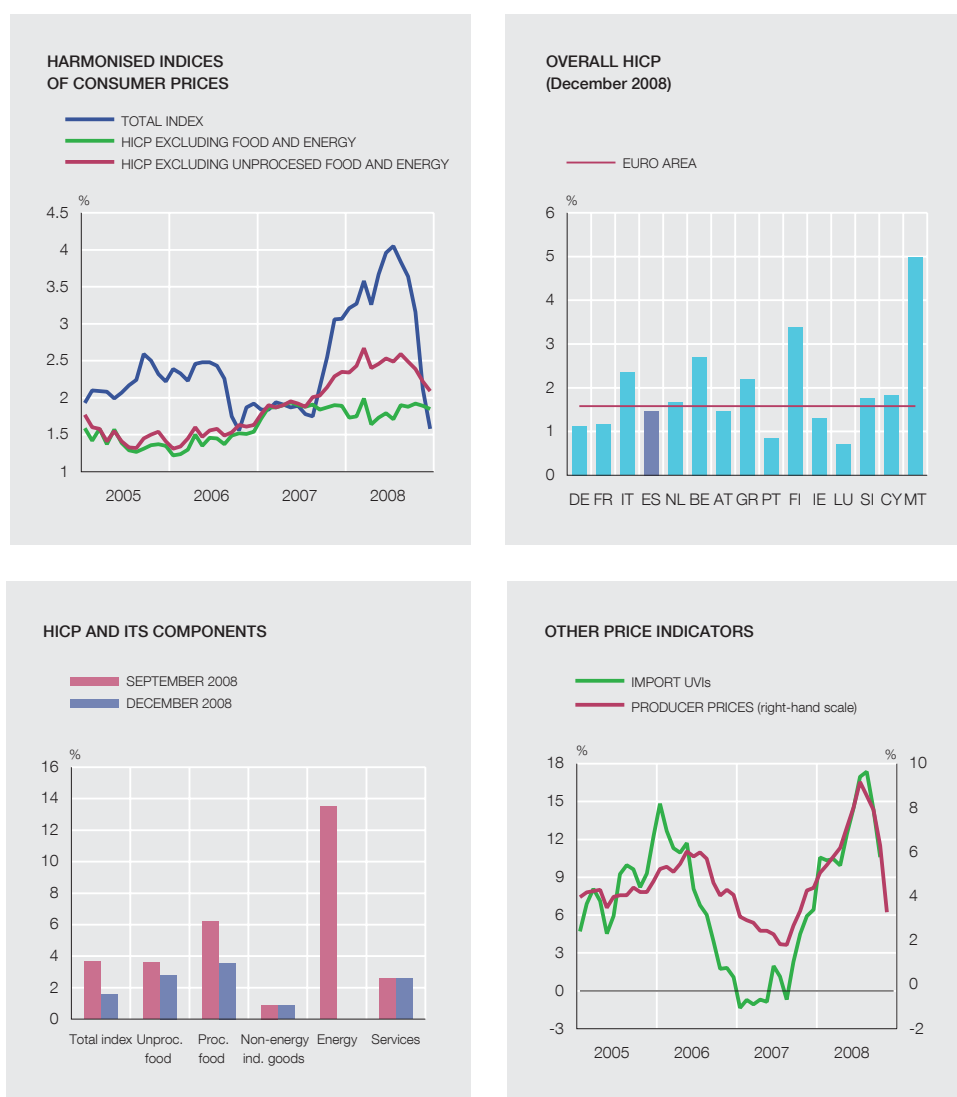
a. Annual growth rate.

The decline in activity indicators in 2008 Q4 reflects the impact of financial turbulence on real activity through the tightening of financial conditions and low confidence levels and, indirectly, lower external demand due to the effects of the crisis on other areas of the world. The growth outlook for 2009 has been revised downwards further and, as indicated by the most recent projections of private analysts, the IMF and the European Commission, GDP may post a negative growth rate of approximately -2% (see Table 2). However, these estimates are subject to very high uncertainty and the recovery of the European economy will hinge on the duration of the financial instability, the degree of feedback between the latter and spending, and the effectiveness of the economic plans adopted in order to recover confidence and stimulate activity.

Euro area inflation slowed more sharply in Q4 and stood at 1.6% in December, 2 pp down on the rate for September. This behaviour is essentially tied to the trend in energy and (to a lesser degree) food prices since the growth rate of the price of other components hardly moderated (see Table 1 and Chart 10). In fact, if food and energy prices are stripped out of the overall index, the resulting aggregate grew 1.8% in December, 0.1 pp less than in September.

Inflation will foreseeably continue to decline over the coming months due to a large extent to the slowdown of its most volatile components, if these prices behave as anticipated by the futures markets. This is being factored in by short-term price indicators, such as the consumer component of industrial prices, which dropped sharply in October and November, and the selling price indicators based on confidence surveys in the closing months of 2008, which indicate a further weakening of the inflation outlook. In the medium term, the prices of the more stable components are expected to also be contained as they adjust to worsening demand. Although wages will continue to post high levels over the coming quarters, since they are mostly the result of agreements adopted in previous months, they should begin to subsequently show a slight moderation due to the effects of the weakening of demand and of employment creation on wage bargaining.

On ECB estimates, the current account deficit in the January-October period stood at €46.9 bn (0.6% of GDP), in comparison with the surplus of €32 bn in the same period in 2007. This deterioration was the consequence of the poor performance of all components except for the balance of services, whose surplus widened slightly. Thus, the merchandise goods surplus has practically disappeared, the income account recorded a clear deficit and the transfers deficit widened. The basic balance, which aggregates the current account balance and net direct and portfolio investment posted a deficit of €10.5 bn in the first ten months of 2008, in contrast to the surplus of €112 bn in the same period of the previous year. This poorer result was due to the strong contraction of direct investment from -€83.7 bn in 2007 to -€210.9 bn



SOURCES: Eurostat and European Central Bank.

to October 2008. Conversely, net portfolio investment expanded with respect to the same period of the previous year by €83.6 bn to €247.3 bn.

The stability programmes submitted by governments to the European Commission and the latter's estimates published in January 2009 show a strong deterioration in the euro area budget balance in 2008, which interrupts the ongoing containment of the deficit since 2004. The euro area's budget deficit stood at 1.7% of GDP in 2008, as against -0.6% in 2007, and was much worse than projected in the stability programmes prepared that year (see Table 3). This result was due, on the one hand, to the worsening of the economic situation and, in particular, to forgone tax receipts now that real financial asset prices and corporate earnings are declining. On the other hand, the introduction of discretionary measures to lower taxes and social contributions also contributed to this decline.

Most euro area countries posted a drop in their fiscal balances in 2008, which was more pronounced in Spain and Ireland due to the effects of the property market crisis on tax receipts. Specifically, it is estimated that in 2008 five countries (Spain, France, Ireland, Greece and



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

TABLE 3

	% of GDP					
	BUDGET BALANCES (a)					
	2007	2008		2009		2010
	Stab.Prog.(b)	EC (c)	Stab.Prog.(b)	EC (c)	EC (c)	
Belgium	-0.3		-0.9		-3.0	-4.3
Germany	-0.2	0.0	-0.1	-0.5	-2.9	-4.2
Greece	-3.5		-3.4		-3.7	-4.2
Spain	2.2	-3.4	-3.4	-5.8	-6.2	-5.7
France	-2.7	-2.9	-3.2	-3.9	-5.4	-5.0
Ireland	0.2	-5.5	-6.3	-6.5	-11.0	-13.0
Italy	-1.6		-2.8		-3.8	-3.7
Luxembourg	3.2	2.3	3.0	1.1	0.4	-1.4
Netherlands	0.3	1.2	1.1	1.2	-1.4	-2.7
Austria	-0.4		-0.6		-3.0	-3.6
Portugal	-2.6		-2.2		-4.6	-4.4
Slovenia	0.5		-0.9		-3.2	-2.8
Finland	5.3	4.4	4.5	2.1	2.0	0.5
Malta	-1.8	-3.3	-3.5	-1.5	-2.6	-2.5
Cyprus	3.5		1.0		-0.6	-1.0
Slovakia	-1.9		-2.2		-2.8	-3.6
PRO MEMORIA: Euro area (including Malta and Cyprus)						
Primary balance	2.3		1.3		-1.0	-1.3
Total balance	-0.6		-1.7		-3.9	-4.3
Public debt	66.1		68.7		72.7	75.8

SOURCES: European Commission and national stability programmes.

- a. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.  
b. Stability Programmes' objectives submitted between late 2008 and early 2009.  
c. European Commission forecasts (January 2009).

Malta) will exceed the deficit threshold of 3% of GDP, and Italy will come very close to that figure (see Table 3). Only Germany's public finances improved in 2008 and were practically in balance, a development not seen since 1989.

On European Commission projections, in 2009 the deterioration of the fiscal balance will be even sharper, at over 2 pp, with the result that the deficit could reach 4% of GDP in the area as a whole, the worst figure since the mid-nineties. This outcome is justified by the negative impact of the cyclical position of the euro area countries (estimated at approximately 1.4 pp) and the fiscal stimulus plans undertaken within the framework of the European Union's Economic Recovery Plan — approximately 1% of GDP — (see Box 3). In 2009, it is estimated that Italy, Portugal and Slovenia will join the group of countries with deficits exceeding 3% of GDP and Germany, Austria, Belgium and Malta will move closer to that reference value.

It is projected that the level of public debt will once again be above 70% of GDP in 2009, following the reduction in recent years, reflecting the worsening of budgetary positions and the effect of plans comprising measures to support the financial system.

Under these circumstances, the European Council has reaffirmed that the revised Stability and Growth Pact (SGP) continues to be the appropriate regulatory framework for coordinating EU Member States' budgetary policies and is sufficiently flexible to meet the size-

able challenges facing fiscal policy, without the need for a temporary suspension of the procedures it includes. The European Commission has clarified such flexibility in the context of the current exceptional economic circumstances. Thus, under the SGP, in situations where there is a serious deterioration in economic growth, deficits of more than 3% of GDP can be reached without them being considered “excessive”, provided that they are temporary and remain close to the 3% threshold. If these requirements are not met, the Commission must implement the excessive deficit procedures established in the Treaty, although it is possible to extend the deadline for correcting the deficit by another year. Finally, if the excessive deficit were to last until the end of that deadline, the Commission may establish new recommendations to contain it, without applying the sanctions envisaged in the Treaty.

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

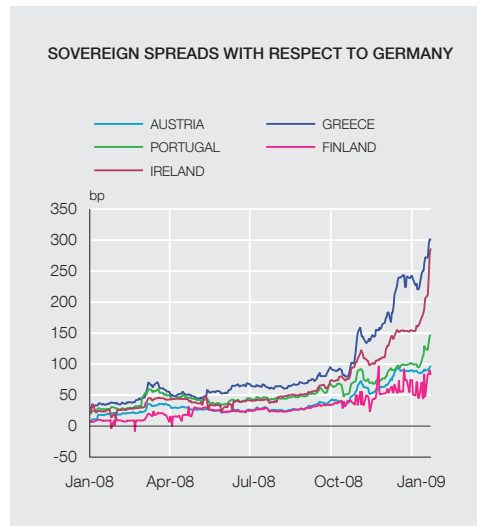
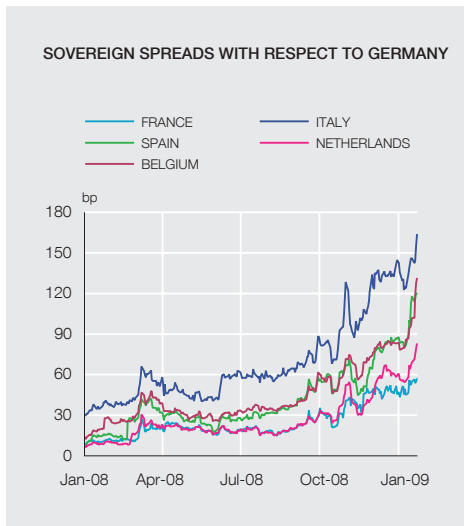
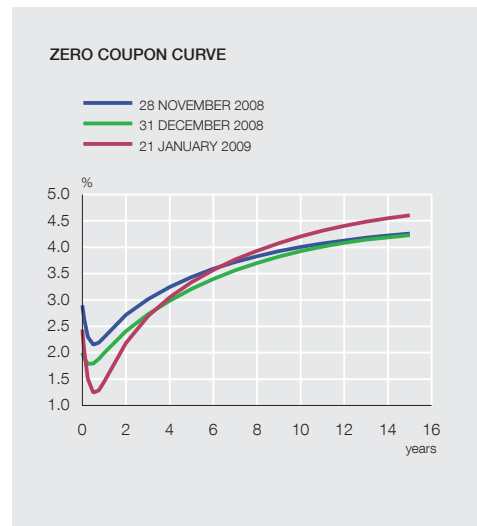
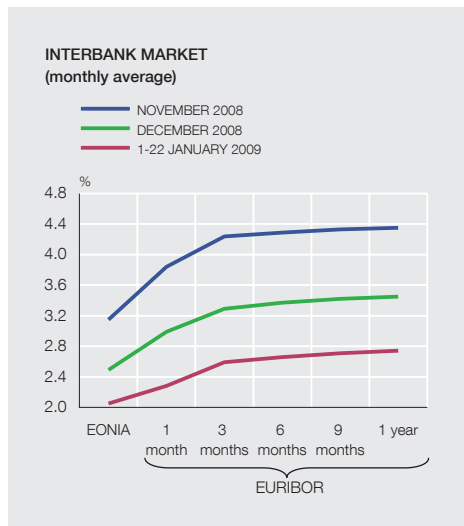
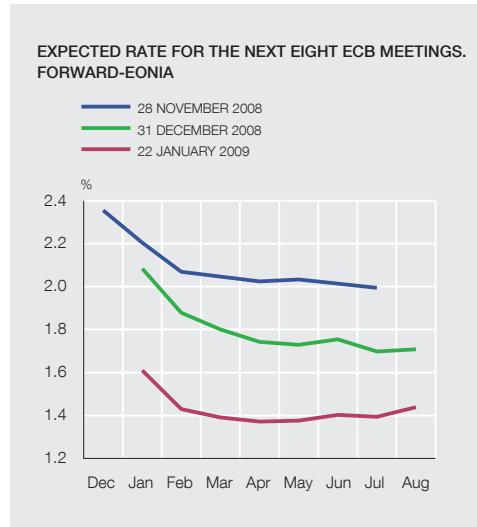
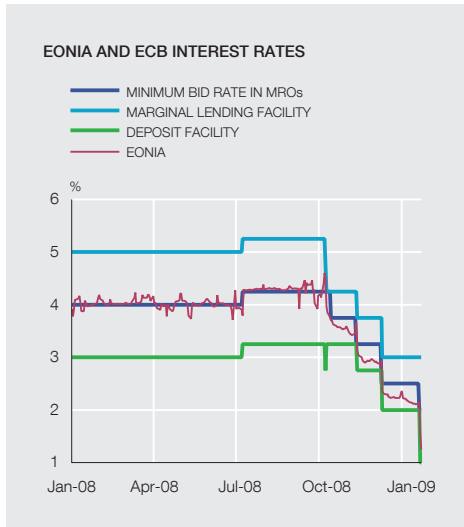
The urgent adoption and implementation of support plans by governments and policies involving the generous supply of liquidity by central banks have contributed to easing the strains following the bout of exceptional instability in the global financial system in September and October. However, against a background characterised by great uncertainty and extreme volatility, risk aversion remained at very high levels as reflected by the premiums demanded by investors on interbank, government debt and corporate bond markets. This resulted in financing conditions remaining tight in the quarter as a whole (see Box 2).

In this setting, the ECB continued to satisfy financial institutions’ large demand for liquidity through weekly auctions, which will continue to be conducted at a fixed rate with full allotment until at least March, and through longer-term operations and auctions in dollars and Swiss francs. The lack of activity on the interbank market continued to prompt high usage of the deposit facility and, consequently, the ECB decided from 21 January to restore the width of the corridor of the standing facilities to 200 bp around the interest rate on the main refinancing operations.

As a result of the substantial downward revision of the inflation outlook, against a setting of a pronounced slowdown of activity, the monetary policy stance had to adapt to the new circumstances. Thus, in October the ECB Governing Council lowered interest rates by 50 bp in concerted action with other central banks. Furthermore, at its regular meetings in November, December and January, it agreed to three rate cuts of 50 bp, 75 bp and 50 bp, respectively, bringing the rate on the main refinancing operations to 2% in January, an overall reduction of 225 bp in the last four months.

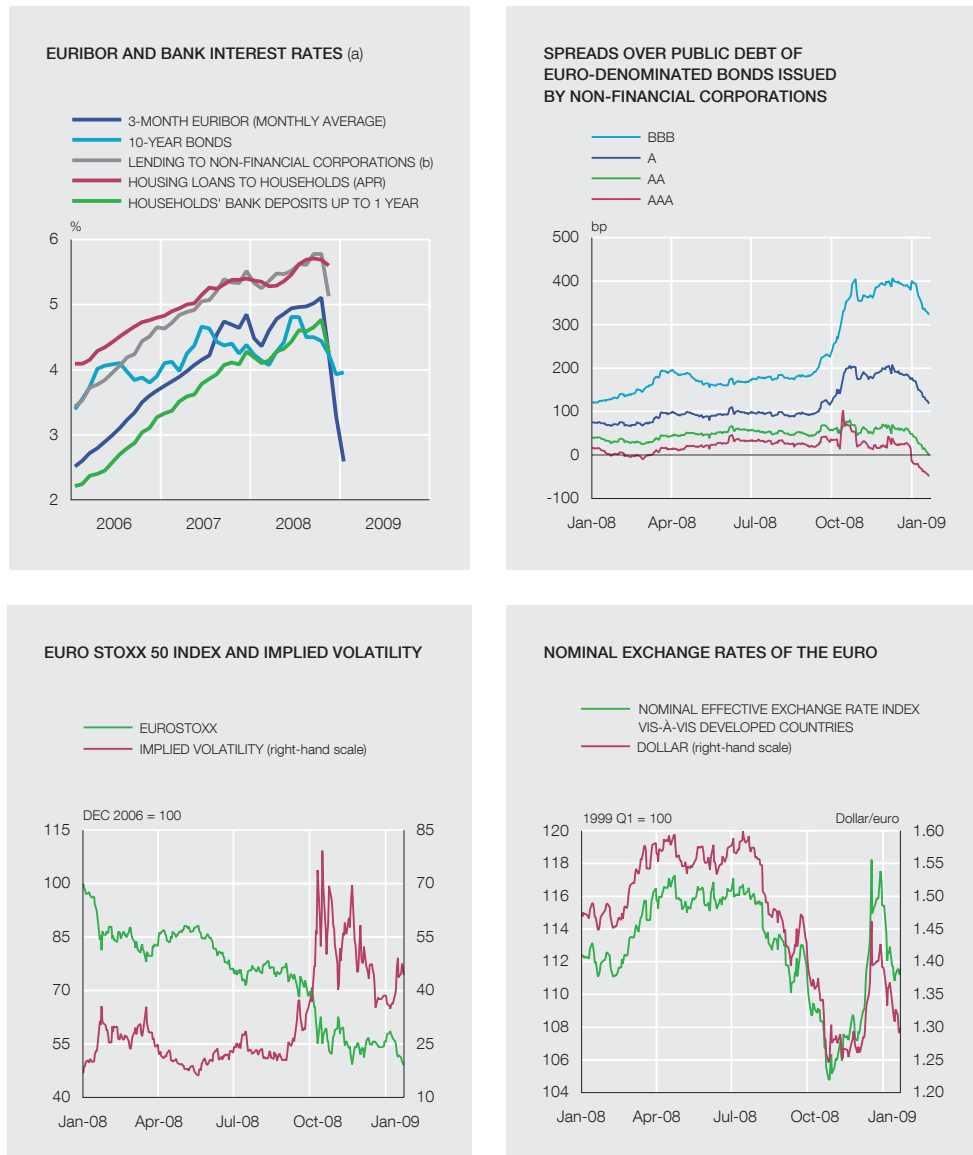
The loosening of monetary policy and the prospect of further rate cuts in the coming months have fed through to money-market interest rates. The yield curve on interbank markets (for unsecured transactions) has moved downwards by approximately 2.5 pp from end-September to 22 January, when the one-year EURIBOR stood at 2.4%, while the one-year EUREPO rate reached 1.1% (see Chart 11). The spread between the two rates attests to the prevailing very high premium in the interbank market.

The revised economic outlook coupled with investment flows to high quality assets put downward pressure on long-term rates in 2008 Q4. This trend was cut short early in 2009 and euro area ten-year government debt yields fluctuated around 4% in January, against a backdrop of investor expectations of a notable increase in the supply of government securities to finance substantial economic support plans. The preference for liquidity and greater risk aversion spurred demand for German government securities; their interest rate stood at approximately 3% in January. Thus, the yield spreads between euro-area Member States’ government debt and the German bond increased, especially after the possible downgrading of certain issuers’



SOURCES: European Central Bank and Banco de España.

a. Estimated by the ECB using swaps market data.

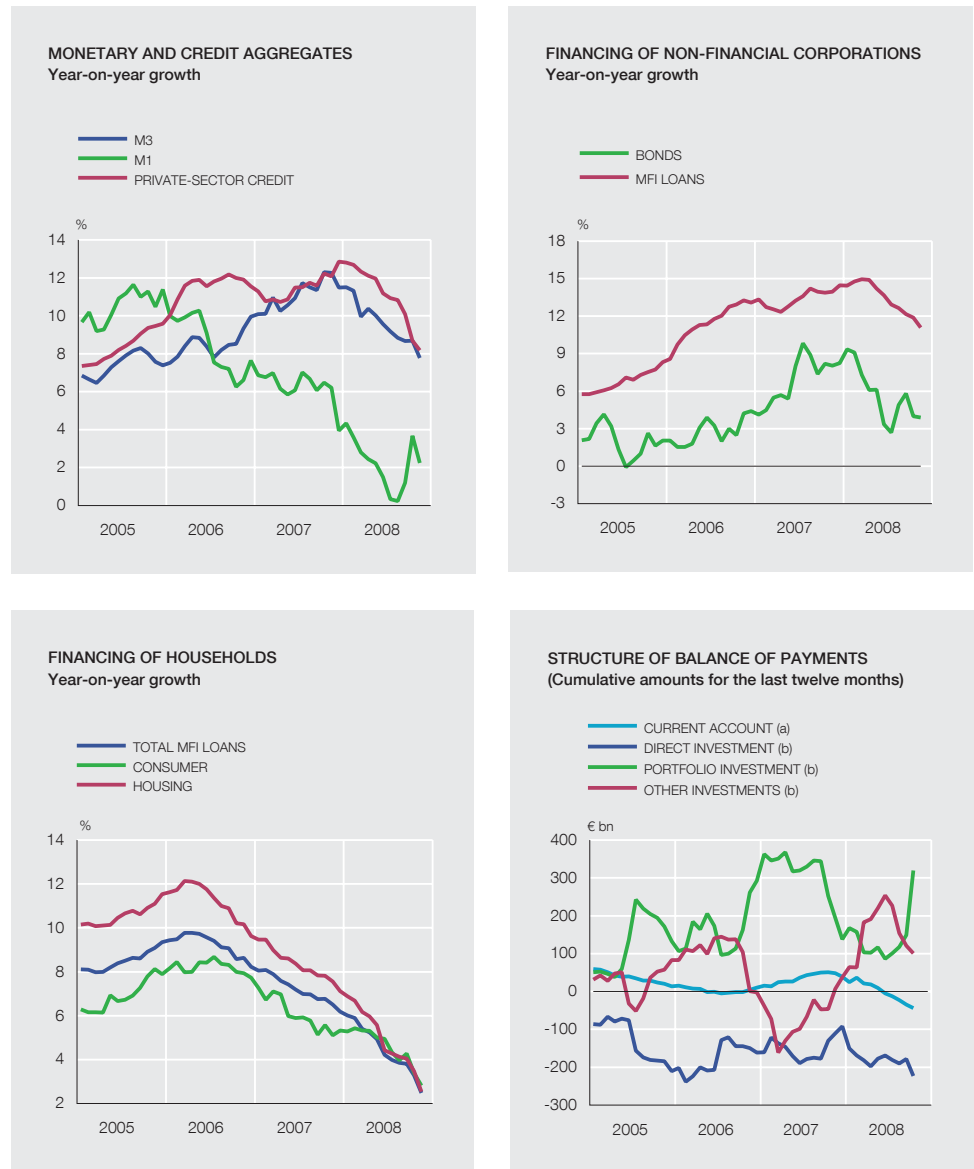


SOURCES: European Central Bank and Banco de España.

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

credit ratings was announced (see Chart 11). The substantial reduction of rates in the US increased the negative spread between US government debt and that of the euro area to levels above 150 bp. Lastly, the spread between corporate private debt and risk-free assets widened sharply in mid-September —and was even wider for bonds with the worst credit ratings— following the heightened financial tensions which had hardly been offset at the end of December and at the beginning of 2009.

On stock markets, the bleaker economic outlook and greater uncertainty were reflected in extremely high volatility during 2008 Q4, in significant falls in valuations during October and November, which were partly corrected in December and early January, and in elevated risk premia (see Chart 12). That said, the decline in the Eurostoxx 50 amounted to 19% in Q4 and 44% in the year as a whole. In the first three weeks of January, stock markets slipped further and stock prices fell by more than 10%.



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).

Volatility was also the main feature on foreign exchange markets. The euro ended the year moving sharply upwards, mainly against sterling but also against the dollar and the yen, although at the beginning of January these trends were inverted (see Chart 12). In 2008 as a whole, the euro appreciated 2.5% in nominal effective terms (NEER), while it depreciated 5.5% against the dollar. In the first half of January, the NEER depreciated 3.3%.

The M3 monetary aggregate slowed significantly in November, following the stability it showed in October. Although financial strains and the widening of the coverage of deposit guarantee systems gave rise to high demand for cash and demand deposits (M1 monetary aggregate) in September and October, this was partially offset in November (see Chart 13). The other monetary assets held on the slowing trend seen since end-2007. The slowdown in credit granted by monetary financial institutions (MFIs) intensified in Q4 largely due to net sales of securities

by credit institutions in an attempt to deleverage. The deceleration of loans to the non-financial private sector became more pronounced in line with higher borrowing costs and tighter supply conditions and the deteriorating outlook for the economy and, in some countries, for the property sector (see Box 2). In any event, the slowdown of loans is less sharp in the case of non-financial corporations which held at its year-on-year rate of increase of approximately 11% in November. In contrast, MFIs' loans to households grew at a much lower rate of 2.5% in November, the year-on-year growth rate for housing and consumer loans stood at 2.5% and 2.8%, respectively.

## 4 The Spanish economy

On Quarterly National Accounts (QNA) estimates, GDP decelerated sharply in 2008 Q3, showing year-on-year growth of 0.9%, 0.9 pp below the rate estimated for the previous quarter. In quarter-on-quarter terms, output was down by 0.2%, posting a negative rate for the first time since the early 1990s. This deterioration in activity reflected the rapid weakening of domestic demand, particularly that of households (private consumption and residential investment). By contrast, the contribution of exports to output growth improved by 0.5 pp to 0.8 pp, since imports slowed by more than exports. On the supply side, all branches of activity showed more moderate growth, particularly construction and industry, where value added fell. The worsening of activity was reflected in employment, which on QNA figures shrank in year-on-year terms by 0.8% in 2008 Q3, compared with an increase of 0.4 pp in the previous quarter. As a result, given the rate of expansion of output, the growth rate of productivity rose by 0.4 pp to 1.7%.

The available information indicates that the weakening of the Spanish economy quickened in 2008 Q4. The instability of the international financial markets increased in late summer and the impact on the global economic environment and on agents' confidence, which has fallen to historical lows in some cases, have added to the correction initiated in previous quarters, leading to a fall in activity. Against this background, it is estimated that the year-on-year change in GDP was  $-0.8\%$  in Q4, 1.7 pp less than in the previous quarter. In quarter-on-quarter terms, output is estimated to have slid by  $-1.1\%$ . This was probably attributable to the marked adjustment in domestic demand, estimated to have fallen by 2.4% year-on-year, while the positive contribution from exports seems to have continued improving to stand at 1.7 pp (see Chart 14).

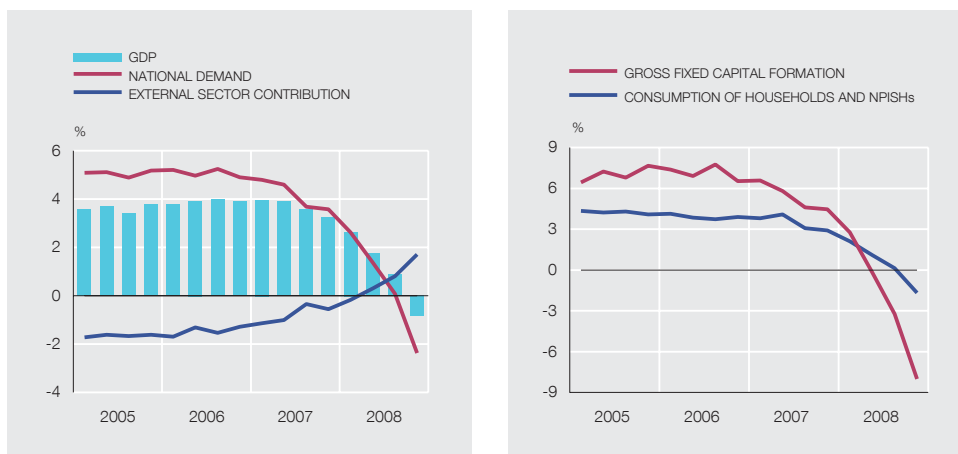
On the supply side, value added in the market economy is estimated to have decreased in nearly all sectors in 2008 Q4, except for services. As to the labour market, the indicators available suggest that the process of job destruction has become more pronounced, with a fall of around 3% in employment. Compensation per employee seems to have continued growing at a high rate, although somewhat lower than in previous quarters, so, along with the higher rate of productivity growth, it is anticipated that the growth of unit labour costs slowed in Q4. As regards consumer prices, the year-on-year rate of change of the CPI decreased rapidly in Q4 to an average of 2.5%, nearly half the figure in the previous quarter, with a value of 1.4% in December, the lowest since December 1998. This trajectory was largely shaped by the path of oil prices, which peaked in July and then fell heavily. However, for the quarter on average, core inflation also decreased (by 0.8 pp) to stand at 2.7%.

### 4.1 Demand

The marked slowdown of final consumption spending of households and NPISHs since the beginning of the year continued in 2008 Q4, and, according to the most recent conjunctural information, this demand component fell in year-on-year terms (see Chart 15). Consumer confidence slipped further, although that of retail traders was, on average, slightly higher than in the previous quarter, worsening at the close of the year. Among the quantitative indicators, the tax authorities' data on large corporations for October and November showed a sharper year-on-year decrease in domestic sales of consumer goods and services than in Q3. The real retail trade index also continued to slow in the October-November period at a faster year-on-year rate than in previous quarters. Lastly, purchases of consumer durables continued to deteriorate strongly, particularly so in the case of cars, the new registrations of which posted a year-on-year fall of more than 45% in Q4. Overall, the synthetic indicator of goods and services consumption is estimated to have slowed sharply in this period.

MAIN DEMAND AGGREGATES (a)

CHART 14

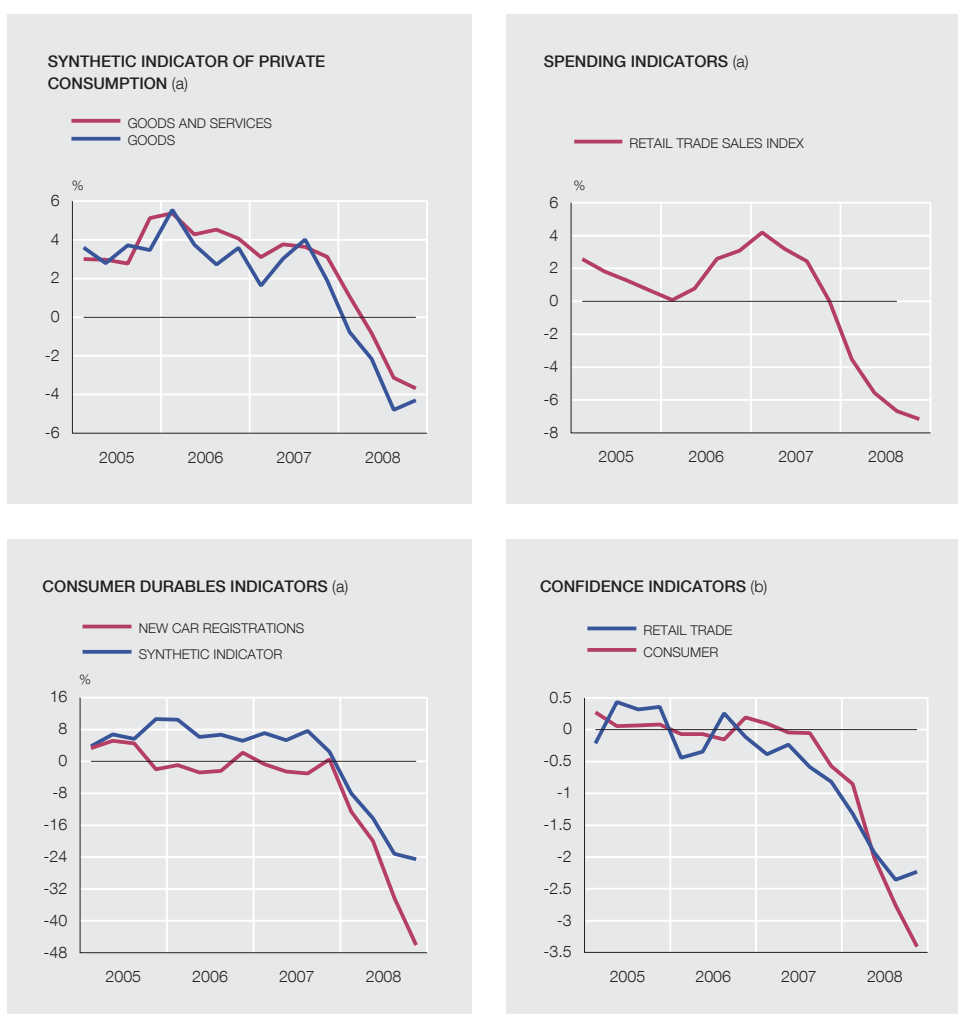


SOURCES: INE and Banco de España.

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 indicators (deviation from the mean, divided by the standard deviation).



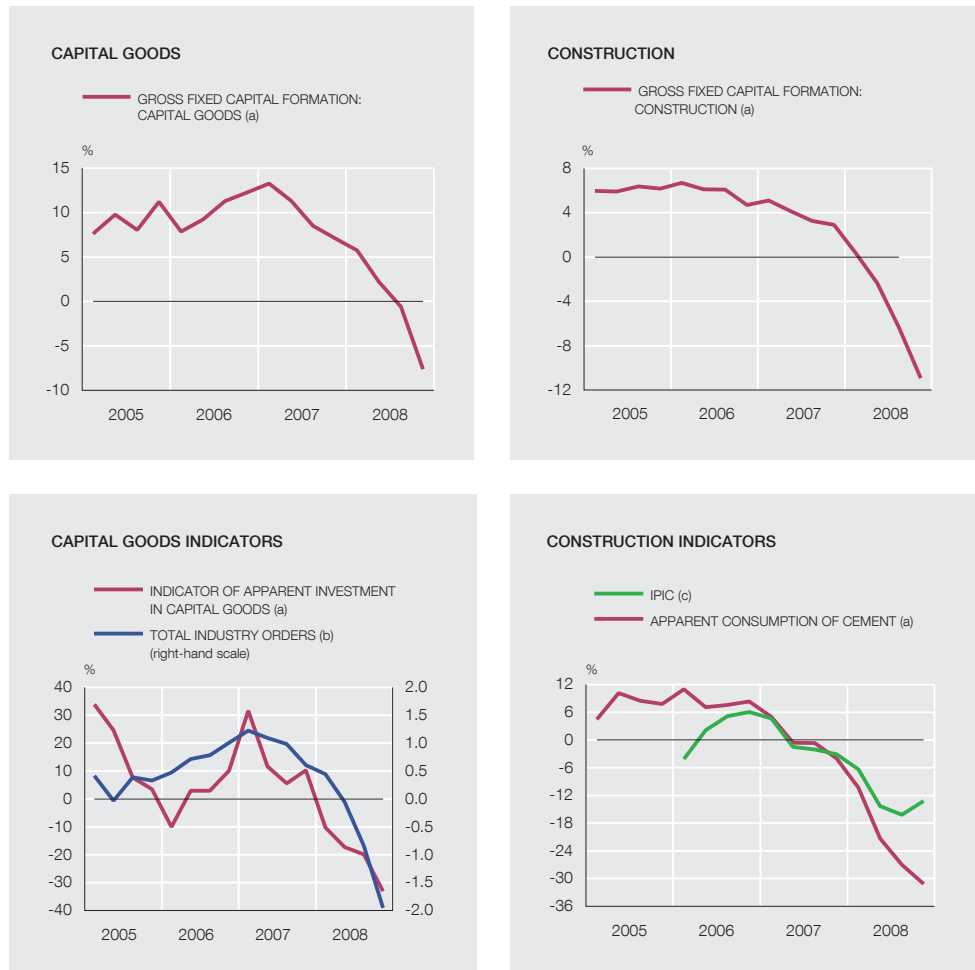
The weakness of household consumption in the latter months of the year reflects the aforementioned loss of confidence, generated by the delicate situation of international financial markets and by the gloomier macroeconomic outlook, and the more unfavourable trend of its determinants. Hence job destruction and a high rate of inflation in the first three quarters of 2008 eased the real rate of increase of household gross disposable income, despite high wage growth. However, from summer household income was boosted by the reduction of €400 in tax withholdings, which, along with the slowdown in consumer prices, led to a notable recovery of real income in the second half of the year. Furthermore, the sharp fall in stock market prices in 2008 and the slowdown in house prices have reduced real household wealth, in a setting of tighter credit conditions. 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 11.9% of disposable income in the four-quarter period to 2008 Q3, 1.7 pp more than at end-2007.

General government final consumption, which grew by 5.9% year-on-year in Q3, is estimated to have continued growing in the last quarter of the year at a very rapid but slightly lower pace, according to available figures for net goods and services purchases provided by the State budget outturn.

Gross fixed capital formation continued to fall in 2008 Q4, according to the available conjunctural information (see Chart 16). In the case of capital goods, the related indicators of apparent investment for that quarter, although incomplete, point to a notably sharper contraction than in the previous quarter. Business survey results worsened markedly in Q4, as reflected by indicators of industry confidence, of business climate in the capital goods sector and of capital goods orders. Also, the tightening of bank financing conditions (although costs moderated slightly at the end of the quarter) and the greater difficulties in raising financing from banks and through other channels are discouraging the investment projects of non-financial corporations. According to the non-financial accounts of the institutional sectors, this set of factors brought a decline in the sector's net borrowing, which, in the period from October 2007 to September 2008, stood at 9% of GDP, 2.1 pp lower than at end-2007. Also contributing to this decrease in net borrowing was the higher saving by corporations, boosted by earlier-than-usual VAT refunds and the lower corporate income tax charge.

The contractionary behaviour of investment in construction became more acute in Q4. The indicators of inputs (such as the domestic production of construction materials and the apparent consumption of cement) saw their rate of decline quicken over the October-November period. The labour market indicators also followed this course, with a year-on-year decline of 20% in the average number of Social Security registrations in this sector in 2008 Q4. The related confidence indicator for construction entrepreneurs for Q4 worsened even more than in the June-August period. With regard to the different types of works, investment in residential building is expected to have fallen at a higher rate than in the preceding quarter, owing to the significant decline in housing starts, which are being affected by the drop in sales and the weakness of the real estate market. Uncertainty over the economic outlook and over the outlook for house prices has affected residential demand by households, and this in turn has tended to discourage new projects from being launched. However, subsidised housing starts surged notably, reaching a growth rate of 70.8% in September and a share of 37% in total housing starts. Non-residential building also contracted according to information on new project approvals. Finally, as in previous quarters, civil engineering works continued to be held back by the low pace of tendering.

The available information indicates that the contribution of net external demand to GDP growth is expected to have continued increasing in Q4 to 1.7 pp, as a result of imports losing momen-



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

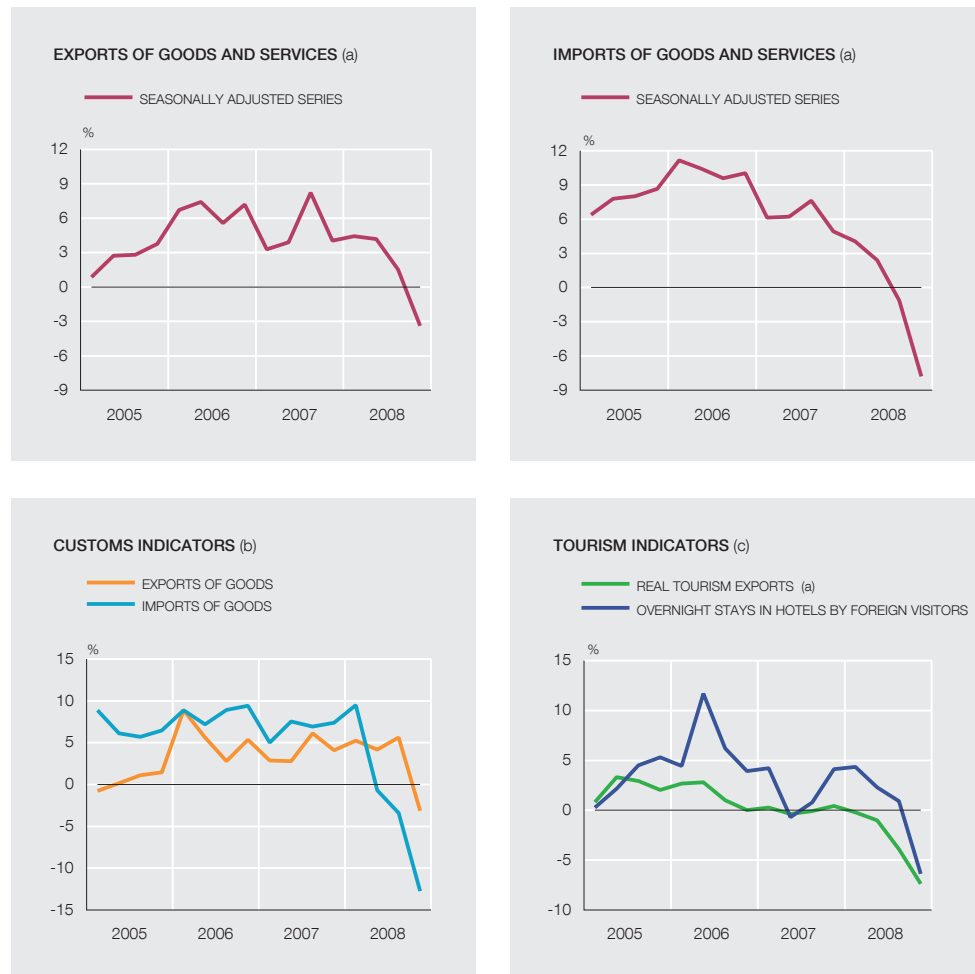
a. Year-on-year percentage change based on the seasonally adjusted series.

b. Normalised indicator (deviation from the mean, divided by the standard deviation).

c. Construction Industry Production Index. Year-on-year percentage change based on the original series.

turn at a greater rate than exports (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 the momentum of previous quarters, 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. The information available suggests that in Q4 both the depreciation of the euro and the behaviour of relative prices allowed a more favourable performance of the price-competitiveness indicators, although over the course of the year to date these indicators have shown some deterioration.

On Customs data, real goods exports fell sharply in October and November, posting a year-on-year decrease of 8.4%, which contrasted with the increase of 7.8% in Q3. In the period to November, real goods exports grew by 2.8%, a rate 1.4 pp lower than that in 2007 as a whole. By product group, in October and November the sharpest fall-off was in capital and non-energy intermediate goods (with rates of -11.5% and -11.8%, respectively), while, by contrast, energy goods and food held up to a greater extent. By geographical area, the decrease was slightly more marked in non-EU sales than in those to the EU. Most notable in the more disaggregated information, for which only nominal data are



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

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

available, was the size of the particularly sharp declines in sales to the United Kingdom and China.

Turning to real exports of tourist services, based on the balance of payments figures available to October, their rate of decline steepened in Q4. Further, in 2008 Q4 numbers of inbound tourists into Spain and overnight stays in hotels fell by 9.5% and 6.3%, respectively, compared with the same period of the previous year. According to the Tourism Expenditure Survey (EG-ATUR), nominal spending by foreign visitors declined by 6.7% in October and November due to the decline in tourist numbers, since average spending per tourist rose. The breakdown by country of origin shows that the decline in incoming tourists in Q4 affected the main markets from which tourists to Spain are drawn, especially the United Kingdom. Meanwhile, the balance of payments figures for October suggest that in Q4 there will have been a certain improvement in real exports of non-tourism services with respect to the previous quarter, attributable to transport and other business services.

On the information available, it is estimated that real goods imports fell off at a notably quicker pace in 2008 Q4. Customs figures show that purchases of goods abroad in real terms de-

clined by 16.8% in October and November, following a 1.9% decrease in Q3. In the first eleven months of the year, real imports fell off by 1.5%. By product group, most noteworthy in October and November were the sharp decreases in imports of capital goods and non-food consumer goods (of 30.3% and 21.5%, respectively), although there was also a very sharp drop in imports of non-energy intermediate goods.

Finally, real imports of services are estimated to have slowed in Q4, owing both to the behaviour of expenditure on non-tourism services and to the trend of tourism imports. In the first instance, with disaggregated data from the October balance of payments, there were notable declines in nominal payments linked to royalties, income from intangible assets and other business services, which were partially offset by financial services.

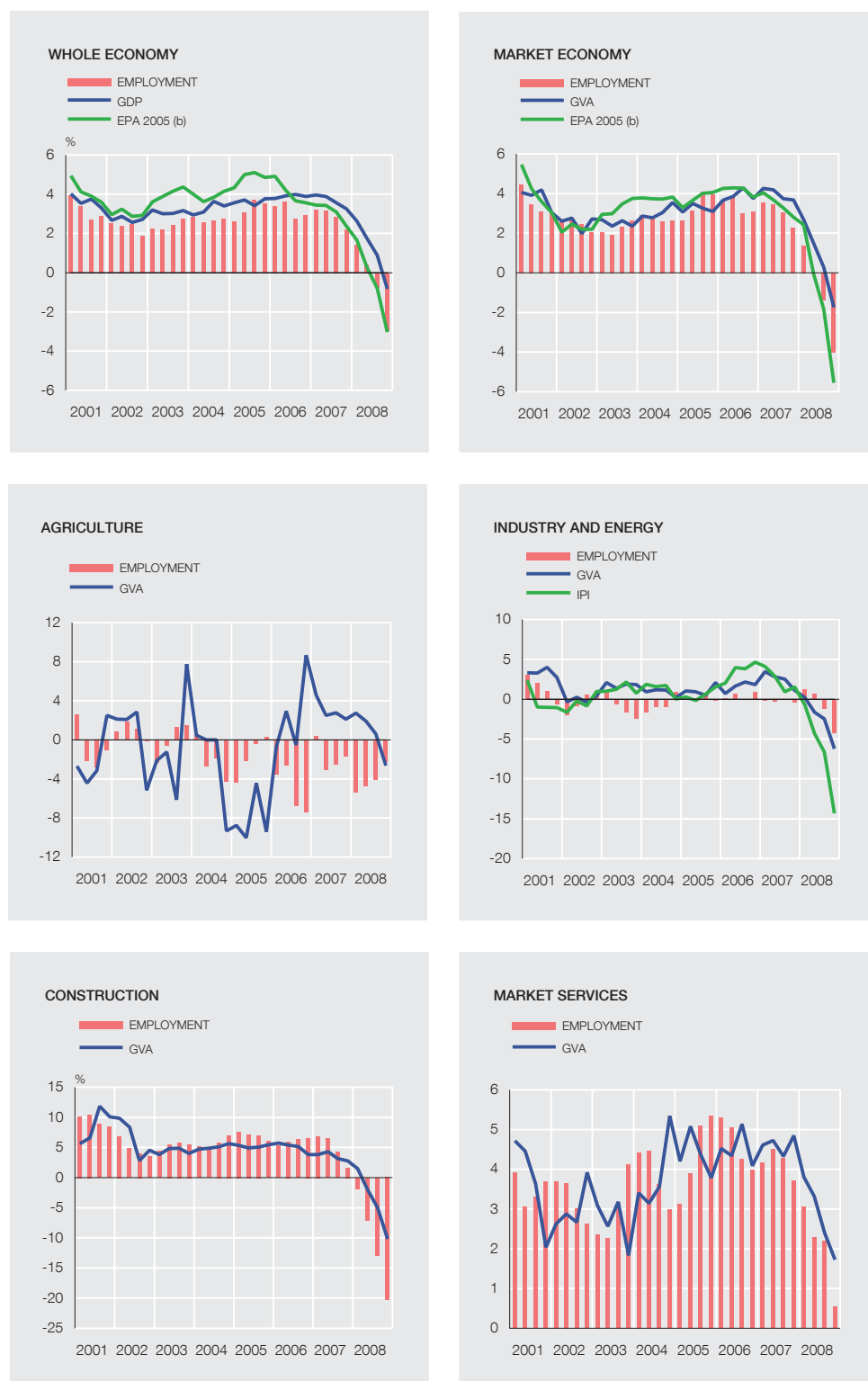
## **4.2 Output and employment**

On the supply side, the loss of momentum of activity in all market-economy productive branches continued in Q4, with declines in value-added in industry, construction and agriculture, and more moderate growth than in the earlier quarters of 2008 in market services (see Chart 18). Production in the industrial and energy sectors is estimated to have fallen in Q4 even more sharply than in the preceding quarter, as a result of the slowdown in energy and the sharp contraction in industry. In line with the performance of large corporations' goods sales, the rate of decline of the non-energy component of the industrial production index quickened in October and November. Although this fall was across the board in nearly all products, it was steepest in domestic consumption goods and capital investment. Labour market-based indicators, such as the average number of Social Security registrations, confirm this ongoing deterioration. Moreover, surveys also point to a further deterioration in industrial activity in Q4. Hence both the European Commission's industrial confidence indicator and the PMI for the manufacturing sector fell in the October-December period in relation to the previous quarter, with a significant decline in the assessment of order books and of future production expectations.

The contraction in construction is also expected to have intensified in Q4 judging by the fall which, as earlier indicated on describing the outlook for investment in construction, has been seen in the related main indicators. Activity in the agricultural and fisheries sectors also decreased in Q4, due to the negative results obtained by most crops.

On the conjunctural information available, the weakening of market services in 2008 Q4 seems to have been more widespread than in Q3. Indeed, large corporations' sales, in real terms and adjusted for calendar effects, fell considerably once again in October and November, as did the turnover according to the services sector activity indicators. The indicators of employment in this sector, such as the average number of Social Security registrations, also point to considerable weakness, with a small year-on-year decrease for the first time in recent years. 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 2008 Q4, reaching historically low levels in some cases. Of the various services branches, transport worsened most in Q4 and wholesale and retail trade showed the largest decreases in activity. Communications and information technology services showed the least signs of weakness.

As regards labour market developments, the indicators available coincide in that the process of job destruction initiated in 2008 Q3 became more acute in Q4. Specifically, the number of Social Security registrations, calculated using average daily data, fell by 3.4%, compared with a 0.9% decrease in Q3. Likewise, the year-on-year decline in INEM (National Public Employment Service) registered hires was more marked in Q4 than in Q3 (-18.9% against -9.9%, respectively). Finally, the recently published EPA (Spanish Labour Force Survey) figures estimated a year-on-year decline in employment of 3%; the decline in employment seen in Q3 (-0.8%) also gathered pace.



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.

As for the productive branches, the EPA information for Q4 indicates that employment fell in all market economy sectors, especially construction. In the market economy as a whole, employment decreased by 5.5%, compared with -1.8% in Q3. In the closing months of the year, job destruction quickened in construction (-20.7%, against -13% in Q3) and in industry (-6.7%, against -1% in the previous quarter). Employment in agriculture continued to decline at a similar rate to that of the previous quarter (-4.7%). Finally, the rate of change of employment in market services turned negative (-0.3%) for the first time in this phase of employment adjustment.

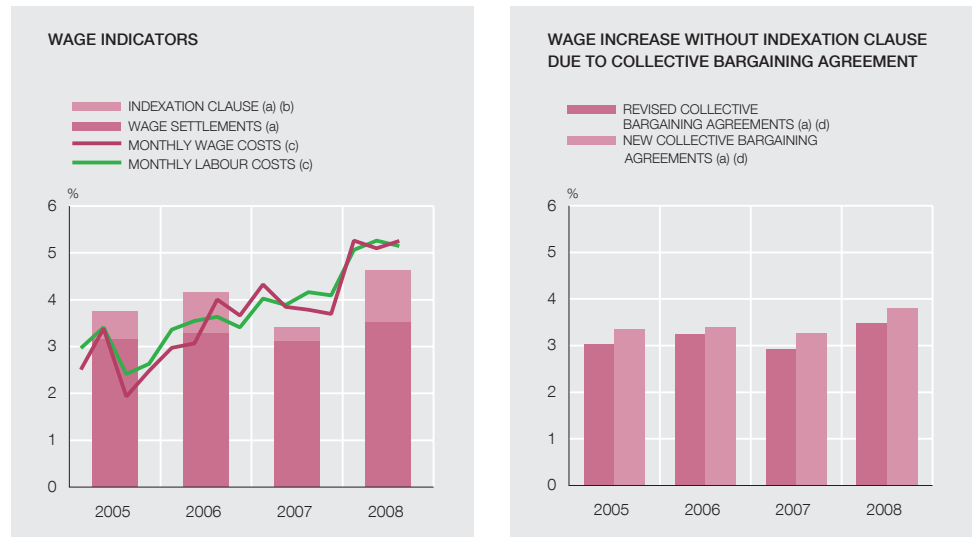
On EPA figures, the decline in employment affected both dependent employees, with a fall of 3.4%, and the self-employed (-1.6%). Overall, dependent employees as a proportion of total numbers employed eased slightly to 82.1%, down 0.3 pp on the ratio a year earlier. Job destruction was concentrated among Spanish nationals (-3.5%), while employment among foreign nationals swung for the first time to a slightly negative rate. As regards contract duration, the year-on-year rate of decline in temporary wage-earners increased to -12.7%, at the forefront of the adjustment in employment, although permanent employment slowed sharply (0.8%, against 2.8% in the previous quarter). As a result, the temporary employment ratio stood at 27.9%, down 3 pp on a year earlier. Lastly, part-time hires showed positive growth (4%), raising the part-time employment ratio to 12.5%, compared with 11.6% a year earlier.

The labour force again grew by 2.9% in 2008 Q4, despite the continuing slowdown in the population aged over 16, which increased by 1.2% (0.2 pp less than in the previous quarter). Further to these figures, the participation rate reached 60.1%, which maintains the year-on-year increase at 1 pp, and therefore the rapid job destruction has not had an observable discouraging effect on decisions to join the workforce, at least for the time being. In terms of the breakdown by gender, the increase in the labour force was due mainly to women (5.3%), since in the case of men the rise was more moderate (1.2%). Specifically, the female participation rate rose by 2 pp in year-on-year terms to 51.4%, while the male rate held steady at 69.2%. By nationality, the dynamism of foreign nationals in the workforce remained high (11.3%), even somewhat stronger than in Q3 (10.7%), despite the slower population growth (8.4%, against 10.4% in the previous quarter), so their participation rate showed a greater increase. In the case of Spanish nationals in the workforce, growth of 1.5% was recorded (1.6% in Q1).

Finally, the sharp fall in employment, combined with the continuing high dynamism of the labour force, resulted in marked growth in unemployment in 2008 Q4 of the order of 600,000 people compared with Q3 and 1,280,000 with respect to end-2007, to take the total to 3,200,000 unemployed. This made for a year-on-year increase in unemployment of 66.4%, and for a rise in the unemployment rate to 13.9%, more than 2.5 pp higher than in the previous quarter.

### **4.3 Costs and prices**

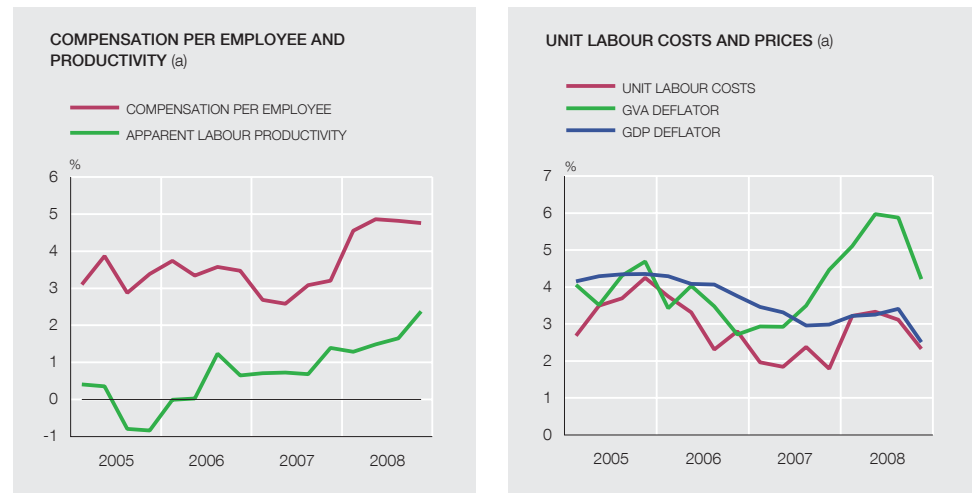
The collective bargaining agreements entered into in the period to December 2008, which affect close to 9 million workers, provide for an average increase in wage rates of over 3.5% (see Chart 19). This figure is more than 0.4 pp up on the agreed increase in 2007 (without considering the impact of the activation of the indexation clauses) and lies above the guidelines agreed in the Interconfederal Agreement for Collective Bargaining for 2008. As is habitual in situations of rising inflation (such as that in the run-up to summer 2008), wage settlements in newly signed agreements have been higher than those in revised agreements spanning several years (3.8% and 3.5%, respectively), although the proportion of employees covered by the latter is far higher, approaching 80% 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, as a result of the high inflation rate in December 2007.



SOURCES: INE and Ministerio de Trabajo e Inmigración.

- a. The last year with information of collective bargaining agreements until December.
- 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.

PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

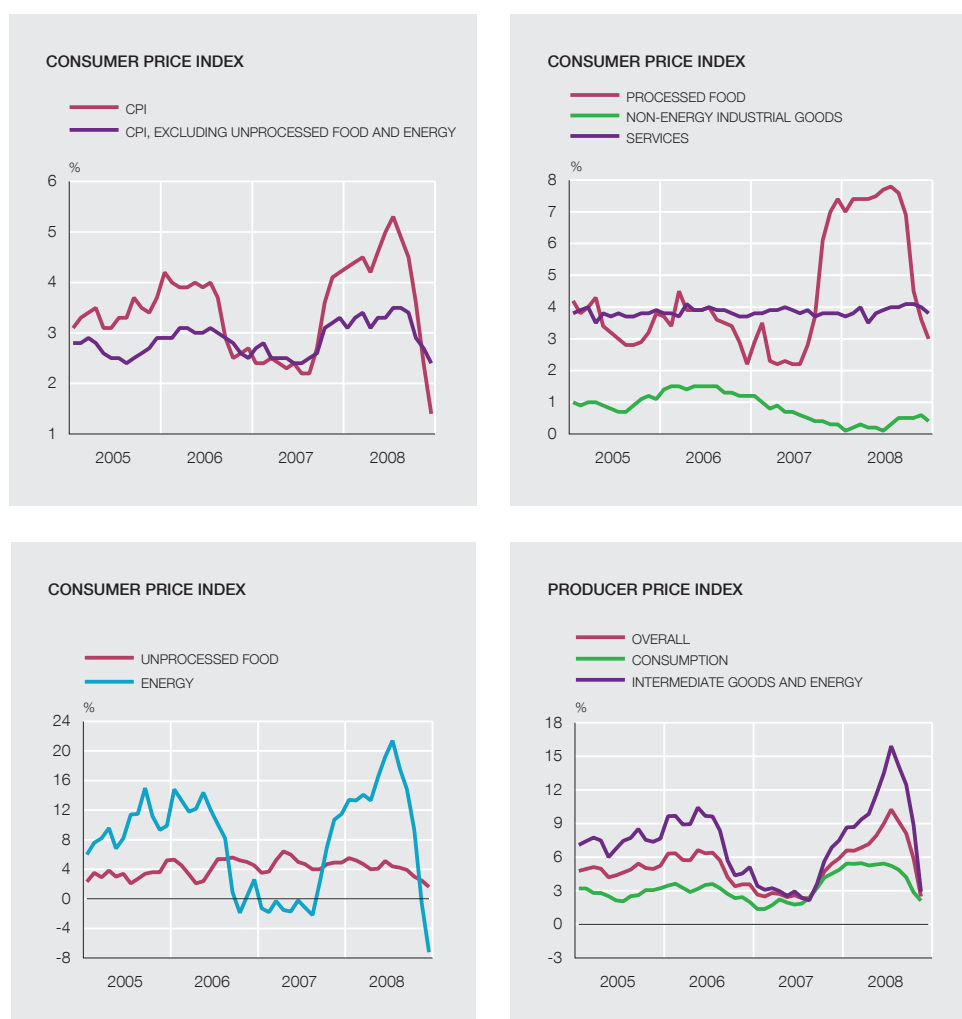


SOURCES: INE and Banco de España.

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

The latest information on total wage costs relates to 2008 Q3. 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% in Q3. In this same period, the latest QNA figures are that the year-on-year growth of compensation per employee for the economy as a whole was also 5.3%, and a somewhat lower figure in the case of the market economy (see Chart 20). The rate of increase of compensation per employee is expected to fall off somewhat in 2008 Q4, and this, combined with the rise in productivity, should lead to some slowing in unit labour costs.

On the latest QNA estimates, the gross value added deflator has been gathering pace since the second half of 2007, although its growth rate decreased somewhat in 2008 Q3 (see Chart 20). This



SOURCE: INE.

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

headway continued to outpace unit labour costs, so the profit per unit of output continued to expand rapidly. This partly reflects the marked decline in VAT payments in 2008 due to the fact that VAT refunds had been made earlier. The rate of change of the GDP deflator, which is not affected by these temporary distortions, showed smaller growth in this period than the value added deflator.

The rise in the domestic component of inflation in the first three quarters of 2008 and the high growth of the import deflator helped to push up the growth rates of the final demand deflator and of the producer prices of goods for the domestic market, as reflected by the domestic demand deflator, which posted year-on-year growth of 3.8% in Q3. However, the inflation of most components of domestic demand is expected to decrease in 2008 Q4.

In Q4 the consumer price indicators left the upward trend initiated a year earlier and their growth rate eased substantially. Year-on-year CPI growth moderated to 2.5% in the October-December period, down 2.4 pp on the previous quarter, standing at 1.4% in the last month of the year (see Chart 21). These developments were basically due to the behaviour of energy prices and to the reversal of the impact exerted by the sharp rise in milk and other processed food prices at end-2007. The growth of 0.4% in energy prices on average for the



quarter was more than 17 pp below the rate in Q3. The drop in oil prices on international markets from summer was the determining factor in this, although the euro's depreciation against the dollar eased its impact on domestic prices. The growth rate of unprocessed food prices fell by 1.8 pp to 2.4%, thanks to the sound behaviour of the prices of fish and some types of meat.

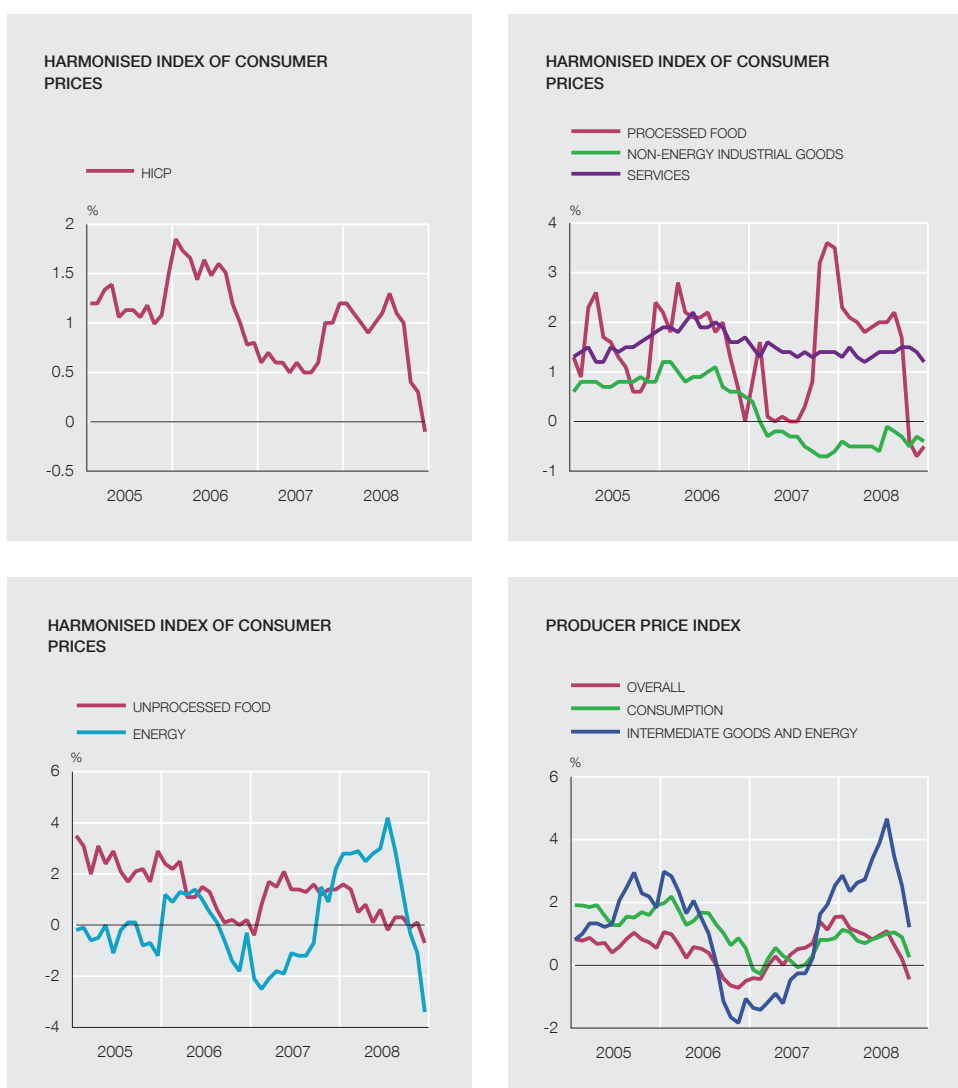
As regards the components of the CPI excluding energy and unprocessed food prices, the greatest moderating influence on average inflation in Q4 came from processed food prices. The growth of the prices of this component slowed drastically to 3.7% (half of the rate in Q3) once the price rises in milk, cereals and related products seen a year earlier had ceased to have an impact. Also, the year-on-year average growth of services prices was 3.9%, down 0.2 pp on the previous quarter; most notable in this respect was the lower growth rate of prices in hotels and restaurants, tourism and recreational services. In contrast, the prices of non-energy industrial goods rose slightly, although within very narrow bounds, by 0.5%, possibly influenced by the depreciation of the euro exchange rate against the dollar. As a result of the performance of its various components, the year-on-year rate of change of the CPI excluding energy and unprocessed food prices decreased by 0.8 pp to 2.7% in Q4.

Similarly to the CPI, the inflation measured by the HICP decreased by 2.5 pp in 2008 Q3 to 2.5% on average. In the euro area as a whole, the decrease of 1.5 pp in average quarterly inflation left the rate at 2.3%; accordingly, Spain's inflation differential with the euro area decreased to 0.2 pp in the October-December period, which is a historical low (see Chart 22). The differential of all components was favourable to Spain, except that of unprocessed food and, to a greater extent, that of services, which, however, decreased somewhat. The downward trend of the differential steepened during the quarter ending December, when it reached a negative value (-0.1 pp) for the first time since inception of the euro area.

Oil price fluctuations also affected the producer price index, the year-on-year rate of which progressively decreased from the high reached in July (10.3%) to -0.2% in December. As in the upturn, this downward trend was affected by the prices of energy and intermediate goods, which slowed markedly, although there was also a moderation in the growth rate of other components. In the euro area as a whole, the growth rate of producer prices slowed less sharply than in Spain, so the growth rate of these prices continued to be lower in Spain and the differential between the two geographical regions broadened in November to 0.8 pp. The import and export prices of industrial products decelerated further in recent months from the highs recorded in Q3, and in November showed growth rates of 0.7% and 1.8%, respectively. The main reason for this moderation is the downward path of energy prices, which fell by nearly 10% in November. The performance of other components was similar in both imports and exports. Thus in October and November intermediate goods prices eased, while those of consumer goods and equipment rose with respect to the previous months.

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

The government presented the tenth stability program update (SPU) on 16 January 2009, with macroeconomic and fiscal estimates and projections for the 2008-2011 period. The SPU reduced its forecast for real GDP growth in 2008 and 2009 to 1.2% and -1.6%, respectively. Also, general government balances have been revised significantly downwards and general government as a whole is now expected to post a deficit of 3.4% of GDP in 2008, which will foreseeably increase to 5.8% of GDP in 2009, due to the fiscal stimulus measures taken and the unfavourable macroeconomic scenario. In the coming years, against a background of progressive recovery of the economy, the budget deficit is pro-



SOURCES: Eurostat and Banco de España.

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

jected to decrease progressively to 3.9% in 2011. By sub-sector, the 2008 budget balance will be determined chiefly by that of central government, for which a deficit of 2.7% of GDP is expected. Moreover, the regional (autonomous) and local governments will end the year with deficits of 1% and 0.5% of GDP, respectively. In contrast, the Social Security system will estimatedly post a surplus of 0.8% of GDP. The increase in the general government deficit projected for 2009 is due to central government, the deficit of which is expected to rise to 4.7% of GDP, and to the Social Security system, whose surplus will fall to 0.2% of GDP, while the regional and local governments will foreseeably slightly reduce the deficits recorded in 2008.

Turning to the budget outturn, on National Accounts methodology and the information available to November 2008, State finances posted a deficit of 1.3% of GDP, which contrasts with the surplus of 2.4% of GDP a year earlier (see Table 4). It should be taken into account that the State balance is highly seasonal and that December is a month which traditionally sees a substantial reduction in the balance recorded up to the previous month.

The regional (autonomous) governments have reached a significant weight in general government in regard to revenue and, above all, expenditure. The latest figures published, which relate to 2007, showed that regional governments received 32% of tax revenue and managed 38% of total expenditure. Notable in regard to this expenditure was that regional governments accounted for 91% of total government spending on health and education.

These figures highlight the need to give attention to the activity of regional governments in any analysis of fiscal policy. In this respect, within the framework of the budgetary stability legislation, on 26 June 2008 Parliament approved the budgetary stability targets<sup>1</sup> for all regional government as a whole for 2009-2011; the targets were set at equilibrium in 2009 and 2010 and a surplus of 0.1% of GDP in 2011. However, owing to the sharp slowdown now besetting the Spanish economy, reflected in a downward revision of the official GDP growth forecasts for this period, on 8 October 2008 the Fiscal and Financial Policy Council decided that the regional governments which approve their budgets for 2009 with deficits lying within the limits set in stability legislation should be exempted from submitting economic and financial re-balancing plans. Under these limits, for GDP growth rates below 2%, the maximum deficit that regional governments can run is 0.75% of

GDP, to which another 0.25% of GDP for productive investment must be added.<sup>2</sup>

Against this backdrop, the regional governments have presented their draft budgets<sup>3</sup> for 2009, the main items of which are given in the accompanying table.<sup>4</sup> The budget projections point to a sharp deterioration in the balance, when compared with the initial budget for 2008, to a deficit of 0.9% of GDP, near the limit set in stability legislation. This decline is attributable to a slowdown in revenue (to the point of posting a negative rate of change, caused by indirect taxes) which outweighs that in expenditure. It should be noted that, as in previous years, expenditure shows substantially higher rates of change than nominal GDP.

Notable on the revenue side is the high growth of direct taxes expected in the case of regional government (particularly personal income tax), in contrast to the fall budgeted for the State, despite the abolition of wealth tax in the autonomous regions. In this respect, it should be kept in mind that personal income tax revenue in the autonomous regions is associated with the advance payments of the regional share by the State (up by

2. The Stability Programme Update, which has been published this January, includes the lower GDP growth rates and confirms that regional governments shall not exceed the deficit limit set in stability legislation. 3. Not including the budgets of the autonomous city enclaves of Ceuta and Melilla. 4. The table compares the initial budgets of the regional governments and, in the last column, of the State.

1. Note that these targets are set in National Accounts terms.

## INITIAL BUDGETS OF THE REGIONAL GOVERNMENTS

	Regional Governments							State
	€m				Rate of change			
	2006	2007	2008	2009	07/06	08/07	09/08	09/08
REVENUE	140,879	154,945	167,993	165,124	10.0	8.4	-1.7	-11.1
Current revenue	132,849	146,836	159,173	155,556	10.5	8.4	-2.3	-10.4
— Direct taxes	24,396	27,215	32,060	38,174	11.6	17.8	19.1	-15.1
— Indirect taxes	47,673	54,631	56,093	44,741	14.6	2.7	-20.2	-5.9
— Charges, prices and other revenue	4,134	4,304	4,546	4,908	4.1	5.6	8.0	34.3
— Current transfers	56,235	60,289	65,917	67,154	7.2	9.3	1.9	-3.4
— Interest and dividends	411	396	557	579	-3.6	40.4	4.0	-3.4
Capital	8,030	8,109	8,820	9,567	1.0	8.8	8.5	-55.1
— Disposal of investments	678	644	703	633	-5.1	9.2	-10.0	-4.8
— Capital transfers	7,352	7,465	8,117	8,935	1.5	8.7	10.1	-57.7
EXPENDITURE	141,758	155,065	168,327	175,295	9.4	8.6	4.1	3.7
Current expenditure	114,707	125,475	136,135	143,320	9.4	8.5	5.3	3.6
— Wages and salaries	44,076	47,835	52,194	55,309	8.5	9.1	6.0	5.8
— Goods and services	22,481	25,261	28,023	29,186	12.4	10.9	4.2	-1.7
— Interest payments	2,274	2,379	2,489	2,717	4.6	4.6	9.1	4.8
— Current transfers	45,726	49,842	53,254	55,900	9.0	6.8	5.0	2.9
— Contingency fund	150	157	175	209	4.6	11.7	19.2	4.9
Capital	27,050	29,591	32,191	31,975	9.4	8.8	-0.7	4.1
— Investment	13,859	15,378	16,429	16,005	11.0	6.8	-2.6	-1.7
— Current transfers	13,192	14,213	15,762	15,970	7.7	10.9	1.3	10.5
BALANCE	-879	-121	-333	-10,171	...	...	...	...

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

25% in comparison with the budget for the previous year<sup>5</sup> and that the regional government budgets therefore reflect this higher revenue.<sup>6</sup>

By contrast, indirect taxes are expected to fall sharply (by 20.2%) because of the foreseeable fall-off in VAT and, above all, in transfer and stamp duty taxes, for which the falls budgeted by some regional governments exceed 40%. The high weight of these property transfer and stamp duty taxes in regional government and its practical lack of importance in State government explain the differences between the changes in indirect taxes projected by regional and State governments. In addition, since the comparisons are between initial budgets, the fall in 2009 partly reflects the fact that 2008 revenue was lower than initially envisaged.

The main revenue item for regional governments is current transfers, more than 50% of which come from the State.<sup>7</sup> Under the system

5. Also, this calculation of personal income tax payments to regional governments in 2009 does not include the new labour income tax rebate of up to €400 introduced in 2008, the cost of which is borne solely by the State. 6. The remainder of the personal income tax revenue of regional government consists of the final settlement of 2007, which was a year in which personal income tax revenue was still high. On the other hand, corporate income tax has little importance in the autonomous regions, since the only one receiving revenue from this source is Navarre. Therefore, the sharp fall in this tax in 2008 only slightly affects aggregate regional government revenue. 7. Via the *fondo de suficiencia* (sufficiency fund), the final settlement of 2007 and other transfers. Notable among these for 2009 are the transfers from the State to regional governments to compensate them for the loss of revenue owing to the abolition of wealth tax.

of regional government financing in force, the volume of these transfers depends mainly on how much revenue is received by the State and, accordingly, a significant slowdown is expected in 2009.

Expenditure is budgeted to grow less than in the previous year, although the rate remains above the projection for nominal GDP. As regards wages, the State budget determines wage growth for general government. However, the budgeted increases in personnel costs have traditionally been larger in regional than in State government, partly because of new transfers of areas of competence to regional governments and certain wage adjustments in the latter. This same trend seems set to continue in 2009, since an increase of 6% is budgeted for the personnel costs of regional government, compared with 5.7% for State government. Meanwhile, expenditure on purchases and current transfers is closely linked to the functions of health care and education in the case of regional government. In both items a slowdown is budgeted for 2009, although their projected growth rates remain above that of nominal GDP. The interest burden is expected to rise by 9.1% in 2009, in line with the increase in regional government debt.

Lastly, the behaviour of current expenditure contrasts with the sharp adjustment of capital expenditure in regional government budgets, which project slowdowns in the growth of real investment (to -2.6%) and capital transfers (to 1.3%), both below the projected increases in State government.

This suggests that the deficit recorded by central government up to November will have increased by year-end. Pointing in the same direction is the cash-basis information on the State accounts, which posted a deficit of €11,038 million to November, compared with a surplus of €24,104 million the previous year. The discrepancies between these two balances (National Accounts and cash-basis) are chiefly due, as is habitual, to adjustments for the different interest allocation criterion and for the change in outstanding rights and obligations.

Likewise on a cash basis, State revenue decreased more than forecast in the Budget Outturn Projection, partially reflecting the sharp deterioration in the second half of the year. In particular, receipts of both direct and indirect tax revenue fell by around 20%.

To analyse revenue, information is also available on total receipts from the main taxes, including both the portion assigned to the State and that corresponding to the ordinary-regime regional governments, although only the State figures are included in Table 4. According to this information, the deterioration in revenue quickened across the board in the past few months. Most noteworthy was the contraction in direct taxes and, in particular, in personal income tax, the revenue from which fell by 2%. The reasons for this included the impact of the new deduction of up to €400, the effect of the 2007 personal income tax reform on the final net tax payable and the refunds under the CUNA Programme. Corporate income tax receipts fell significantly in the January-November 2008 period, posting a rate of -36%. This tax has been

The Social Security system posted a surplus of €16,312 million in the period January–October 2008, down 6.7% on the same period a year earlier, which was a less favourable outturn than in the period to July. Revenue growth slowed between August and October to 7%, while expenditure gained momentum, rising by 10.2%.

The growth of revenue from social security contributions slowed to 5.5% from the rate of 6.6% recorded to July, partly reflecting the loss of dynamism of Social Security registrations.

Turning to expenditure, that ear-marked for contributory pensions held at a growth rate near 8.1% to October, which was above the 7.4% budgeted for the year as a whole. The number of contributory pensions rose by 1.4% on average for the year, slightly higher than in the previous year (1.3%). The growth rate of expenditure on sickness benefits slowed notably between August and October to

7.1% in October, albeit standing well above the budgeted increase.

As regards the National Public Employment Service (hereafter “SPEE”, by its Spanish abbreviation), the data for which are not shown in the adjoining table, the contributions received were up by 5.2% to August, the latest month for which accurate information is available, while rebates on contributions in respect of employment-promoting contracts decreased by 9.1% in the same period.

The growth of expenditure earmarked for unemployment benefits accelerated sharply to November, increasing by 31.1% year-on-year, while registered unemployment grew by 49.7% year-on-year to December. On data to August, the number of beneficiaries increased by 28% compared with the same month a year earlier, leaving the coverage ratio at 74.2%, slightly less than one percentage point above that recorded in the same month of 2007.

### SOCIAL SECURITY SYSTEM (a)

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

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

EUR m and %

	Budget			Outturn		Outturn JAN-OCT		
	2007	2008	% change	JAN-JUL	2007	2008	% change	
	1	2	3=2/1	4	5	6	7=6/5	
1 REVENUE	106,142	114,081	7.5	8.3	93,003	99,507	7.0	
1.1 Social security contributions	97,942	105,107	7.3	6.6	85,898	90,650	5.5	
1.2 Current transfers	5,963	6,796	14.0	35.6	5,042	6,033	19.7	
Other	2,237	2,177	-2.7	11.0	2,063	2,825	36.9	
2 EXPENDITURE	98,390	106,048	7.8	9.7	75,522	83,195	10.2	
2.1 Wages and salaries	2,253	2,412	7.1	7.5	1,738	1,890	8.7	
2.2 Goods and services	1,807	1,978	9.5	7.7	1,408	1,462	3.9	
2.3 Current transfers	93,743	101,056	7.8	9.6	71,726	78,053	8.8	
Contributory pensions	80,099	86,041	7.4	8.0	61,221	66,184	8.1	
Sickness	7,313	7,716	5.5	15.7	5,628	6,025	7.1	
Other	6,330	7,298	15.3	22.9	4,876	5,842	19.8	
2.4 Other	588	601	2.2	40.2	650	1,791	175.5	
3 BALANCE	7,752	8,033	3.6	1.1	17,482	16,312	-6.7	

SOURCES: Ministerio de 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 are not available until October 2008.

b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

EUR m and %

	Outturn 2007	Percentage change 2007/2006	Budget outturn projection 2008	Percentage change 2008/2007	Outturn JAN-SEP Percentage change 2008/2007	Outturn		
						2007	2008	Percentage change
						JAN-NOV	JAN-NOV	
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
<b>1 REVENUE</b>	159,840	12.7	142,247	-11.0	-16.1	148,407	120,150	-19.0
Direct taxes	96,980	19.5	83,624	-13.8	-18.3	89,798	70,128	-21.9
<i>Personal income tax</i>	48,626	17.3	44,645	-8.2	-10.0	46,237	41,155	-11.0
<i>Corporate income tax</i>	44,823	20.5	35,445	-20.9	-29.5	40,540	25,958	-36.0
<i>Other (a)</i>	3,531	42.8	3,534	0.1	0.8	3,020	3,015	-0.2
Indirect taxes	48,445	0.2	42,423	-12.4	-18.6	46,396	37,925	-18.3
VAT	33,752	-4.7	27,791	-17.7	-26.3	32,924	24,676	-25.1
<i>Excise duties</i>	11,468	15.9	11,458	-0.1	-0.8	10,518	10,398	-1.1
<i>Other (b)</i>	3,224	7.2	3,174	-1.6	-2.7	2,954	2,850	-3.5
<i>Other net revenue</i>	14,415	16.4	16,200	12.4	8.1	12,214	12,097	-1.0
<b>2 EXPENDITURE</b>	139,704	7.2	150,289	7.6	5.2	124,304	131,188	5.5
Wages and salaries	23,678	6.6	25,425	7.4	6.7	20,455	21,831	6.7
Goods and services	4,454	17.2	4,212	-5.4	2.5	3,511	3,580	2.0
Interest payments	14,539	-6.9	16,094	10.7	14.2	14,326	15,708	9.6
Current transfers	77,680	7.6	83,661	7.7	4.5	70,681	74,388	5.2
Investment	10,106	11.8	10,575	4.6	6.7	7,937	8,646	8.9
Capital transfers	9,248	23.5	10,321	11.6	-12.9	7,394	7,035	-4.9
<b>3 CASH-BASIS BALANCE (3 = 1 - 2)</b>	20,135	—	-8,042	—	—	24,104	-11,038	—
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	165,179	12.2	146,640	-11.2	-15.3	152,395	124,902	-18.0
Uses	151,683	6.7	164,280	8.3	8.3	127,032	138,962	9.4
NET LENDING (+) OR BORROWING (-)								
	13,496	—	-17,640	—	—	25,363	-14,060	—
As a percentage of GDP	1.3	—	-1.6	—	—	2.4	-1.3	—

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.

affected by the worsening of corporate profits and by legislative changes with a negative impact on revenue: the effect of the 2007 reform on the final net tax payable, the change in the method of calculating advance payments and the second tax rate cut. As far as indirect taxes are concerned, VAT revenue to November fell by 13.7% and excise tax revenue by 0.6%. Lastly, the items grouped under other revenue fell by 1%.

With regard to State outlays, except for goods and services purchases and real investment, the other sources of expenditure were contained to some extent, compared with the figures forecast in the Outturn Projection. Against this background, the growth of personnel costs held steady at 6.7%, while interest payments slowed notably. Most notable in regard to capital spending was the pick-up in real investment, which grew at a rate of 8.9% to November.

#### 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 €84,713 million in the first ten months of 2008, representing a year-on-year increase of 5%, a significantly lower rate than in 2007 (see Table 5). This reflected a 4.3% increase in the current account deficit, which was the outcome of the rise in the energy

EUR m		JANUARY-OCTOBER		RATE OF CHANGE 08/07 (b)
		2007	2008	
CREDITS	Current account	291,131	308,870	6.1
	<i>Goods</i>	155,620	166,119	6.7
	<i>Services</i>	79,790	83,317	4.4
	— Tourism	36,968	37,264	0.8
	— Other services	42,822	46,054	7.5
	<i>Income</i>	43,048	47,539	10.4
	<i>Current transfers</i>	12,673	11,895	-6.1
	Capital account	4,732	6,187	30.8
	Current + capital accounts	295,863	315,057	6.5
DEBITS	Current account	377,164	398,620	5.7
	<i>Goods</i>	228,139	239,380	4.9
	<i>Services</i>	59,244	61,794	4.3
	— Tourism	12,055	12,132	0.6
	— Other services	47,189	49,662	5.2
	<i>Income</i>	68,741	76,404	11.1
	<i>Current transfers</i>	21,040	21,042	0.0
	Capital account	1,667	1,151	-30.9
	Current + capital accounts	378,831	399,771	5.5
BALANCES	Current account	-86,033	-89,750	-3,717
	<i>Goods</i>	-72,519	-73,261	-742
	<i>Services</i>	20,546	21,524	978
	— Tourism	24,913	25,131	219
	— Other services	-4,367	-3,608	759
	<i>Income</i>	-25,693	-28,865	-3,172
	<i>Current transfers</i>	-8,367	-9,147	-781
	Capital account	3,065	5,036	1,971
	Current + capital accounts	-82,968	-84,713	-1,746

SOURCE: Banco de España.

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

deficit and, to a lesser extent, of the respective deficits on the income and current transfers balances, which the improved surplus on the services balance and the correction of the deficit on non-energy goods were unable to offset. The surplus on the capital account rose notably to €5,036 million.

In the first ten months of 2008, the deficit on the trade balance increased by only 1% to €73,261 million. This rate of increase, appreciably lower than that seen in 2007 as a whole, is the result of higher growth in nominal exports (6.7%) than imports (4.9%). According to Customs data, the gap between exports and imports in real terms was even wider, albeit partially cushioned by the deterioration in the terms of trade brought about by oil prices. The energy bill, which increased appreciably between January and October 2008, was the determining factor behind the rise in the nominal trade deficit, since the non-energy deficit was significantly corrected.

The services balance posted a surplus of €21,524 million in the first ten months of 2008, up 4.8% on the same period in 2007. This increase in the surplus was due to the slight improve-

ment in the surplus on tourism to €25,131 million, and, more importantly, to the correction to the deficit on other services, which took it to €3,608 million. Nominal tourist receipts and expenditure both grew weakly in the first ten months of 2008 (0.8% and 0.6%, respectively). As to other services, in the first ten months of the year receipts were more dynamic than expenditure (growth rates of 7.5% and 5.2%, respectively), which appreciably reduced the deficit on this item.

The deficit on the income balance grew by 12.3% in the first ten months of 2008, with similar growth in receipts and expenditure (10.4% and 11.1%, respectively). The notable increase in the surplus on foreign direct investment income was offset by the rise in the deficits on portfolio investment income and on other investment income. The deficit on current transfers in the first ten months of the year rose by 9.3% due to a 6.1% reduction in receipts while expenditure held unchanged. The decline in receipts was centred on those from the EU, particularly those relating to the agricultural funds and the European Social Fund. Payments to the EU were driven by those relating to the GNI resource, the growth of which was dampened by remittances sent abroad, which fell by 6.1% in the first ten months of 2008, in contrast to their buoyancy during the recent expansionary phase of the Spanish economy.



## 5 Financial developments

### 5.1 Overview

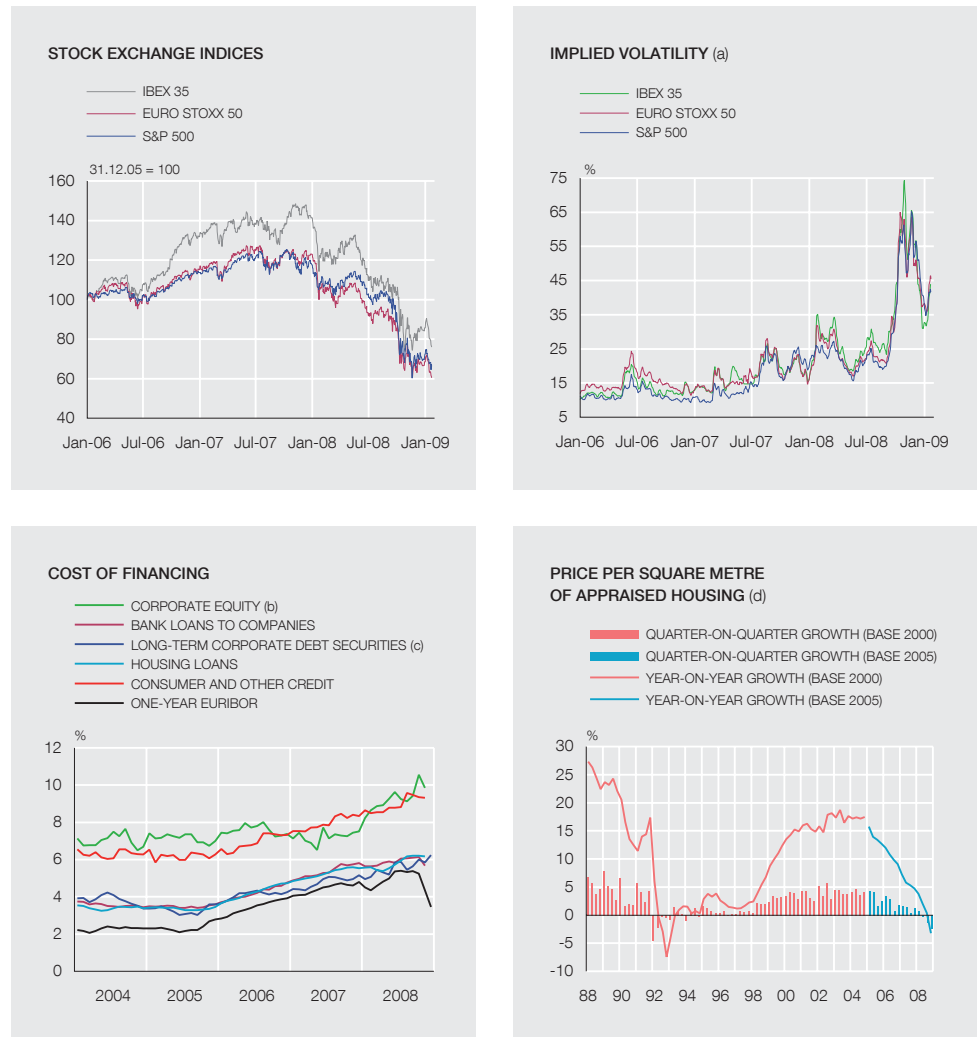
Developments on domestic and international financial markets in 2008 Q4 were influenced by the worsening of the financial crisis from the end of the summer and the deterioration in economic growth prospects. Against this background, the stock market price falls seen in previous months continued, while volatility increased notably, reaching historically very high levels, although it fell substantially in the final weeks of the year (see Chart 23). Accordingly, at year-end, the IBEX 35 was down 16.3% from its end-September level, which was a smaller decline than those recorded by the Eurostoxx 50 index of European companies (19.3%) and the S&P 500 for US companies (22.6%). During 2008, as a whole, the Spanish index fell by 39.4%, a similar decline to that in the US reference (38.5%) and less than that in the European one (44.3%).

One-year EURIBOR dropped from 5.5% at end-September, to 3% at year-end, basically as a result of the downward revision to expectations of official rates and also, albeit to a smaller extent, because of the decline in the risk premium it incorporates. However, the spread between this benchmark and the cost of secured financing operations (repos) remained very wide (140 bp), showing that the strains in the interbank market persist. Public debt yields also fell, both at long and especially at short term, as a consequence of the lower observed and forecast official rates and the deterioration in the economic growth prospects in the euro area. Thus, as at end-2008 the return on Spanish twelve-month Treasury bills stood at 2.1%, some 2.1 pp less than three months earlier, while that on ten-year bonds fell from 4.6% to 3.9%. This decline was, as in the case of most euro area sovereign debt, smaller than that in the German bund, so that the spread between them widened to a mean of 90 bp in December. Meanwhile, the average credit risk premia for Spanish non-financial corporations traded on the derivatives markets reached 280 bp in the same period, an increase of more than 180 bp from end-Q3.

During 2009 to date, stock markets have continued to slide. On 22 January, the IBEX 35 was 11.2% lower than at end-2008, a similar decline to that in the Eurostoxx 50 (11.9%), and greater than that in the S&P 500 (8.4%). At the same time, one-year EURIBOR remained on a downward path, reaching 2.4%, while the return on long-term debt issued by the Spanish Treasury rose by 40 bp, widening the spread over the German bund to 120 bp. On 19 January, Standard & Poor's downgraded Spanish government debt by one notch (from AAA to AA+). By contrast, the credit risk premia for non-financial corporations fell somewhat during this period.

In the property market, according to data published by the Ministry of Housing, the price of unsubsidised housing fell by 2.4% in 2008 Q4, which led to a reduction in the year-on-year growth rate from 0.4% in September to -3.2% in December.

The latest data available, relating to November, on the interest rates applied by banks to new loans to households show little change on the September levels. Yet, given the significant falls in market yields during the last two months of the year and during 2009 to date, there will foreseeably be a reduction in the price of credit to households shortly. In the case of the cost of bank financing for corporations, to which these changes are generally passed through more rapidly, declines have already begun to be seen. Likewise, the cost of issuance of short-term debt also fell. By contrast, that of long-term debt and of equity increased, relative to the end-Q3 figures. However, according to the October Bank Lending Survey (BLS), financial institutions expected the credit standards for households and firms



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 weighted average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.  
 d. New statistic from 2005.

to continue to tighten during Q4. Also, the latest information on other lending conditions apart from the interest rate (term, security required) suggests that they have tended to become more demanding.

In line with the tightening of the credit supply and lower demand, in 2008 Q4 the deceleration of private-sector debt continued. The year-on-year growth of household financing stood at 5% in November, around 1.5 pp less than two months earlier. This decline occurred in housing loans and consumer and other credit. Corporate borrowing expanded by slightly more than 8% relative to the same period in 2007, 1.2 pp down on September. However, this higher buoyancy in comparison with household borrowing could be partly explained by companies' growing recourse to previously approved credit lines (see Box 6). The latest information on lending by purpose in Q3 shows that it slowed in all sectors, albeit more sharply in non-real estate services. Even so, the loans raised by this sector, as in the case of industry, continued to expand by more than 10% in year-on-year terms.

The credit lines customarily arranged by firms for a particular amount and term allow them to make use of this financing at different points in time. Typically, a portion of the agreed amount remains drawable (undrawn) for subsequent use and is not included in banks' assets. The greater or lesser recourse to these open credit lines, along with the net flow from new loans and repayments, determines the behaviour of total credit in lenders' balance sheets.

In particular, in periods like the present, in which credit institutions tend to tighten the financing offered by them, firms could partly counter the lower availability of funds by stepping up their use of previously agreed credit lines, which, moreover, will tend to offer better cost and other conditions than new facilities. There is some empirical evidence that this phenomenon is usual in periods in which credit conditions are less accommodating (see Jiménez et al, 2008).<sup>1</sup>

Against this background, this box uses the information at the Banco de España on credit granted but not drawn down to study this phe-

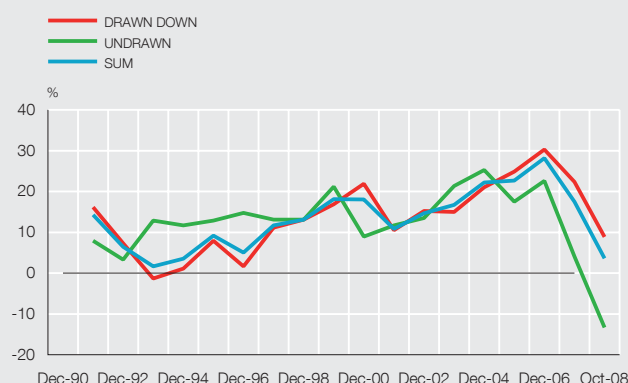
nomemon in Spain.<sup>2</sup> The analysis centres on the non-financial corporations segment, since this form of financing is much less usual for individuals and the amount undrawn by them is little more than 5% of the volume drawn down. This ratio has remained relatively unchanged in the last few months.

Panel 1 shows the growth of lending by all Spanish banks to resident non-financial corporations, distinguishing between the amount drawn down, that undrawn and the sum of the two.<sup>3</sup> As can be seen, the amount undrawn has negative year-on-year growth rates since the beginning of 2008, indicating either that firms have recently made greater use of credit lines arranged in the past or that

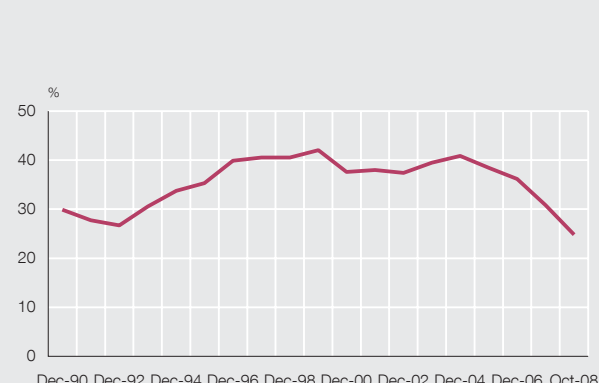
2. Specifically, the amount undrawn by other resident sectors as a whole is included in the confidential balance sheet of credit institutions under off-balance-sheet items. Also, more disaggregated, albeit not exhaustive, information can be obtained from the Banco de España's Central Credit Register (CCR). 3. The input data for the panel are drawn from the CCR, so low-amount credits (less than €6,000) are not included. However, the resulting rates of change differ very little from those derived from the analysis of bank balance sheets because this minimum threshold is low and, therefore, the volume of credits below it is scantily significant.

1. "Empirical analysis of corporate credit lines", Documento de Trabajo no. 0821 of the Banco de España.

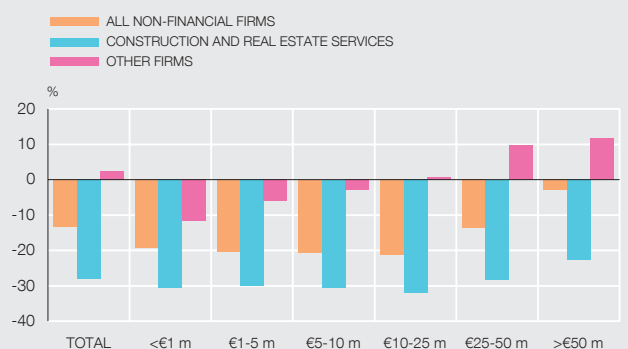
1 BEHAVIOUR OF CREDIT (a)



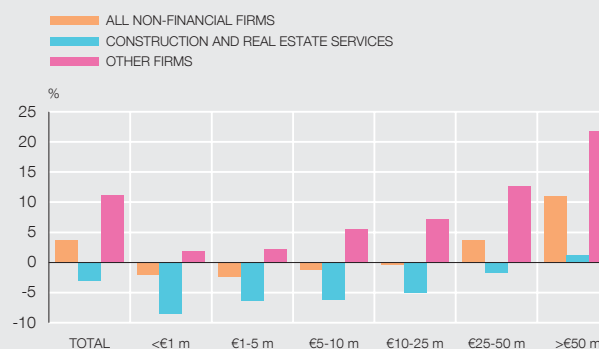
2 UNDRAWN/DRAWN RATIO (b)



3 CHANGES IN THE AMOUNT OF UNDRAWN CREDIT BY SECTOR AND TOTAL BANK DEBT (c) (d)



4 CHANGES IN THE AMOUNT OF DRAWN PLUS UNDRAWN CREDIT BY SECTOR AND TOTAL BANK DEBT (c) (d)



SOURCE: Banco de España

- a. All non-financial firms. Year-on-year rates of change.
- b. All non-financial firms.
- c. Year-on-year rates of change as at October 2008.
- d. Firms are classified by the total volume of their debt included in the CCR. Although this is an imperfect measure of firm size, it is the only one available in this database.

the volume of new credit lines opened in that period has been below that of the facilities reaching maturity. Whatever the case may be, these results indicate that recently the supply of financing has been less expansionary than suggested by the behaviour of on-balance-sheet credit. In this respect, the sum of credit drawn down and that undrawn is an indicator that better reflects the changes in the supply of financing. In the last two years this variable has slowed somewhat more sharply than on-balance-sheet lending and its growth rate has been lower (3.6% in October 2008, somewhat more than 5 percentage points below that of loans recorded on books).

As a result, the ratio of undrawn to drawn credit, which as shown by Panel 2 follows a cyclical pattern, fell below the minimum reached in the previous cycle (1992), thereby reducing the scope for firms to keep using this type of financing to cope with the tighter credit conditions.

Panel 3 shows the growth rate of undrawn credit in October 2008 (latest available figures), disaggregated by sector and by volume of firms' bank debt, the latter variable being intended as a proxy of firm size. The breakdown by economic sector reveals significant differences in the performance of this indicator between the real estate sector (construction and real estate services), which shows a fall of 28% compared with the same period of the previous year, and the

aggregate of other productive activities, which exhibits positive, albeit low, growth (2%).

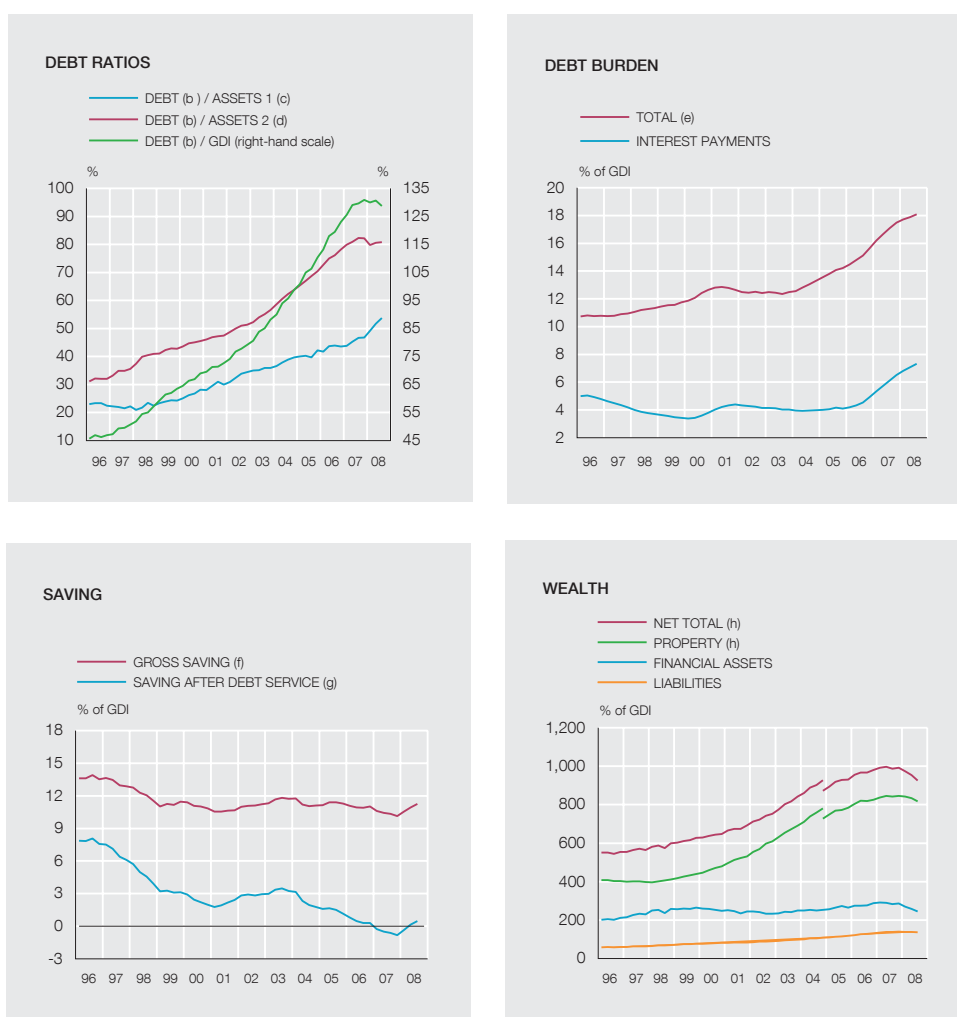
Panel 3 shows that for the two sectoral categories there is a clear and direct relationship between the size of firms' outstanding loans and the pace of undrawn lines of credit. In particular, this variable has negative year-on-year growth for companies with bank debt below €10 billion. This may reflect stricter credit conditions for small and medium-sized firms than for larger ones, although it cannot be ruled out that demand factors also play a part.

Lastly, in Panel 4 it can be seen that the two patterns noted above are also detected by the financing indicator obtained by taking the sum of undrawn and drawn credit. In particular, last October the year-on-year growth rate of this variable was negative for the real estate sector and positive, albeit very low (below 3%) for firms in other productive activities with outstanding loans below €5 billion.

In short, the results of this box indicate, first, that the greater use of previously arranged credit lines has helped somewhat to ease the deceleration of corporate debt in recent months. Additionally, the evidence shows significant differences in the growth rates of (undrawn and drawn) financing by economic sector and by firm size. In particular, lower buoyancy of credit is detected in real estate sector companies and in SMEs.

It is estimated that the moderation in the rise of household credit contributed to a slight decrease in the ratio of debt to gross disposable income (GDI) in 2008 Q3, while the debt burden continued to grow as a result of the increase in the average cost of outstanding loans (see Chart 24). However, the increase in the sector's gross savings ratio resulted in a new recovery of its ability to save, after debt service. The latest advance data indicate that the same pattern continued in 2008 Q4. In line with these developments, the financial accounts show that the sector's net borrowing fell slightly between June and September. In parallel, during the same period household net wealth dropped as a percentage of GDI, a trend which, judging by price developments in financial and real estate assets, likely continued until the end of 2008.

During the summer months firms' aggregate debt ratio and debt burden continued to grow (see Chart 25). However, the most recent data point to a slight drop in the former during 2008 Q4. According to the Financial Accounts, this sector's net borrowing decreased between June and September to slightly above 9% of GDP, in cumulative twelve-month terms, almost 2 pp less than in June. Gross operating profit remained considerably buoyant to Q3 according to the National Accounts, with cumulative annual growth to that date of 7.8%. However, the sample of firms reporting to the quarterly survey of the Central Balance Sheet Data Office (CBQ), in which large firms predominate, attests to a significant slowdown in profit during the same period, coupled with higher debt ratios and interest payments relative to income generated. The combined effect of these developments was the rise in the indicators of financial pressure on investment and employment, especially for the group of companies which is in a less favourable financial situation.

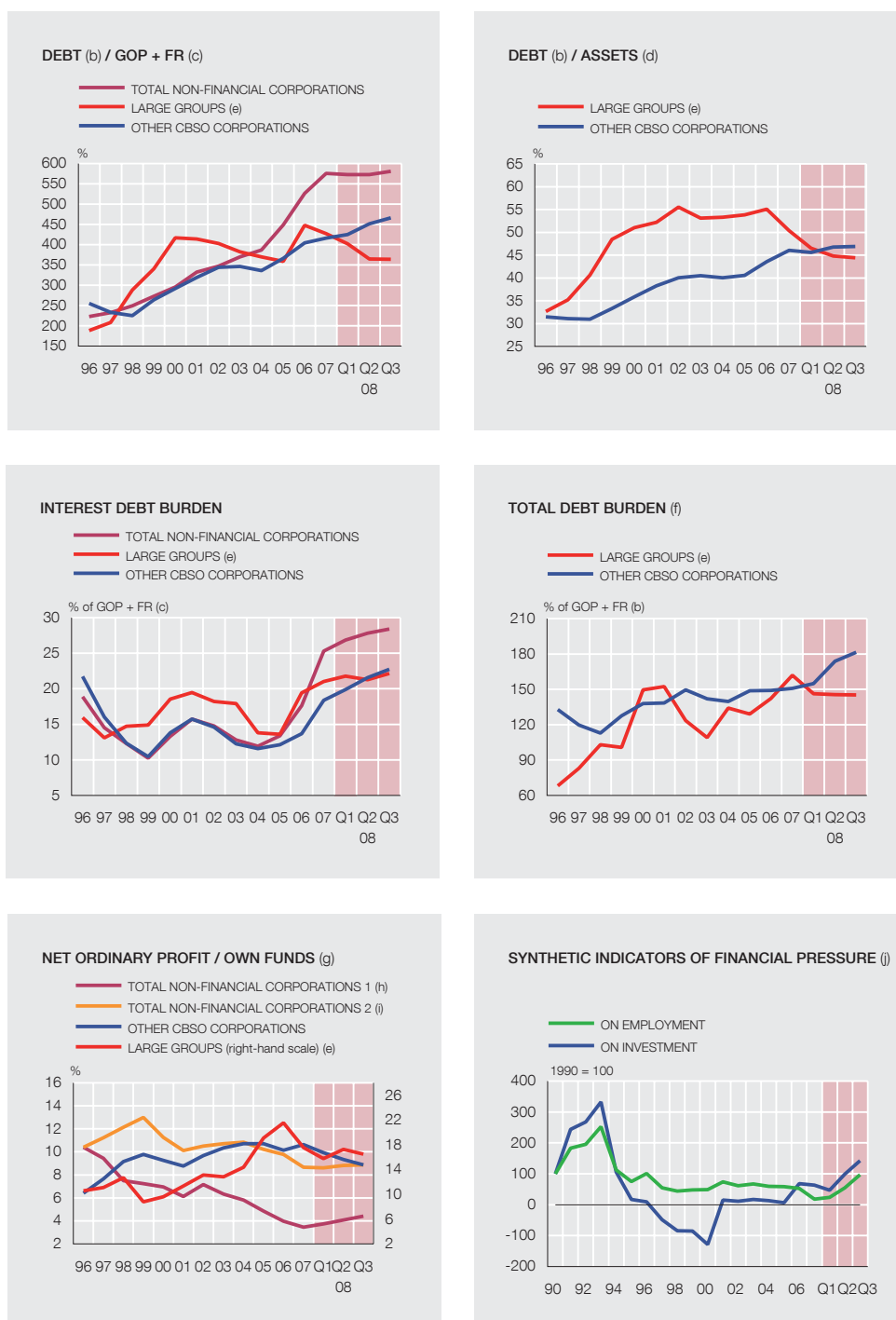


SOURCE: Banco de España.

- 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.

The growing level of financial pressure experienced by certain private-sector segments continued to be reflected in notable increases in doubtful asset ratios, which for the other resident sectors (including, in addition to households and corporations, financial intermediaries other than credit institutions) stood at 3.2% in November, 1.5 pp higher than the data for June.

The most recent Financial Accounts data show a slight reduction in the nation's net borrowing during 2008 Q3 (9.6% of GDP in cumulative twelve-month terms, as against 10% in June). It is estimated that these developments were the result of the deficit posted by general government, which largely offset the drop in households' and firms' negative net transactions and the increase in financial institutions' surplus (see Table 6). The funds required to cover the external deficit were not raised in full by sectors other than the Banco de España, with the result that, once again, the Banco de España's net external assets were negative (for an amount equiva-



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,  $NOP = GOS + \text{interest and dividends received} - \text{interest paid} - \text{fixed capital consumption}$ .
- h. Own funds valued at market prices.
- i. Own funds calculated by accumulating flows from the 1996 stock onwards.
- j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

% GDP	2003	2004	2005	2006	2007		2008		
					Q3	Q4	Q1	Q2	Q3
					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	-13.5	-13.8	-13.6	-12.1	-9.8
<i>Non-financial corporations</i>	-3.9	-4.5	-7.1	-9.4	-11.2	-12.2	-12.5	-11.2	-9.3
<i>Households and NPISHs</i>	0.1	-0.6	-1.3	-1.7	-2.3	-1.6	-1.1	-0.9	-0.5
Financial institutions	1.0	0.6	0.9	0.6	1.6	1.9	2.0	1.6	1.8
General government	-0.2	-0.4	1.0	2.0	2.7	2.2	1.7	0.5	-1.6
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.2	-8.7	-11.4	-17.0	-16.4	-18.1	-18.8	-16.0	-14.3

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.

lent to 3.1% of GDP, in cumulative annual terms), albeit lower in absolute value than the figure posted half-way through the year (4.2%).

In short, the most recent information continues to point to a tightening of the credit supply and an increase in the proportion of agents subject to a high degree of financial pressure. The sizeable drop in the EURIBOR in recent months will foreseeably tend to reduce the cost of new private-sector borrowing and the debt burden borne by indebted corporations and households. The ongoing strains in international financial markets continue to be an unfavourable factor for the financing possibilities of economies which, like the Spanish economy, have a high external deficit. However, the initiatives adopted by national and international economic authorities to restore the normal functioning of markets will contribute to moderating the scope of this risk. In the case of Spain, on the cut-off date of this report the Fund for the Acquisition of Financial Assets (which was created to inject liquidity into the financial system to prevent the interruption of credit flows) had already held three auctions and placed more than €13 bn of funds. Similarly, State guarantees were given to 53 credit institutions for new debt issues which can be undertaken until 15 December 2009 for a combined maximum amount of €100 bn, although no operations of this type have been performed yet.

## 5.2 Households

The most recent information (relating to November) on the interest rates of new loans shows that, relative to September, they have remained the same for housing and dropped by 15 bp for consumer credit and other lending. The notable reduction in interbank yields in recent months points to a considerable reduction in the cost of bank borrowing for households, given the close relationship between the two interest rates. Nevertheless, the latest data available on credit conditions indicates that they are tighter as regards the security required (which has increased) and maturities (which are shorter). Accordingly, respondents to the October BLS anticipated that they would apply stricter credit standards in 2008 Q4.

In 2008 Q4 household debt continued to move on a slowing path and its year-on-year growth rate stood at 5% in November, 1.5 pp down on September. The breakdown by purpose shows a moderation in the rise of liabilities in terms of housing and of consumer and other purpose loans (their growth rate fell to around 5%).

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

TABLE 7

% of GDP	2005	2006	2007	2008		
				Q1	Q2	Q3
<b>HOUSEHOLDS AND NPISHs</b>						
Financial transactions (assets)	10.4	11.0	7.7	7.0	5.5	4.1
Cash and cash equivalents	4.0	3.1	-1.0	-1.0	-1.7	-1.6
Other deposits and fixed-income securities (a)	1.6	5.8	7.8	7.8	8.1	7.7
Shares and other equity (b)	0.2	-1.1	0.7	0.6	0.9	0.8
Mutual funds	1.9	0.2	-1.2	-1.4	-2.8	-3.5
Insurance technical reserves	2.0	1.8	1.0	0.9	0.9	0.8
<i>Of which:</i>						
<i>Life assurance</i>	0.7	0.6	0.3	0.2	0.2	0.2
<i>Retirement</i>	1.0	0.9	0.6	0.5	0.5	0.5
<i>Other</i>	0.7	1.2	0.4	0.1	0.0	-0.1
Financial transactions (liabilities)	11.7	12.6	9.3	8.1	6.4	4.6
Credit from resident financial institutions (c)	12.3	13.0	9.4	8.0	6.6	5.0
<i>House purchase credit (c)</i>	10.2	9.9	7.2	6.2	4.7	3.7
<i>Consumer and other credit (c)</i>	2.2	3.1	2.2	1.8	1.8	1.3
<i>Other</i>	-0.6	-0.4	0.0	0.1	-0.2	-0.5
<b>NON-FINANCIAL CORPORATIONS</b>						
Financial transactions (assets)	18.2	22.4	12.9	10.1	5.8	3.6
Cash and cash equivalents	2.0	2.3	-0.4	-1.1	-1.1	-0.5
Other deposits and fixed-income securities (a)	1.2	1.6	2.4	2.8	2.6	1.8
Shares and other equity	7.2	10.9	6.7	5.2	2.4	1.8
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	3.9	7.7	5.5	5.6	3.6	4.1
<i>Other</i>	7.7	7.7	4.2	3.2	2.0	0.5
Financial transactions (liabilities)	25.2	31.8	25.0	22.6	17.1	12.9
Credit from resident financial institutions (c)	12.9	17.6	13.9	12.4	9.3	7.2
Foreign loans	2.1	3.4	2.6	2.7	2.4	2.5
Fixed-income securities (d)	0.3	1.8	0.5	0.3	0.5	0.1
Shares and other equity	3.7	2.5	5.0	5.0	4.4	3.6
<i>Other</i>	6.2	6.6	3.0	2.2	0.5	-0.5
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (e)	21.2	24.2	15.4	13.3	10.3	8.1
Households and NPISHs	20.9	19.6	12.7	10.7	8.6	6.6
Non-financial corporations	21.4	28.0	17.4	15.3	11.6	9.2

SOURCE: Banco de España.

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

According to the most recent Financial Accounts data for 2008 Q3, financial asset flows continued to fall (see Table 7) and, in cumulative annual terms, amounted to approximately 4% of GDP, almost 1.5 pp below their level in June. These developments were mainly as a result of the more pronounced net outflows from mutual funds (-3.5% of GDP) and the moderation of investment in time deposits which, while the most buoyant component, saw their net volumes fall to 7.7% of GDP (down from 8.1% posted three months earlier).

In 2008 Q3, the household debt ratio dropped slightly, in line with the lower growth rates of borrowing, to approximately 128% of GDI. In contrast, the debt burden ratio continued



to climb, as a consequence of the rise in interest rates in the preceding months and, in 2008 Q3, slightly exceeded 18% of GDI. However, it is estimated that households' saving, net of the expenses associated with their liabilities, continued along the path of recovery on which it embarked at the beginning of the year. The latest information on the sector's net wealth, relating to September 2008, shows it declined as a percentage of GDI, which was attributable to less buoyant real estate values and the unfavourable trend in financial asset prices.

The higher debt burden and rising unemployment rate contributed to an increase in the proportion of households encountering difficulties in servicing their debts. Thus, in September 2008 the doubtful asset ratio for households stood at 2.5%, in comparison with 2% posted in the previous quarter. This rise was similar for all types of loans. Specifically, the doubtful asset ratio for housing loans climbed from 1.3% to 1.9%, while that for other loans increased from 3.6% to 4.3%.

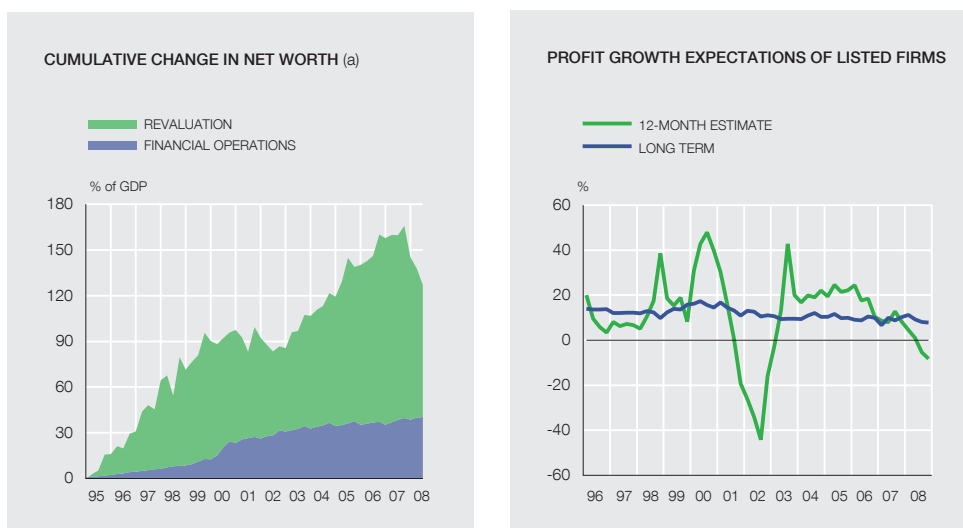
### **5.3 Non-financial corporations**

The interest rate on new loans to corporations of less than €1 million and of over €1 million fell between September and November (latest available data) by 58 bp and 14 bp, respectively. Like households, the drop in recent months in interbank market yields will foreseeably continue to pass through to the price of bank financing, although recent developments show a widening of the margin applied to smaller amounts, which are more frequent among SMEs. However, the October BLS showed that entities expected that credit standards were going to continue to tighten during 2008 Q4. Lastly, in line with the drop in market interest rates, the cost of issuing short-term debt fell (by 67 bp), whereas that of issuing equity and long-term debt rose (by 43 pb and 58 bp, respectively) since the drop in government debt yields was amply offset by the increase in risk premia.

In this setting, the buoyancy of corporate debt continued to moderate to a growth rate of approximately 8% in November in year-on-year terms, more than 1 pp below the figure for September 2008. Lending by resident institutions, which represents the main source of corporate financing, performed in a similar way. The breakdown of this heading by productive activity (the latest data refer to 2008 Q3) shows a widespread slowdown, which was sharper in non-property services (the year-on-year growth rate dropped by 5 pp in relation to June to 17%) and more moderate in industry (down by slightly more than 1 pp, to 11%). The growth of borrowing by construction and the real estate sector (4% and 8%, respectively) was lower than that of non-financial corporations as a whole.

According to the Financial Accounts for 2008 Q3, the sector's borrowing fell by almost 2 pp, to slightly above 9% of GDP, in cumulative twelve-month terms. The *financing gap*, the indicator which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, also fell (by 1.5 pp), although it remained above 14% of GDP.

The performance of liabilities and income led to slight growth in Q3 in the corporate debt-to-earnings ratio with respect to the June figure. This, coupled with the increase in the average cost of balance-sheet funds, resulted in a further rise in interest payments to approximately 28% of gross operating profit plus financial revenue. The profits generated between January and September grew 7.8%, which enabled the return on capital to hold at similar values to those of previous months. However, the sector's doubtful asset ratio continued to climb, reaching 2.8% in September, 1.2 pp more than halfway through the year. This indicator's rise was especially steep in construction and real estate services, up from 2% to 4.2% during the same period.



SOURCES: I/B/E/S and Banco de España.

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

The Central Balance Sheet Data Office Quarterly Survey (CBQ) information for 2008 Q3, based on a sample in which large corporations predominate, shows a slight increase in the debt ratio and the debt burden. Higher debt-related expenses and the slowdown of activity triggered a drop in net ordinary profit between January and September in relation to the same period in the previous year, which was reflected in lower return on equity. By sector, industry experienced a particularly pronounced drop in profits, while energy and services performed less unfavourably. As a consequence of all these developments, the synthetic indicators of financial pressure on investment and employment rose, especially for the group of corporations in a worse financial position.

Lastly, analysts once again revised downwards profit growth expectations for listed non-financial corporations for the next 12 months, which remain negative and, to a lesser extent, those relating to a longer time frame (see Chart 26).

#### 5.4 General government

In September 2008 general government had a net borrowing position which, in cumulative four-quarter terms, stood at 1.6% of GDP, in comparison with a surplus of 0.5% in June (see Chart 27). The detail by instrument shows that the deficit was covered through the issuance of securities at short and, especially, medium and long term and the decline in the balance of deposits net of lending. As a result of the decrease in the average cost of funds, in spite of higher debt, interest payments held steady as a proportion of GDP at 1.6%.

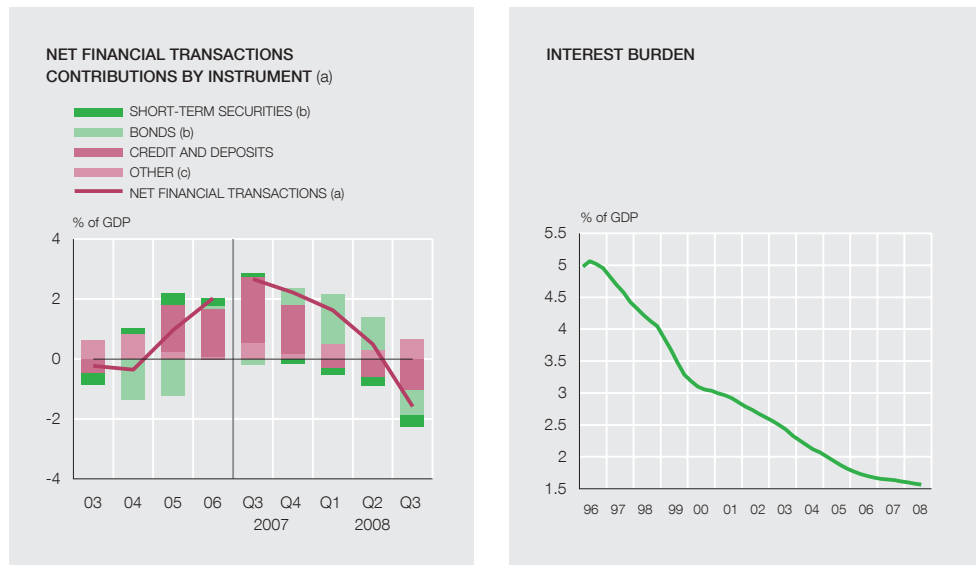
#### 5.5 The rest of the world

In 2008 Q3, the debit balance of the nation's financial transactions fell slightly, in cumulative twelve-month terms, to 9.6% of GDP (10% in June), representing a change in the upward trend in this variable which had been seen since the end of 2003. By sector, this result was the consequence of a pronounced decline in households' and corporations' borrowing and, to a lesser degree, of the moderate increase in the surplus of financial institutions which was not totally offset by lower general government net lending, which posted a deficit (see Table 6).

The detail by sector of the financial transactions vis-à-vis the rest of the world shows that during 2008 Q3 there was a net inflow of capital, channelled through the non-financial private

**GENERAL GOVERNMENT**  
Four-quarter data

CHART 27

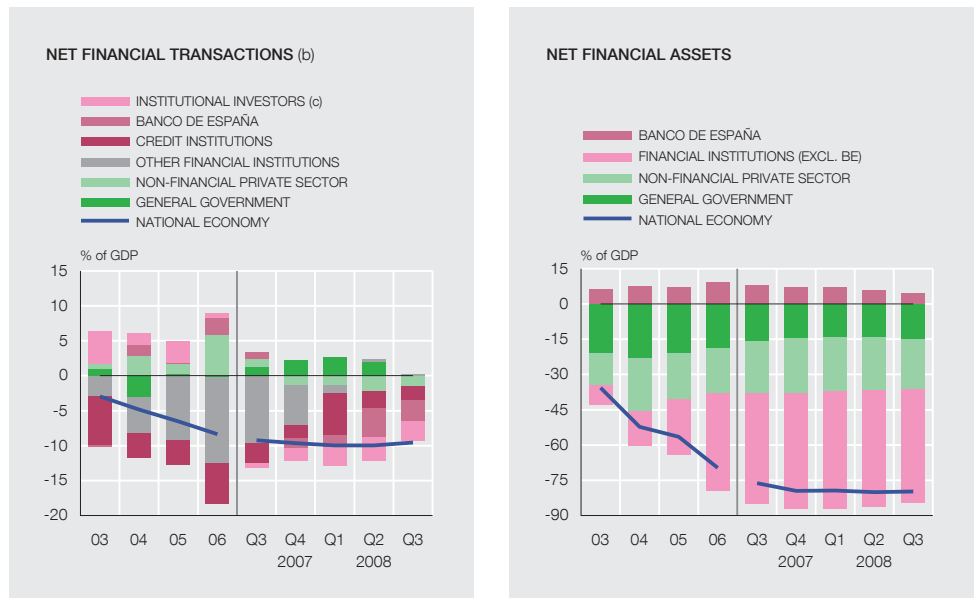


SOURCE: Banco de España.

- 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.

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

CHART 28



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.

% of GDP	2005	2006	2007	2008		
				Q1	Q2	Q3
NET FINANCIAL TRANSACTIONS	-6.5	-8.4	-9.7	-10.0	-10.0	-9.6
FINANCIAL TRANSACTIONS (ASSETS)	18.7	17.6	13.0	9.0	7.2	7.2
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.2	5.2	2.1	-0.7	1.6	1.3
<i>Of which:</i>						
<i>Interbank (a)</i>	3.1	3.4	4.2	1.7	4.6	2.1
Securities other than shares	8.7	-1.2	1.6	1.5	0.9	0.9
<i>Of which:</i>						
<i>Credit institutions</i>	6.6	-2.1	1.8	2.1	1.7	1.6
<i>Institutional investors (b)</i>	2.3	0.6	-0.1	-0.5	-0.5	-0.6
Shares and other equity	5.1	10.2	7.8	6.3	3.2	3.6
<i>Of which:</i>						
<i>Non-financial corporations</i>	3.9	7.7	5.5	5.6	3.6	4.1
<i>Institutional investors (b)</i>	0.9	1.2	-1.0	-1.9	-2.6	-2.1
Loans	1.1	2.1	1.2	1.3	1.7	1.8
FINANCIAL TRANSACTIONS (LIABILITIES)	25.2	26.0	22.7	19.0	17.2	16.8
Deposits	5.6	0.3	7.3	11.2	13.0	11.3
<i>Of which:</i>						
<i>Interbank (a)</i>	7.2	0.6	6.7	10.9	10.7	8.6
Securities other than shares	15.8	21.7	7.9	-0.2	-3.2	-1.5
<i>Of which:</i>						
<i>General government</i>	0.2	1.3	-1.5	-2.3	-1.7	0.3
<i>Credit institutions</i>	6.3	8.0	3.5	0.8	-1.1	-1.6
<i>Other non-monetary financial institutions</i>	9.3	12.4	5.9	1.2	-0.4	-0.2
Shares and other equity	0.9	-0.1	4.3	4.7	4.8	4.5
<i>Of which:</i>						
<i>Non-financial corporations</i>	1.0	-0.5	4.5	4.7	4.4	4.0
Loans	2.3	3.6	2.8	3.0	2.4	2.5
Other, net (c)	-0.8	-0.8	0.0	-0.2	0.4	0.5
MEMORANDUM ITEMS						
Spanish direct investment abroad	3.7	8.1	8.7	8.9	7.2	6.9
Foreign direct investment in Spain	2.2	2.2	4.0	5.6	6.2	6.4

SOURCE: Banco de España.

a. Correspond only to credit institutions and include repos.

b. Insurance corporations and portfolio investment institutions.

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

sector, institutional investors (which continued to unwind positions in the rest of the world) and general government. However, these funds were insufficient to cover the nation's overspending relative to the revenue and financing granted by other financial corporations. In this way, the Banco de España's net assets vis-à-vis non-residents fell again, although by a smaller amount than that posted between March and June, and the net flows during the last twelve months stood at 3.1% of GDP, in comparison with 4.2% in 2008 H1 (see Chart 28).

Capital inflows fell slightly in 2008 Q3 to 16.8% of GDP, in cumulative twelve-month terms, 0.4 pp lower than in June (see Table 8). By instrument, there was less recourse (in gross terms) to the interbank market (although, in net terms, the amount of these flows increased slightly) and

the volume of purchases of shares and other equity by non-residents declined (4.5% of GDP), as a result of the drop in portfolio acquisitions since foreign direct investment in Spain recovered slightly (6.4% of GDP). Net financing obtained through securities other than shares, albeit still negative, was less so than three months earlier (-1.5% of GDP, as opposed to -3.2%), due to the increase in funds raised and channelled through securities issued by general government.

Capital outflows held at 7.2% of GDP in cumulative twelve-month terms, the same level seen three months earlier. By instrument, net purchases of shares and other equity were more buoyant, in spite of the fall in Spain's direct investment abroad (6.9% of GDP, 0.3 pp down on Q2). This was offset by the decline in the cash and deposits heading (including operations on the interbank market, which contracted from 4.6% of PIB to 2.1% between June and September). Conversely, investment in fixed-income securities showed no considerable changes.

As a result of changes in cross-border financial flows, asset prices and the exchange rate, the Spanish economy's accumulated net debt vis-à-vis the rest of the world remained at approximately 80% of GDP (see Chart 28). By sector, this was essentially the result of the improvement in the debit positions of financial institutions and the non-financial private sector, which was offset by the reduction in the credit balance of the Banco de España and the increase in general government liabilities.

23.1.2009.