QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

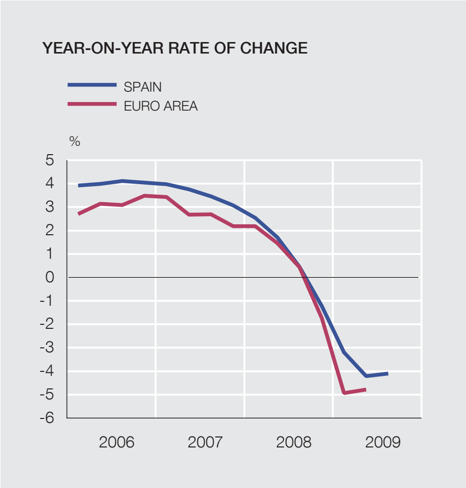
Economic activity continued to fall during 2009 Q2, albeit at a less sharp pace than in Q1, when the most acute phase of the contraction was seen. GDP posted a quarter-on-quarter decline of 1.1% (against a rate of -1.6% in the first three months of the year), while the related year-on-year rate of decline was 4.2%. The fall in output was due to the reduction (at a year-on-year rate of 6.9%) in national demand, while net external demand made a positive contribution of 3.1 pp to GDP growth.

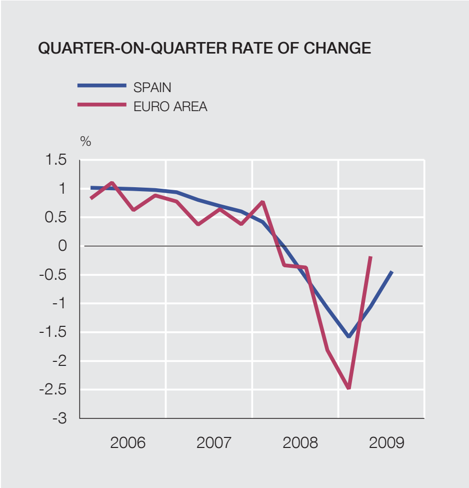
The indicators for Q3 confirm the slowing trend of the rate of contraction in activity, in an environment in which financial market normalisation continued and in which global macroeconomic conditions showed signs of stabilising. The estimates made on the as-yet incomplete information available point to a quarter-on-quarter decline in GDP of 0.4%, the least pronounced since the recession began; that said, this more favourable performance is linked in part to public measures with temporary effects. The year-on-year rate of GDP contracted by 4.1% in Q3 (0.1 pp less than in Q2), as a result of a lesser fall-off in national demand (to 6.5%) and of a positive contribution of net external demand (of 2.7 pp). The easing in the quarter-on-quarter path of decline was extensive to the main components of domestic expenditure, although more markedly so in household consumption, where the direct aid for car purchases was influential, and in public investment, where there was headway in the roll-out of Local Investment Fund projects. In step with these developments, the fall in the gross value added of the main productive branches was less than that in the previous quarters, and the pace of deterioration in the labour market slowed. The EPA data for Q3 show a year-on-year decline in employment of -7.3%, while the unemployment rate stabilised at 17.9% of the labour force. Finally, there was a further reduction in the rate of change of the CPI in the three months from July to September to -1%, largely as a result of the sharp correction core inflation is undergoing, as reflected by the CPI excluding energy and unprocessed food prices, which stood at 0.1% at the end of the quarter, the lowest rate of the time series.

In terms of the international economic outlook, the improvement in financial markets dating back to March continued and there were signs of economic recovery in a good number of economies. This followed the notable moderation in the decline in activity in Q2, as a consequence of the aggregate demand stimulus and financial system support policies. In these circumstances, GDP may be expected to post positive quarter-on-quarter growth rates in Q3, with this trend more marked in the emerging economies, led by developments in Asia and, in particular, by China and India. Global inflation continued to fall, meaning that the growth rates of consumer prices turned negative once more in a good number of countries. On the foreign exchange markets, the dollar depreciated against the main currencies. And on the commodities markets, Brent oil prices rose in the second half of October to around $77 per barrel, and gold reached a high in dollar terms.

The improvement in the economic and financial situation in recent quarters has led to an upward revision of growth prospects for 2009 and 2010. For this latter year, the IMF forecasts an increase in world output of close to 3% (compared with the 1.1% decline estimated for this year). Nonetheless, uncertainty over the timing and intensity of the recovery remains high due principally to the doubts overshadowing the growth capacity of the main economies once the fiscal and monetary stimuli are withdrawn. The continuing adjustments in the labour market, the deterioration in public finances and the ongoing deleveraging in the banking sector are

GROSS DOMESTIC PRODUCT (a) CHART 1





SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

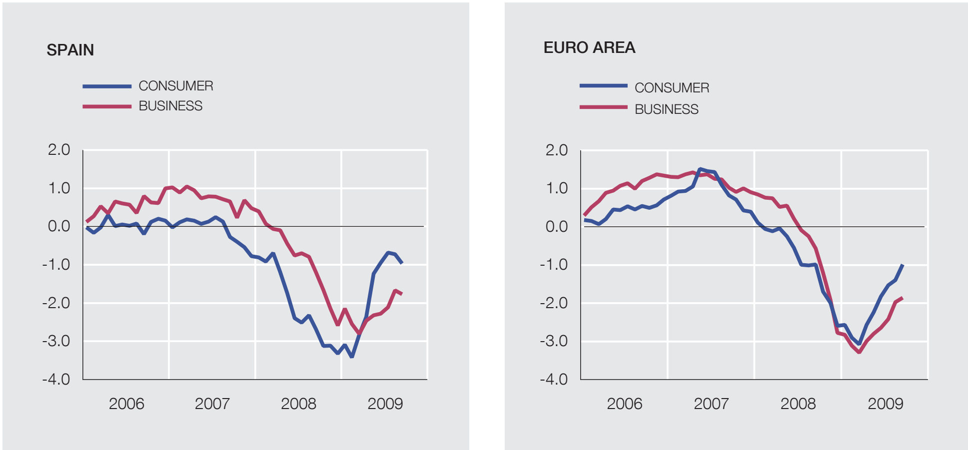
factors that may compromise the path of recovery. At the same time, there is growing concern over the long-term effects of the massive public support provided, which has focused attention on the need for potential and appropriately designed exit strategies. In this respect, while the short-term priorities – as endorsed by the recent Pittsburgh G-20 Summit – remain to restore the proper workings of financial markets and to retain the aggregate demand stimulus policies, it is necessary at the same time to identify the right moment to withdraw the extraordinary measures adopted and to design the means of doing so without undermining what has been achieved.

In the period under study, the monetary and fiscal policy stance remained very expansionary. With regard to public finances, the combination of discretionary measures to stimulate aggregate demand along with the operation of the automatic stabilisers has prompted a strong increase in budget deficits, the financing of which has required the issuance of sizeable volumes of public debt. On IMF forecasts, the budget deficit in the group of the main developed economies might stand at 10% of GDP in 2009.

Turning to monetary policy, central banks kept intervention rates at the all-time lows reached in the previous quarters and continued to offer an unlimited supply of liquidity. In the United States, the official interest rate held in a range of 0% to 0.25%, while there was some redeployment of certain liquidity and financing facilities, accommodating the lower demand by financial institutions. That said, the use of other facilities continued to be stepped up. The Bank of England kept its official rates unchanged at 0.5%, while extending its asset purchase programme in August to £175 billion.

These same broad trends prevailed in the euro area. The indicators available suggest that growth might resume positive rates in Q3, boosted by the improvement in international trade and the aggregate demand stimulus and financial system support policies that have helped stabilise markets. The latest forecasts from international organisations and private institutions have also revised upwards the projected growth for economic activity in the euro area in 2009 and 2010, although they continue to expect the foreseeable recovery to be very gradual and not free from difficulties. Inflation, which continued to be highly influenced by oil price developments, remained negative during Q3 (-0.3% in September). As the base effects associated

CONFIDENCE INDICATORS (a) CHART 2



SOURCE: European Commission.

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

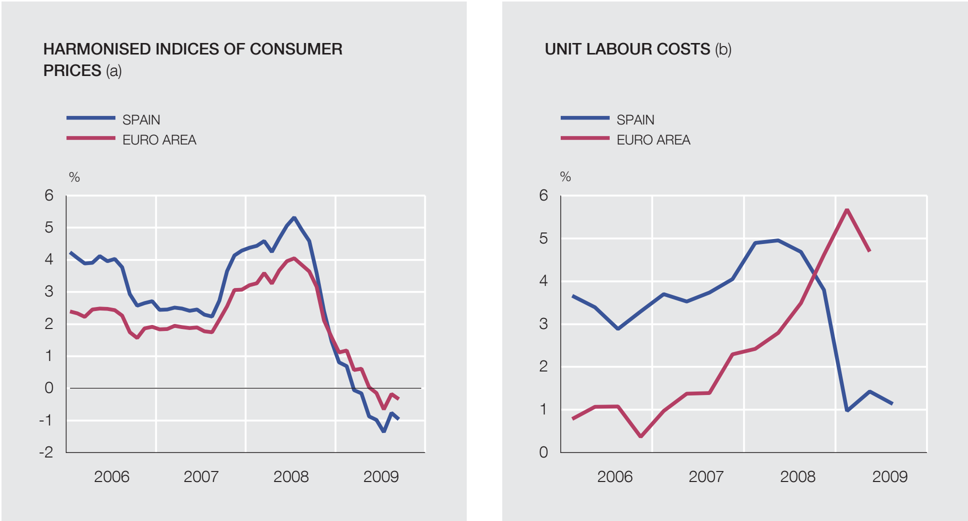
with past increases in commodities prices peter out over the coming months, moderately positive inflation rates will foreseeably be resumed towards the end of the year. Moving into the medium term, the high level of slack in productive capacity makes it very unlikely that inflationary pressures will emerge.

On the economic policy front, and according to the latest figures reported by the Member States under the Excessive Deficit Procedure, the general government deficit would stand at 6.1% of GDP in 2009, compared with 1.9% the previous year. At its August, September and October meetings, the ECB decided to keep its official interest rates at 1% for the main refinancing operations and at 0.25% and 1.75% for the marginal lending and deposit facilities, respectively. This decision was taken against the background of growing signs of economic stabilisation, and the prospect that in the coming months the inflation rate will once again stand at a moderately positive level and that medium- and long-term inflation expectations will be anchored at levels compatible with the monetary policy objective. Furthermore, the ECB continued to provide an ample volume of liquidity through the various instruments at its disposal, including a second one-year refinancing operation at a fixed rate of 1% in late September. The Eurosystem launched a purchase programme for guaranteed bonds and covered bonds issued in the euro area, which is exerting a most favourable impact on the working of markets.

As a result of all these measures, in Q3 and in October to date both the global and euro area financial stress indicators have continued on the improving course initiated last March. On the interbank markets, interest rates continued to decline while the spread between interbank rates and those on secured bank loans narrowed further. Risk premia on credit derivatives markets also declined and stock markets prices climbed notably, while their volatility lessened. Finally, on the government debt markets, long-term yields fell, despite the improved economic outlook and the increase in issues.

Accordingly, the external environment of the Spanish economy has begun to show signs of improvement and financing conditions are continuing to normalise. In Spain, bank lending costs for households and firms generally continued to decline, although they remain at higher levels than those existing before the last interest rate cycle began, especially in the case of higher-risk transactions. These developments reflect a more cautious lending policy on the

PRICES AND COSTS CHART 3



SOURCES: Eurostat, ECB and INE.

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

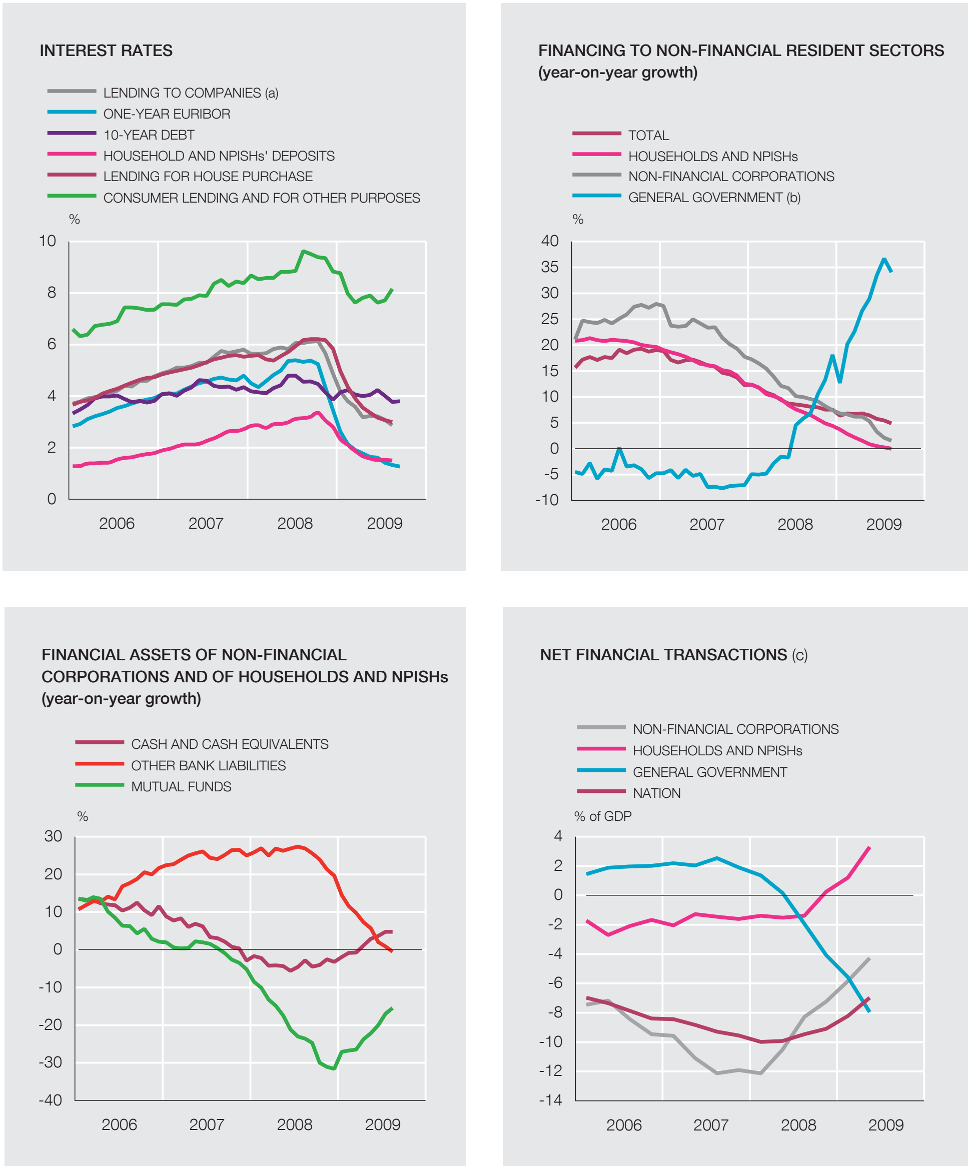
part of banks, in response to the deterioration in the macroeconomic outlook and to the rise in bad debts. And this is also mirrored in other conditions for granting loans, which are expected to have been tightened, albeit at a more moderate rate than in previous quarters. Stock market prices continued to move on the rising trajectory on which they embarked in March, driving a recovery in this component of financial wealth (the IBEX has posted a rise of 28% in 2009 to date). By contrast, real estate prices remained on a declining path, dipping 0.9% between July and September (8% year-on-year), although this was a less pronounced fall than in the three previous months.

Against this backdrop, the decline in household spending slackened in Q3 owing to the slowdown in the declining path of consumption. This was the result, above all, of the boost provided by the direct aid programme for car purchases (the so-called Plan 2000E). Conversely, residential investment remained markedly sluggish, falling at an estimated year-on-year rate of 27%, which was slightly more negative than in Q2. However, the cuts in interest rates and in house prices have placed the affordability indicators at more moderate levels, which will help boost house purchases.

Household consumption is estimated to have fallen at a year-on-year rate of 4.9%, 0.8 pp less than the rate for the previous quarter but indicative nevertheless of the considerable slackness this national demand component is showing. Indeed, despite the expansionary impact on disposable income of the sizeable transfers of income by general government, the reduction in interest payments and the fall in the inflation rate, very powerful factors remain in place that are inhibiting household spending decisions. Specific mention may be made here of the direct effect of heavy job destruction on household wage income, to which the negative wealth effects associated with the reduction of real estate asset prices should be added. In any event, the adjustment in consumption is proving greater than these main determinants (disposable income and wealth) would warrant, and the rising course of the household saving rate is intensifying. In fact, in cumulated four-quarter terms this rate stands at 17.5% of household disposable income, which marks a historical high and is 7 pp greater than the minimum rate reached in 2008 Q1. This behaviour

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCE: Banco de España.

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

shows the reaction of households to the uncertainty of the current circumstances and, most particularly, to the increase in unemployment, which encourages precautionary saving. Nonetheless, the increase in saving is a pre-requisite for the resumption of a sustainable path of expenditure and is part of the adjustment needed to improve households' financial position.

In the setting described, household debt continued to fall, but at a lesser pace than in previous quarters, so that its year-on-year growth in August was zero. This was the case both for loans for house purchases and for those for consumption and other purposes, which showed year-on-year rates of change at 0.5% and -1.4%, respectively. However, the fall in credit was scarcely apparent in the household debt ratio, which remained at a similar level to that of the previous quarter, and in any case below the high reached in late 2008, although the interest burden continued to decline. Despite this relative improvement in the sector's financial position, deteriorating economic conditions and, in particular, rising unemployment are expected to have contributed to increasing the proportion of households facing difficulties in servicing their debt.

The start-up of investment projects by companies continued to decline, in line with the pattern in previous months. This is consistent with the weakness of demand (in both its national and external components), with expectations of losses and with the uncertainty over the start of a sustained recovery. According to information from the non-financial accounts of the institutional sectors, the fall in business investment had prompted a reduction in net borrowing in Q2, to 5.2% of GDP in cumulated four-quarter terms. Financing conditions evidenced an incipient improvement in Q3, as manifest in the reduction in the cost of financing – both bank lending and that instrumented through securities issues – and in some easing in the perception by the business sector of the degree of difficulty of raising finance, although credit accessibility conditions remained restrictive overall. Given these determinants, the growth rate of credit to companies continued to decline, falling by 1.1% in August on the same period a year earlier. Nonetheless, the corporate debt ratio is expected to have held stable in Q3, since the slowdown in borrowed funds is estimated to have been offset by the unfavourable course of business income. The decline in financing costs is expected to have checked the interest burden on companies, although their bad debt ratios continued to increase, mainly in the construction and real estate services sectors.

As regards foreign trade, the as-yet incomplete information suggests that foreign demand once again cushioned the impact of the contraction in domestic spending on economic activity in Q3, as has been the case since early 2008. Net external demand is estimated to have made a very high positive contribution of 2.7 pp, but one lower than that in Q2. The rate of decline of both goods and services exports and imports from the rest of the world eased, in a less unfavourable international setting whose reflection was the resumption of positive growth rates in some of our main trading partners.

It is in fact the contraction in domestic demand that lies at the root of the deep cut in 2009 in the trade deficit, which has narrowed by 52% in the first eight months of the year, compared with the same period in 2008. The same factor also explains the reduction in the current account deficit which, on balance of payments figures, fell by 48% to July. This augurs a further reduction in the nation's net borrowing in Q3, after this variable had stood in the previous quarter at 7% of GDP in cumulated four-quarter terms, almost 3 pp below the level a year earlier. Nonetheless, this correction in the external imbalance is based above all on the fall in imports, whereby in order for this trajectory to firm, it is necessary to strengthen the export base and promote the competitiveness of Spanish companies.

On the supply side, the rate of decline of the gross value added of the main productive branches was also lower than in Q2, a trend that is in any event more visible in terms of the quarter-on-quarter profile. Particular mention should be made of the less unfavourable trajectory of activity in the construction sector, the result of the rise in civil engineering works due to the notable volume of projects linked to the State Local Investment Fund being rolled out. Conversely, residential building is expected to have declined at a similar rate to that of the previous quarter, in a setting in which, in addition to the worsening demand outlook and the increase in financial pressure facing the sector, the volume of finished houses remains high as does overcapacity.

The slowdown in the rate of decline of gross value added was accompanied by a lesser fall-off in employment which, on the estimates made, might be expected to have fallen by 7% year-on-year (compared with a year-on-year rate of -7.1% in the three previous months). As in the preceding quarters, job destruction was more pronounced in market activities, for which a year-on-year decline in employment of over 9% is estimated. Job destruction – as in previous quarters – affected temporary contracts most especially, whereby the ratio of temporary to permanent employees stood in Q3 at 25.9%. The lesser pace of job destruction was concentrated in construction, for the above-mentioned reasons; and yet, there are estimated to have been no improvements in manufacturing industry or in market services, even though the pace of job destruction in these branches has been comparatively lower during the current cyclical phase. Productivity continued to grow sharply, in line with the previous quarter.

Labour costs eased to some extent, though possibly insufficiently so judging by the extreme weakness of the labour market and price developments. Collective bargaining agreements recorded to September included an increase in wage rates of 2.7%, almost 1 pp down on 2008, although this was mainly due to the absence of any impact from the wage indexation clauses this year, the outcome of the behaviour of prices. Nonetheless, information from other labour statistics and developments in compensation per employee in the first half of the year show higher rates of increase in labour costs, at close to 4%. While this rate might be reflecting in part the effects induced by job destruction in low-wage activities, it should be considered as very high given the situation of the economy and, most particularly, the labour market. The increase in compensation per employee in the market economy in Q3 is estimated to stand at a level similar to that of previous quarters, which would entail a significant rise in labour costs in real terms. In any event, the increase in productivity is providing for a significant containment of unit labour costs, which are posting increases far lower than those in the euro area in recent quarters.

Inflation responded forcefully to the weakness of demand. Consumer prices, the year-on-year rate of change in which reached a low of -1.4% in July, continued to post negative rates in August and September (-1% in this latter month). Much of this was due to the strong decline in energy product prices, compared with the high levels they had reached a year earlier. But it also reflects the sharp correction in core inflation, which ended the quarter with year-on-year growth of only 0.1%. Of particular note was the fall in non-energy industrial products, amplified by the reduction in car prices, and the abrupt slowdown in services prices. The latter had traditionally been relatively insensitive to the cyclical situation, but on this occasion their year-on-year rate of change was trimmed by almost 2 pp in one year, to 1.8% in September. Prices continued to trend more moderately in Spain than in the euro area, meaning that the price differential in Q3, measured by the HICP, remained negative at -0.7 pp. It would be highly desirable to maintain the current pattern marked by the absence of inflationary pressures and to harness this to entrench a comparative advantage on which to base the recovery. To do this it would be necessary to address the pertinent reforms in the market for goods and services that would help maintain the pattern of moderation in price formation once expenditure were to pick up.

The strong adjustment in activity is likewise manifest in public finances, which continued to worsen in Q3, driven additionally by the impact on tax takings of the expansionary measures adopted and by the decline in extraordinary revenue. The State Budget for 2010, recently approved by the Council of Ministers, evidences this deterioration in the projected deficit for 2009, which stands at 9.5% of GDP, while it plans to place it at 8.1% in 2010. The public debt ratio is expected to rise to 62.5% of GDP in 2009. The planned reduction of the deficit, in a less adverse cyclical environment than that in 2009, would stem mainly from the projected increase in revenue arising from the reversal of the temporary effects of some of the expansionary measures taken in recent years, and also from the increases planned for personal income tax, VAT and tax on saving, as well – albeit to a lesser extent – as from specific public spending adjustments. The State Budget for 2010 confirms the commitment to budgetary stability, in line with Community agreements. But it is not free from risks. Strict budgetary compliance will therefore require rigorous monitoring and control of the deviations in revenue and expenditure that might arise, and the contribution of the regional and local governments in reducing the deficit.

2 The external environment of the euro area

The pointers indicating growing stabilisation before the summer were followed, in 2009 Q3, by widespread signs of a pick-up in activity, led by the Asian emerging economies. At the same time, financial markets continued to move towards a certain degree of normalisation, characterised by investors' growing appetite for risk, an easing of financial conditions and growing activity in certain market segments, such as private fixed income. However, the recovery is expected to be a gradual and delicate process: on the one hand, because output gains are being driven, in the short term, by restructuring of inventories, which is a temporary factor; and on the other, because economic and financial activity is still highly dependent on the support measures introduced in most countries. Economic recovery is also conditioned by the processes of financial adjustment still under way in the developed economies, and, in particular, by the deleveraging of households and firms, the necessary restructuring of their wealth and the difficult credit climate, in a setting in which certain financing market segments, such as securitisation, have still to recover.

Thanks to the pick-up in parts of the financial markets, the big US financial institutions – with notable exceptions – reported better-than-expected results in Q3, meaning that many of them have been able to reduce the public stake in their shareholdings. Moreover, in the United States and in certain other countries, the first steps have been taken to reduce recourse to some of the financial system support measures, such as guarantees, financing and liquidity lines. Nevertheless, the situation is still far from normal.

Price indicators on most financial markets proved favourable in the quarter. Interbank and credit market spreads continued to narrow, and stock markets climbed considerably, returning to the levels seen before the collapse of Lehman Brothers in September 2008. Despite the increase in public debt issues and the growing appetite for risk, long-term interest rates declined significantly, against a backdrop of strong demand stemming from the bond purchase programmes launched by some central banks and uncertainty regarding the strength of the economic recovery. On the foreign exchange markets, the dollar, the renminbi – which remains pegged to the dollar – and sterling depreciated against virtually all currencies. The emerging markets also performed very well, in some segments even better than the developed economies. Lastly, on the commodities markets, the price of oil remained within the range set following the price rises seen in Q2, as did prices of the main industrial metals and food prices, while the price of gold rose sharply in dollar terms, but not in other currencies such as the euro or the yen.

In the United States, the final GDP estimate for 2009 Q2 showed a contraction of 0.2% in quarterly terms (-0.7% annualised), a considerable improvement on the Q1 figure (-1.7%). The higher-frequency indicators for Q3 continued to give mixed signals. Activity indicators showed positive growth: PMIs pointed to expansion in activity, and industrial production rose in September for the third consecutive month, while installed capacity utilisation returned to the level seen in March. On the demand side, consumer confidence continued to improve in the quarter, returning to January 2008 levels, and spending indicators also progressed well, albeit on the back of public schemes to encourage consumption. Housing market indicators continued to reflect the signs of growing stability noted in Q2, and there was a halt in the fall in house prices. However, the rate of job destruction remained high (although down on Q1), taking the unemployment rate from 7.2% at end-2008 to 9.8% in August. Turning to prices, the overall index fell by 1.3% year-on-year in September, while the core inflation rate rose slightly, to 1.5%.

AN APPROXIMATION OF THE COST OF THE CRISIS IN TERMS OF ACTIVITY

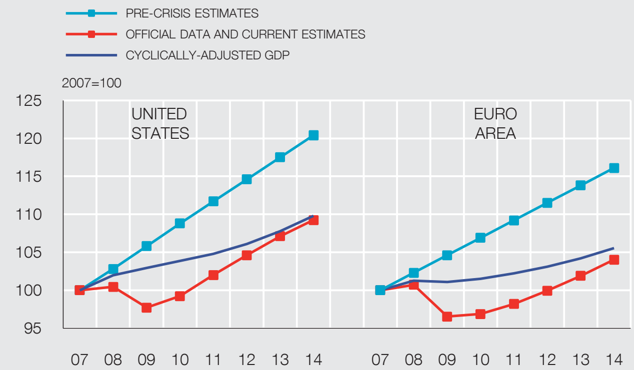
Although the decline in activity as a result of the economic crisis seems to have bottomed out, and, in recent months, growth forecasts in most economies have been revised upwards, the global economy is experiencing the deepest and most widespread recession since the Second World War.

It will be some time before it will be possible to calculate the cost of the crisis in terms of output losses. However, a simple approximation of the expected impact of the crisis may be made by comparing the medium-term GDP forecasts available before the onset of the financial turmoil with the latest forecasts, considering the economic activity data for 2008. Specifically, this exercise compares the forecasts contained in the IMF's *World Economic Outlook* as at April 2007 and September 2009. Insofar as is possible, the path of cyclically-adjusted GDP should also be considered. Given the severity of the recession, this variable permits a better assessment of the impact of the crisis on growth in the medium term, and may be interpreted, with certain reservations, as an approximation of the future growth potential forecast. Box 2 presents a more detailed analysis of the possible impact of the crisis on potential euro area GDP.

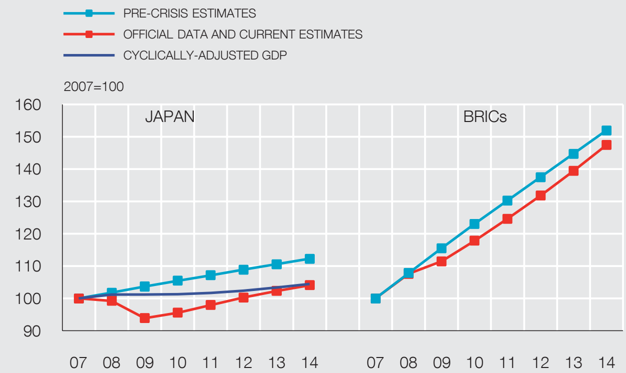
Panels 1A and 1B depict GDP in the period 2007-2014, for a selected group of countries, taking the first year as the base year (2007=100). In the case of the current forecasts, a distinction is drawn between GDP and cyclically-adjusted GDP, subtracting from the former the output gaps forecast by the IMF. This is not possible for the emerging economies, as there are no data on output gaps. The accompanying table records some of the key results of the comparative exercise for the main advanced economies.

As the panels show, the recession has given rise to very substantial output gaps in all countries. The widest gaps, recorded in most cases in 2009, range between 3 pp of GDP in the euro area and 7 pp in Japan. However, the crisis has also had a considerable impact on growth forecasts for cyclically-adjusted GDP, as shown by the decline in the slope of the attendant line in the panels. In most cases, the line depicting cyclically-adjusted GDP flattens out post-crisis, signalling potential growth rates close to zero due to the recession-induced lower stock of capital and lower employment. As the projection period progresses, the output gaps become narrower and, as employment and investment recover, cyclically-adjusted growth

1A GDP FORECAST BEFORE AND AFTER THE CRISIS



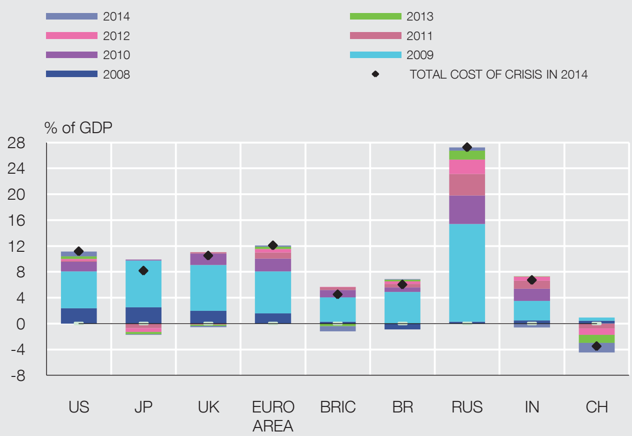
1B GDP FORECAST BEFORE AND AFTER THE CRISIS



1 RESULTS OF THE EXERCISE FOR THE ADVANCED ECONOMIES

	Maximum output gap (a)	Δ Cyclically-adjusted GDP. 2005-2007 average	Δ Cyclically-adjusted GDP. 2014	Total cumulative cost of crisis. 2007-2014 (% of GDP) (b)
United States	-4.5	2.4	2.0	11.2
Japan	-7.0	1.7	1.2	8.2
United Kingdom	-4.9	2.4	1.8	10.5
Euro area	-3.1	2.5	2.1	12.1

2 COST OF THE CRISIS IN TERMS OF ACTIVITY (2007-2014). TOTAL AND ANNUAL CONTRIBUTIONS



SOURCES: IMF (WEO April 2007, Art. IV Staff Reports 2007, and WEO October 2009) and Banco de España.

a. As a percentage of cyclically-adjusted GDP.
b. Difference between the 2014 GDP forecast before and after the crisis, vis-à-vis 2007 GDP.

begins to rebound. Panels 1A and 1B show that, towards the end of the projection period, the output gaps disappear in all countries, save in the euro area. However, in the advanced economies, growth rates do not return to their pre-crisis levels, not even when the cyclical factors cease to be significant. As the table shows, growth in 2014 is some 0.5 pp lower than the average growth of the three years previous to the crisis: the United Kingdom posts the largest downward revision, from 2.4% to 1.8%, while the United States and the euro area are both down 0.4 pp, from 2.4% to 2% and from 2.5% to 2.1%, respectively. Although there are no cyclically-adjusted GDP data for the emerging economies, the parallel performance of the pre-crisis and post-crisis estimates as from 2010-2011 suggests that the expected decrease in growth in the medium term will be insignificant.

The cost of the crisis in terms of activity in the projection period (2008-2014) is reflected by the difference between the 2014 GDP levels expected before the crisis and those expected on current forecasts. Panel 2 presents a comparison of the total cost for different countries, expressed as a percentage of 2007 GDP, indicating each year's contribution to the cumulative cost. Negative contributions mean that the current growth forecast is higher than the pre-crisis forecast. As to be expected, given the size of the output gaps and the lower forecast growth potential, the bulk of the costs arises in 2009.

According to this approximation, the cost of the crisis amounts to some 10% of GDP in the advanced economies. For the United States, the estimated cost represents more than 11 pp of GDP, compared with 12.1% for the euro area, 10.5% for the United Kingdom and 8.2% for Japan. The cost for the emerging economies is considerably lower (4% for the BRIC group of countries as a whole), but highly disparate: for Russia the cost amounts to more than 25% of GDP, while for China it is negative, as the current forecasts are better than those existing before summer 2007.

The results of this comparative exercise show that the crisis is expected to entail a high cost in terms of activity; this cost will be considerably higher in the advanced economies than in the emerging ones (4%), with just a few exceptions. Moreover, in the advanced economies, the sharp drop in growth at the end of the projection period, in comparison with the pre-crisis forecast, has implications for the longer term, as it suggests a permanent, or at least highly persistent, decrease in their growth potential.

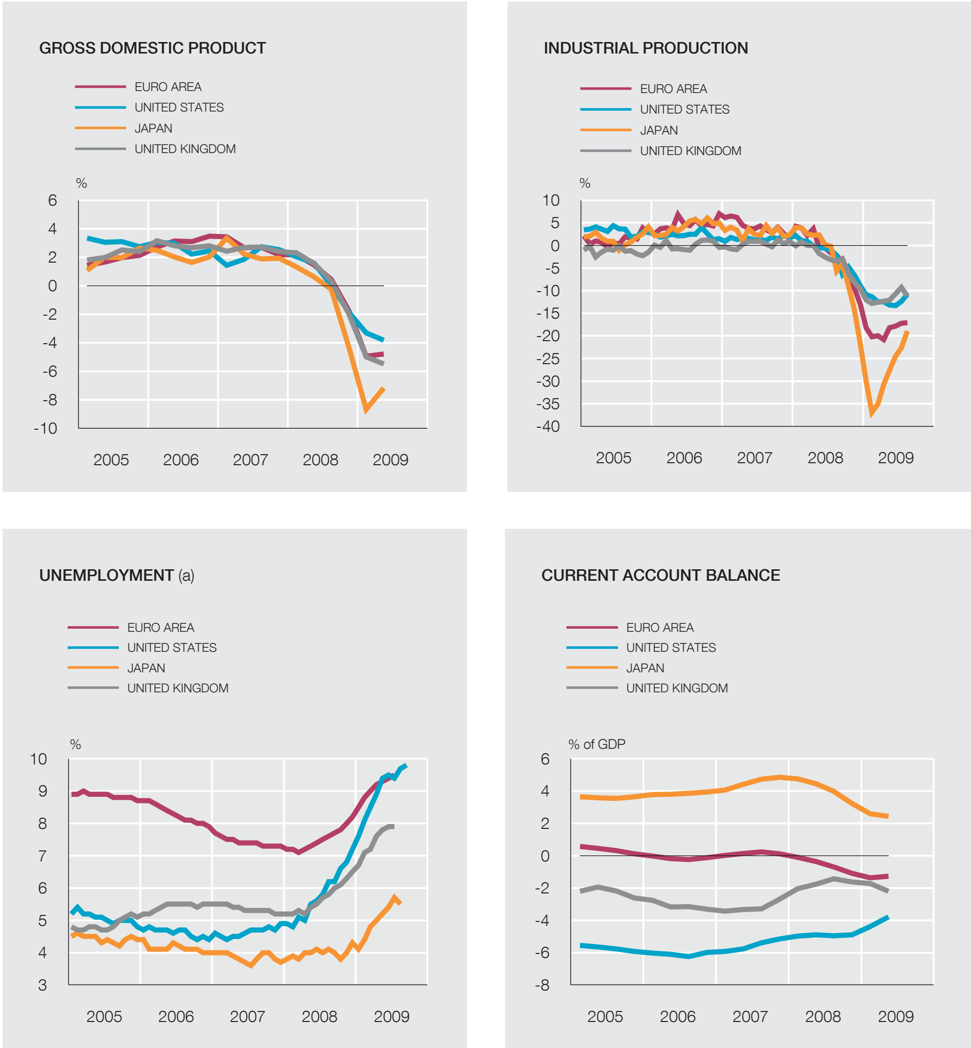
In this setting, at its September meeting, the Federal Reserve held the target federal funds rate unchanged in a range of 0% to 0.25%. Most of the support measures continue in place, but some liquidity lines and guarantees introduced post-crisis have been allowed to lapse, having been used only marginally as the financial climate has improved. Lastly, the figures for the close of fiscal year 2009 show a deficit of $1.4 trillion (10% of GDP), somewhat below the CBO's forecast in August ($1.6 trillion), and net public debt of $6.7 trillion (47.2% of GDP).

In Japan, the revised GDP figure for Q2 reflected a positive quarterly rate of growth of 0.6% (-7.2% year-on-year), in comparison with the decline of 3.3% in Q1. In Q3, the economy continued to show signs of improvement in activity, but some imbalance remained between the strength of external demand and the weakness of domestic demand. All exports-related indicators continued to climb, but private investment and consumer-related indicators have still not consolidated. Industrial production rose in August, for the fifth consecutive month, while, in September, the manufacturing PMI remained above the level associated with expansion. Despite the signs of improvement in household consumption, linked to tax relief, in August retail sales continued to shrink in comparison with a year earlier. The labour market improved in August and the unemployment rate dropped to 5.5%. As regards prices, the rate of decline of the CPI intensified in August, to -2.4% year-on-year. Against this backdrop, the Bank of Japan made no change to its official interest rate or to its asset purchase programme (although there were signs of a gradual future exit), expressing caution in its forecasts.

In the United Kingdom, GDP for Q2 contracted by 0.6% in quarterly terms (-5.5% year-on-year). The preliminary estimate for Q3 points to a decline of 0.4% in quarter-on-quarter terms (-5.2% year-on-year), even though the latest supply and demand indicators (industrial production, PMI and retail sales) showed signs of recovery. Conversely, the weakness in the labour

MAIN MACROECONOMIC INDICATORS
Year-on-year rates of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

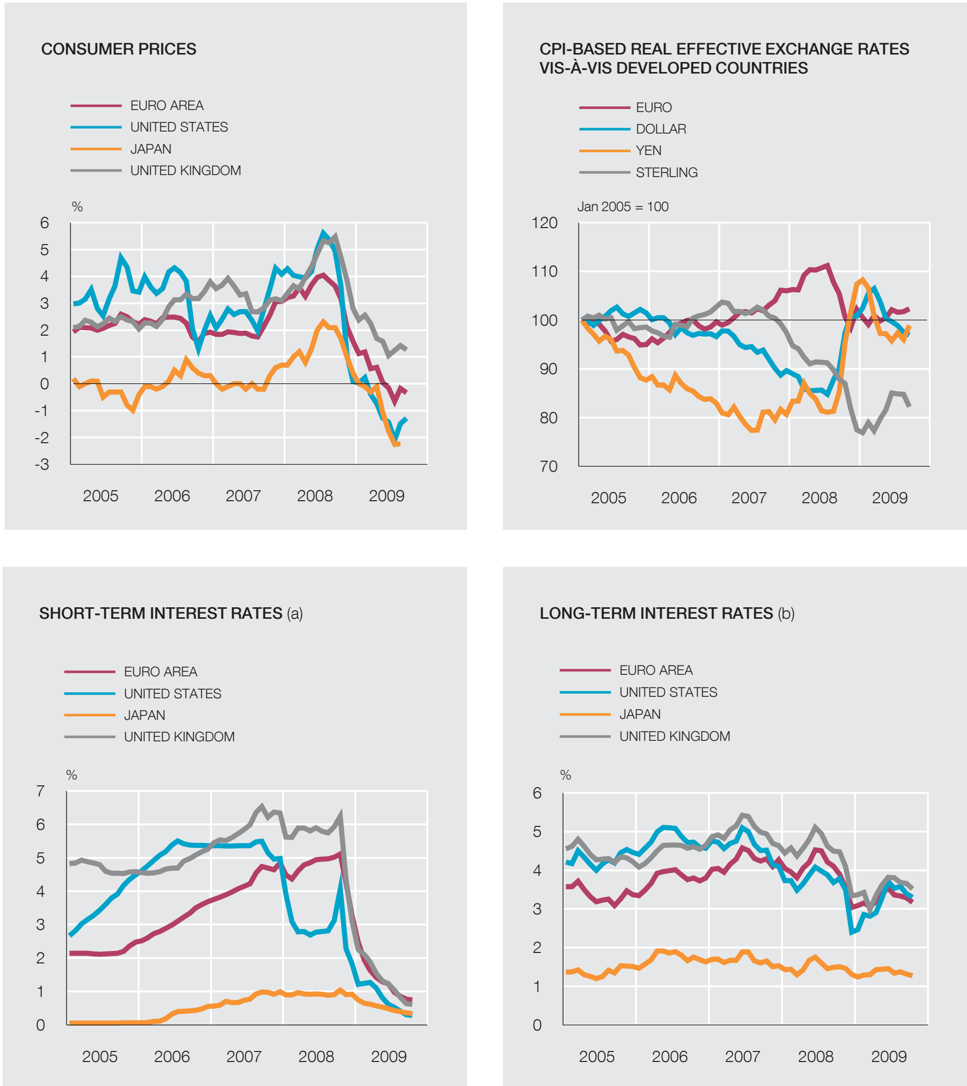
a. Percentage of labour force.

market persisted and, despite the lower level of deterioration in July, the unemployment rate remained at 7.9%. In addition, bank lending remained sluggish, particularly for SMEs and households, although there was a rebound in housing loans, reflecting, in part, the growing stability of the real estate market. The rate of inflation fell by 0.5 pp in September, to 1.1%, below the 2% target. The Bank of England kept its official interest rate unchanged and, in August, extended its asset purchase facility to £175 billion.

In the new EU Member States not belonging to the euro area, the year-on-year decline in GDP intensified across the board in 2009 Q2 (-4.6%, against -3.7% in Q1), save in Poland where the rate of growth of GDP rose from 0.8% to 1.1% year-on-year. The widespread negative performance was essentially due to the deep adjustment in domestic demand, although exports also fell considerably. However, imports fell much more sharply, so that net external demand made a positive contribution to GDP growth and, moreover, current account deficits narrowed considerably (in fact some countries even recorded a surplus in the first half of the year). The severe deterioration of economic activity is driving up budget deficits, which are expected to exceed 3% of GDP in all the new EU Member States in 2009, with the exception

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

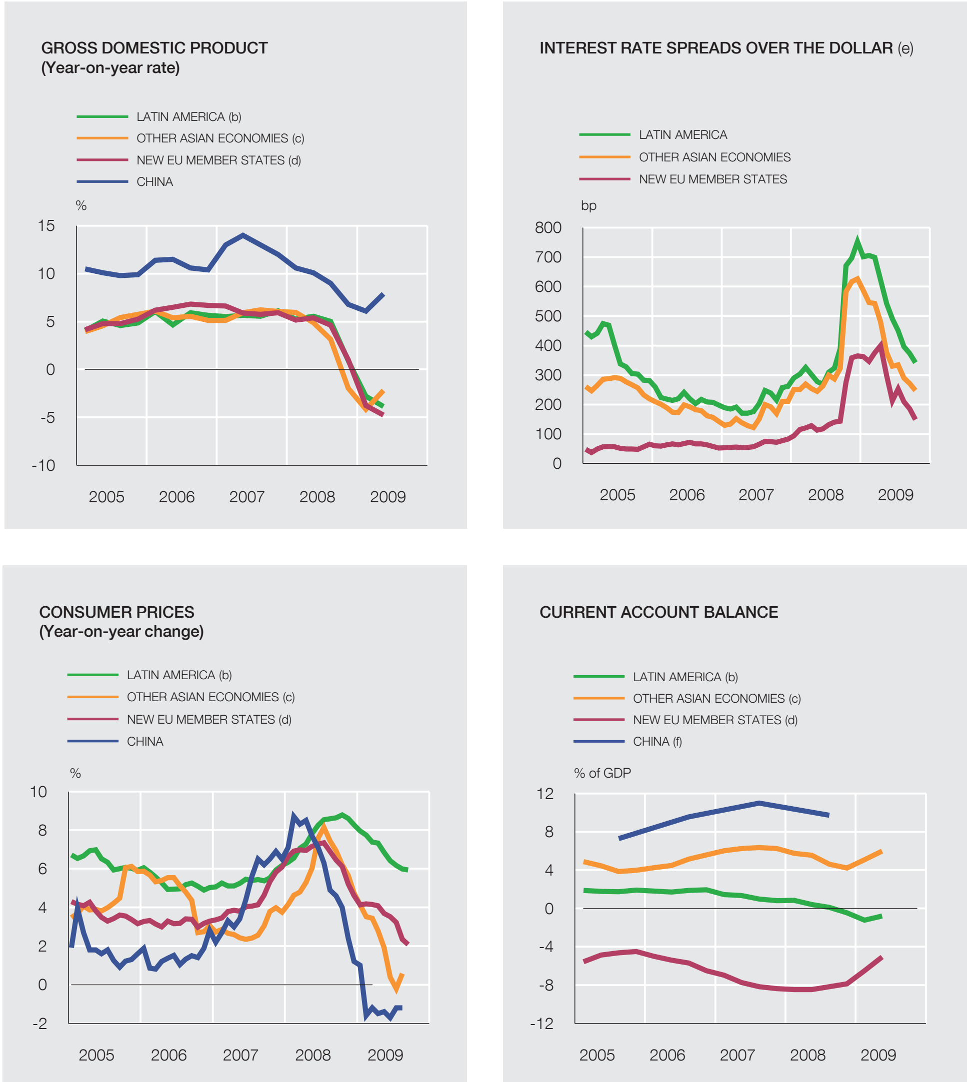
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

of Bulgaria. The higher-frequency indicators for Q3 point to some improvement, with a somewhat less pronounced fall in industrial production, retail sales and trade flows. Throughout Q3, the aggregate inflation rate continued to head slowly downwards (3.1% year-on-year in September), leading to further official interest rate cuts in Romania and Hungary.

In China, GDP accelerated to a year-on-year rate of 8.9% in Q3, 1 pp more than in Q2, essentially due to the impulse provided by economic policy. The supply-side indicators showed industrial production accelerating gradually, while business confidence continued in clearly expansionary territory. The domestic demand indicators (investment in fixed assets and retail sales) also developed favourably, while the trade surplus remained at moderate levels, although with a recovery in real imports. In turn, the strong build-up in international reserves may suggest continued short-term capital inflows. By the end of Q3, year-on-year inflation was in less negative territory (CPI: -0.8%; producer prices: -7%), due to lower base effects, against the backdrop of a sharp rebound in credit and in the money supply, leading to measures announced to contain credit growth. In the rest of Asia, GDP grew at a rate of 2% year-on-year in Q2, underlining the fact that the region is ahead in the economic cycle. Many countries of

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy, based 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, Estonia, Latvia, Lithuania, Bulgaria and Romania.
e. JP Morgan EMBI spreads. The data on the new EU Member States are for Hungary and Poland. The Asia aggregate does not include China.
f. Annual data.

the region saw an improvement in economic activity in Q3, reflected in higher industrial production and exports. In turn, the decline in prices tended to stabilise, and the monetary policy stance was unchanged, with scarcely any moves in official interest rates.

In Latin America, activity recovered in 2009 Q2, with GDP growing by 0.5% in quarterly terms (-3.9% year-on-year), after falling by 2.3% in Q1. This was due to the good performance of Brazil (whose GDP rose by 1.9%, on the back of higher exports), Colombia and Argentina. By contrast, Mexico's GDP fell by 1.1% in quarterly terms (-10.3% year-on-year). The slump in imports, largely due to lower private consumption, together with the price rises in certain commodities, led to an improvement in trade balances. The Q3 indicators appear to point to a slight recovery, even in the countries worst hit by the crisis, such as Mexico. The rate of inflation continued to decline, to 5.9% year-on-year in September, its lowest level since November 2007, as food and energy prices and, to a lesser extent, administered prices, all fell. Only Argentina and Venezuela saw a sharp rise in inflation. In this setting, the region's central banks made further official interest rate cuts in Q3, ranging from total cuts of 775 bp in Chile to 375 bp in Mexico. Fiscal indicators deteriorated severely throughout the region, especially in Mexico, which in Q2 posted the worst deficit in annualised terms since 1990.

The expectations of a certain degree of economic recovery in the euro area consolidated as Q3 progressed. The conjunctural indicators available show that, after five quarters of negative growth, GDP growth rates could have turned positive again, driven by the improvement in international trade and by the demand stimulus and financial system support measures that have helped stabilise the markets. In this setting, in their latest forecasts, international organisations and private institutions have raised their economic growth estimates for the euro area for 2009 and 2010, although they continue to think that the foreseeable recovery will be very gradual, with obstacles along the way. The labour market, which has proved quite resilient to date in the euro area as a whole, the notable deterioration of public finances and the deleveraging in the banking sector, which has been badly hit by the financial crisis and the economic downturn, are all fragile elements whose performance over the coming months will have to be carefully monitored. In addition, any disorderly exchange rate moves could lead to a curb on growth in world trade and in euro area exports.

The rate of inflation continued to be highly influenced by the price of oil, remaining negative throughout Q3, with year-on-year growth of –0.3% in September. However, as the base effects associated with past rises in commodities prices become exhausted in coming months, inflation rates will foreseeably turn moderately positive again towards the end of the year. Into the medium term, the high level of slack in productive capacity makes it very unlikely that inflationary pressure will emerge over the relevant horizon for monetary policy. Against this backdrop, the ECB's Governing Council held official interest rates unchanged at 1%, indicating that medium and long-term inflation expectations remain anchored at levels consistent with the monetary policy target.

Most European countries continued to implement the temporary fiscal measures that, with the backing of the European Economic Recovery Plan, have helped offset contractionary pressure. But it is precisely now, when the results of these measures start to emerge and the key conjunctural indicators start to show that the crisis is abating, that solutions should be sought for the difficult balance between allowing economic recovery to continue while, at the same time, appropriately signalling the commitment to budgetary stability in the medium term. Thus, while the short-term priorities, as recently endorsed at the G20 in Pittsburgh, remain centred on re-establishing the correct functioning of the financial markets and maintaining aggregate demand stimulus policies to support the signs of economic recovery, it is also important to identify the correct time for withdrawal of the extraordinary fiscal measures and to outline efficient exit strategies that will not undermine the goals achieved but will set the foundations for firm and credible budgetary consolidation in the medium term.

The present situation should also act as a catalyst for structural reforms in key areas, such as labour and product markets, and the banking sector, which is in need of restructuring and consolidation. These structural reforms would boost growth potential, countering the possible negative impact of the financial crisis (see Box 2), they would provide the necessary flexibility for optimum advantage to be taken of the benefits of the recovery when it comes, and they would increase economies' resilience to any obstacles that may arise along the road to recovery.

3.1 Economic developments

The National Accounts data for 2009 Q2 confirmed the lower level of contraction in activity in the euro area. Thus, after the quarter-on-quarter drop of 2.5% in Q1, activity fell back by

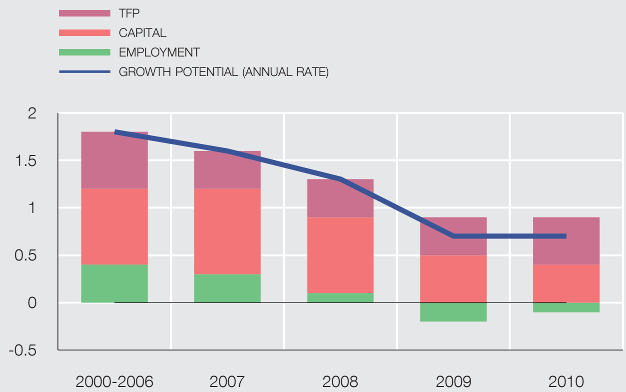
Estimating the impact that the crisis may have on growth potential is a complex task, so the results should be treated with great caution. First, due to the inherent difficulty in measuring the potential or trend output of an economy. In the literature there are various generally-accepted procedures (statistical filters, production functions, structural VAR models, etc.) that may give different quantitative results, especially at times of severe crisis, such as that experienced in recent months, which entail a structural break in relationships between the different variables and in the data series used.

The effects of financial crises on growth potential feed through various channels, affecting both the stock of physical and human capital and the efficiency with which these factors are employed, i.e. total factor productivity (TFP). Here it is essential to draw a distinction between temporary effects on output levels, temporary effects on GDP growth (which have a long-lasting adverse impact on an economy's potential GDP), and other much more persistent effects that may result in permanently lower trend growth rates than before the crisis (which have a more adverse impact on GDP levels).

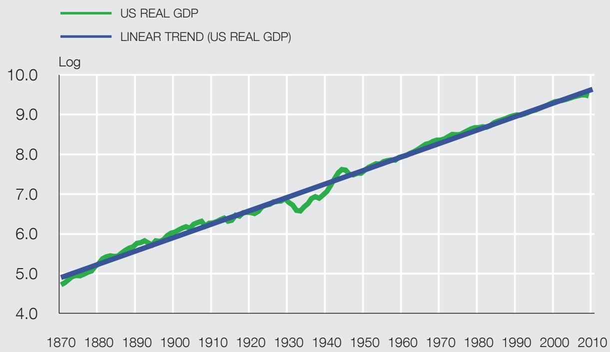
In the short and medium term, financial crises signify a dramatic reduction in an economy's productive capacity, owing to their effect on physical and human capital. Higher financing costs and tighter credit standards cut back investment considerably, while corporate bankruptcies signify accelerated depreciation of installed productive capacity. Moreover, lower activity levels may lead to higher structural unemployment in economies with less flexibility for reallocation of resources. The impact on TFP is ambiguous, as it leads to lower innovation (which is highly pro-cyclical), but it also drives out companies that, in principle, are less productive and belong to sectors that are oversized. To illustrate these effects, Panel 1 depicts the results published by the European Commission, which estimates that the crisis could more than halve growth potential in the euro area in 2008-2010, compared with the rates close to 2% recorded in 2000-2006, primarily as a result of the lower contribution of capital and of the labour factor.

The question that poses the most uncertainty, however, is whether the economy will recover its past trend growth rates, once the crisis and the necessary adjustment process are over. The clearest example in this respect is the United States, which throughout its history has recorded a quite stable trend growth rate, to which it has returned after crisis episodes. In fact, as Panel 2 shows, an estimated (log-linear) trend for the entire sample period (1870-2008) tracks the growth path of the US economy quite closely. Some of the small European economies, such as Finland and Sweden, record a similar

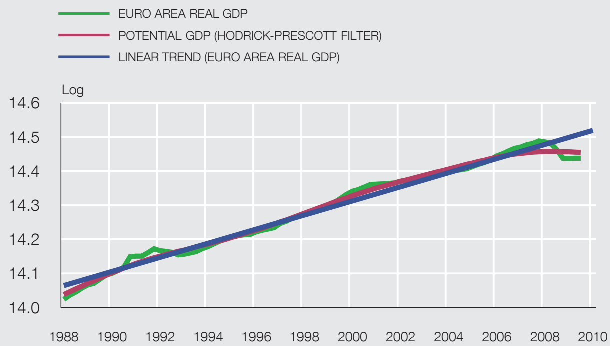
1 CONTRIBUTION IN PERCENTAGE POINTS TO GROWTH POTENTIAL IN THE EURO AREA



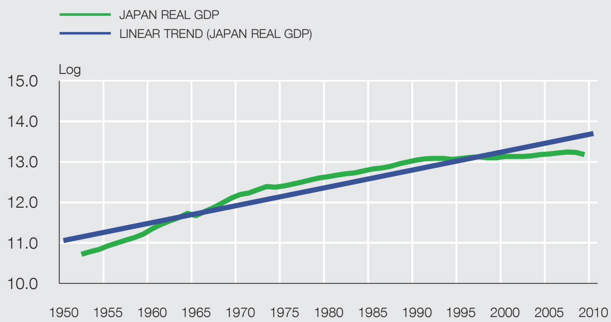
2 GDP GROWTH IN THE UNITED STATES VIS-À-VIS TREND GROWTH (1870-2009)



3 GDP GROWTH IN THE EURO AREA VIS-À-VIS TREND GROWTH (1988-2009)



4 GDP GROWTH IN JAPAN VIS-À-VIS TREND GROWTH (1952-2009)



SOURCES: European Commission and Johnston & Williamson (2008).

experience, having made notable efforts in innovation and introduced radical changes in their productive models post-crisis.

However, extrapolating these experiences to the present situation may entail risks. A crisis as severe as that seen in recent months may have long-lasting implications for agents' attitudes to risk, which would delay restructuring of the productive process, limiting capital inflows into new activities and firms, and would prompt a sharper fall in innovation, with long-term effects on total factor productivity. Furthermore, long-term unemployment leads to permanent destruction of human capital and may have a negative impact on labour market participation rates, disrupting incentives for job-seekers and migrant workers. Economic policy may also affect long-term growth if protectionist measures are raised, or fiscal measures are introduced that sow doubts as to the sustainability of public finances in the long term. Japan, where it is estimated that growth potential decreased significantly after the financial crisis of the 1990s, is a case in point.

In its latest *World Economic Outlook*, the IMF analyses the experience of numerous economies that have undergone financial and/or banking crises in the past, presenting evidence to suggest that following a long period of adjustment, trend growth rates in most of the economies analysed return to close to their pre-crisis levels. However, even so, seven years on from the end of the crisis, potential or trend GDP is 10% lower than it would have been had there been no crisis (more than 20% lower in many economies in the case of the Great Depression). Hence the need for structural reform policies that will iron out rigidities, boost knowledge and innovation and facilitate the reallocation of resources to new sectors and business opportunities that emerge post-crisis.

0.2% in Q2 (see Table 1). This lower rate of decline was essentially due to a more moderate slowdown in gross fixed capital formation and in exports, consistent with the recovery in world trade, driven by the increased dynamism of the Asian economies (see Chart 8). In turn, private consumption rose slightly, after four quarters of negative growth, thanks to notable household spending on automobiles and rising consumer confidence, while government consumption grew at a similar rate to the previous quarter. Thus, the negative contribution to GDP made by domestic demand, excluding stocks, was lower in absolute terms than in the previous quarter, while the positive contribution of the net external balance rose to 0.5 pp, as imports contracted more sharply than exports. Lastly, the change in stocks detracted from GDP growth to the tune of 0.6 pp. Turning to the breakdown by branch of activity, value added declined in industry and in construction, while services grew in comparison with the previous quarter.

The lower level of contraction in activity was a common feature of most of the euro area economies, largely due to the progressive export recovery. Some countries, such as Germany, France, Greece and Portugal, recorded positive growth rates in quarter-on-quarter terms. Specifically, both Germany and France saw their GDP rise by 0.3%, driven also by the improvement in gross fixed capital formation, while Italy recorded negative growth of 0.5%, dragged down by the negative contribution of net external demand.

Employment again posted a negative rate of growth vis-à-vis the previous quarter (–0.5%), slightly higher than the Q1 figure. However, employment patterns in the euro area as a whole are the result of very different adjustments on the different labour markets, according to each country's sectoral make-up and productive structure and to the specific effects of the employment support measures introduced. In year-on-year terms, employment fell by 1.8%. There was a further steep decline, although less than in Q1, in apparent labour productivity, as GDP contracted more sharply than employment. The lower rate of deterioration of productivity, together with the more moderate rate of growth of compensation per employee, drove unit labour costs (ULCs) up by almost 5%, an increase which, although smaller than that seen in the previous quarter, was well above the increase in final prices, meaning that margins narrowed again (see Chart 8).

EURO AREA ECONOMIC INDICATORS (a) TABLE 1

	2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NATIONAL ACCOUNTS (q-o-q rates of change. unless otherwise indicated):								
GDP	0.8	-0.3	-0.4	-1.8	-2.5	-0.2		
Private consumption	0.2	-0.4	0.0	-0.5	-0.5	0.1		
Public consumption	0.5	0.8	0.5	0.6	0.6	0.7		
GFCF	0.7	-1.3	-1.5	-3.5	-5.4	-1.5		
Imports	1.8	-1.1	0.3	-4.6	-7.9	-2.9		
Exports	2.0	-0.5	-1.0	-7.0	-9.2	-1.5		
Contributions to quarter-on-quarter GDP growth (pp):								
Domestic demand (excl. stocks)	*0.4*	*-0.4*	*-0.2*	*-0.9*	*-1.3*	*-0.1*		
Change in stocks	*0.3*	*-0.2*	*0.4*	*0.2*	*-0.7*	*-0.6*		
Net external demand	*0.1*	*0.3*	*-0.5*	*-1.1*	*-0.6*	*0.5*		
GDP (year-on-year rate of change)	2.2	1.5	0.4	-1.8	-4.9	-4.8		
ACTIVITY INDICATORS (quarterly average):								
IPI seasonally and working-day adjusted	1.0	-1.1	-1.6	-8.0	-8.5	-1.2	*1.7*	
Economic sentiment	101.4	97.7	89.9	75.6	65.7	70.2	79.9	
Composite PMI	52.1	50.8	47.6	40.2	37.6	43.2	49.5	53.0
Employment	0.4	0.1	-0.3	-0.3	-0.7	-0.5		
Unemployment rate	7.2	7.4	7.6	8.0	8.8	9.3	*9.5*	
PRICE INDICATORS (y-o-y change in end-period data):								
HICP	3.6	4.0	3.6	1.6	0.6	-0.1	-0.3	
PPI	5.8	7.9	7.7	1.2	-3.2	-6.5	*-7.5*	
Oil price (USD value)	104.3	132.0	98.1	40.5	46.8	68.8	67.7	*72.3*
FINANCIAL INDICATORS (end-period data):								
Euro area 10-year bond yield	4.2	4.9	4.5	3.8	4.1	4.2	3.8	*3.9*
US-euro area 10-year bond spread	-0.69	-0.88	-0.88	-1.76	-1.31	-0.63	-0.47	*-0.45*
Dollar/euro exchange rate	1.581	1.576	1.430	1.392	1.331	1.413	1.464	*1.502*
Appreciation/depreciation of the NEER-22 (b)	3.7	3.5	-0.6	2.7	-0.7	-1.1	0.1	*1.9*
Dow Jones EURO STOXX 50 index (b)	-17.5	-23.8	-30.9	-44.3	-15.5	-2.0	17.2	*17.7*

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

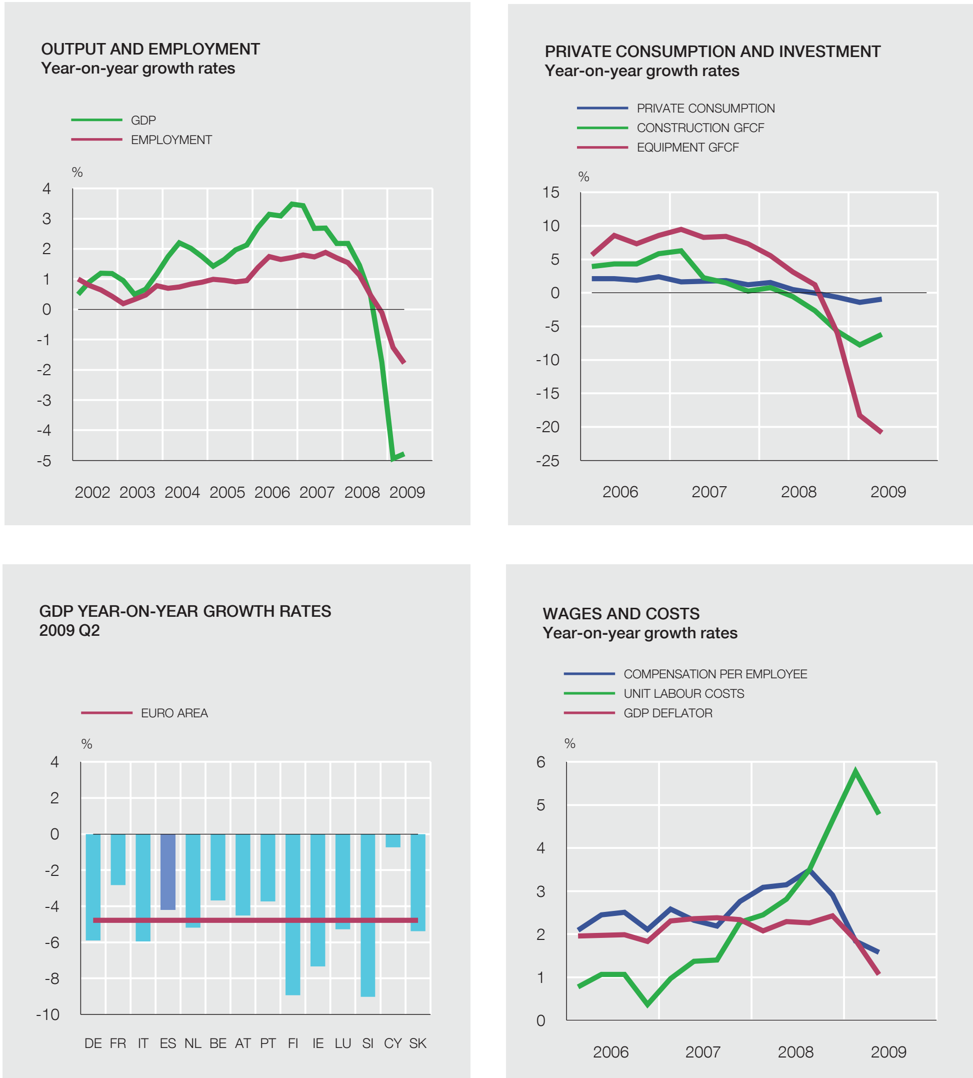
a. Information available to 23 October 2009. The information in italics does not cover the full quarter.
b. Percentage change over the year.

The latest conjunctural data suggest that the signs of stabilisation that emerged in previous months have consolidated and that the euro area economy is heading towards a certain degree of recovery, albeit possibly on a very gradual scale. Thus, on the supply side, industrial production posted positive rates of growth and new industrial orders rose significantly (see Chart 9). In turn, the European Commission's confidence indicators recorded further progress, as did industry and services PMIs, topping the 50 mark that generally indicates expansion. On the labour front, sentiment indicators improved, although they are still historically very low, and the unemployment rate rose to 9.6% of the labour force.

Demand indicators also improved, in general, throughout Q3, although somewhat less noticeably in the case of private consumption indicators. Specifically, retail sales declined in July and August, while new car registrations rose more moderately than in Q2, as the funds earmarked to stimulate demand in this sector petered out in some countries. Conversely, consumer and retail trade confidence indicators rose. As regards investment, the assessment of order books according to the European Commission's survey recovered slightly, after eight quarters of consecutive declines. Nevertheless, productive capacity utilisation remains at all-time lows. External demand figures improved considerably in Q3. Thus, the trade balance nominal data reflect higher exports, on average, while the Commission's quarterly industrial opinion survey points to strong growth in export expectations. In step with this widespread improvement in

EURO AREA NATIONAL ACCOUNTS

CHART 8



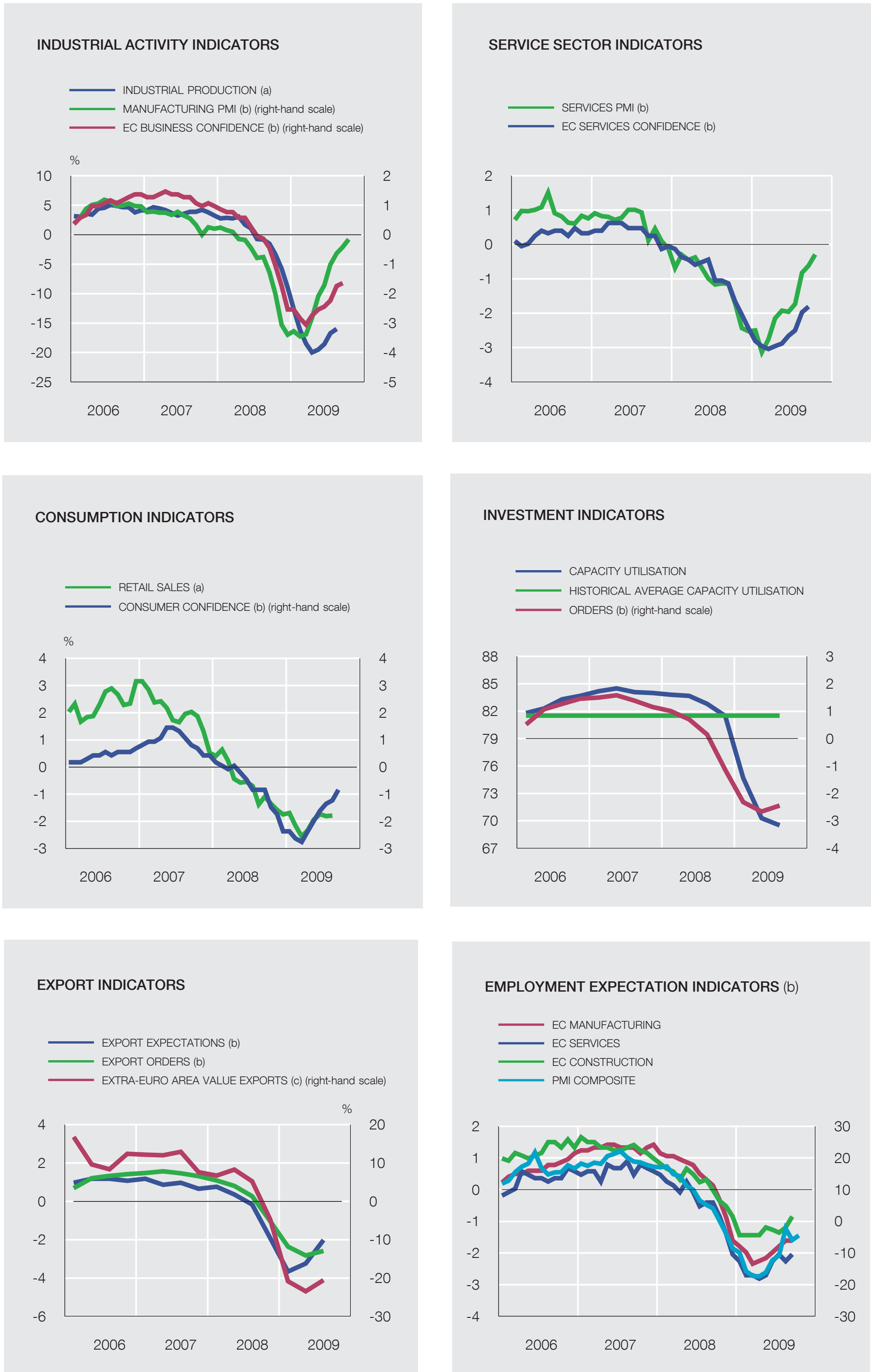
SOURCES: Eurostat and national statistics.

external sector data, the average assessment of order books also recorded a more moderate decline, and lastly, the Commission's stock valuation indicator suggests a slower pace of de-stocking in Q3.

In short, the latest available data point to moderate GDP growth in 2009 Q3, largely driven by external demand and by the substantial macroeconomic impulse provided by monetary and fiscal policy. Moreover, the considerable negative contribution made by the inventory cycle in the first half of the year should become positive in the second half. In this setting, most private analysts and international organisations have raised their economic growth forecasts for the euro area, which now point to a decline of some 4% in 2009 (see Table 2). In the more medium term, these same organisations picture a slow recovery scenario, as some of the factors that may drive GDP in the second half of 2009 are temporary ones. Furthermore, how and when the vulnerabilities present in the euro area economy are dealt with may determine the pace of recovery from the crisis. First, the relative resilience of the labour market and of employment, which has remained contained, backed by temporary measures designed to save jobs by cutting working hours, will be put to the test in coming months. Second, the appreciation of the

EURO AREA. ACTIVITY, DEMAND AND EMPLOYMENT INDICATORS

CHART 9



SOURCES: European Commission, Eurostat and Markit Economics.

a. Non-centred year-on-year rates, based on the quarterly moving average of the seasonally-adjusted series.
b. Normalised series.
c. Original series year-on-year rates. Quarterly average.

GDP AND HICP PROJECTIONS FOR THE EURO AREA (a)

TABLE 2

	2009		2010	
	GDP	HICP	GDP	HICP
ECB (September 2009)	-4.1	0.4	0.2	1.2
European Commission (September 2009)	-4.0	0.4		
IMF (September 2009)	-4.2	0.3	0.3	0.8
OECD (September 2009) (b)	-3.9	0.5		0.7
Consensus Forecast (October 2009)	-3.9	0.3	1.1	1.2
Eurobarometer (October 2009)	-3.9	0.3	1.2	1.1

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

a. Annual rates of change.
b. The inflation data relate to the June projection.

euro exchange rate could make it difficult for optimum advantage to be taken of the external sector momentum (see Box 3). Third, the considerable deterioration of public finances places their sustainability at risk, at least until such time as governments begin to draw up medium-term budgetary consolidation strategies that will not hamper the incipient recovery. And lastly, the international financial crisis and the economic downturn have had a major impact on the banking system, which continues to depend on public support measures and is still deleveraging, and this could limit credit supply growth.

As expected, inflation in the euro area as a whole was negative throughout Q3, as a result of the base effects stemming from last year's high commodities prices (see Chart 10). By component, the growth rate of processed food prices continued to head down, as did that of unprocessed food prices, which turned negative. By contrast, inflation in non-energy industrial goods was stable throughout the quarter. Thus, core inflation, as measured by the overall index that excludes unprocessed food and energy, was more subdued, falling by just 0.1 pp, to 1.1%, between July and September. Towards the end of the year, as the base effects gradually disappear, the rate of inflation will foreseeably return to positive values, but these will remain moderate for some time, in view of relative demand weakness and excess installed capacity. Producer prices continued to contract sharply, declining by 7.5% in August, despite showing signs of an incipient turnaround.

According to information published by the ECB, the euro area current account deficit totalled €54.1 billion (1% of GDP) in the period January-July 2009, slightly more than the €48.7 billion deficit (0.9% of GDP) recorded in the same period of 2008. This increase in the deficit was essentially due to the deterioration of the positive services balance, which was only partially offset by the improvement in the positive balance on trade in goods, while the income and transfers deficits remained unchanged. By contrast, in respect of the financial account, net capital outflows in the form of direct investment amounted to €42.1 billion in the period January-July (down on the €131 billion recorded in the same period a year earlier), while portfolio investment gave rise to net inflows totalling €250.4 billion, €100 billion more than a year earlier. Accordingly, the basic balance, which aggregates the current account balance and these two types of investment, was positive to the tune of €154.2 billion, in contrast to the deficit of €36 billion recorded in the period January-July 2008 (see Chart 11).

The available data on the budget outturn point to a marked deterioration of fiscal balances in 2009, in excess of that estimated by the European Commission in its spring forecasts. Thus, according to the latest figures reported by the different countries under the Excessive Deficit

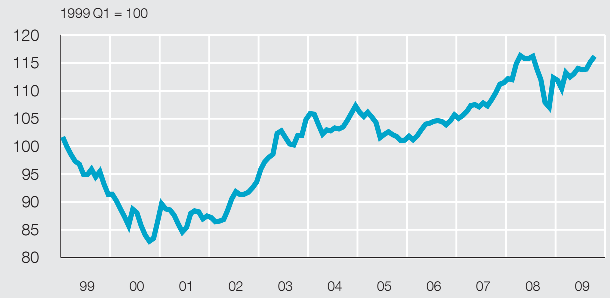
In October, the nominal effective exchange rate (NEER) of the euro returned to the all-time highs seen in mid-2008. As Panel 1 shows, since end-2008 the effective exchange rate has turned upwards again, in line with the path tracked since 2006 and that was interrupted in mid-2008, coinciding with the episode of severe instability on the global financial markets when some international investors came to view dollar-denominated government assets as safe-haven assets. Since bottoming most recently in November 2008, the NEER of the euro has appreciated by more than 8%, as extreme risk aversion has gradually diminished. The European currency has been generally strong vis-à-vis the currencies of the euro area's main trading partners since then, though most especially against the dollar, the renminbi and sterling (see Panel 2).

There is some empirical evidence to suggest that, at present levels, the NEER of the euro is above equilibrium, although there is much uncertainty regarding the extent of this possible overvaluation, so these calculations should be treated with great caution. Specifically, using three different approaches – macroeconomic balance, equilibrium real exchange rate and external sustainability – the International Monetary Fund[1] estimates that the euro exchange rate may have deviated from its estimated equilibrium level, on data to March 2009, by between 0% and 15%. Given the latest NEER moves, the present deviation would be greater.

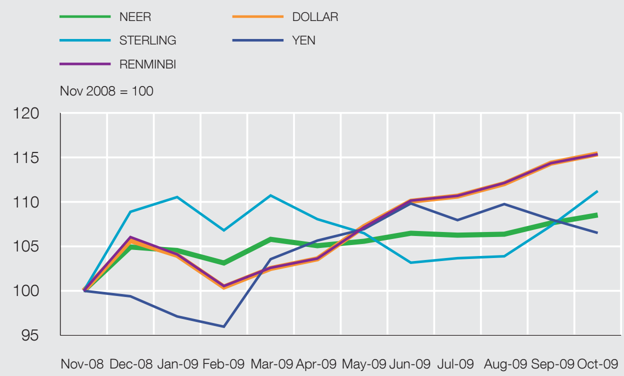
Various macroeconomic models may be used to assess the effects of fluctuations in the euro exchange rate on activity and prices in the euro area. In these models, the exchange rate transmission mechanism runs essentially via the repercussions on foreign trade. Euro exchange rate appreciation, for example, signifies lower extra-euro area import prices (measured in euro) and, therefore, a lower rate of

1. IMF, *Euro Area Policies: 2009 Article IV Consultation-Staff Report*, July 2009.

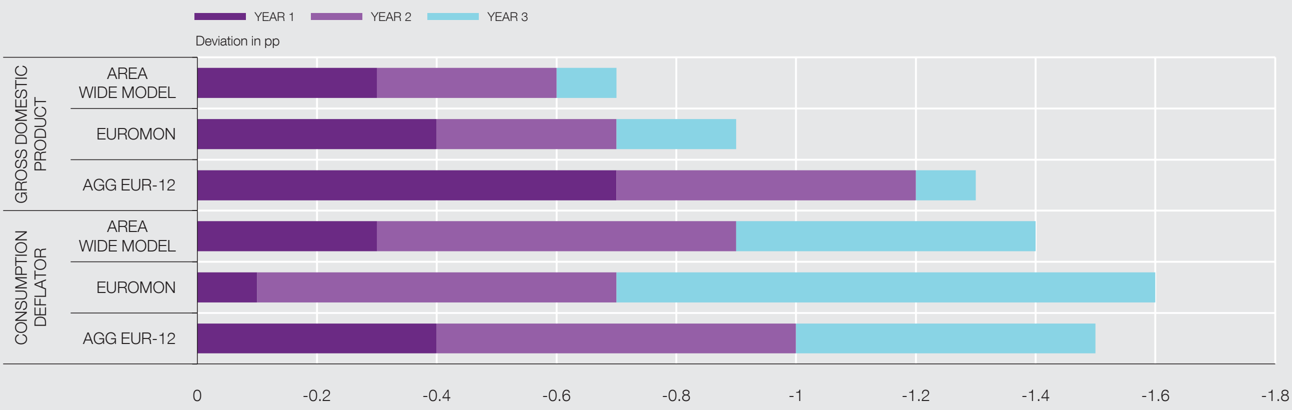
1 NOMINAL EFFECTIVE EXCHANGE RATE (NEER) OF THE EURO



2 NEER OF THE EURO AND BILATERAL EXCHANGE RATES



3 OUTCOME OF A 10% APPRECIATION OF THE NEER OF THE EURO (a)



SOURCES: ECB and G. Fagan & J. Morgan (2005), *Econometric Models of the Euro-area Central Banks.*

a. Estimates obtained using ECB and Eurosystem national central bank models: the Area Wide Model (AWM) is the ECB model that aims to proxy the behaviour of the euro area as a single economy; the EUROMON is a multi-country model of De Nederlandsche Bank (the central bank of the Netherlands); and AGG EUR-12 is the result of aggregation of the elasticities of the macroeconomic models of the national central banks of the euro area.

change of consumer prices and of the GDP deflator. Moreover, the loss of price-competitiveness stemming from NEER moves will prompt changes in net external demand, due to the impact on export and import volumes. Secondarily, lower momentum in final demand – linked to lower exports – gives rise to lower productive investment by firms and lower employment and, consequently, to lower disposable household income and expenditure. In turn, wage demands will react to changes in the economic situation, prompting a slowdown in production costs that will tend to offset the effects on activity, at least in part, and to strengthen the effects on prices.

Drawing on the results of these models, a permanent 10% increase in the NEER of the euro may signify a decline in the rate of growth of activity of 0.3 pp to 0.7 pp of GDP after one year, along with a drop in inflation, in terms of the consumption deflator, of 0.1 pp to 0.4 pp (see Panel 3). Moreover, it is estimated that the total pass-through to the euro area economy would be completed approximately by the third year, giving rise, vis-à-vis the central scenario, to a cumulative decline of 0.7 pp to 1.3 pp in terms of GDP and of 1.3 pp to 1.6 pp in terms of the consumption deflator.

Procedure (EDP), the general government budget deficit of the euro area is expected to amount to 6.1% of GDP in 2009, compared with 1.9% in 2008 (see Table 3), and to 6.6% of GDP in 2010. This worsening is due to temporary factors connected with the impact the economic cycle is having on public finances and the gradual implementation of discretionary fiscal stimulus measures (estimated as verging on 1.1% in 2009 as a whole and on 0.8% in 2010), and to more permanent factors, mainly connected with the disappearance of the extraordinary revenue recorded in the economic boom years, and especially the revenue linked to real estate and financial expansion.

At a disaggregated level, in 2009 the budget deficits of most euro area countries will exceed the reference value of 3% of GDP set in the Stability and Growth Pact. Thus, on 7 October, the European Commission resolved to launch the excessive deficit procedure for Austria, Belgium, Germany, Italy, the Netherlands, Portugal, Slovenia and Slovakia (and for the Czech Republic), so that, at present, Cyprus, Luxembourg and Finland are the only euro area countries not subject to this procedure.

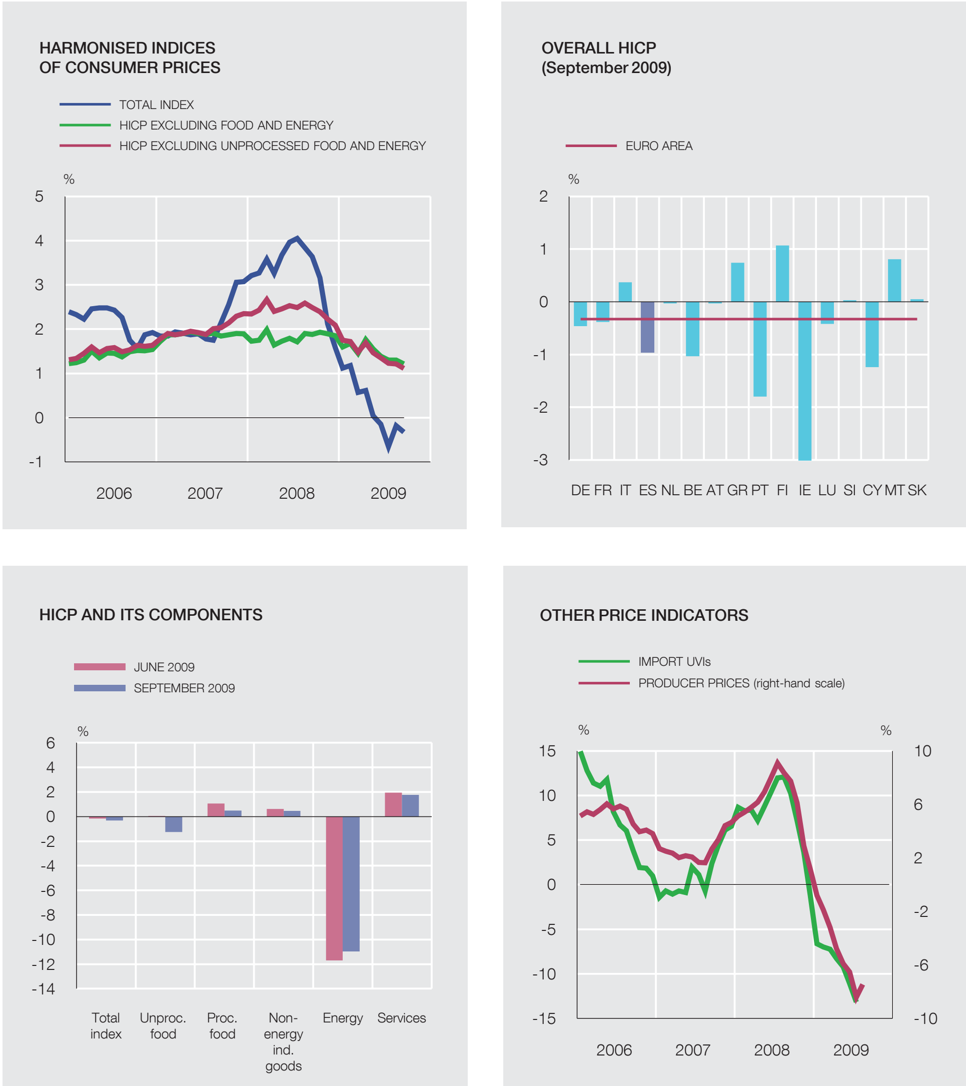
In this setting, public debt is rising substantially and is expected to reach 84% of GDP in 2010, against 69.4% in 2008. The marked deterioration of public finances, along with the risks connected with the contingent liabilities acquired by general government under the banking sector bail-outs and ageing-related costs, reflect the difficult balance required of fiscal policy, which must continue to contribute to the growing stabilisation of activity in the short term, and at the same time prepare a medium-term structural consolidation strategy that will rule out any doubts regarding the future sustainability of the debt position. In this respect, at the ECOFIN meeting of 1-2 October, governments agreed that the stability programmes to be presented in early 2010 would include exit strategies envisaging withdrawal of the demand stimulus measures when economic recovery becomes consolidated. In light of the marked decline in budget balances, it was also agreed that fiscal consolidation efforts should exceed the 0.5% of GDP per year established in the Stability and Growth Pact, especially in the countries with the highest deficits and public debt levels.

3.2 Monetary and financial developments

As the global financial situation continued to improve in Q3, likewise in the euro area: risk premia narrowed further, stock markets rose substantially and volatility declined on these markets and on the foreign exchange markets. The momentum on the primary markets and the lower recourse had by banks to State guarantees also reflected this progressive normalisation. The quarter also saw the first announcements of repayment of the public funds received at the peak of the crisis.

EURO AREA. PRICE INDICATORS
Year-on-year rates of change

CHART 10

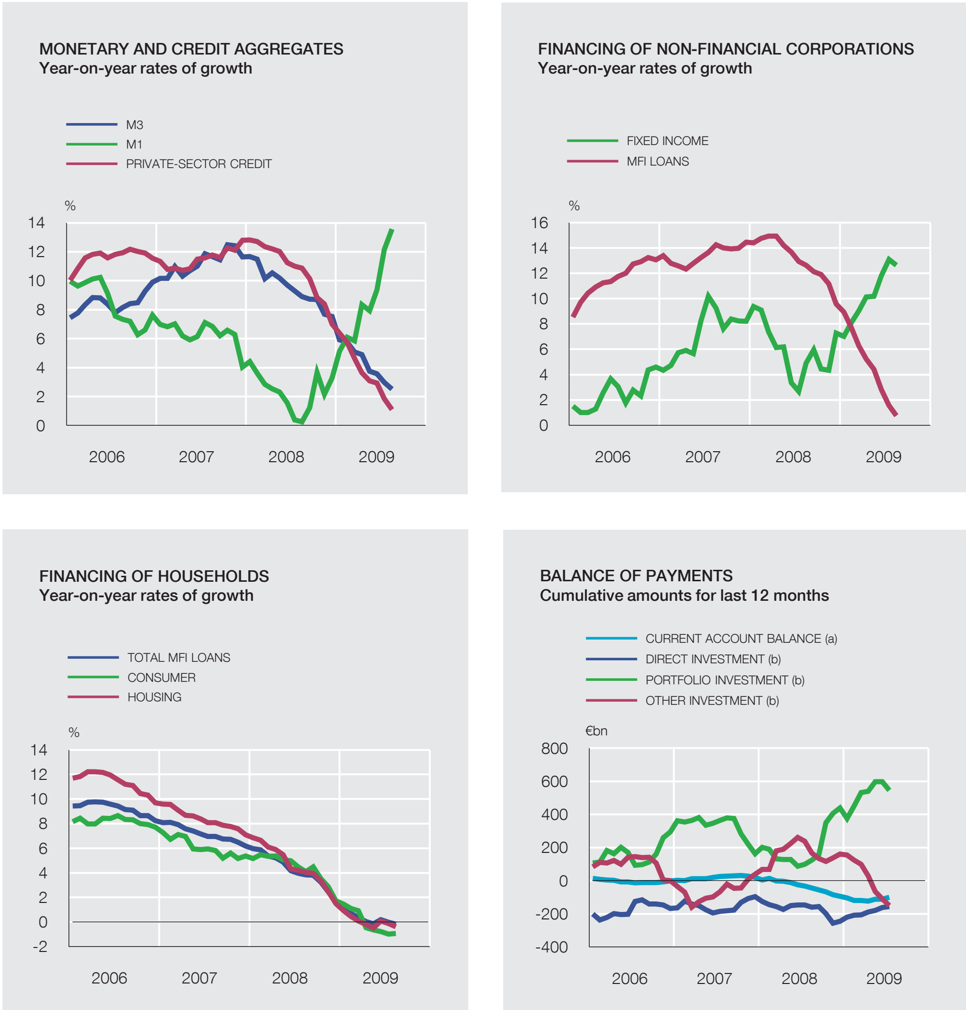


SOURCES: Eurostat and ECB.

Important progress was made towards establishing a new supervisory architecture in Europe, with the European Commission's legislative proposal for the creation of two supervisory bodies: the European Systemic Risk Board (ESRB), which will be responsible for macro-prudential supervision; and the European System of Financial Supervisors (ESFS), which will strengthen micro-prudential supervision.

The financial market recovery that began in March was backed by signs of an incipient turnaround in the global macroeconomic situation, and by the extraordinary measures taken by governments and monetary authorities in the last year. However, in addition to being dependent on these public measures, the financial situation also continues to be marked by great uncertainty and persistent fragility. Thus, the banking system remains subject to a process of restructuring and deleveraging and, as revealed by the latest ECB and IMF estimates, is still exposed to high potential losses stemming from credit risk. Furthermore, bank lending conditions remained tight and this, together with sluggish demand, meant that private sector financing continued to decelerate over the summer.

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS — CHART 11



SOURCES: ECB and Banco de España.

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

The ECB's Governing Council kept its main refinancing operations rate at 1%, and its marginal deposit and lending facilities rates at 0.25% and 1.75%, respectively, throughout Q3 (see Chart 12). This decision was taken against the backdrop of growing signs of economic stabilisation, prospects of the rate of inflation returning to moderately positive levels in coming months, and signs that inflation expectations for the medium and long term are firmly anchored at levels compatible with the monetary policy target (inflation rates below – but close to – 2%).

Moreover, the ECB maintained its ample liquidity supply policy, meeting all requests for funds at its weekly and longer-term refinancing operations, including the second tender for funds with a maturity of 12 months, made at a fixed rate of 1% at end-September. In turn, by mid-October, the Eurosystem's covered bond purchase programme launched in July had reached more than 30% of its target volume (€60 billion up to mid-2010). This initiative had a considerable impact on the covered bond market, as the premia traded decreased and the issue volume rose. Lastly, in agreement with the Federal Reserve, the ECB extended its dollar liquidity operations (at 7 days) to January 2010 and stopped its operations at 84 days due to low demand.

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES

TABLE 3

% of GDP

	BUDGET BALANCES (a)					
	2007	2008	2009		2010	
		EDP (c)	EC (b)	EDP (c)	EC (b)	IMF (d)
Belgium	-0.2	-1.2	-4.5	-5.9	-6.1	-6.3
Germany	0.2	0.0	-3.9	-3.7	-5.9	-4.6
Greece	-3.7	-7.7	-5.1	-12.5	-5.7	-7.1
Spain	1.9	-4.1	-8.6	-9.5	-9.8	-12.5
France	-2.7	-3.4	-6.6	-8.2	-7.0	-7.1
Ireland	0.3	-7.2	-12.0	-11.9	-15.6	-13.3
Italy	-1.5	-2.7	-4.5	-5.3	-4.8	-5.6
Luxembourg	3.7	2.5	-1.5	-2.2	-2.8	-4.4
Netherlands	0.2	0.7	-3.4	-4.8	-6.1	-5.7
Austria	-0.6	-0.4	-4.2	-3.9	-5.3	-5.6
Portugal	-2.6	-2.7	-6.5	-5.9	-6.7	-7.3
Slovenia	0.0	-1.8	-5.5	-5.9	-6.5	-5.6
Finland	5.2	4.5	-0.8	-2.7	-2.9	-4.2
Malta	-2.2	-4.7	-3.6	-3.8	-3.2	-4.4
Cyprus	3.4	0.9	-1.9	-2.9	-2.6	-6.3
Slovakia	-1.9	-2.3	-4.7	-6.3	-5.4	-4.4
MEMORANDUM ITEMS: Euro area (including Cyprus, Slovakia and Malta):						
Primary balance	2.3	1.1	-2.3		-3.3	
Total balance	-0.7	-1.9	-5.3	-6.0	-6.5	-6.6
Public debt	66.0	69.3	77.7	78.4	83.8	

SOURCES: European Commission, Eurostat and IMF.

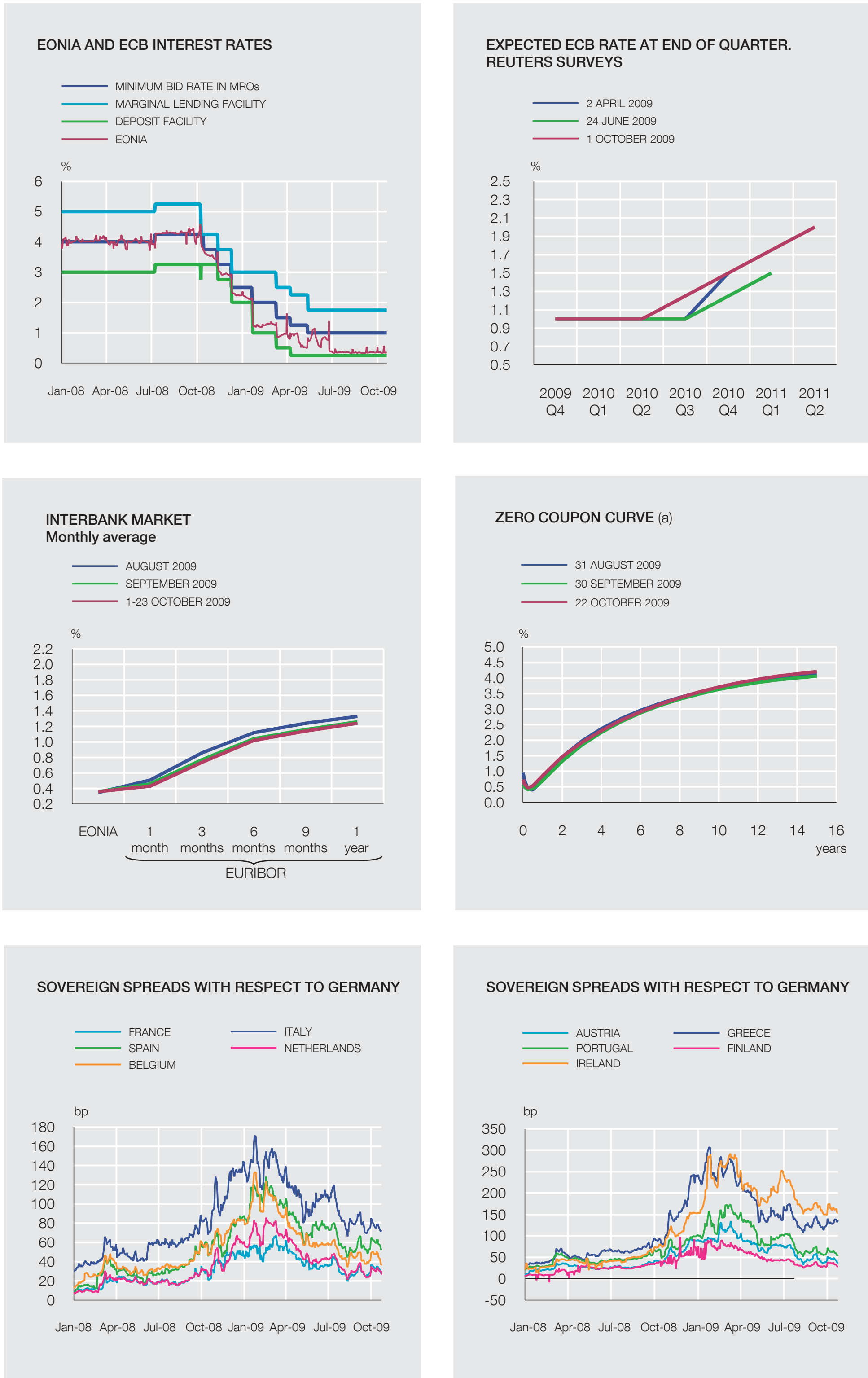
a. Deficit (–) / surplus (+). Cells in which the deficit exceeds 3% of GDP have been shaded.
b. European Commission April 2009 forecasts.
c. Notification of Excessive Deficit Procedure, autumn 2009.
d. IMF October 2009 forecasts.

Interest rates on interbank deposits continued to decline in the quarter. Reflecting the ample liquidity position, the overnight market rate (EONIA) slipped well below the main refinancing operations rate, averaging close to 0.35% since July. Risk premia – proxied as the spread between the EURIBOR and repo rates at the same maturity – continued to decline, to less than 40 bp in 3-month operations, and in October the EURIBOR fell to lows verging on 0.75% and 1.25% for deposits at three and 12 months, respectively (see Chart 13). The cumulative decline in interest rates continued to feed through to the cost of loans, albeit unevenly, largely reflecting the differences in risk and in the interest rate fixation period. Thus, while the cost of consumer loans remained high (above 7% in August), the cost of large business loans (more than €1 million) fell below 2.5%, signifying a cumulative decrease of almost 320 bp on a year earlier.

Private sector financing continued to lose momentum, on the back of lower demand, as economic activity and investment remained weak and credit conditions tightened. According to the October Bank Lending Survey (BLS), there was no significant change in Q3 in credit standards, which remained tight. In turn, the first half-yearly survey on access to financing for SMEs shows that access to bank lending became more difficult in 2009 H1. Some 17% of the companies surveyed said they had difficulties accessing financing, although the majority – some 77% – said they had received all or part of any funds requested, while 12% of applications for funds were rejected.

EURO AREA INTEREST RATES

CHART 12

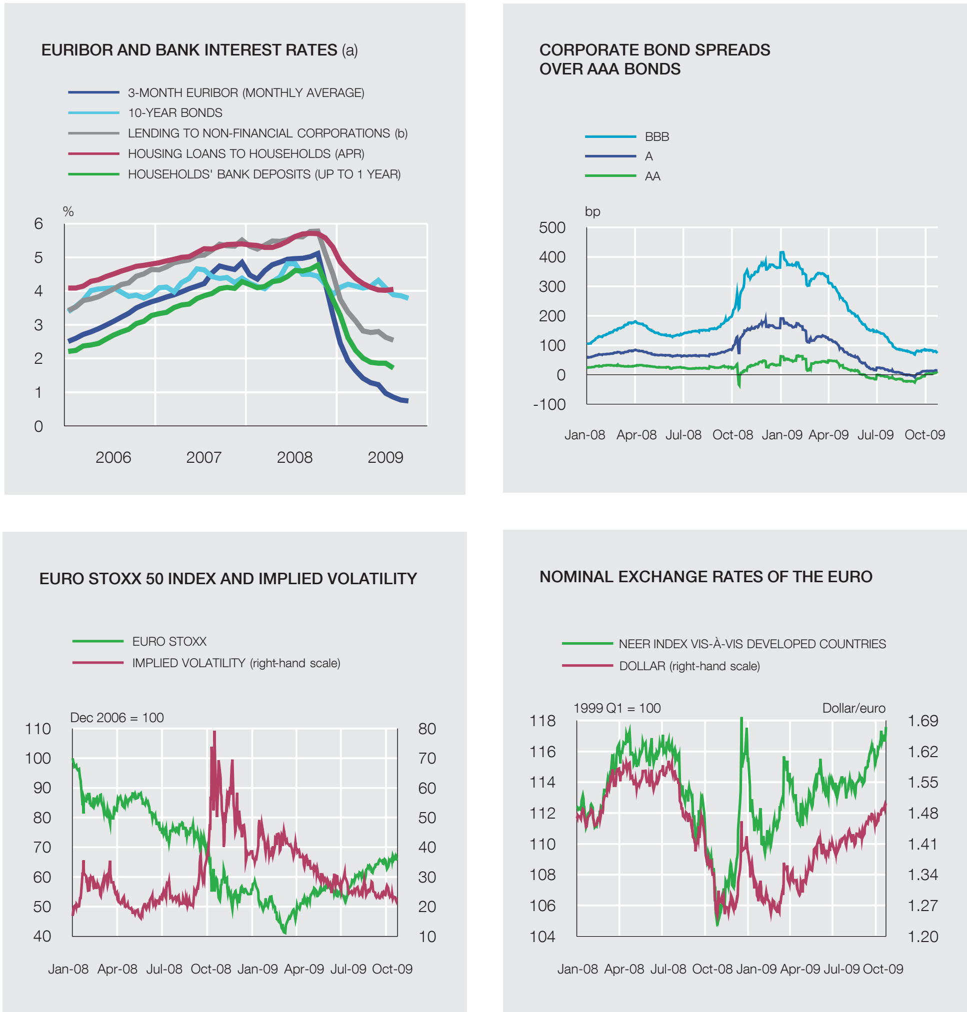


SOURCES: ECB and Banco de España.

a. ECB estimate using swap market data.

EURO AREA INTEREST RATES, STOCK MARKET INDEX AND EXCHANGE RATE

CHART 13



SOURCES: ECB and Banco de España.

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

Against this backdrop, the rate of growth of bank lending for non-financial corporations fell to 0.7% year-on-year in August, while for households it remained close to zero. A breakdown of lending by purpose shows that housing and consumer loans fell slightly year-on-year. In business loans there was a widespread slowdown in all maturities, although the rates of growth differ substantially, falling by almost 9% year-on-year in the case of loans for up to 12 months, but climbing by some 4% year-on-year in the case of loans with longer maturities. Moreover, the notable slowdown in the rate of growth of business overdrafts – comparable to credit lines in most euro area countries – reflects companies' increased use of this source of financing at the start of the crisis, to adjust to lower cash flow levels and the extremely tight conditions on new loans. However, the slowdown in business loans continued to be partially offset by an increase in long-term fixed-income issues, whose outstanding volume grew by more than 20% year-on-year to August.

Despite the increased financial stability and the investment flows in recent months towards higher-risk assets, government bond yields in the euro area have tended to decline, to a monthly average of 3.8% at the date of this report going to press, compared with 4.3% in June. This is a similar move to that seen in the United States, where 10-year sovereign bond yields were some 40 bp lower than in the euro area in October. Spreads on the different sovereign bonds within the euro area also narrowed to August, remaining relatively stable thereafter.

The gain in confidence was also apparent in the lower risk premia on the private fixed-income markets, both for financial and non-financial corporations. Moreover, risk spreads on the covered bond market continued to narrow, backed by the ECB's covered bond purchase programme.

The recovery was once again most keenly reflected on the world equity markets, as the climb in stock prices that began in March continued, resulting, in the case of the EURO STOXX 50 index, in a gain of 18% in the year at the date of this report going to press. Furthermore, as the uncertainties diminished, market volatility continued to decline (see Chart 13).

Volatility also continued to fall on the foreign exchange markets and, as from July, the euro appreciated notably against both the dollar and sterling (by 3.6% and 6.7%, respectively, in Q3) (see Chart 13). In October, the nominal effective exchange rate of the euro returned to the all-time highs recorded in mid-2008 (see Box 3).

Lastly, the broad monetary aggregate M3 continued to lose momentum to August, growing by 2.5% year-on-year. The lower short-term interest rates and the positive slope of the yield curve meant that investment continued to switch out of M3, a move reflected in the redemptions of fixed-term deposits and marketable securities. At the same time, the fall in the opportunity cost also supported a shift in assets within M3 in favour of M1 (cash and deposits), which grew by more than 13% year-on-year in August.

4 The Spanish economy

On Quarterly National Accounts (QNA) estimates, the rate of deterioration of the Spanish economy eased off in 2009 Q2 as real GNP fell quarter-on-quarter by 1.1% (compared with -1.6% in the first quarter of the year). By contrast, in year-on-year terms, the drop in GDP sharpened by 1 pp to -4.2% as a result of the strong fall-off in national demand. The contribution of net exports, however, improved by 0.2 pp to 3.1 pp. On the supply side, all branches of activity except those in the primary sector recorded steeper falls than in Q1, including most notably the year-on-year decline of 16.8% in the value added of manufacturing industry. Job destruction quickened to a rate of -7.1%, so the year-on-year growth rate of apparent productivity remained high (3.2%).

According to the available economic information, the fall-off in activity in quarter-on-quarter terms again moderated in Q3. Specifically, it is estimated that the quarter-on-quarter change in GDP was -0.4% (against -1.1% in Q2), while in year-on-year terms GDP fell by 4.1%, which was 0.1 pp less than in the previous period (see Chart 14). This improvement in GDP is partly linked to the effects of certain government measures with a temporary impact (such as the Plan 2000E, to encourage new car purchases, and the State Fund for Local Investment). These measures were reflected in a less marked fall-off in national demand to 6.5% in year-on-year terms. The positive contribution of the external sector continued to be high, although lower than in the preceding quarter, standing at 2.7 pp.

Also on the supply side, the most recent indicators suggest that GDP declined somewhat more slowly in Q3 and that there was a smaller fall-off in employment, which, according to estimates, decreased by 7% in year-on-year terms. Apparent productivity again grew strongly, in line with the previous quarter. This allowed the rate of expansion of unit labour costs to remain relatively moderate, despite the fact that compensation per employee again grew vigorously at a rate well above that of inflation. Thus in Q3 the adjustment of the Spanish labour market again fell exclusively on employment, instead of on wages, unlike in other European countries. Lastly, the CPI again showed negative year-on-year rates of change in Q3, reaching a value of -1% in September. Mention should be made of the notable response of inflation to the weak demand, which led the growth of the CPI excluding unprocessed food and energy to stand at 0.1% at the end of the quarter, the lowest rate in its time series.

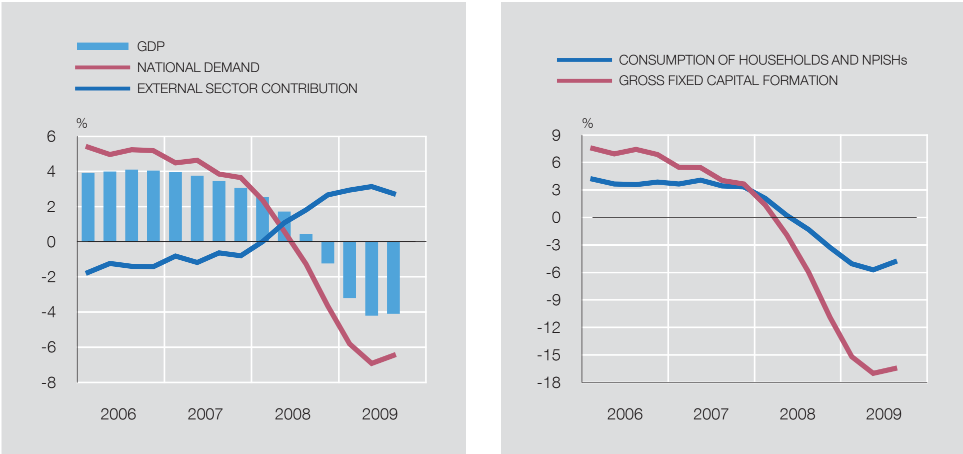
4.1 Demand

2009 Q3 saw the prolongation of the weak final consumption spending by households and NPISHs seen in previous quarters, although the indicators point unequivocally to a lower rate of decline (see Chart 15). Among the survey-based indicators, both consumer and retail trader confidence improved on average in Q3 with respect to Q2 although the latest developments point in both cases to a certain stagnation at low levels, still far below the historical average. As regards quantitative indicators, the retail trade index and the domestic sales of consumer goods and services by large firms provided by the tax authorities showed smaller year-on-year decreases in the average for July and August. Finally, in summer car registrations rose by 18% year-on-year in September, this development being closely tied to the stimulus provided by the Plan 2000E.

The persistent weakness of household consumption is explained above all by the uncertainty derived from the marked deterioration in the labour market, by the negative impact of job destruction on wage income and, to a lesser extent, by the tight credit terms and by the negative effects of the downward trend in house prices on household real estate wealth. These factors

MAIN DEMAND AGGREGATES (a)

CHART 14

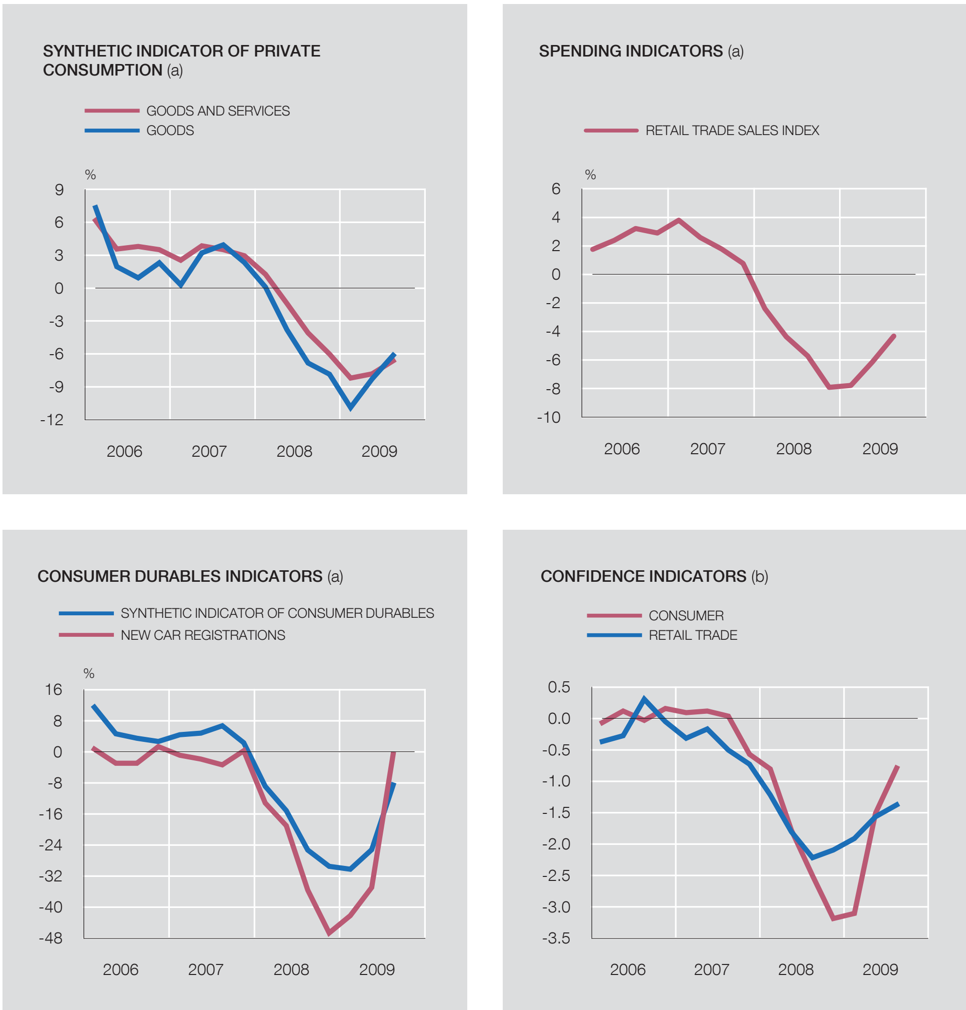


SOURCES: INE and Banco de España.

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.

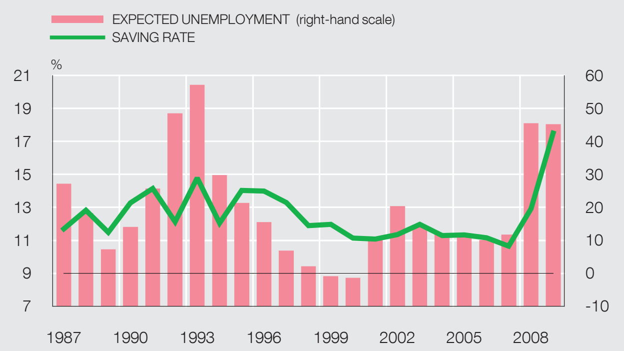
a. Year-on-year percentage change based on the seasonally adjusted series.
b. Normalised indicators (deviation from the mean, divided by the standard deviation).

The current recession of the Spanish economy has brought a sharp decline in household consumption. Since this decline in consumption exceeds the adjustment in household disposable income, the saving rate has increased notably. In terms of moving four-quarter periods, the saving rate stood at 17.5% in 2009 Q2, nearly 7 pp more than in 2007 and also above the values seen in the crisis of the early 1990s (see Chart 1). Although the household saving rate usually increases in times of weak economic activity, the current increase is much more substantial than that of other periods, such as 1991-1993 and 2002-2003.

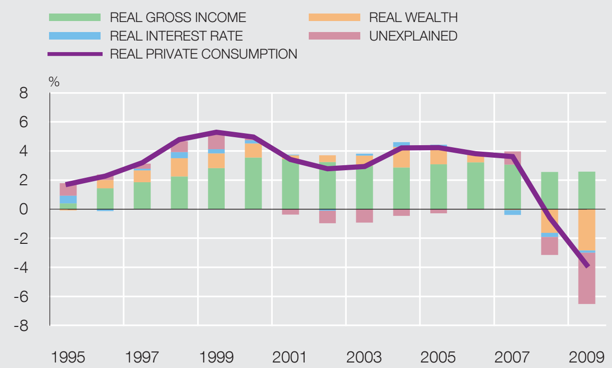
The factors potentially determining the behaviour of the saving rate are diverse. To the extent that households try to smooth their level of consumption over their lifetime, changes in their current income perceived as temporary may not be reflected in spending and thus not lead to changes in saving, with increases in this variable in the periods of higher current income, and vice versa. However, if these changes in income are judged to be permanent, households are likely to adjust consumption to a greater extent. This same response may occur when they are uncertain about their future income, giving rise to increased saving for precautionary reasons when the economic outlook worsens. Also, changes in household real or financial wealth will affect the resources held by them in the medium or long term, and may thus induce an adjustment in consumption and changes in the saving rate (wealth effect). Other variables, such as real interest rates, also affect consumption, since higher rates make future consumption cheaper in relative terms (intertemporal substitution effect), which will increase the saving rate. Additionally, when financial institutions tighten the conditions under which they grant credit to households, some households cannot finance their present consumption by borrowing (or, in other words, by a negative lending ratio) and are forced to increase their saving rate.

These arguments help us to understand the increase in saving observed in Spain in the current recession, although it is difficult to assess the relative importance of each of them. The macroeconomic model of the Banco de España (MTBE) shows that the fall-off in consumption in 2008 and, in particular, in 2009 seems to have gone beyond what would be expected from the recent behaviour of current income and the real interest rate, and from the decrease in Spanish household wealth (see Charts 2 and 3). Specifically, these factors only explain around half of the increase in the saving rate from 2007 to 2009 Q2. Among the factors which may explain this surge in saving are the prospects of household income growth (negatively af-

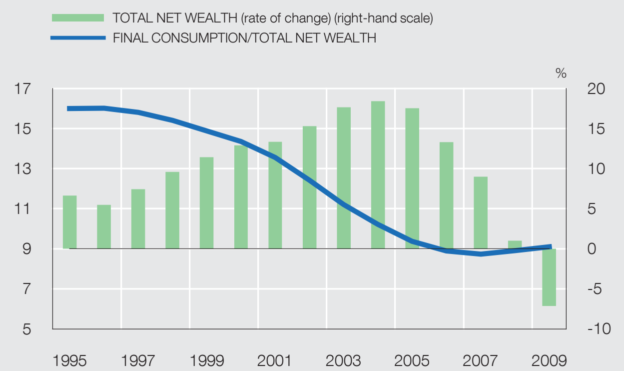
1 SAVING RATE



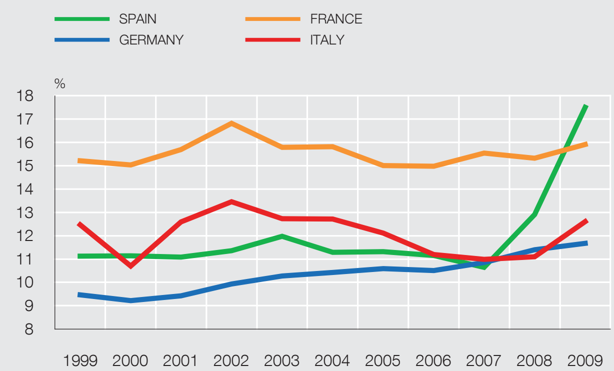
2 PRIVATE CONSUMPTION. CONTRIBUTIONS TO REAL GROWTH (a)



3 CONSUMPTION AND WEALTH



4 SAVING RATE (b)



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

a. Quarterly Macroeconomic Model of the Banco de España (MTBE). In 2009, contributions to cumulative annual growth up to Q2.
b. In 2009, in the case of Spain the chart plots the saving rate for a moving four-quarter period ending in Q2 of each year. For other countries, the 2009 Q1 figure is used.

fected by the sharp deterioration in the labour market), the situation of heightened uncertainty in which consumers have to make decisions (aggravated ostensibly by the financial and economic crisis), the tightening of bank lending conditions through mechanisms other than price and the possible partially Ricardian behaviour of agents as public finances worsen.

These factors, and particularly the weak labour market, may be playing a major role in explaining the recent path of the saving rate in Spain. The fact that Spain is the country where the unemployment rate and saving rate have increased the most in the euro area underscores the importance of employment prospects and their impact on the uncertainties surrounding consumer decisions as factors explaining the behaviour of that variable(see Chart 4).

In the medium term precautionary saving will foreseeably decrease to more moderate levels, although possibly in the coming years, unlike what happened in expansionary phase, the saving rate will remain at levels above its historical average. Nevertheless, looking forward to 2010, the interpretation of the behaviour of the saving rate may be complicated by the rise in VAT in July of that year, since it cannot be ruled out that this tax rise may induce people to bring forward in time a certain volume of spending on durable goods in the first half of the year and, accordingly, to reduce their saving rate. However, this effect would be countered by another of opposite sign in the second half.

have predominated over others which are trending more favourably, such as the low rate of inflation, the moderating credit interest rates, the positive effect on disposable income of net transfers from general government and the increase in financial wealth, which expanded in Q3 due to the ongoing strong recovery of stock market prices first seen in the preceding quarter. According to the latest data on the non-financial accounts of the institutional sectors, which relate to 2009 Q2, the uncertainty of households about their future income (impacted by the extensive job destruction) and about the value of their net wealth led to a jump in the household saving rate which, in cumulative four-quarter terms, reached 17.5% of disposable income. This marks a historical high and is 2.8 pp higher than the rate recorded in 2009 Q1. Box 4 analyses in more detail the determinants of this sharp increase in the saving rate.

Based on the information on personnel costs and net procurements in the State budget outturn, it is estimated that general government final consumption decelerated notably year-on-year in Q3.

In 2009 Q3 investment in capital goods again fell steeply, although there was probably not any additional deterioration in year-on-year terms. Of the conjunctural information available, that on apparent investment in capital goods, with as yet still largely incomplete data, and on industrial/commercial vehicle registrations (available up to September) continued to show strong contraction, although the rate of fall of the latter variable lessened substantially with respect to prior quarters (see Chart 16). Business confidence, both in industry as a whole and, in particular, in the branch producing capital goods, performed more favourably in this period, while the perception of the order book did not change substantially. The sharp decrease in national demand and the still weak external demand, along with the ongoing tight bank lending conditions and the uncertainty over the commencement of a sustained recovery, continued to hold back the start-up of investment projects by non-financial corporations, and these factors were outweighed by the fall in credit interest rates. According to the information on the non-financial accounts of the institutional sectors, the fall in business investment gave rise in Q2 to a decrease in the sector's net borrowing to 5.2% of GDP in cumulative four-quarter terms, down 1.5 pp on Q1. Also contributing to this result, although to a lesser extent, was the increase in business saving due to the decrease in interest and tax payments, which amply offset the lower growth in operating surplus.

The available information suggests that in Q3 the rate of decline of investment in construction steadied in year-on-year terms, albeit at very negative levels (see Chart 16). The overall sector

GROSS FIXED CAPITAL FORMATION

CHART 16

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

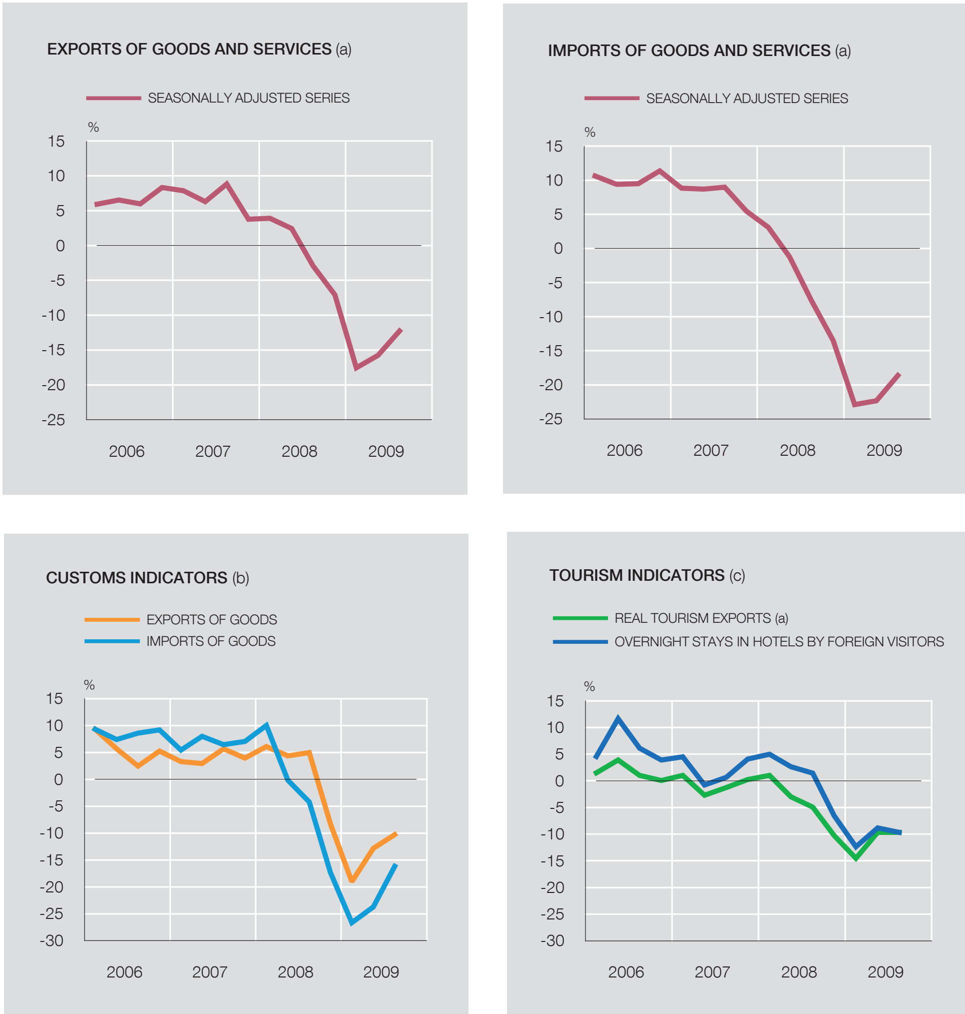
a. Year-on-year percentage change based on the seasonally adjusted series.
b. Normalised indicator (deviation from the mean, divided by the standard deviation).
c. Construction Industry Production Index (Eurostat). Year-on-year percentage change based on the seasonally adjusted series.

indicators relating to inputs (such as apparent consumption of cement and the industrial production index of construction materials), available up to August, and to employment (social security registrations and unemployment), with information up to September, showed more moderate year-on-year falls than in previous quarters. Additionally, the construction business confidence survey showed that construction firms' perceptions of the sector's performance and outlook improved in Q3.

The less unfavourable path of the sector as a whole is explained by the rise in non-residential construction, particularly civil engineering works revitalised through projects linked to the State Fund for Local Investment. This factor seems to have been offseting the additional deterioration of investment in residential building, estimated to have declined more quickly than in the previous quarter as a result of the decrease in the number of houses under construction, as the number of completed units has continued to exceed housing starts (measured by the number of new project approvals). On the housing demand side, the last few months have seen a moderation in the rate of decline of purchases and sales, as shown by proprietary rights transfer statistics and by the number of new mortgages. This somewhat more favourable performance seems to be linked to the improvement in credit accessibility indicators (measured through the

FOREIGN TRADE
Year-on-year percentage change

CHART 17



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

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

level of the instalments that have to be paid in the year following the purchase), which, in turn, is explained by the decreases in interest rates and in house prices. However, as in previous quarters, there are significant factors acting to curb housing demand, such as the uncertainty over household labour income stemming from the increase in the unemployment rate. Finally, non-residential building project approvals showed an appreciable loss of momentum in Q3.

Turning to foreign trade, the latest available information indicates that in 2009 Q3 the positive contribution of net external demand to GDP growth continued to be high, although lower than in Q2. This behaviour took place against a background in which both exports and, above all, imports continued to fall off notably year-on-year (see Chart 17). However, the rate of year-on-year decline of both flows moderated, so that, in quarter-on-quarter terms, exports posted, as in the previous quarter, a positive rate, and imports steadied following the sharp falls of the previous quarters. This recovery in cross-border trade is in line with the less unfavourable international setting, which is reflected in a return to positive growth rates of some of Spain's main trade partners, and with a less negative performance of national demand and industrial production in Spain. As analysed in detail in Box 5, the adjustment of imports has been much

IMPROVEMENT OF THE SPANISH TRADE DEFICIT: ANALYSIS BY PRODUCT TYPE AND GEOGRAPHICAL AREA

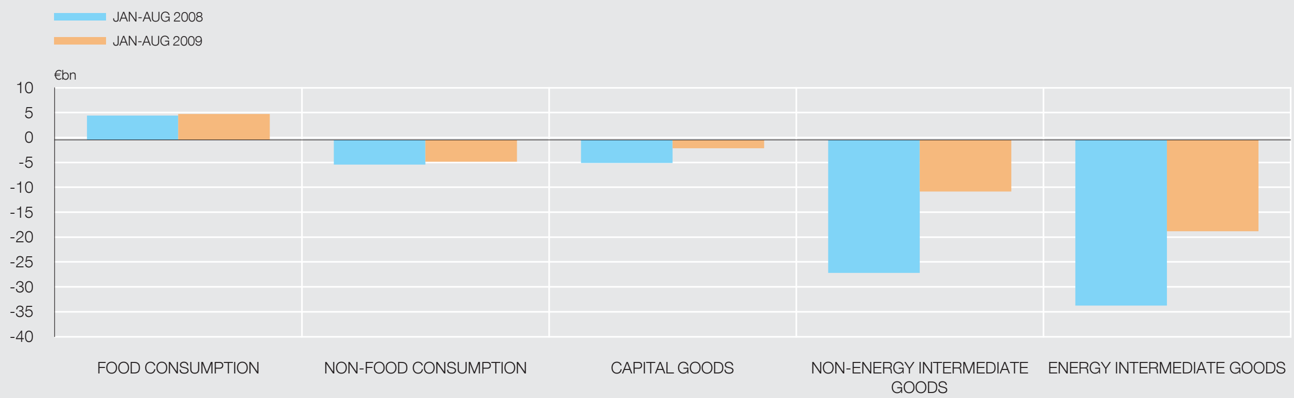
BOX 5

Since the end of 2008 the high trade deficit built up by the Spanish economy in recent years has been undergoing a rapid and significant correction. On Customs data, in the first eight months of 2009 the cumulative deficit was 52% less than in the same period of the previous year. This decrease initially reflected the significant fall in Spanish imports of goods and subsequently became more pronounced due to the improvement in the terms of trade, specifically owing to oil price falls and to the appreciation of the euro. To these two effects should be added the improved performance of exports in recent months, particularly those to the euro area. A disaggregated analysis of the behaviour of the trade balance may help to identify what type of goods or which counterparty countries account for the decrease in the deficit. This may also give an idea as to whether the correction will be of a lasting nature.

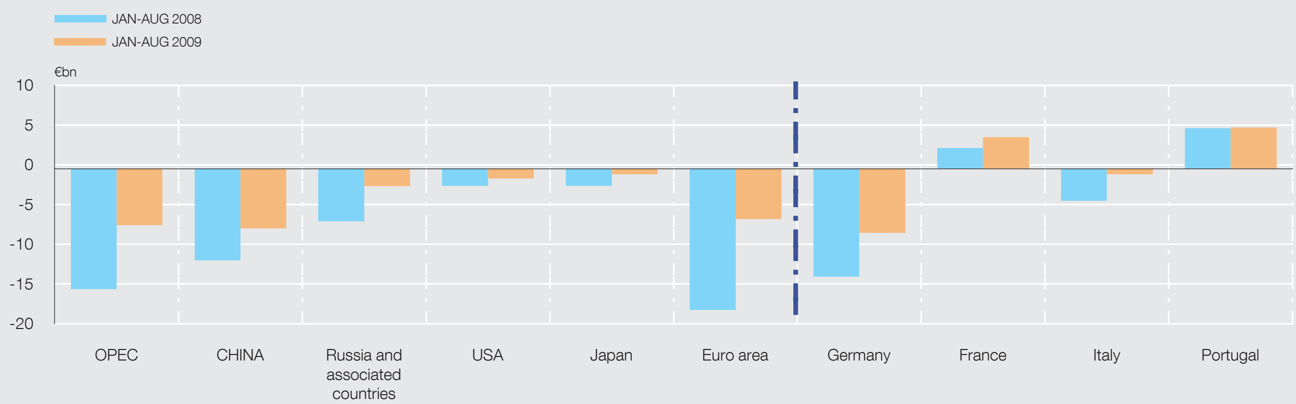
Among the major product groups, the Spanish economy has traditionally only run a surplus in food and automobile trade, while it has posted a deficit in other consumer goods, capital goods and, above all, in intermediate goods, the balance of which represented nearly 90% of the trade deficit in 2008. The trade data for the period January-August 2009 indicate that the decrease in the trade deficit is concentrated precisely in these intermediate goods. The energy deficit decreased to nearly half in that period and the deficit in non-energy intermediate goods fell by 60%. In other goods the variations have been favourable, but less sizeable: the surplus on food (the demand for which is less dependent on the cyclical position of the economy) widened slightly, while the deficit in non-food consumer goods was corrected slightly, as was, to a somewhat greater extent, that in capital goods (see Chart 1). These results reflect the decrease in imports of inputs, against a background of strong contraction in investment and industrial activity and of weakness in private consumption in Spain, as well as the impact of cheaper oil and other commodity prices. Specifically, according to the industrial production index, the manufacture of machinery and mechanical equipment, manufacture of electrical and electronic material and equipment and manufacture of transport equipment sectors, all highly dependent on imports, posted declines of around 30% year-on-year in Spain in the first eight months of 2009. In the case of non-food consumer goods trade, it should be emphasised that the cumulative figure for the year masks the reduction in the negative balance of the durable goods component in recent months, due, above all, to the recovery of automobile exports to the euro area, closely linked to the direct aid for vehicle purchases approved by various European governments.

In the disaggregation by geographical area, Spain has also traditionally shown a negative balance vis-à-vis most other countries, with

1 TRADE BALANCE BY PRODUCT TYPE: LEVELS IN €bn



2 TRADE BALANCE BY GEOGRAPHICAL AREA: LEVELS IN €bn



SOURCE: Ministerio de Economía y Hacienda.

IMPROVEMENT OF THE SPANISH TRADE DEFICIT: ANALYSIS BY PRODUCT TYPE AND GEOGRAPHICAL AREA (cont'd)

BOX 5

Portugal, the United Kingdom and, in recent years, France being the main exceptions. Given the above-mentioned developments in the trade balance by type of goods, it is not surprising that the decrease in the trade imbalance has been particularly significant in the oil exporting countries, such as Russia (our main supplier) and the OPEC countries (see Chart 2). These countries account for around 35% of the total correction to the trade deficit. Second, in line with the notable decrease in capital goods investment and industrial activity, the trade deficit with China decreased substantially (explaining 11% of the total adjustment). Also significant was the decrease in the negative balance with Latin America.

Notable among the more industrialised countries was the decrease in the deficit with the euro area, which represented nearly one-third of the correction in the first eight months of 2009, and, to a lesser extent, the decrease in Spain's deficit with Japan and the United States. In the case of trade with euro area countries, the larger relative decrease in imports (particularly of industrial intermediate goods and capital goods) than in exports in that period explains the observed decline in the trade deficit. Contributing most notably to this correction were the goods transactions with Germany, Italy and France, while the surplus with Portugal remained practically unchanged.

So far the correction to the trade balance has derived mainly from the weakness of imports, against a background of marked sluggishness in demand, and from cheaper commodity prices. Therefore, to permanently lock in a more moderate trade balance, exports will have to play a larger role. In this respect, the growth forecasts published by most international organisations point to a more rapid recovery in world trade than in that predicted for Spain. Hence the improvement in the international markets represents an opportunity for Spanish exports to strengthen and improve their positions, which would allow the trade deficit to be further reduced and would raise the contribution of exports to the growth of activity.

more significant than that of exports, and this has enabled the trade deficit to be reduced substantially. As to the performance of competitiveness indicators, the information to August shows that both the depreciation of the euro (measured in year-on-year terms) and the decrease in relative prices allowed the price-competitiveness indices of Spain vis-à-vis the developed countries to perform favourably in comparison with those at the same dates a year earlier.

The Customs data show that real goods exports decreased year-on-year by 8.1% on average in July and August, a significantly slower rate of fall than that of Q2 (-14.7%). In the first eight months of the year as a whole, however, exports fell off notably by -14.4%, with widespread decreases in the main product groups, particularly marked in exports of consumer durables, intermediate products and capital goods. In the last few months, the steep rate of deterioration of car exports at the beginning of the year lessened thanks to the recovery in European demand for automobiles as a result of the direct aid for car purchases implemented by some of the main European countries. In addition, food exports showed more moderate falls to August (of -1.9%), while certain manufactured consumer products, such as textiles, quickened their positive rates during the period. By geographical area, in recent months Community exports showed notably slower rates of decline, in step with the incipient recovery of the main euro area economies. The more disaggregated information, for which only nominal data are available, revealed that the first eight months of 2009 as a whole saw particularly sharp fall-offs in sales to Russia and the United Kingdom, while exports to the OPEC countries stagnated.

As regards exports of tourism services, the balance of payments information available to July points to a slight easing in their rate of fall in nominal terms. By contrast, the tourism expenditure survey (EGATUR) shows that the nominal spending of foreign visitors decreased by 7% in July and August as a whole, against -5.3% in Q2. In Q3, which is the peak tourism quarter, the fall in inflows of foreign tourists moderated by around 0.4 pp to -7.8%, thanks to the more favourable trend in those from France, while inflows from the other main providers of tourists continued to weaken. In particular, the disaggregation by country of origin shows an especially sharp fall in the case of the United Kingdom (our main provider of tourists), due to the recession in that country and to the depreciation of the pound sterling against the euro. The drop in the number of overnight stays at hotels by foreign travellers steepened in this quarter to -9.5%, 1.6 pp more than the fall in Q2. In the first nine months of the year as a whole, both inflows of tourists and overnight stays in hotels decreased by around 10%. Lastly, the balance of payments data relating to July point to a continued high rate of fall of real exports of non-tourism services in Q3, despite the less unfavourable behaviour at world level of goods trade and passenger traffic.

On the import side, it is estimated from the latest information that the fall in real goods imports slowed in 2009 Q3. In this respect, Customs data show that goods imports fell by 15.8% on average in July and August, clearly below the average decline of 25.7% in Q2. In the period from January to August, real goods imports decreased by 23.4% year-on-year, reflecting the negative performance of national demand and of exports. By product group, the largest adjustments were in imports of capital goods, non-energy intermediate goods and consumer durables. However, the July and August data show a clear decrease in the rate of deterioration of durable goods purchases and of imports of inputs for the manufacture of chemicals, transport equipment and textiles.

Lastly, on balance of payments data for July, the rate of decline of real imports of services lessened somewhat in Q3 due to the tourism payments component, while non-tourism services payments showed a similar fall to that of Q2.

4.2 Production and employment

In Q3 the gross value added of the market economy as a whole continued to fall rapidly year-on-year, although probably less sharply than in the previous quarter. In quarter-on-quarter terms, the fall-off was less marked for the second quarter running, following the low reached in Q1. This behaviour was roughly the same across the main productive sectors (see Chart 18).

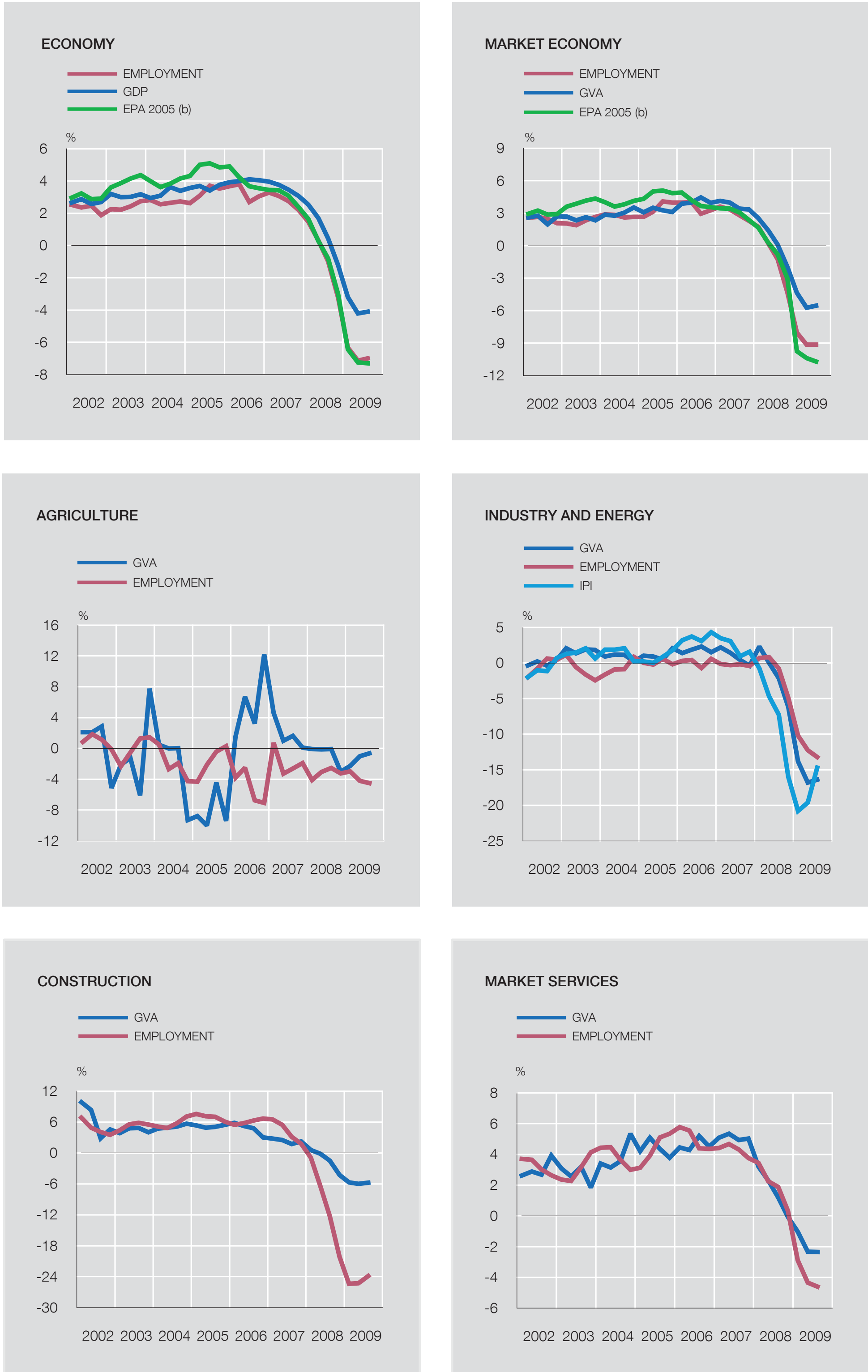
Specifically, on the conjunctural information available, in Q3 the fall in the value added of industry is expected to continue in year-on-year terms, although at a somewhat slower pace than in Q2. Thus, the industrial production index (IPI) contracted in the months of July and August as a whole at a lower rate than in the period April-June. This slight improvement was seen in all types of products, except non-food consumer goods, which, however, were those in which the fall was smallest. Among the labour market indicators, the number of social security contributors showed a similar decrease to that in the previous period. The main survey-based indicators of the sector, such as the purchasing managers' index and the industrial confidence index, continued to show signs of improvement, departing progressively from the lows reached at the beginning of the year.

As regards the market services sector, the latest conjunctural information available points to a year-on-year fall in 2009 Q3 of a size similar to that in Q2. Among the quantitative indicators, the rate of decline of business turnover continued to moderate in July, while the sales of services to large corporations, measured in real terms and seasonally adjusted, posted a decrease of 11.4% on average for July-August, down 2 pp on the previous quarter. Turning to the survey-based indicators, services confidence improved in the quarter as a whole, as did, albeit more timidly, retail trade confidence and the PMI indicator, which still remains at a recessionary level. The employment indicators continued to show notable weakness, with year-on-year falls in average social security registrations in the sector similar to those in Q2.

As for the labour market, the information available to September suggests that the rate of deterioration of employment has slowed. Thus social security registrations decreased by 6% in Q3 as a whole (6.7% in Q2), which represents, for the first time since the current process of

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

CHART 18



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

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

job destruction began, a slowdown in the fall in employment. In terms of seasonally-corrected series, the monthly falls seen in recent months have also been smaller than those at the beginning of the year. The lower year-on-year rate of job destruction in Q3 was concentrated in construction (where declines in social security registrations moderated, probably reflecting the activities relating to the State Plan for Local Investment) and in agriculture (which showed positive growth). By contrast, the rate of decline of average social security registrations in industry and in market services stabilised. Finally, the year-on-year decrease in INEM-registered hires was also less sharp in the period July-September than in the previous quarter.

Lastly, the Spanish Labour Force Survey for Q3 shows a year-on-year fall in employment of -7.3%, practically steady following the -7.2% of the previous quarter. The decrease in employment seems to have affected all branches of the market economy, with the highest year-on-year falls in employment in this quarter in industry (-14.9%) and market services (-6.2%) and a slight moderation of the steep year-on-year rate of decline of employment in construction to -23.3%.

On Spanish Labour Force Survey figures, the fall in employment affected both wage-earners, who decreased by 6.5%, and non-wage-earners (-10.5%). The job destruction was, as in recent quarters, more marked among foreign nationals (-10%), although employment among Spanish nationals also fell sharply (-6.8%). As regards contract duration, the year-on-year rate of decline in temporary employment moderated slightly (-18.2%), although again accounting for nearly all the adjustment in employment, while permanent employment showed a negative year-on-year change (-1.7%). As a result, the temporary employment ratio stood at 25.9%, down 3.6 pp on a year earlier. Lastly, part-time hires decreased slightly in contrast to the sharp fall in full-time employees. Thus, as in the last few quarters, the part-time employment ratio rose again, this time to 12.3%, against 11.4% a year earlier.

The labour force fell by nearly 100,000 people in Q3 as the slowdown of recent quarters steepened to a year-on-year growth rate of 0.2%, 1 pp less than a quarter earlier. This moderation was a result of the deceleration of the population above age 16, which increased by 0.4% (0.3 pp less than in the previous quarter), and, above all, of the year-on-year fall in the participation rate (-0.2 pp), negative for the first time in this quarter in the current recession. The moderation was apparent in both the male and the female labour forces, although the female labour force showed growth of 2.6%, while the male labour force shrank by 1.6%. By nationality, the growth in the number of foreign members of the labour force slowed to 2.5%, mainly as a result of smaller inflows of immigrants (2.1%, against 4.6% in the previous quarter). Spanish nationals in the labour force decreased by 0.2% year-on-year, following a slight increase in the previous quarter (0.5%).

Lastly, unemployment decreased slightly (by around 14,000 people) in Q3 as a result of the decline in the labour force. Nevertheless, the year-on-year increase in unemployment remained high at around 1.5 million people, with a year-on-year rate of change of 58.7%, down from 73.7% in Q2. The unemployment rate held steady at the 17.9% reached in the previous quarter, albeit more than 6 pp above that a year earlier. The INEM-registered unemployment coincided in showing a slower rise in the number of unemployed in Q3, with a year-on-year increase of 43.5%, following a rate of 52.9% in Q2.

4.3 Costs and prices

The data available on collective bargaining agreements registered up to September show an increase in wage settlements of 2.6%, as opposed to 3.6% in 2008 (see Chart 19). These agreements affect somewhat more than seven and a half million workers (nearly 70% of the wage-earners covered in 2008). Although scarcely representative because of the low number

WAGE INDICATORS AND LABOUR COSTS

CHART 19

SOURCES: INE and Ministerio de Trabajo e Inmigración.

a. The last year, with information of collective bargaining agreements until September 2009.
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 signed and with economic effects in the year, this being the first or only year they are in force.

of workers affected (somewhat fewer than half a million), the increase set in the newly signed agreements was also 2.6%, clearly higher than the observed inflation rates.

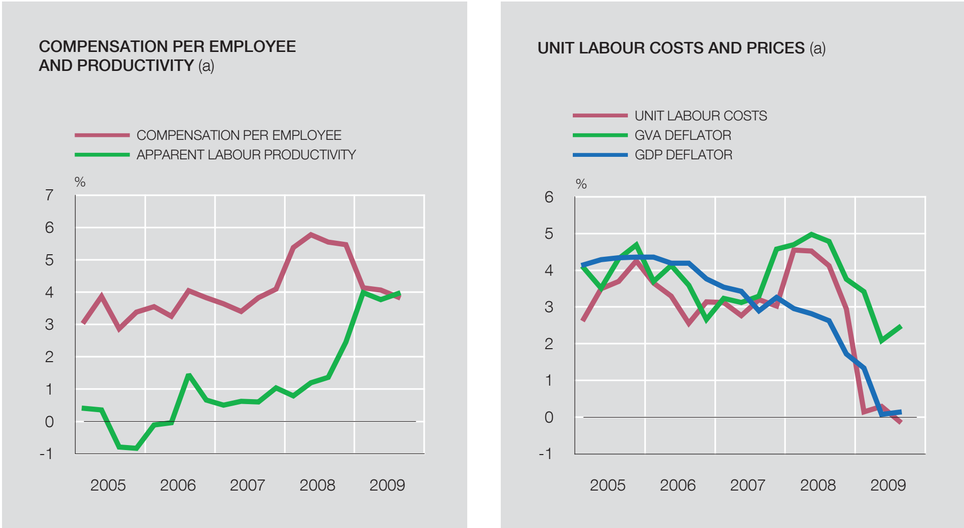
The QNA figures for 2009 Q2 showed a rise in the compensation per employee in the total economy, since the rise of 4.6% year-on-year was 0.3 pp higher than in Q1. In the market economy, the growth of this variable held steady at 4.1%. This reflects notable slippage with respect to the wage increase pacted in the collective bargaining. For this purpose, it should be recalled that the impact of indexation clauses was zero in 2009, so the observed behaviour must relate to a high positive drift explained by the composition effects normally observed in periods of strong job destruction (since comparatively more jobs with lower-than-average compensation were eliminated). In Q3 the growth rate of compensation per employee is expected to slow slightly, although it continued to expand at a substantially higher rate than prices (see Chart 20).

In Q3 the final demand deflator is estimated to have kept falling at the same rate, since both the domestic component of inflation (measured by the GDP deflator) and the import deflator showed similar rates to those of the previous quarter. By final demand component, the decrease in the national demand deflator moderated slightly, unlike the behaviour of the export deflator, which seems to have fallen more sharply. Mention should be made of the expected fall-off in the residential investment deflator (in line with the house price trend) and the ongoing negative rates of change in the private consumption deflator.

In this respect, the various consumer price indicators continued to slow in Q3. Thus in September the CPI decreased by 1%, after reaching a low of -1.4% in July (see Chart 21). In average terms, the fall in Q3 was 1.1%, against -0.7% in the previous period. By component, in the period July-September, energy goods prices continued to show the highest negative rates

PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

CHART 20



SOURCES: INE and Banco de España.

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

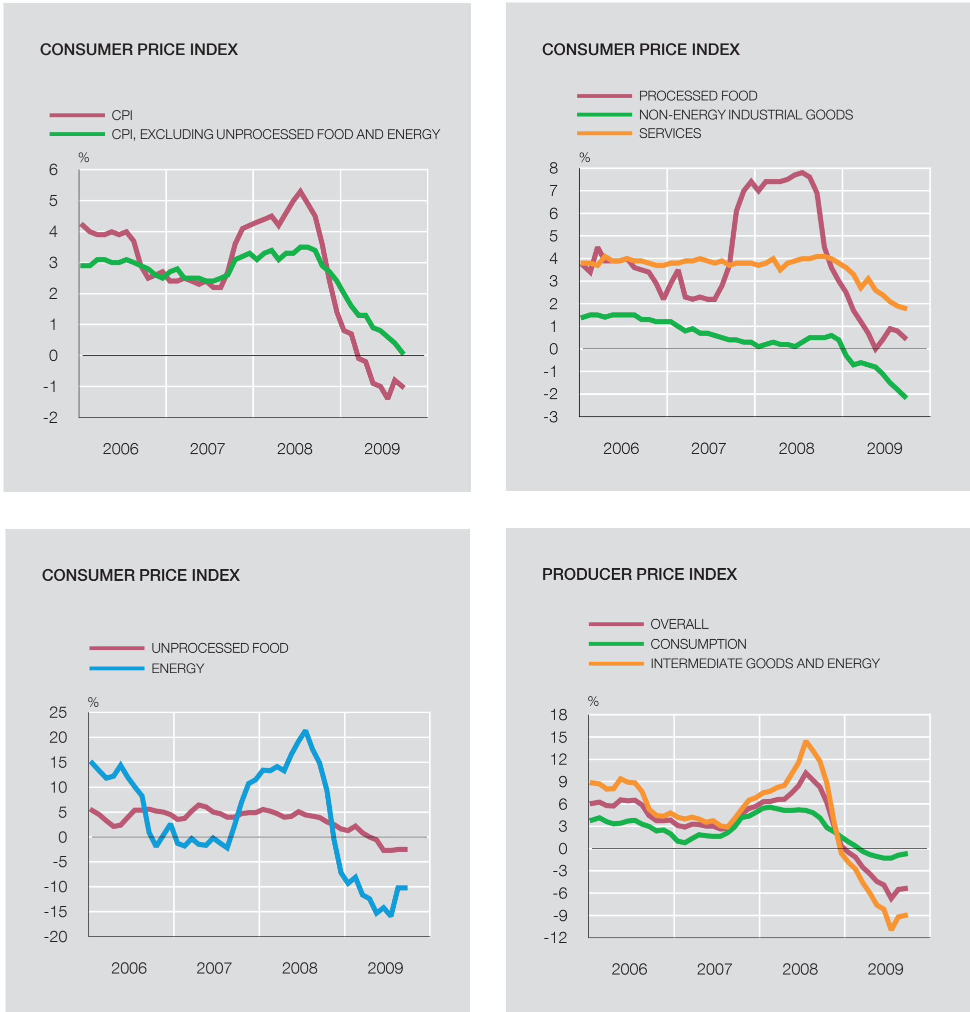
of change (-12.1%), basically due to a comparison effect with the same quarter of 2008, derived from the sharp rise in oil prices until July last year. In addition, dollar-denominated oil prices grew less in Q3 than in Q2, the deceleration being greater when measured in euro because of this currency's appreciation against the dollar. Lastly, this component reflected the drop in natural gas and butane prices. By contrast, the prices of this component were driven upward by the rise in electricity rates and oil taxes. Meanwhile, in Q3 non-energy industrial goods prices decreased by 1.8% amidst a decline in automobile prices, partly related to the incentives introduced to encourage new car purchases. The prices of services, which historically have been insensitive to the cyclical situation, continued to slow notably to an average quarterly rate of 1.9%. The fall in unprocessed food prices accelerated to -2.6%, while processed food prices rose slightly to 0.7%, partly influenced by the rise in tobacco prices in June and July. As a result of the behaviour of its various components, the CPI excluding energy and unprocessed food prices continued the downward path initiated at the end of 2008 and posted a year-on-year rate of 0.4% on average in Q3.

The behaviour of prices in Spain continued to be more moderate than in the euro area, so that the Q3 inflation differential, measured by the harmonised index of consumer prices (HICP) was again negative (-0.7 pp) (see Chart 22). The lesser growth of prices in Spain extended to most components. Specifically, in Q3 on average, the differential was zero in the case of processed food and energy and negative in the other groups, including most notably services, where the differential had been continuously positive (and high) since inception of the euro area until last August.

The industrial price index continued to exhibit negative rates of change in August, although at 5.5% the fall was less than in July. The non-energy component fell by 4% (-4.3% in July). Once again, the easing was particularly marked in energy and intermediate goods prices. In terms of differentials relative to the euro area, the most strongly contrasting behaviour was concentrated in energy and non-durable goods prices. Lastly, the import and export price indices of industrial products held on their markedly declining trend, and in August posted rates of -9.8% and -4.6%, respectively, somewhat less than in July. In both cases, this behaviour resulted from the moderation of the substantial rates of fall of energy prices,

PRICE INDICATORS (a)
Spain

CHART 21



SOURCE: INE.

a. Year-on-year percentage change based on the original series.

partially offset by an additional reduction of the inflationary pressure on other components.

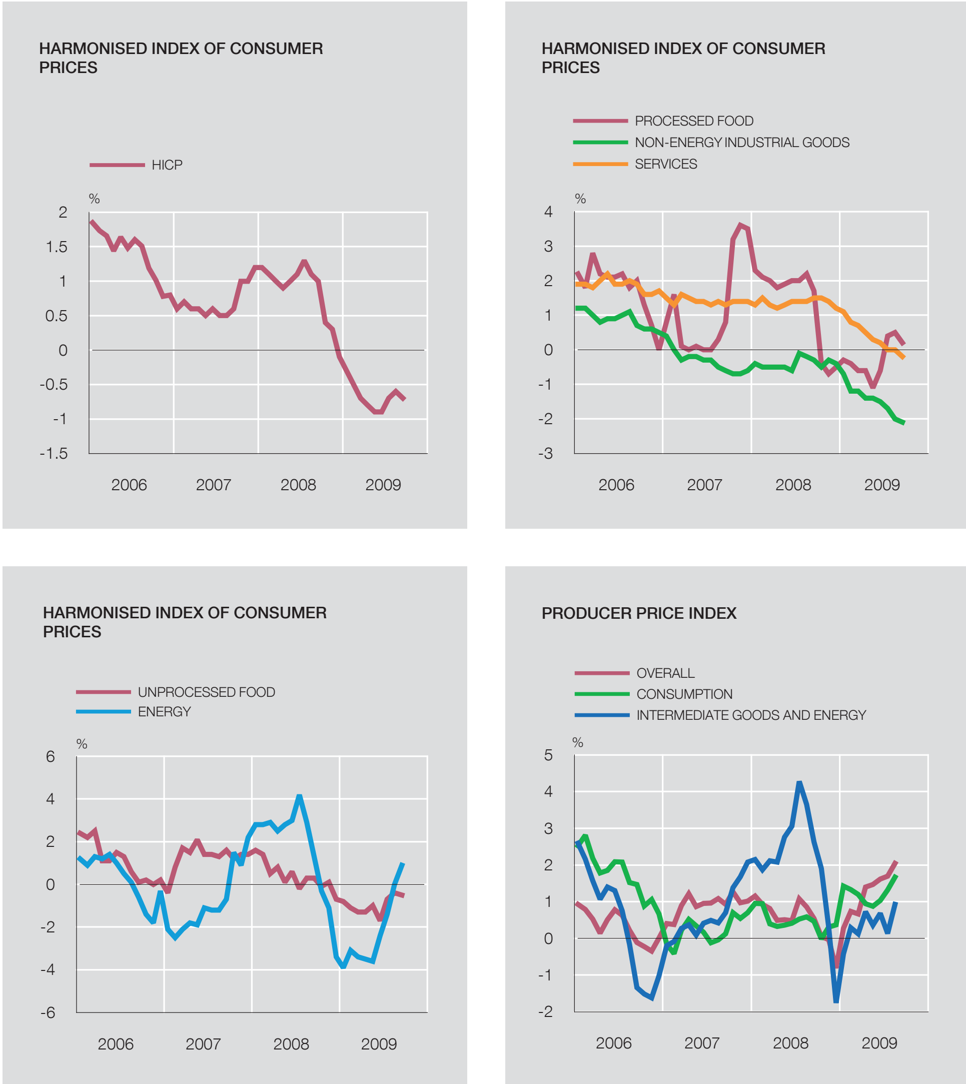
4.4 The State budget

On 26 September the government, acting through the Council of Ministers, approved the draft State budget for 2010, in which the target set was a general government deficit of 8.1% of GDP. This projection represents a slight worsening with respect to the budgetary stability target of 7.9% of GDP approved last June. Also, the State budget projection is that the end-2009 balance of the National Accounts of the general government sector will be a deficit of 9.5% of GDP, which significantly deviates from the initial projection included in the State budget for 2009, in which the deficit was estimated at 1.9% of GDP. The breakdown by sub-sector envisages a central government deficit this year of 8.1% of GDP, while it is estimated that the autonomous (regional) governments and the local governments will end the year with deficits of 1.5% of GDP and 0.3% of GDP, respectively. The social security system will foreseeably post a surplus of 0.4% of GDP.

According to the budget outturn included in the State budget, the State will post a deficit in cash terms of €83.3 billion in 2009, significantly higher than envisaged in the initial budget,

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

CHART 22



SOURCES: Eurostat and Banco de España.

a. Year-on-year percentage change based on the original series.

which put the deficit at €16.8 billion. This difference results from the projected deterioration in revenue (particularly marked in VAT) and from the expenditure overrun, mainly due to the extraordinary transfer to the National Public Employment Service and the State Fund for Local Investment.

The State budget outturn to September resulted in a deficit of €62.8 billion, as compared with the deficit of €13 billion recorded in the same period of the previous year. In Q3 the deterioration of revenue eased up slightly, with a cumulative fall of 24.4%, against the decline of 29.4% up to June, while the already high growth rate of payments rose further to 25.3%, against 22.9% in the first half of the year.

To analyse revenue, information is available on the receipts from the main taxes, including both the portion assigned to the State and that corresponding to the regional governments under the ordinary regime (see memorandum items in Table 3). The aggregate information is more instructive for assessing the receipts from the main taxes and confirms the loss, albeit more subdued,

STATE BUDGET OUTTURN TABLE 4

€m and %	Outturn 2008	Percentage change 2008/2007	Outturn projection 2009	Percentage change 2009/2008	Outturn JAN-JUN Percentage change 2009/2008	Outturn 2008 JAN-SEP	Outturn 2009 JAN-SEP	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	129,335	-19.1	100,682	-22.2	-29.4	93,566	70,701	-24.4
Direct taxes	74,096	-23.6	57,979	-21.8	-34.3	53,912	37.833	-29.8
Personal income tax	*43,413*	*-10.7*	*32,309*	*-25.6*	*-40.0*	*30,582*	*20,739*	*-32.2*
Corporate income tax	*27,301*	*-39.1*	*22,300*	*-18.3*	*-24.7*	*20,703*	*14,404*	*-30.4*
Other (a)	*3,382*	*-4.2*	*3,370*	*-0.4*	*7.0*	*2,627*	*2,690*	*2.4*
Indirect taxes	39,229	-19.0	25,471	-35.1	-39.1	29,258	20,159	-31.1
VAT	*24,923*	*-26.2*	*11,491*	*-53.9*	*-49.4*	*18,380*	*10,742*	*-41.6*
Excise duties	*11,220*	*-2.2*	*11,242*	*0.2*	*-11.2*	*8,520*	*7,349*	*-13.7*
Other (b)	*3,086*	*-4.3*	*2,738*	*-11.3*	*-12.4*	*2,358*	*2,068*	*-12.3*
Other net revenue	16,010	11.1	17,232	7.6	*27.0*	10,395	12,709	22.3
2 EXPENDITURE	148,082	6.0	184,012	24.3	22.9	106,575	133,501	25.3
Wages and salaries	25,266	6.7	26,873	6.4	4.7	18,049	18,918	4.8
Goods and services	4,553	2.2	4,803	5.5	-1.3	2,847	2,894	1.7
Interest payments	15,929	9,6	17,434	9.4	-1.4	13,914	15,317	10.1
Current transfers	82,755	6.5	106,067	28.2	21.5	60,188	77,089	28.1
Investment	10,656	5.4	11,172	4.8	10.3	6,732	6,918	2.8
Capital transfers	8,923	-3.5	17,663	98.0	—	4,846	12,365	155.2
3 CASH-BASIS BALANCE (3 = 1 – 2)	-18,747	—	-83,330	—	—	-13,009	-62,800	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)								
Personal income tax	71,341	-1.8	65,734	-7.9	-19.2	52,569	46,839	-10.9
VAT	48,015	-14.0	29,281	-39.0	-35.8	36,045	23,816	-33.9
Excise duties	19,570	-1.1	20,450	4.5	-4.9	14,679	14,316	-2.5

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.

of receipts seen in the State. Overall, receipts are being affected both by the weak behaviour of tax bases, attributable to the impact of the economic crisis, and by the impact of some discretionary measures. In the case of personal income tax, the amount of withholdings decreased by 3.7% due to the 2 pp cut in the mortgage expense withholding rate for incomes below €30,000 introduced this year and to the residual impact of the tax credit of up to €400 since 2008 H2, which will not be fully offset until the end of the year, while the withholdings on investment fund gains decreased by 47.5%. As for corporate income tax, the final settlements submitted in Q3 showed a sharp fall in receipts. According to the figures in the budget outturn projection, a certain pick-up in overall receipts from direct taxes can be expected in the last part of the year.

According to the cumulative data to Q3 on indirect taxes, VAT again showed the sharpest declines (33.9%), although they were somewhat less marked than in the first half of the year. Along with the fall in consumption and in real estate transactions, VAT receipts are also being affected by two other factors: first, by the negative effect on receipts derived from the somewhat earlier refunds with respect to the normal schedule (which will foreseeably be offset in the last part of the year), and, second, by the new system of monthly refunds due to the regulations introduced this year. In any event, according to the budget outturn projection, the moderation of the falls in Q3 might be temporary, the projected rate of change being approxi-

The Social Security system posted a non-financial surplus of €7,578 million to July 2009, down 33.2% on the same period of 2008. This represented a worsening of the outturn figures with respect to May. The fall in non-financial revenue moderated to a cumulative rate of -0.3%, while expenditure gained momentum and showed a rise of 6%. Thus, non-financial revenue continued below the figures budgeted for the year as a whole (by 8.4% with respect to the 2008 budget), while expenditure was slightly below the budgeted rise of 7.9%.

Revenue from Social Security contributions contracted by 2.2% to July, reflecting the impact of the adverse employment trend on the average number of Social Security registrations, which, on the most recent information, fell by 5.7% to September 2009. As regards expenditure, that earmarked for contributory pensions rose by 6.7%, in line with the growth shown in previous months, although below the 8.5% budgeted for 2009 as a whole. The number of contributory pensions stabilised at a growth rate of around 1.7%, which was higher than the average for the previous year as a whole (1.4%). Expenditure on sickness benefits fell sharply by 26.2%, meaning that it was well below the budgeted increase.

As regards the National Public Employment Service (SPEE, by its Spanish abbreviation), the data for which are not included in the adjoining table, the contributions received fell by 9.7% to May, while rebates on contributions in respect of employment-promoting contracts decreased by 12.3% to April. Expenditure earmarked for unemployment benefits continued to grow significantly (65.7%) year-on-year to August 2009, although this figure represents a certain deceleration compared with previous months. On data to August, the number of beneficiaries rose by 50.9% on the same month a year earlier, while registered unemployment grew by 48% year-on-year in the same period. As a result, the coverage rate in that same month stood at 77.7%, 1.5 pp higher than in August 2008. The latest available information, to September, indicates that the rise in unemployment growth moderated somewhat to 45.7%.

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

€m and %

	Budget	Budget		Outturn JAN-JUL		
	2008	2009	% change	2008	2009	% change
	1	2	3 = 2/1	5	6	7 = 6/5
1 REVENUE	114,113	123,726	8.4	70,415	70,189	-0.3
1.1 Social security contributions	105,107	113,324	7.8	63,668	62,267	-2.2
1.2 Current transfers	6,796	7,439	9.5	4,865	5,387	10.7
1.3 Other	2,209	2,963	34.1	1,882	2,535	34.7
2 EXPEDITURE	106,080	114,476	7.9	59,066	62,611	6.0
2.1 Wages and salaries	2,390	2,453	2.7	1,337	1,399	4.6
2.2 Goods and services	1,996	1,995	-0.1	1,062	945	-11.0
2.3 Current transfers	101,095	109,465	8.3	56,504	59,356	5.0
Contributory pensions	*86,041*	*93,339*	*8.5*	*47,852*	*51,040*	*6.7*
Sickness benefits	*7,716*	*8,144*	*5.6*	*4,327*	*3,196*	*-26.2*
Other	*7,339*	*7,982*	*8.8*	*4,325*	*5,121*	*18.4*
2.4 Other	599	563	-6.0	163	910	—
3 BALANCE	8,033	9,250	15.2	11,349	7,578	-33.2

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 2009.
b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 5

€m		JANUARY-JULY 2008	JANUARY-JULY 2009	RATE OF CHANGE 2009/2008 (b)
CREDITS	Current account	219,932	185,477	-15.7
	Goods	*118,171*	*94,379*	*-20.1*
	Services	*55,497*	*50,409*	*-9.2*
	— Tourism	23,576	21,165	-10.2
	— Other services	31,920	29,245	-8.4
	Income	*37,663*	*32,034*	*-14.9*
	Current transfers	*8,600*	*8,655*	*0.6*
	Capital account	4,803	3,604	-25.0
	Current + capital accounts	224,734	189,080	-15.9
DEBITS	Current account	286,255	220,271	-23.1
	Goods	*173,700*	*119,001*	*-31.5*
	Services	*40,835*	*36,281*	*-11.2*
	— Tourism	7,807	6,630	-15.1
	— Other services	33,028	29,650	-10.2
	Income	*56,320*	*50,704*	*-10.0*
	Current transfers	*15,400*	*14,285*	*-7.2*
	Capital account	762	1,261	65.5
	Current + capital accounts	287,017	221,532	-22.8
BALANCES	Current account	-66,323	-34,795	31,528
	Goods	*-55,528*	*-24,622*	*30,906*
	Services	*14,662*	*14,129*	*-533*
	— Tourism	15,769	14,534	-1,235
	— Other services	-1,107	-406	701
	Income	*-18,657*	*-18,670*	*-13*
	Current transfers	*-6,800*	*-5,631*	*1,169*
	Capital account	4,041	2,343	-1,698
	Current + capital accounts	-62,282	-32,452	29,830

SOURCE: Banco de España.

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

mately -40% at the end of the year. For their part, excise taxes showed growth of 2.5%, partly due to the increases in taxes on oil and tobacco approved at mid-year. Lastly, the items aggregated under the heading "Other revenue" showed relatively high growth to September, partly explained by the fees earned by the State for guarantees on financing transactions entered into by credit institutions within the framework of Royal Decree-Law 7/2008 of 13 October 2008 (on urgent economic and financial measures relating to the concerted action plan of euro area countries) and by the issue premia on public debt issued at a discount.

State cash-basis expenditure increased by 25.3% in cumulative terms to September, accelerating slightly with respect to the first half of the year. This high growth is essentially due to transfers from the State to other general government sectors. Thus, the current transfers include that made to the National Public Employment Service to finance unemployment benefits, and the capital transfers include those to local government by the State Fund for Local Investment. Meanwhile, interest payments also accelerated sharply in Q3, in line with the behaviour of public debt. The budget outturn projection does not foresee significant changes in payments in the last part of the year with respect to the September outturn.

4.5 *Balance of payments*

In the first seven months of 2009, the combined current and capital account balance was a deficit of €32.5 billion, down 48% on the same period of the previous year. The percentage decrease in the negative current account balance was of a similar size, amounting, in nominal terms, to €34.8 billion, which represented a sharpening of the correction trend initiated in the previous year. This decrease is explained basically by the correction of the trade deficit and, to a much lesser extent, by the improvement in the current transfers balance, which offset the decrease in the services surplus. The income deficit remained practically unchanged in year-on-year terms.

In the first seven months of 2009, the trade deficit decreased by 56% in year-on-year terms to €24.6 billion. This rate of decrease is appreciably more pronounced than that in the same period of the previous year. Between January and July 2009, both goods exports and particularly goods imports fell off significantly in real terms, to which must be added the effect of the improvement in the terms of trade. The energy bill decreased in the first seven months of the current year, against a background of decline in net imports of energy products in real terms and of marked decline in oil prices on international markets with respect to the same period of the previous year. The non-energy trade imbalance also decreased, falling even more sharply than the energy deficit.

The services balance showed a surplus of €14.1 billion in the first seven months of 2009, down 4% on the same period of 2008. This decrease is explained by the fall of 8% in the positive tourism balance, which could not be countered by the notable correction in the non-tourism services deficit. Nominal tourism receipts fell by 10% between January and July, while tourism payments fell off by 15%. As regards other services, the first seven months of 2009 saw decreases in both receipts and payments (8% and 10%, respectively).

The negative income balance held practically steady in year-on-year terms in the period January-July 2009. This movement was a result of a fall-off in both payments and, more especially, receipts (10% and 15%, respectively). The current transfers deficit decreased by 17% in year-on-year terms in the first seven months of the year. This development took place against a background of stable receipts, which only grew by 1%, and of declining payments, down by 7%. Finally, the current account surplus decreased by 42% between January and July with respect to the same period of the previous year. This decline was fairly general across the various capital account headings, reflecting mainly the decrease in general government receipts from the various Community funds.

5 Financial developments

5.1 Overview

During 2009 Q3 the normalisation of domestic and international financial markets continued and the confidence of market agents recovered further. Against this backdrop, prices on Spanish stock markets rose and volatility decreased and, at the cut-off date of this article, the IBEX 35 stood 19.9% above its end-June level, a similar rise to that of the EUROSTOXX 50 index of European companies (20.2%) and somewhat higher than that of the S&P 500 for US companies (17.4%). Consequently, in 2009 to date the indices have gained 27.7%, 17.7% and 19.5%, respectively (see Chart 23).

On the interbank markets, interest rates continued to decline, and on 23 October the twelve-month EURIBOR stood at 25 bp below its end-Q2 level. This development was accompanied by a further decrease of 23 bp in the spread between the twelve-month EURIBOR and the twelve-month Eurepo (for secured transactions), which points to the gradual easing of strains on these markets, although this indicator still remained at historically high levels (of around 45 bp).

Interest rates on long-term government debt also fell. Thus, on 23 October the yield on ten-year bonds stood at 3.71% (34 bp below its end-June level). In line with market normalisation, the yield spreads between securities issued by euro area Member States narrowed; in the case of Spanish ten-year bonds the spread over German debt was slightly above 50 bp, 23 bp less than at the close of Q2. Likewise, the credit risk premia of the main Spanish non-financial corporations traded on derivatives markets declined by 25 bp on average to 85 bp.

On the real estate market, according to the latest data from the Ministry of Housing, the price of unsubsidised housing continued to fall during 2009 Q3, albeit at a lower pace than during the preceding months. Thus the quarter-on-quarter and year-on-year rates of decline stood in September at 0.9% and 8%, respectively, in comparison with the declines of 1.9% and 8.3% in June (see Chart 23).

The cost of bank credit for households and companies generally continued to decrease in line with market yields (see Chart 23). The spreads over the latter remained relatively stable during Q3, albeit at high levels in comparison with those before the beginning of the last cycle of interest rate declines, especially in the case of higher-risk transactions. These data seem to confirm, therefore, that this rise is a result not only of the usual lag in the pass-through of interest rates, but it also includes a re-assessment of risk by institutions (for more details, see Box 7). Further, the cost of issuance of corporate fixed-income securities at both short and long term and, more significantly, that of issuing equity, moved downward. However, according to the October Bank Lending Survey (BLS), other lending conditions (term, security required) seem to have tightened again, although at a more moderate rate than in previous months.[1] The same survey shows that banks' approval criteria were relatively stable between July and September. The forecasts for 2009 Q4 indicate that lending criteria will remain approximately unchanged and that corporate and household demand for credit will fall moderately, although, as a result of the previous months' tightening, credit conditions during this period will foreseeably be stricter for borrowers than those prior to the financial crisis.

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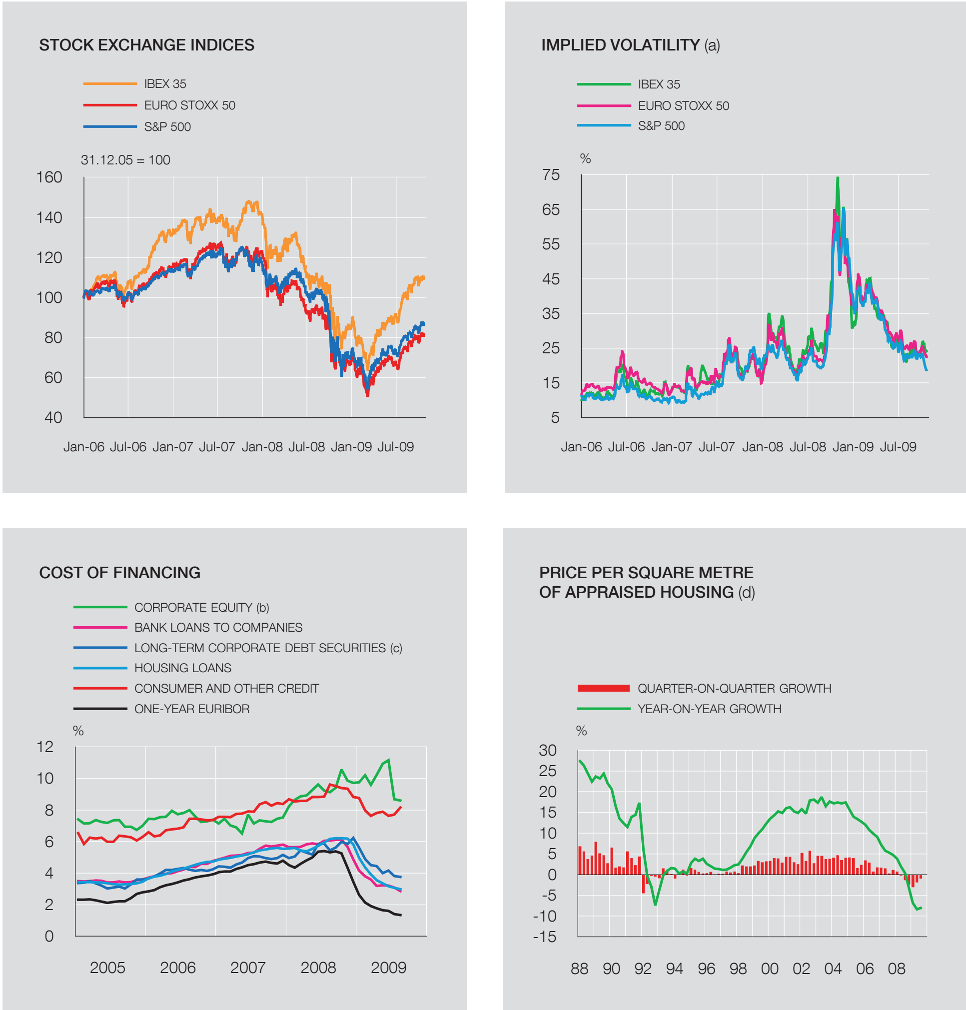
1. For more details, see the article "Encuesta sobre Préstamos Bancarios en España: octubre 2009" by Jorge Martínez Pagés in the *Boletín Económico* of October 2009.

FINANCING CONDITIONS AND ASSET PRICES

CHART 23



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 long-term debt is calculated as the sum of the average 5-year CDS spread for Spanish non-financial corporations and the 5-year euro swap rate.
d. Base 2001 until December 2004; base 2005 from that date.

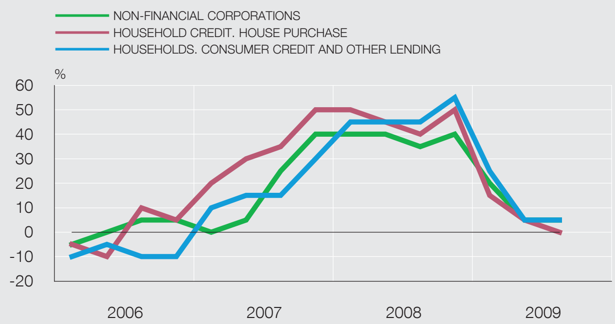
The latest available data on credit to the private sector continue to show further declines in the year-on-year growth rates, sharper for corporations (down by nearly 2 pp to approximately 1.5% between June and August) than for households (down 0.5 pp to zero). Seasonally-adjusted quarter-on-quarter rates remained negative yet, while the pace of decline of household liabilities slackened, that of corporate debt quickened, especially for credit extended by resident institutions (whose growth rate is also negative in year-on-year terms).

As a result of the scant changes in household liabilities and income in 2009 Q2, it is estimated that this sector's ratio of debt to gross disposable income (GDI) remained in June at approximately the same levels as in March (see Chart 24). This development, together with the interest rate cuts, seems to have been reflected in a fall in the debt burden. Also, the path of recovery, initiated at the beginning of 2008 by household saving after debt servicing, apparently continued due to the rise in gross saving. The sector's net wealth in relation to GDI slipped once again between April and June as a result of the drop in the price of real estate, the main asset owned by households. The preliminary estimates available for Q3 indicate that all these trends will continue.

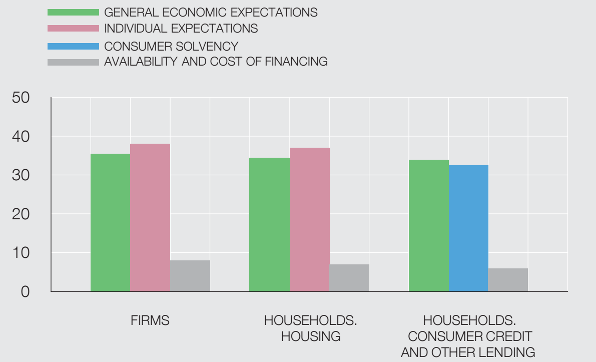
The supply of credit in bank lending is determined by the criteria applied by institutions to decide whether or not they grant financing (credit standards) and by the conditions under which the funds are provided in the first place. These latter conditions include most notably the margins applied to the reference interest rates, the term and the collateral requirements.

The Bank Lending Survey (BLS) provides qualitative information on credit standards. According to the responses of the banks surveyed,

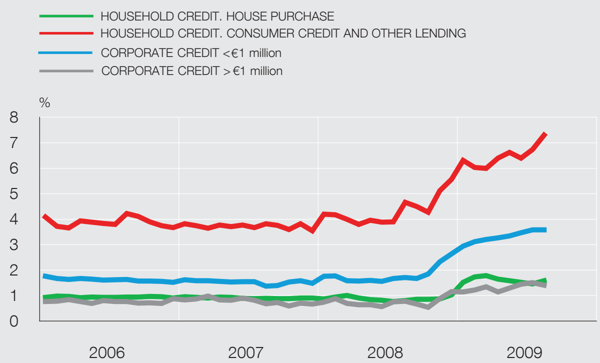
1 TIGHTENING OF CREDIT STANDARDS (a)



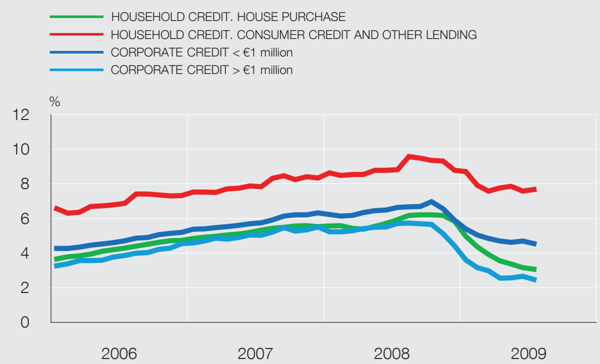
2 FACTORS EXPLAINING THE TIGHTENING OF CREDIT STANDARDS. BLS JUNE 2007 - SEPTEMBER 2009 (b)



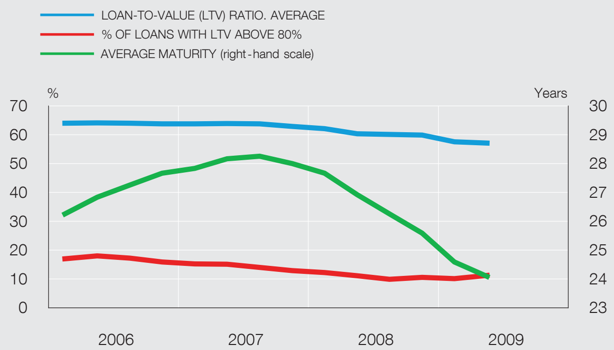
3 INTEREST RATE SPREADS (c)



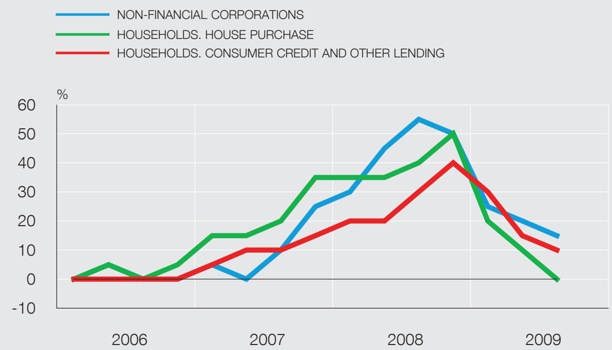
4 INTEREST RATES



5 MORTGAGE LOAN MATURITY AND COLLATERAL



6 COLLATERAL REQUIREMENTS. BLS (a)



SOURCES: Colegio de Registradores (panel 5) and Banco de España (other panels).

a. Bank Lending Survey (BLS). Indicator = % of institutions reporting a considerable increase x 1 + % of institutions reporting some increase x 1/2 - % of institutions reporting some decrease x 1/2 - % of institutions reporting a considerable decrease x 1.
b. Average of institutions' responses in the period analysed. Indicator prepared analogously to that explained in a).
c. The reference rate used is the 3-month EURIBOR in the case of corporate loans and of consumer credit and other lending, and the 1-year EURIBOR averaged over the preceding two months (to 2008) and over the previous month (from 2009) in the case of household loans for house purchase.

after notably tightening standards in 2008, during 2009 banks have tended to moderate this tightening, leaving standards practically unchanged in 2009 Q3 (see panel 1).[1] Panel 2 shows how, according to this same source, the main factors explaining these developments relate to the perception of higher borrower credit risk, against a backdrop of progressive and pronounced macroeconomic deterioration and of considerable increases in doubtful loans ratios. Contrastingly, the potential problems of liquidity or fund-raising associated with the impact on wholesale markets of the international financial crisis seem to have had a much more limited role in explaining these developments.

With regard to the conditions applied in the loans granted, there has recently been a rise in margins, which has been substantially more pronounced in higher-risk loans, a trend also identified by the BLS (see panel 3). Thus, in loans to households, margins have increased more in consumer credit and other lending – where doubtful loan ratios are highest and have been rising faster in recent quarters – than in house purchase loans. Moreover, a part of the increase for housing loans has been corrected since April 2009. Similarly, in corporate loans, those of less than €1 million, which have a higher proportion of SME borrowers (generally associated with higher risk), have shown the largest change in margins. This evidence therefore suggests that factors linked to the perception of higher probability of default are responsible for the recent changes in spreads between the lending interest rates applied by institutions and the market rates. In any event, thanks to the significant decrease in market rates, this development has been compatible with a decrease in the cost of bank financing in all segments in this period (see panel 4).

The more cautious attitude of institutions when it comes to approving loans is also apparent in the higher collateral required, which enables banks to reduce losses in the event of default. Thus, in mortgage lending, the average loan-to-value ratio of new lending has been falling since mid-2007, and in 2009 Q2 it stood at around 57%, compared with a value near to 64% before the outbreak of the crisis in summer 2007. Similarly, the percentage of loans in which this ratio exceeds 80% has decreased to 11%, down 7 pp from the figure at mid-2006. According to the BLS, the increase in the collateral requirements has also affected lending to firms and households for purposes other than house purchase (see panel 6). Thus the heightened concern about credit risk has been reflected in shorter terms, which for mortgages stood at around 24 years in mid-2009, compared with 28 years in June 2007 (see panel 5).

In short, the evidence presented in this box suggests that the changes in the credit supply conditions since the onset of the financial crisis have been determined basically by the heightened concern of institutions about credit risk, against a background of marked macroeconomic deterioration and of significantly higher doubtful loans ratios.

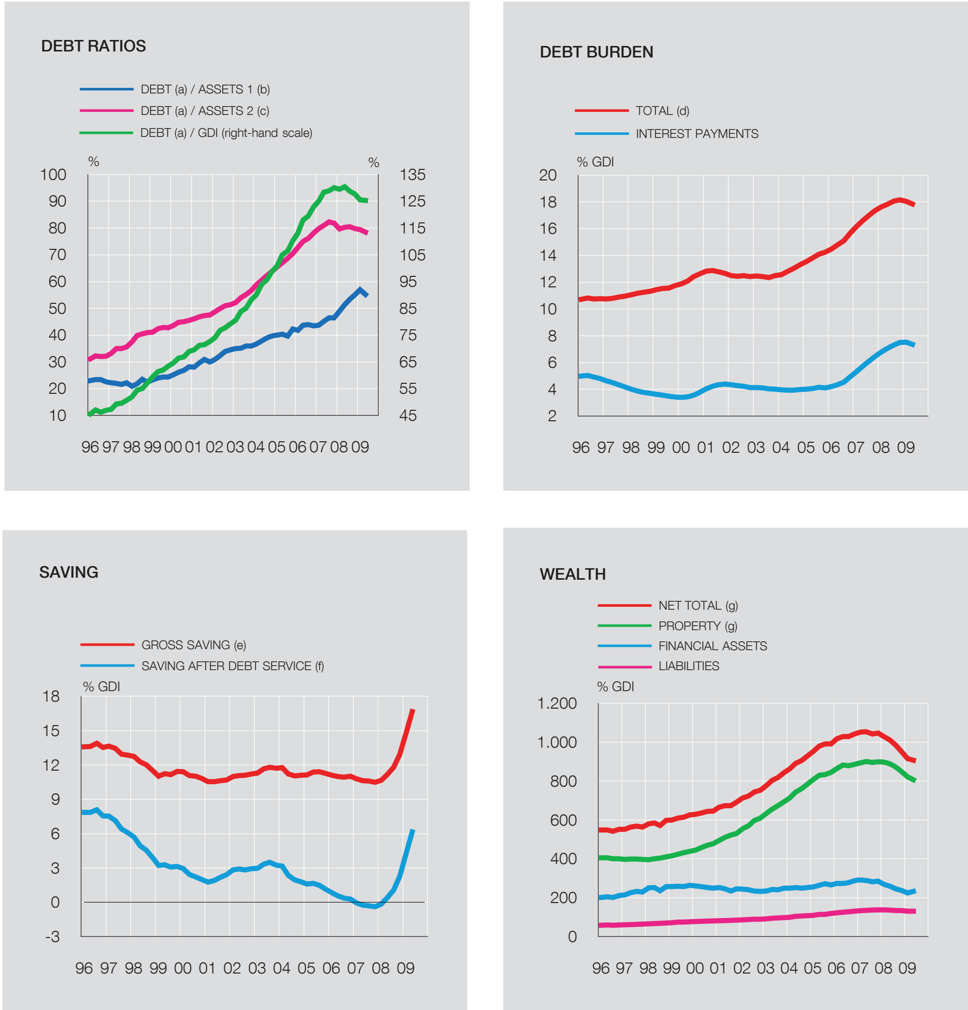
1. For more details about recent developments in credit supply and demand in Spain and their conditioning factors see "Encuesta sobre Préstamos Bancarios: octubre de 2009", by Jorge Martínez Pagés, in the October 2009 edition of the *Boletín Económico.*

Turning to firms, the National Accounts show an unfavourable course of income in Q2. It is estimated to have begun to fall off, resulting in a drop in return on equity (see Chart 25). In spite of this, the sector's debt burden ratio fell in relation to income generated as a result of the decrease in the cost of borrowing, while the debt ratio remained steady. The available preliminary estimates indicate that these trends will continue during the summer months. The most recent information, i.e. that relating to Q2, on corporations contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are predominantly larger firms, continues to show a sharper deterioration of results in comparison with the National Accounts. That led to a sizeable fall-off in the return on capital, a rise in the debt ratio and to the debt burden remaining at a similar level to three months earlier, despite the drop in financial cost. As a combined effect of these developments, the synthetic indicators of financial pressure on investment and, to a greater extent, on employment continued to rise. Similarly, analysts continue to factor-in falls in the profits of listed companies over the next twelve months, although recently they have revised these expectations slightly upwards.

As a result of the deteriorating macroeconomic situation, the financial pressure borne by certain segments of the non-financial private sector seems to have continued to increase in recent months. This was reflected in further increases in the aggregate ratio of doubtful assets of other resident sectors (which include households, non-financial corporations and non-monetary financial institutions), albeit more slowly than in the preceding months. This indicator thus

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 24



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

a. Includes bank credit and off-balance-sheet securitised loans.
b. Assets 1 = total financial assets less "Other".
c. Assets 2 = assets 1 less shares less holdings in mutual funds.
d. Estimated interest payments plus debt repayments.
e. Balance of households' use of disposable income account.
f. Gross saving less estimated debt repayments.
g. 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.

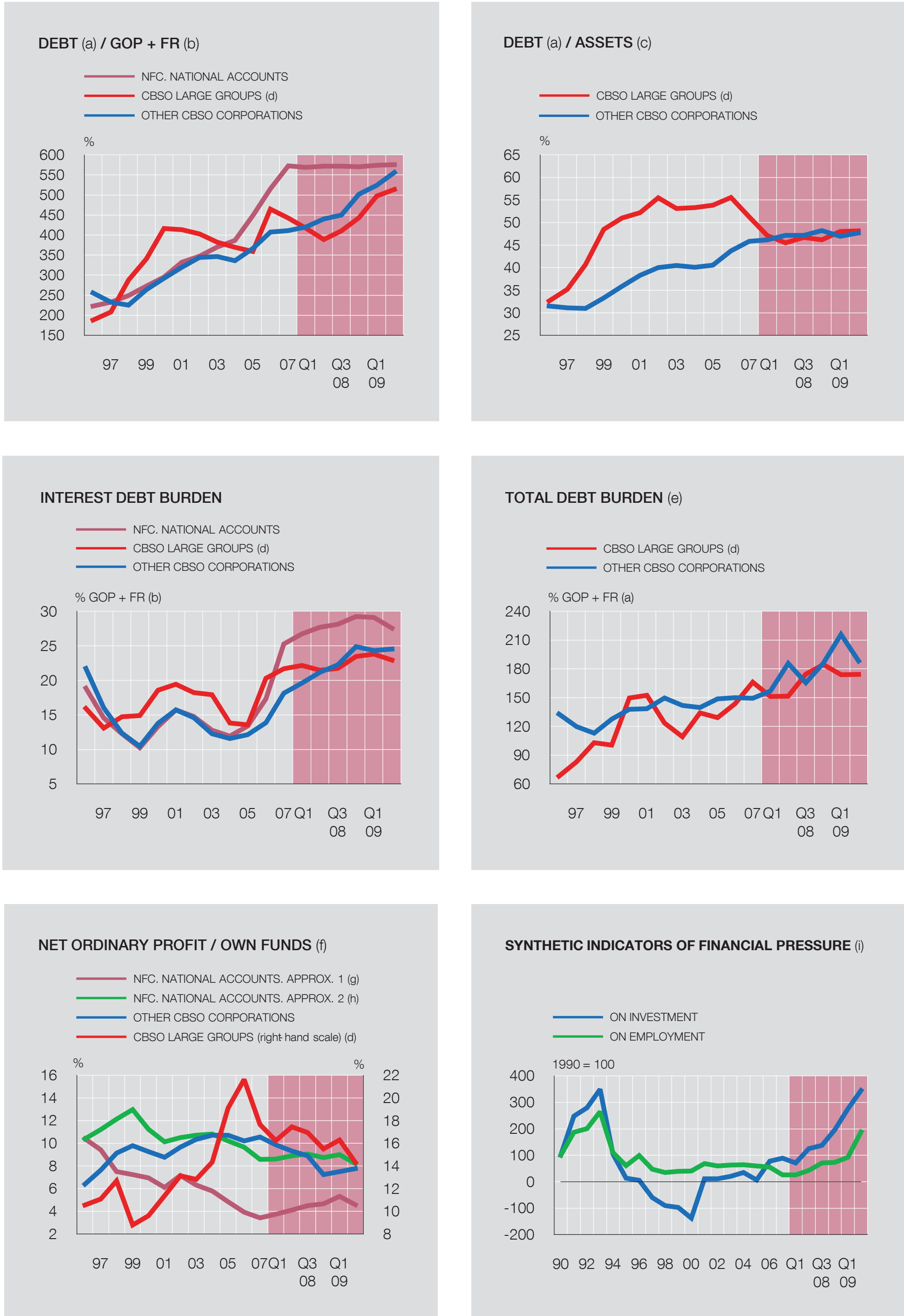
stood at 4.9% in August, 0.7 pp above its level in March, as compared with the rise of 1.3 pp during the previous five months.

The most recent Financial Accounts data continue to show a decrease in the nation's net borrowing (see Table 6). In cumulative twelve-month terms, the latter stood at 7% of GDP in 2009 Q2 (in comparison with 8.2% in March) as a result of the increase in the general government deficit (to 8% of GDP), which was amply compensated for by the decrease in households' and firms' net borrowing (1% of GDP, compared with 4.6% three months earlier). In line with the rise in the government deficit, the bulk of this borrowing was financed through debt issued by general government (4.2% of GDP in cumulative one-year terms).

In short, the most recent information continues to show declines in the cost of borrowing for households and corporations, a development which seems to have helped reduce the debt burden of indebted agents. However, the macroeconomic downturn and the drop in the value

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 25



SOURCES: INE and Banco de España.

a. Interest-bearing borrowed funds.
b. Gross operating profit plus financial revenue.
c. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
d. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
e. Includes interest plus interest-bearing short-term debt.
f. NOP, using National Accounts data, is defined as GOS plus interest and dividends received less interest paid less fixed capital consumption.
g. Own funds at market price.
h. Own funds calculated by accumulating flows from the 1996 stock onwards.
i. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 6

% GDP

	2004	2005	2006	2007	2008			2009	
					Q2	Q3	Q4	Q1	Q2
National economy	-4.8	-6.5	-8.4	-9.6	-9.9	-9.5	-9.1	-8.2	-7.0
Non-financial corporations and households and NPISHs	-5.1	-8.4	-11.1	-13.5	-12.0	-9.7	-7.0	-4.6	-1.0
Non-financial corporations	*-4.5*	*-7.1*	*-9.5*	*-11.9*	*-10.5*	*-8.3*	*-7.2*	*-5.8*	*-4.3*
Households and NPISHs	*-0.6*	*-1.3*	*-1.7*	*-1.6*	*-1.5*	*-1.4*	*0.3*	*1.2*	*3.3*
Financial institutions	0.6	0.9	0.7	2.1	1.9	2.1	2.0	2.0	2.0
General government	-0.4	1.0	2.0	1.9	0.2	-1.9	-4.1	-5.6	-8.0
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.7	-11.4	-17.3	-15.5	-16.3	-14.2	-10.9	-8.8	-6.4

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.

of real estate assets (the main component of household wealth) seemingly continued to have an unfavourable effect on the private sector's aggregate financial position, once again raising the financial pressure borne by certain segments.

5.2 Households

During July and August the cost of new housing loans dropped 18 bp to 3%, while that of consumer and other loans, which tends to rise in the summer months, increased by 53 bp to 8.2%. However, according to the October BLS, conditions other than interest rates seemingly tightened, although at a lower rate than during previous quarters. In any event, this survey shows relatively stable credit standards, unchanged for housing loans and only slightly more severe for other loans. The institutions surveyed did not anticipate significant changes in the credit supply for 2009 Q4.

The year-on-year growth rate of household debt continued to decrease, but to a lesser degree than in previous quarters, and reached zero in August compared with 0.5% in June. By purpose, falls in the year-on-year rate of expansion of liabilities were observed both in housing credit and in consumer and other credit, with rates dipping to 0.5% and -1.4%, respectively. The quarter-on-quarter growth rate of this sector's borrowing remained negative, although it seemingly recovered slightly in comparison with preceding months (-0.2% in annualised terms, as against -1.5% in June).

According to the latest Financial Accounts data (for 2009 Q2), between April and June household investment in financial assets recovered in cumulative annual terms to 2.6% of GDP, 0.7 pp above its March level (see Table 7). Behaviour was very uneven from one instrument to another. Thus, flows of cash and cash equivalents (cash and sight deposits) rose to 2.5% of GDP (in comparison with 0.3% in March), net redemptions of investment funds continued -albeit for a smaller amount than three months earlier (-1.7% of GDP compared with -2.7% in March)- and there was a fall in the momentum of time deposits, which showed net outflows although in cumulative twelve-month terms investment in this type of asset remained positive (1.8% of GDP compared with 4.1% in the previous quarter).

As a result of the scant variations in household liabilities and income in 2009 Q2, the household debt ratio (measured by debt as a percentage of the sector's GDI) remained steady. This,

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

TABLE 7

% GDP	2005	2006	2007	2008	2009	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	10.4	11.0	7.2	3.4	1.9	2.6
Cash and cash equivalents	4.0	3.1	-1.0	-0.5	0.3	2.5
Other deposits and fixed-income securities (a)	1.6	5.8	7.5	7.1	4.1	1.8
Shares and other equity (b)	0.2	-1.1	0.5	0.0	0.1	0.0
Mutual funds	1.9	0.2	-1.1	-3.4	-2.7	-1.7
Insurance technical reserves	1.9	1.8	0.9	0.4	0.5	0.5
Of which:						
Life assurance	*0.7*	*0.6*	*0.2*	*-0.1*	*0.0*	*0.1*
Retirement	*0.8*	*1.0*	*0.4*	*0.5*	*0.4*	*0.4*
Other	0.7	1.1	0.4	-0.2	-0.3	-0.5
Financial transactions (liabilities)	11.7	12.7	8.8	3.2	0.7	-0.7
Credit from resident financial institutions (c)	12.3	13.0	9.4	3.4	1.6	0.1
House purchase credit (c)	*10.5*	*10.0*	*7.1*	*2.7*	*1.6*	*0.6*
Consumer and other credit (c)	*1.9*	*3.0*	*2.1*	*0.8*	*0.2*	*-0.2*
Other	-0.6	-0.3	-0.5	-0.2	-0.9	-0.8
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	18.1	23.3	13.9	3.8	3.1	-2.0
Cash and cash equivalents	2.0	2.3	-0.4	-1.1	-0.7	-0.8
Other deposits and fixed-income securities (a)	1.2	1.9	2.0	1.9	1.0	0.5
Shares and other equity	7.2	11.3	8.0	2.4	2.3	1.6
Of which:						
Vis-à-vis the rest of the world	*3.9*	*8.0*	*6.4*	*3.2*	*2.6*	*1.7*
Other	7.6	7.7	4.3	0.6	0.4	-3.3
Financial transactions (liabilities)	25.1	32.8	25.8	11.1	8.9	2.3
Credit from resident financial institutions (c)	12.9	17.6	13.9	5.5	3.7	1.2
Foreign loans	2.1	3.3	2.8	2.3	2.4	2.4
Fixed-income securities (d)	0.3	1.8	0.5	0.3	0.7	0.3
Shares and other equity	3.7	2.9	5.3	2.3	1.9	1.4
Other	6.1	7.2	3.4	0.6	0.1	-3.0
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	21.2	24.2	15.5	6.1	4.5	2.1
Households and NPISHs	20.9	19.6	12.5	4.4	2.2	0.5
Non-financial corporations	21.4	27.9	17.7	7.4	6.2	3.3

SOURCE: Banco de España.

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

along with the decrease in interest rates, was reflected in a slight fall in the debt burden as a percentage of GDI, which stood at slightly below 18% (0.2 pp less than in March). These developments, combined with lower household consumption, were conducive to a further increase in household saving net of the expenses associated with liabilities, which increased by almost 2 pp to 6.2% of GDI. In line with this, according to the Financial Accounts, the sector's net lending rose to 3.3% of GDP, in cumulative twelve-month terms. Net wealth relative to GDI decreased once again between April and June as a consequence of the fall in the price of real estate, which is the main component of these agents' assets. The decline, however, was more moderate than in previous quarters due to the developments in financial assets which, bolstered by greater investment in them and by stock market price rises, saw their value increase for the first time since the end of 2007. The available provisional information indicates that all of these trends will continue in 2009 Q3.

In spite of the moderation of the debt burden, the worsening macroeconomic conditions and, in particular, the rise in unemployment seem to have contributed to a further increase in the proportion of households encountering difficulties in servicing their debt. As a result, in Q2 the doubtful asset ratio for households reached 3.8%, up 0.2 pp on the previous quarter, which, nonetheless, represents a slower rate than in previous months. A more detailed analysis by type of loan reveals that the ratio continues to be higher for consumer and other loans than for house purchase and refurbishment loans, although in Q2 it seems to have increased less (6.7%, practically the same level as in March, in the case of the former, as compared with a 0.2 pp rise to 3% in the case of the latter).

5.3 Non-financial corporations

Corporate financing costs also decreased in 2009 Q3. Thus, the interest rate on bank loans under €1 million dropped in July and August by 25 bp (to 4.4%), while that on bank loans for a higher amount fell 41 bp (to 2.3%). This confirms the trend that began a year ago of a sharper drop in the cost of larger loans (which has fallen 340 bp since October 2008) than in the cost of smaller loans (more common among SMEs), which decreased by 250 bp in the same period. Similarly, on data to September, the issuance cost of short-term and long-term securities dropped by 45 bp and 50 bp, respectively, and the returns demanded by shareholders fell more sharply (250 bp), in line with the notable rise in stock market prices.

According to the October BLS, institutions tightened loan approval criteria very slightly in Q3, and expected them to remain the same over the next three months. In the same vein, the information provided by the Chambers of Commerce Survey on SME access to financing for this period includes moderate variations in the percentage of these firms that considers they have difficulty in accessing borrowed funds.

Although financing conditions have improved, the growth rate of corporate debt continued to decline in both year-on-year and quarter-on-quarter terms. The year-on-year growth rate stood in August at approximately 1.5%, almost 2 pp below the figure for June. The slowdown was particularly sharp for credit extended by resident institutions, which represents the main source of borrowing for the sector, and slipped by slightly more than 1% in comparison with the same period last year. The seasonally adjusted quarter-on-quarter and annualised growth rate of the balance of loans amounted in August to -6% (-3.4% in June). Conversely, other borrowed funds (non-resident loans and funds raised with fixed-income securities), which are mainly used by larger companies, continued to show positive growth.

The latest information on credit breakdown by productive activity, relating to June 2009, shows a widespread slowdown in all sectors. The year-on-year negative rates continued for construction (-13.4%) and agriculture and fishing (-7.8%), at the same time as there was a considerable deceleration in funds raised by industry (7.1%) and, to a greater degree, by non-real estate service companies (5%), which saw their debt increase at double-digit year-on-year growth rates three months earlier. Conversely, the balance of loans extended to real estate service firms grew at a similar rate to that of in March.

Against this backdrop, and according to the Financial Accounts for 2009 Q2, the sector's net borrowing fell by 1.5 pp to slightly more than 4% of GDP. The *financing gap*, the indicator that approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, fell by more than 2 pp to 6.4% of GDP.

The National Accounts show the unfavourable course of income which has seemingly begun to decline. Thus, during 2009 Q1 firms' gross operating profit contracted by 1.9% in relation to the same period in 2008. Ordinary net profit, which includes net interest income, dividends and fixed capital consumption, performed more unfavourably, contracting by 7.8% between January and June with respect to the first six months of 2008 and prompting a fall in return on equity. Nevertheless, the financial burden ratio decreased due to the lower borrowing costs, while the debt ratio remained steady . The most recent preliminary estimates indicate that these trends will continue during Q3.

The Central Balance Sheet Data Office Quarterly Survey (CBQ) information for 2009 Q2, based on a sample in which large corporations predominate, shows a marked deterioration in corporate results, sharper than that inferred from the National Accounts. This negative development affected all sectors, although within those branches best represented in the CBQ, its impact on industry was particularly severe. The decline in profit for the year was also confirmed by analysing the percentage of firms that reported profits in 2009 H1, which stood at 58%, ten percentage points less than a year earlier. Similarly, the proportion of firms with a high financial burden[2] rose further to 21% in June, as compared with 19% in March. The unfavourable course of profits brought a reduction in return on capital, pushed the debt ratio higher (in spite of the scant buoyancy of debt) and scarcely changed the associated debt burden (even though interest rates fell). As a consequence of all these developments, the synthetic indicators of financial pressure on investment and, to a greater extent, on employment rose once again.

The negative profit performance was also reflected once again in a rise, albeit lower than in previous months, in the non-financial corporations' doubtful loans ratio, which stood at 5.3% in June, 0.5 pp higher than in March 2009. Companies in the construction and real estate service sectors continued to experience the greatest difficulties in servicing their debts. The combined doubtful loans ratio for these companies increased from 7.5% to 8.1% between March and June, while in all other branches of activity it rose slightly less from 2.5% to 2.9% during the same period.

Analysts' projections continue to envisage that the profits of listed companies will keep sliding significantly over the next twelve months. Although these projections have been revised slightly upwards, they are, nevertheless, in line with a decline in the longer tem (see Chart 26).

5.4 General government

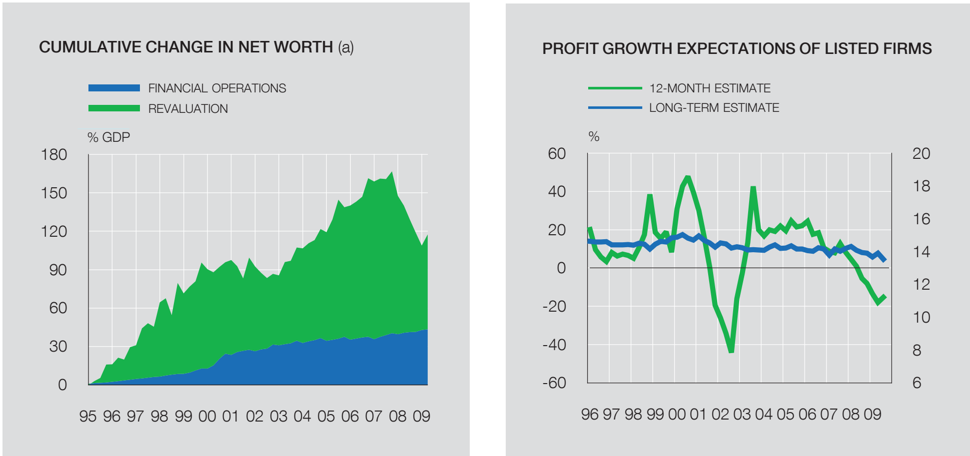
As a result of the increase in public spending and the decline in revenue, general government net borrowing increased substantially in Q2 to 8% of GDP in June, in cumulative twelve-month terms, 2.4 pp more than in March (see Table 6 and Chart 27).

The breakdown of financial flows shows that the government deficit was financed essentially through the issuance of short-, and particularly medium- and long-term, fixed-income securities. These operations represent a net inflow of funds between mid-2008 and June 2009 equivalent to 11.1% of GDP. General government acquired securities (mainly as a consequence of the investments of the Social Security Reserve Fund and the Fund for the Acquisition of Financial Assets) during the same period for an amount equal to 2% of GDP, while at the same time the deposit balance increased by more than the amount of net credit received by this sector, resulting in an increase in net assets through this channel of 1.2% of GDP.

2. Firms whose interest burden exceeds the 90th percentile of the distribution of this variable in the period 1985-2001, the level above which, according to the available estimates, it has an impact on business investment levels.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26

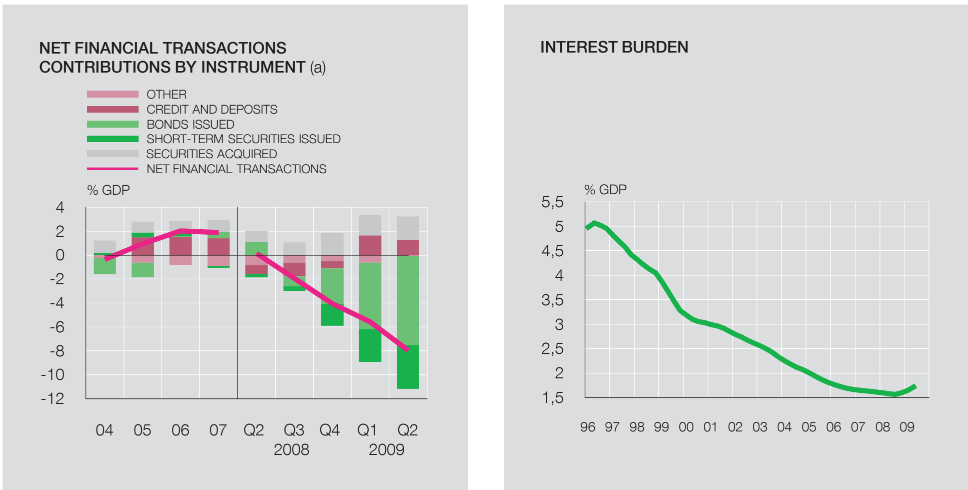


SOURCES: I/B/E/S and Banco de España.

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

GENERAL GOVERNMENT
Four-quarter data

CHART 27



SOURCE: Banco de España.

a. A postive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilites.

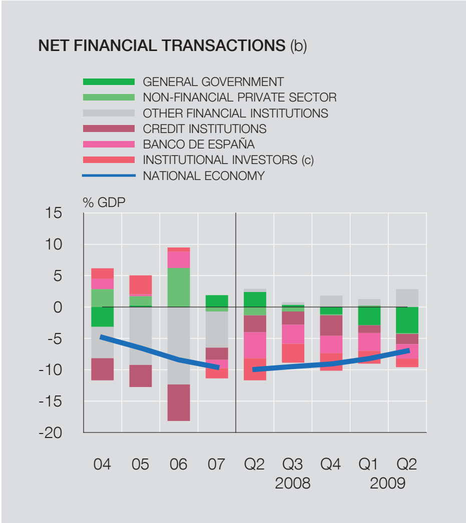
The increase in liabilities over the last twelve months, together with the decline of GDP, brought a rapid rise in the debt/GDP ratio from 35.8% in mid-2008 to 47% in June 2009. The drop in interest rates softened the impact of the debt growth on the related debt burden, which climbed marginally to 1.7% of GDP (1.6% a year earlier). In the medium-term, however, the normalisation of monetary policy stance will foreseeably involve an increase in the cost of debt. In this setting, with the target of ensuring long-term sustainability of debt, it is important that public finances quickly resume the path of fiscal consolidation.

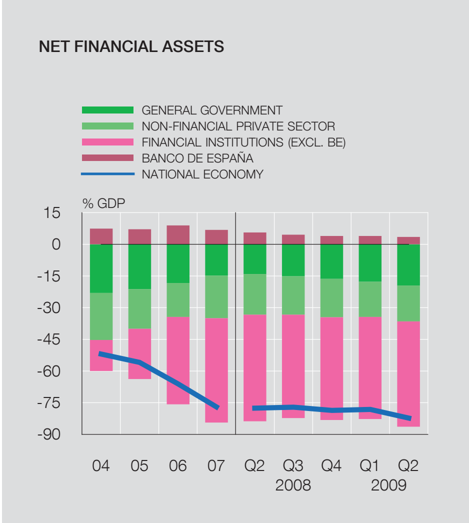
5.5 The rest of the world

In 2009 Q2, the debit balance of the nation's net financial transactions fell to 7% of GDP, in cumulative twelve-month terms, compared with 8.2% in March. By sector, this was due to lower corporate borrowing and an increase in the credit balance of households, which offset the rise in the general government deficit (see Table 6).

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.

The breakdown of financial transactions vis-à-vis the rest of the world by sector shows that, in line with the rise in the government deficit, the bulk of the nation's net borrowing was covered by general government debt issuance (4.2% of GDP, in cumulative twelve month terms) (see Chart 28). Institutional investors continued to unwind positions in the rest of the world between June 2008 and mid-2009, although to a lesser degree than three months earlier. Similarly, the net funds raised abroad through assets issued by credit institutions increased to 1.7% of GDP, although net capital outflows in the form of instruments issued by other financial institutions (apart from institutional investors and the Banco de España) increased. Lastly, the net flow of the Banco de España vis-à-vis non-residents turned negative again, albeit in a lower amount than in March (-2.3% of GDP, against -2.8%).

Financial flows vis-à-vis the rest of the world declined further in cumulative twelve-month terms. However, the quarterly breakdown shows that they recovered slightly between March and June, although they did not reach their levels prior to the bankruptcy of Lehman Brothers in September 2008. The volume of capital inflows decreased to slightly more than 4% of GDP in cumulative four-quarter terms, 4.3 pp below the amount recorded in March (see Table 8). This decrease affected most instruments; the highest declines were seen in deposits and securities other than shares issued by other non-monetary financial institutions, which include securitisation special purpose entities (the flows received by general government through the net issuance of this type of securities increased by 1 pp). Foreign direct investment in Spain dropped by 0.4 pp to 2.4% of GDP.

Capital outflows between mid-2008 and June 2009 were negative (-2.7% of GDP, compared with 0.4% in March) (see Table 8), although they were positive in quarterly terms. By instrument, interbank deposits recorded the highest decline, with the result that, in net terms, the balance of funds raised through this channel increased in one year by an amount equivalent to 6.5% of GDP. By contrast, net purchases of securities other than shares increased, turning positive and reaching a volume equivalent to 0.5% of GDP, in comparison with -0.2% in the

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 8

% GDP

	2005	2006	2007	2008	2009	
				Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-6.5	-8.4	-9.6	-9.1	-8.2	-7.0
FINANCIAL TRANSACTIONS (ASSETS)	18.5	17.6	14.0	3.0	0.4	-2.7
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.2	5.2	2.1	-0.3	-2.1	-5.8
Of which:						
Interbank (a)	*3.1*	*3.4*	*4.2*	*-0.5*	*-2.3*	*-5.6*
Securities other than shares	8.7	-1.2	1.6	1.3	-0.2	0.5
Of which:						
Credit institutions	*6.6*	*-2.0*	*1.8*	*1.5*	*0.7*	*1.5*
Institutional investors (b)	*2.3*	*0.6*	*0.2*	*-0.9*	*-1.5*	*-1.5*
Shares and other equity	5.1	10.4	8.6	1.9	2.5	2.2
Of which:						
Non-financial corporations	*3.9*	*8.0*	*6.4*	*3.2*	*2.6*	*1.7*
Institutional investors (b)	*0.9*	*1.2*	*-1.1*	*-1.6*	*-0.8*	*-0.5*
Loans	1.1	2.1	1.2	0.9	1.0	1.1
FINANCIAL TRANSACTIONS (LIABILITIES)	25.0	26.0	23.5	12.1	8.6	4.3
Deposits	5.6	0.3	7.3	9.0	4.3	1.9
Of which:						
Interbank (a)	*7.2*	*0.6*	*6.7*	*6.2*	*1.9*	*0.9*
Securities other than shares	15.8	21.3	8.1	-2.4	0.3	-0.7
Of which:						
General government	*0.2*	*1.0*	*-1.4*	*1.3*	*2.5*	*3.4*
Credit institutions	*6.3*	*8.0*	*3.6*	*-1.9*	*-1.1*	*-1.2*
Other non-monetary financial institutions	*9.3*	*12.3*	*5.8*	*-1.8*	*-1.0*	*-2.9*
Shares and other equity	0.9	0.2	4.5	3.4	1.9	1.4
Of which:						
Non-financial corporations	*1.0*	*-0.2*	*4.7*	*2.5*	*1.2*	*0.6*
Loans	2.3	3.5	3.1	2.2	2.5	2.6
Other, net (c)	-0.9	-0.5	0.1	0.7	0.4	0.0
MEMORAMDUM ITEMS						
Spanish direct investment abroad	3.7	8.4	9.6	5.0	4.9	4.0
Foreign direct investment in Spain	2.2	2.5	4.8	4.4	2.8	2.4

SOURCE: Banco de España.

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

previous quarter. Net purchases of shares and other equity fell and Spanish foreign direct investment decreased even more sharply to 4% of GDP, almost 1 pp less than in March.

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 rose to 82% of GDP, 4.2 pp above the figure for March (see Chart 28). By sector, this was essentially due to the increase in the debit positions of financial institutions and general government. Also, non-financial private sector debt vis-à-vis the rest of the world increased, albeit to a lesser degree, while the credit balance of the Banco de España decreased.

23.10.2009.