

QUARTERLY REPORT ON THE SPANISH ECONOMY

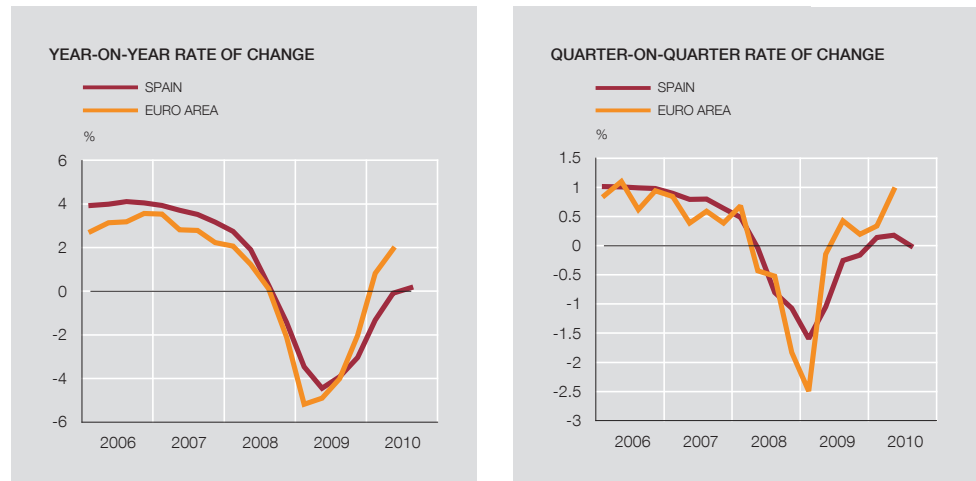
1 Overview

The slow recovery in the Spanish economy that had begun in the opening months of 2010 continued in Q2, posting a quarter-on-quarter rate of increase in GDP of 0.2%, although the year-on-year figure resulted in a decline of 0.1%. On the expenditure side the fall in national demand slackened markedly (-0.4% year-on-year), influenced by temporary factors that led some spending decisions to be brought forward, while the positive contribution of net external demand fell to 0.4 pp of GDP.

The information available for Q3 suggests a transitory weakening in economic activity, due largely to the tailing off of certain expansionary factors. These include most notably the end on 30 June of the so-called Plan 2000E, a direct public aid programme for car purchases, and the reversal of the effect of the spending brought forward in the first half of the year, as the rise in VAT took effect from 1 July. Compounding this further will be the impact on the public components of national demand of the budgetary austerity measures approved in May. Under these circumstances, the estimates made on the basis of the conjunctural information available indicate that GDP is expected to have stabilised at the levels of the previous quarter, registering a zero quarter-on-quarter rate of change, which nonetheless entails a 0.2% year-on-year increase in output, following seven consecutive quarters of declines. On the expenditure side, growth is estimated to have been underpinned by the contribution of net external demand, adding 1.2 pp to the increase in output, while the decline in national demand intensified to -1%. From the supply-side perspective, construction and services felt the impact of the loss of momentum in domestic expenditure, and employment continued to show no signs of recovery, although a very sharp cut in the rate of job destruction is observable when the calculation is made in year-on-year terms. According to the EPA figures, employment fell by 1.7% in year-on-year terms, as compared to -2.5% in the previous quarter, and the unemployment rate fell 0.3 pp to 19.8% in a context in which the labour force picked up. Inflation rose during the quarter, placing the year-on-year rate of change in the CPI at 2.1% in September (1.5% in June), chiefly the result of the pass-through of the VAT rise in July to final prices. The pass-through is estimated to be on a lesser scale than in previous episodes involving changes in indirect taxation. The rise in prices extended to core inflation, which rose to 1.1% in September, and impacted the inflation differential with the euro area, which widened slightly to 0.3 pp that month.

On the international economic front, there was an easing in the bout of financial instability experienced by the European countries in Q2 further to the spread of the effects of the Greek fiscal crisis. Tensions on sovereign debt markets abated in a relatively generalised fashion as a result of the firm action by the European authorities, the ECB and the governments of the countries most affected. That said, there was subsequently the odd bout of instability centred in particular on the sovereign debt issued by the Irish and Portuguese governments. The banking system saw its wholesale funding markets restored to normal working order, and the substantial volatility that stock markets had shown during the spring was corrected. There were, however, considerable tensions on foreign exchange markets. These resulted in a sizable depreciation of the dollar against the main currencies, set against growing discrepancies between the prospects for recovery of the different geographical areas and significant divergences in the monetary and fiscal policy stances applied.

The pick-up in the world economy continued to be led by the emerging countries, particularly the Asian nations. Meanwhile, the cyclical situation in the developed countries was marked by greater moderation, especially in the United States, where the economic outlook worsened,



SOURCES: ECB, INE and Banco de España.

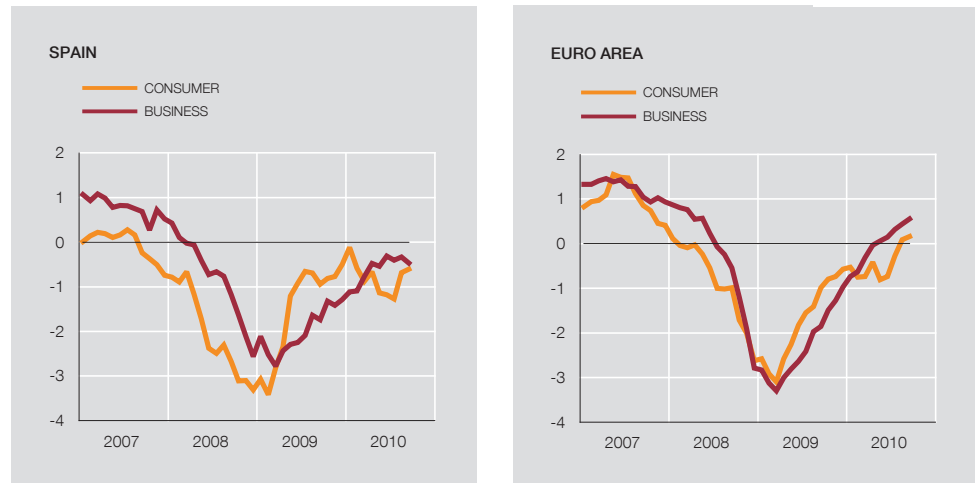
a. Seasonally adjusted series.

leading the Federal Reserve to announce a new phase of monetary expansion. Inflation generally remained low, while commodities prices increased across the board.

Economic activity in the euro area continued to trend favourably after the summer, albeit at a somewhat lower rate of expansion than in the previous quarter, driven by the strength of the German economy. The lesser momentum of the external sector, the disappearance of certain temporary factors and the progressive withdrawal of the economic policy stimuli are at the root of this slower pace. The absence of inflationary pressures in the medium term, against the background of gradual recovery described, meant that the monetary policy stance remained accommodative. At its September, October and November meetings, the ECB Governing Council decided to leave official interest rates unchanged at their all-time low of 1% for the main refinancing operations, and at 1.75% and 0.25%, respectively, for the marginal lending and deposit facilities.

The ECB took steps towards defining its strategy for the gradual withdrawal of the extraordinary measures introduced during the financial crisis, although it continued with the policy of abundant liquidity provision it had been pursuing. Specifically, at the September meeting, it announced that it would retain its fixed-rate tender procedure with full allotment, at least until the end of 2010, although in the case of three-month loans it said that the rate would be adjusted on the basis of the average MRO rate. Further, the Securities Markets Programme it introduced in May to restore the normal functioning of the debt markets remained in place.

In the fiscal realm, budget deficits in the euro area are expected to hold at high levels in 2010, similar to those of the previous year, despite the implementation of adjustment programmes by the countries with the biggest deficits. As part of the discussions on how to improve economic governance in the euro area, major steps were taken including, inter alia, the introduction of mechanisms to reinforce EU countries' commitment to budgetary stability. The most notable headway in defining this reform was seen in the proposals submitted by the task force set up at the April European Summit, in which the EC, the ECB and the European Commission all participate, which were approved by the Heads of State and of Government on 28 October. In fiscal terms these proposals call for a significant reform of the SGP that will accord greater



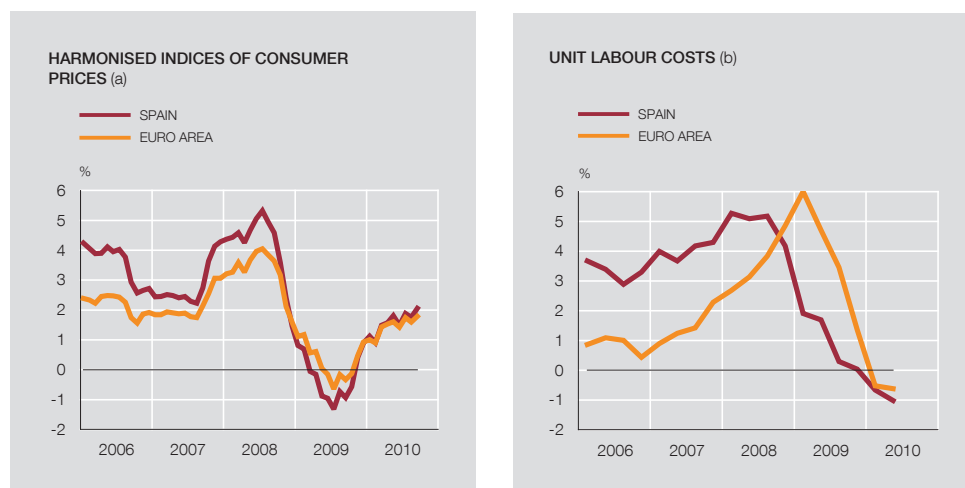
SOURCE: European Commission.

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

significance to the public debt criterion when assessing countries' fiscal positions, and they advocate a more extensive and transparent sanctions regime. The task force also proposes a new mechanism to head off and, where appropriate, correct the build-up of macroeconomic imbalances that might compromise the Economic Union project, and the strengthening of the euro area economic policy coordination and surveillance mechanisms. Finally, the Heads of State and of Government agreed to set up a permanent crisis mechanism to safeguard financial stability across the euro area, which will entail a limited amendment to the EU Treaty. The design of the mechanism will be specified over the remainder of this year (see Box 3 for greater details in this connection).

Progress was made in the design and implementation of supervisory and financial assistance mechanisms at the European level. On 22 September the European Parliament approved the reform of the European framework of financial system supervision, placing particular emphasis on macro-prudential aspects so as to detect in advance potential practices that might entail major risks for the financial sector and result in a new crisis. The agreement envisages the creation, from January 2011, of the European Systemic Risk Board and of the three European Supervisory Authorities, which will seek to ensure the sound functioning of the banking, insurance, pensions and securities sectors. The European Financial Stability Facility (EFSF) became fully operational once the Member States committed themselves to guaranteeing over 90% of the vehicle's total funding. The Basel III accord on new capital requirements for financial institutions was a further step forward in the reform of the international financial system.

Against this backdrop, Spain managed to decouple itself from the countries most affected by the sovereign debt crisis in the euro area. It did so thanks to the measures agreed in the European arena and, above all, to the Spanish government's measures in May and June relating to budgetary consolidation, labour market reform and financial system restructuring. The publication in July of the stress tests of EU credit institutions reinforced confidence in the solvency of the Spanish financial system and contributed to a more realistic view of the Spanish economy's situation and an appreciation of the economic policy efforts deployed. Stock market prices duly rose while volatility diminished (the IBEX 35 was around 17% up over the course of



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

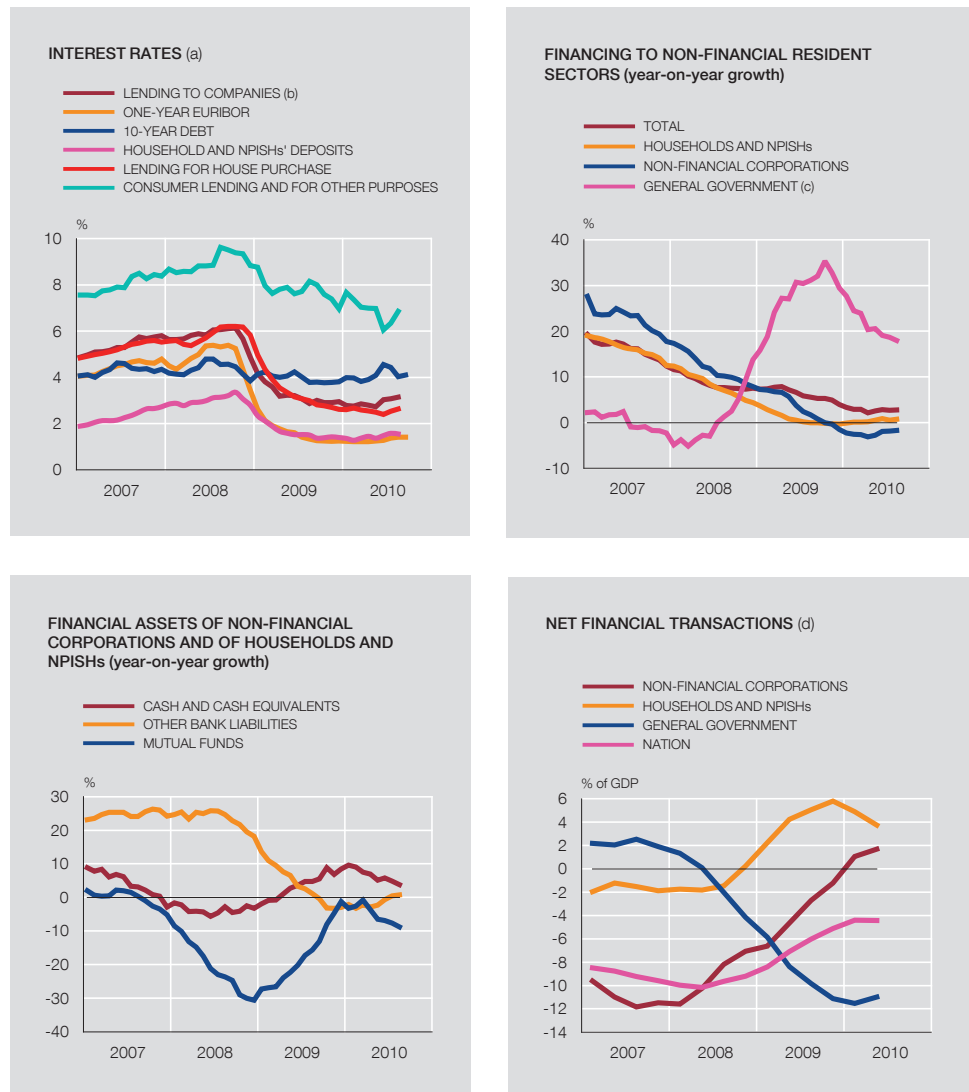
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

the quarter), and the risk premia on both public- and private-sector bonds fell. Indeed, Spanish 10-year government bond yields declined more than they did on the German Bund, and the spread between both narrowed to stand at end-October at 165 bp, having risen to some extent in the opening days of November. In the real estate market, according to the latest figures published by the Ministry of Housing, property prices continued on a downward course in Q3, taking the related year-on-year rate of change to -3.4% (-3.7% in Q2), confirming the less pronounced slowing path observable in recent quarters.

In sum, the serious financial constraints brought about by international investors' loss of confidence in the Spanish economy were overcome during the quarter. This improvement allowed some easing in market borrowing conditions for public and private agents, although the cost of funds raised by institutions remains higher than that prevailing prior to the sovereign debt crisis.

Under the conditions described, the recovering trajectory of household consumer spending seen in previous quarters was interrupted, and there was an estimated quarter-on-quarter decline that would place the quarterly rate of change in this variable at around 1%. The end of the government scheme involving direct assistance for car purchases, combined with the VAT rise, contributed to reining back household consumption following the bringing forward of durables purchases seen in the previous months. Once these effects – which have altered the profile of consumption throughout the year – have petered out, household purchases of goods and services may be expected to resume a course of gradual recovery, within the foreseeably limited perimeters marked by disposable income and wealth developments. Offsetting this effect, households may pursue their spending plans by drawing on the still-high saving ratio. As a result, the decline in this variable since the start of the year, down 2 pp from its 2009 high to 16.2% of disposable income in 2010 Q2 on four-quarter cumulated figures, which is still far above its historical average, might further intensify.

The ongoing adjustment of residential investment continued, with an estimated fall of 16.1% year-on-year (-19.3% in the previous quarter). During the quarter there was once again a rise in certain housing demand indicators. This would be attributable, once the effects of the bring-



SOURCE: Banco de España.

a. In June 2010 the statistical requirements relating to interest rates applied by credit institutions to their customers were amended, potentially causing breaks in the attendant series. Of particular significance was the change in the interest rates on consumer credit and other loans, as a result of which, from that month, operations transacted using credit cards have not been included.

b. 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.

c. Consolidated financing: net of securities and loans that are general government assets.

d. Four-quarter cumulated data.

ing forward of spending due to the rise in indirect tax are stripped out, to the improvement in the affordability indicators and to property-purchase decisions being brought forward in light of the partial elimination in January 2011 of personal income tax deductions for purchase of the principal residence.

In this context of expenditure containment, the outstanding balance of household debt held stable, posting a year-on-year rate of change of 0.7% in August. The reasons for this were the moderate increase in lending for house purchases (1%) and the maintenance of lending for consumption and other purposes at similar levels to those in 2009. Given the sluggish pace of income, the household debt ratio is expected to hold at a similar level to that prevailing mid-year.

Business investment fell further in a setting in which the relative strength of exporting firms' demand for capital goods was unable to offset the plethora of factors that continue to weigh on the start-up of new investment projects. These included the slackness of domestic demand and uncertainty over the intensity of the recovery, in a situation in which capacity utilisation remains at a relatively low level, along with the process of financial deleveraging in which the sector remains immersed, which should continue in the coming months. In addition, the end of the plan to boost commercial vehicle sales, which had sustained business spending over the past year, also influenced the quarter-on-quarter reduction in investment in equipment, following four quarters of positive rates of increase. And further, the cut in investment in infrastructure, which is being carried out to some extent with private-sector participation, might have begun to have a bearing on the component of investment in other construction.

This pattern of business spending was accompanied by an increase in saving, meaning that, drawing on information from the non-financial accounts of the institutional sectors, non-financial corporations reduced their net borrowing, which stood at -0.7 pp of GDP in Q2 on four-quarter cumulated figures. This was consistent with a further contraction in credit extended to companies (-2.2% year-on-year in August), albeit on a far lower scale than in the previous months.

Turning to foreign trade, the positive contribution of net external demand in Q3 rose substantially (adding 1.2 pp to the increase in GDP, in year-on-year terms). This was the outcome of the rise in exports and the decline in imports. The latter corrected the unusual rise in the first half of the year in imports, which was linked to the pick-up in certain domestic demand components, in particular purchases of durable goods, owing to the above-mentioned temporary factors. Exports, for their part, grew robustly once more, due to the strength of growth in the emerging economies and to the recovery in the euro area, as well as to the favourable behaviour of competitiveness in terms of relative prices and costs. Trade in tourist services held on the recovering path initiated at the start of 2010, with the strength of the exports component particularly to the fore, while non-tourist services remained most sluggish.

Despite these developments, the reduction in the trade deficit this year has been checked. While the deterioration in the energy component lies behind this, the trajectory of the non-energy deficit has also ceased moving downwards, prompting a slowdown in the correction of the nation's net borrowing, which stood at -4.4% of GDP in Q2 (-5.1% in 2009) according to the sectoral non-financial accounts. Further headway must therefore be made in correcting the trade deficit, whereby perseverance will be required to entrench the improved competitiveness attained in recent months and to reduce the high dependence on imported energy, which sets a limit on how far the deficit can be cut.

General government conduct began to reflect the impact of the austerity plans set out in the first half of the year. In addition to their effect on household income, the measures adopted also bore down on government consumption and public investment. The strength of revenue and the incipient downturn in expenditure (which should be pursued further over the rest of the year) are in principle compatible with the deficit target laid down in the draft State budget for 2010 (9.3% of GDP), at least for the State, for which information is available.

Into 2011, the draft budget cuts the deficit target to 6% of GDP for the overall general government sector, stemming from deficit balances for the State, regional government and local government (of 2.3%, 3.3% and 0.8%, respectively), and a surplus balance for the Social Security system (0.4%). A further increase is foreseen in the public debt/GDP ratio, from an estimated 62.8% in 2010 to 68.7% in 2011. The tight fiscal policy stance envisaged in the budg-

et should see progress towards meeting the commitments entered into at the European level. But the programmed budgetary consolidation path is not free from risks. Strict compliance with it requires monitoring and rigorous control of the revenue shortfalls and expenditure overruns that might arise in the various general government sub-sectors and, where necessary, additional consolidation measures should be applied.

From the supply-side standpoint, value added in the market economy held at a similar level to that of the previous quarter. This was as a result of the decline in construction activity, which was influenced by the weakness of residential investment and the impact of the budgetary austerity measures, and the estimated slowdown in market services, which were affected by the slackness of consumption. Employment showed no signs of picking up, and a slight decline in this variable is estimated, of a similar magnitude to that in the previous quarter.

Labour costs are expected to have continued on the moderating path on which they embarked at the beginning of the year, driven by the cuts in public-sector wages; in contrast, average private-sector wage settlements held at 1.3%, a similar rate to March and still above the recommended ceiling for new collective bargaining agreements under the multi-year pact entered into by the social agents last February. Wage increases negotiated in collective agreements may be expected to fall further in the rest of the year, all the more so if employers and employees make use of the provisions offered by Law 35/2010 of 17 September 2010 on urgent labour market reform measures, which includes the possibility of companies in a vulnerable economic situation resorting to wage opt-out clauses. Foreseeably, unit labour costs will continue to fall as a result of developments in productivity, which will still be reflecting the intensity of job destruction over the course of this cyclical phase.

As indicated, inflation rose and averaged 2% in Q3 (1.6% in Q2), reflecting the impact of the rise in VAT on final prices. As Box 4 shows, it is estimated that the increase in indirect tax accounts for between 0.4 and 0.6 pp of this rise, meaning the degree of pass-through has not been more than 50%, below what occurred in previous episodes of VAT tax changes, probably as a result of the weakness of domestic spending. It is to be expected and would be desirable that, once the base effects linked to this regulatory change disappear, in the second half of next year, core inflation should return to the low level it showed before the rise in VAT. The absence of indexation clauses in collective bargaining in 2011, as established in the above-mentioned pact, will help prevent the impact of the VAT tax rise from exerting second-round and inflation-inertia effects.

Finally, it is expected that the stagnation of the Spanish economy in Q3 will be temporary and, now the effects of the shift in spending decisions to the first half of the year in anticipation of the VAT rise have run their course, that economic activity will resume the path of mild recovery initiated at the start of the year. Nonetheless, if the recovery is to gain the force needed to create jobs, a continuing positive contribution by net external demand will be necessary. And so too will a progressively more dynamic private sector, underpinned by sound finances and by the improvement in agents' expectations that an ambitious range of structural reforms should foster.

2. The external environment of the euro area

There was a significant change in Q3 in the catalysts of global economic and financial developments, which generally had a positive influence on the behaviour of the international financial markets. After the fears surrounding the European sovereign debt crisis, which dominated in Q2, concern during the summer was centred on the uncertainty regarding the recovery in the developed economies, in particular in the United States. The increasing divergence in recovery rates across regions, with much greater dynamism in the emerging economies, has led to large differences in economic policy stances, which have given rise to increasing exchange rate tensions in the last month and a half, against a background of falling long-term interest rates in the developed economies. The main cause of these tensions has been the prospect of a new phase of monetary expansion in the United States. The Federal Reserve has shown itself to be increasingly open to the possibility, basing its change of position on the weakness of economic growth and on the low levels of inflation, when the scope for fiscal action is limited for economic reasons and by the proximity of the elections. Although the effectiveness of a new wave of extraordinary measures is uncertain, the markets are already discounting further quantitative easing, which has prompted a general depreciation of the dollar and an increase in tensions on the foreign exchange markets. Although China has increased the rate of appreciation of the renminbi against the dollar, this is still insufficient to bring about an appreciation of its currency in effective terms. Against this background, many countries have had to withstand strong upward pressures on their exchange rates, which they have done in several different ways: by interrupting the cycle of official interest rate rises (as in certain emerging economies); by accumulating larger volumes of reserves; by intervening directly on the foreign exchange markets (Japan); or by strengthening capital controls (e.g. Brazil).

As regards developments in the various different financial markets, stock markets posted widespread losses in August, with an increase in volatility, owing to the uncertainty regarding the US economic recovery. However, in September and October these losses were reversed and credit markets improved, partly on account of the expectations of greater monetary stimulus from the Federal Reserve and, in the case of the financial sector, the increase in confidence stemming from the approval of Basel III and the positive assessment of the effects of US financial reform. For their part, the public debt yields of the main economies fell at all maturities, especially at the long ones, the segment on which monetary expansion measures are expected to be focused. In the foreign exchange markets, the dollar has depreciated against the main currencies by 5-10% in the last three months, while the Chinese renminbi has appreciated by little more than 2% against the dollar. In the emerging markets the improved economic outlook and favourable interest rate spreads led to growing capital inflows, which, in turn, generated strong stock market gains, a narrowing of sovereign spreads and upward exchange-rate pressures. At the same time, commodity prices experienced widespread gains, following the falls of the previous quarter. Metal prices rose by 16% and food prices 13%, Brent crude is currently trading at around \$80-85 per barrel, some \$10 above its level at the beginning of July, while the price of gold was above \$1,300 per ounce. These rises are connected with the depreciation of the dollar and the fall in interest rates.

In the United States, the Q3 GDP growth estimate was an annualised quarter-on-quarter growth rate of 2% (3.1% year-on-year), as against 1.7% in Q2 (3% year-on-year). The acceleration was primarily due to the positive contributions of private consumption and the change

in inventories. However, the latest indicators have intensified the doubts regarding the recovery, given the pronounced labour market weakness, the stagnation of the residential housing market (analysed in Box 1), the slackness of consumption and the concerns over the strength of investment. Specifically, retail sales slowed during the quarter, despite the pick-up recorded in September, while consumer sentiment worsened. At the same time, the job creation data remained very disappointing, with the unemployment rate remaining at 9.6% of the labour force. The residential housing market indicators fell sharply following the withdrawal of tax credits for house purchases at the end of April, despite the slight rise in sales and in housing starts in September. As for inflation, annual CPI inflation in September stood at the same level as in June (1.1%), while underlying inflation fell to 0.8%, its lowest level for fifty years. Against this background, the Federal Reserve left its official interest rate unchanged (between 0% and 0.25%) and reiterated that it would keep it at exceptionally low levels for an extended period. It showed more concern about the downside risks to activity and prices, confirming its desire to carry out, if necessary, further bond purchases to stimulate the economy, thereby anticipating a new round of quantitative easing (QE2).

In Japan, quarter-on-quarter GDP growth stood at 0.4% (2.4% year-on-year) in Q2, down from 1.2% in the previous quarter (4.7% year-on-year), owing to the stagnation of consumption, the negative contribution of inventory accumulation and a larger contraction in public investment. The latest data point to a decline in industrial output, linked to a reduction in exports, against a background of decelerating global demand and yen appreciation, and a deterioration in business and consumer sentiment, which points to a more pronounced decline in activity at the end of the year. However, in the labour market the unemployment rate fell by 0.3 percentage points during the quarter, to 5% of the labour force, with a marked recovery in employment. At the same time, the rate of decline in consumer prices accelerated, to -0.6% year-on-year in September, and underlying inflation remained at -1.5%. In this setting of greater concern about the rate of recovery and the upward trend in the yen, the Bank of Japan intervened in the foreign exchange markets in mid-September selling an amount of yen estimated at 0.4% of GDP. In October, it reduced the official rate of interest to the range 0%-0.1% and approved a fund of ¥5 billion (1.1% of GDP) to purchase assets, in order to reduce longer term rates.

In the United Kingdom, the initial estimate of GDP growth in Q3 was 0.8% quarter-on-quarter (2.8% year-on-year), below the Q2 rate of 1.2% (1.7% year-on-year). Likewise, the highest frequency data suggest a moderation in growth from Q3, given the slackness of business sentiment and private consumption and the weakness of the external sector. In the labour market, the unemployment rate fell by 0.1 percentage points to 7.7% of the labour force, with a good rate of job creation. However, the recovery in the real-estate market in mid-2009 seems to have come to a halt, with a weakening of demand that has led to further price stagnation. As for consumer prices, the CPI remained at 3.1% year-on-year in September and underlying inflation moderated to 2.7%. Against this background, the Bank of England at its October meeting held the official interest rate unchanged at 0.5%, without modifying its asset purchase programme.

The non-euro area EU Member States that joined the EU in 2004 or 2007 recorded year-on-year GDP growth of 1.8% in Q2, up from 0.5% in Q1, driven by the buoyancy of exports to the euro area, while domestic demand remained weak, except in Poland. The Q3 indicators show a growing improvement in industrial production and signs of recovery of private consumption in some countries. However, the recovery is very uneven across countries, being more pronounced in Poland, the Czech Republic and Estonia, while year-on-year growth rates are still negative in Latvia, Bulgaria and Romania. In the latter case the deterioration of the economic

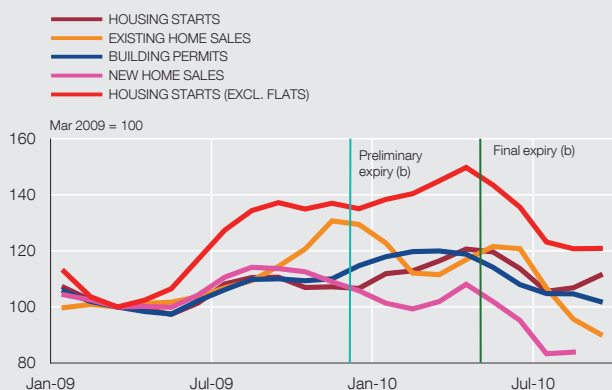
The housing market has been at the epicentre of the US economic and financial crisis. Not only was mortgage financing the proximate trigger of the financial turbulence that initiated the crisis, but also adjustment in the real-estate sector was one of the factors responsible for the economy's entry into recession, with particularly strong effects on the labour market and the financial position of households. From September 2008, the US authorities implemented a substantial battery of public measures in order to normalise the market. However, their partial withdrawal, against a background of economic and financial fragility, has shown that private demand is still insufficient to underpin real-estate activity. This box analyses the recent developments in the US housing market, identifying the factors feeding the risks of a relapse, in the absence of additional public assistance and given the restricted scope for further fiscal support.

The recent adjustment in the housing market has been very severe by historical standards. The correction began at the beginning of 2006,

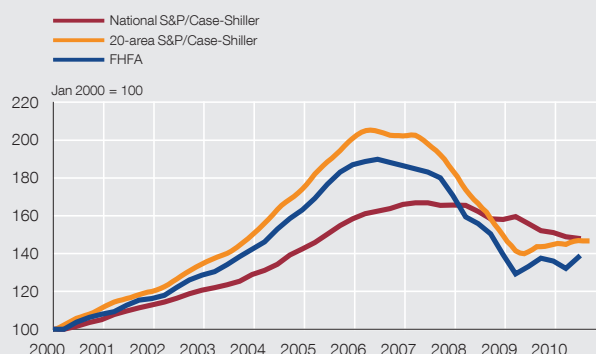
establishing the conditions that would give rise to the subprime mortgage crisis in mid-2007, and, in September 2008, the real-estate adjustment intensified with the financial collapse. Housing starts fell from 2.3 million, at the peak of the cycle, to 477,000 at the trough (beginning of 2009), while existing home sales fell from 7.1 million to 4.5 million over the same period (see Panel 1). Prices, as measured by the Case-Shiller index for the 20 main urban areas, fell by 32% (see Panel 2). In response to the collapse in the market, public support measures,¹ which commenced with the placement into conservatorship of Fannie Mae and Freddie Mac, in September 2008, were decisive in stabilising the market. On one hand, with the support of the purchase of a large proportion of their asset-backed securities by

1. For a detailed study of the fiscal and monetary support for the mortgage market, see Cuadro-Sáez, Romo and Rubio (2010), "El mercado hipotecario residencial en Estados Unidos. Evolución, estructura e interrelación con la crisis", *Boletín Económico*, June, Banco de España

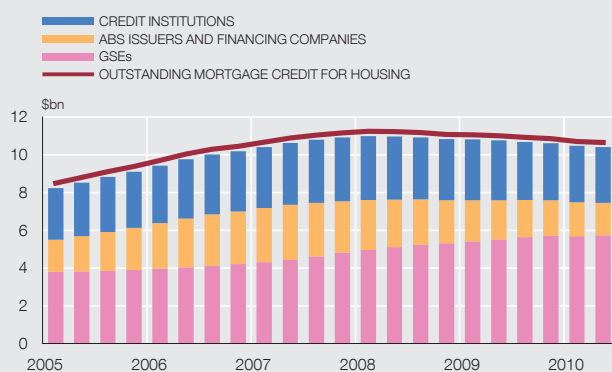
1 HOUSING STARTS, PERMITS AND SALES (a)



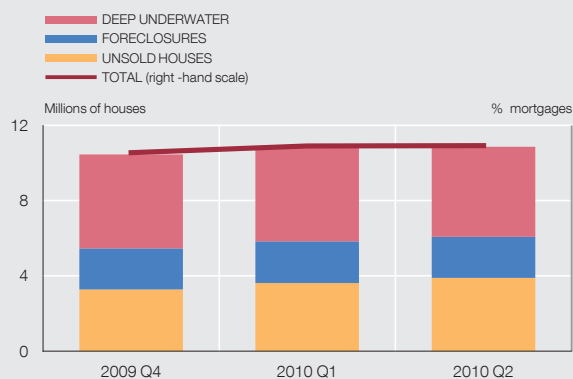
2 HOUSE PRICES



3 ROLE OF GSEs IN THE MORTGAGE MARKET (outstanding amount)



4 HOUSES TO BE SOLD: CURRENT AND POTENTIAL VALUE (c)



SOURCES: National Association of Realtors, Bureau of the Census, Federal Housing Finance Agency, S&P Case Shiller, Federal Reserve Board (Flow of Funds) and First American Corelogic.

a. For simplicity of presentation, the series are represented as a three-month moving average.
 b. Reference dates for the tax credit for new house purchasers.
 c. "Deep underwater" includes those mortgages with a loan-to-value ratio of over 125%.

the Federal Reserve, these government sponsored entities that have been taken under federal government control increased the volume of low-cost financing, while tax credits were established for new house purchasers, which proved to be decisive in reactivating the market (see Panel 3). On the other hand, measures were taken to prevent avoidable foreclosures, through programmes to modify troubled mortgages and to refinance mortgages with stringent conditions, and funds were set up for the stabilisation of areas particularly affected by foreclosures. This battery of measures, along with the stabilisation of economic activity, successfully reversed the downward trend in the market; between spring and autumn 2009 housing starts and sales increased by more than 20% and house prices stabilised.

Although the withdrawal of the tax credits for house purchases², initially planned for October 2009, was postponed until April 2010, given the doubts surrounding the capacity of private demand to reactivate the market, it led to a significant slowdown in real estate activity, confirming that the recovery in the market had been based on the public support. Housing starts and building permits for houses other than flats contracted by 20% between April and September, and sales of both new and existing homes fell by 25% over the same period. At the same time the stock of unsold houses has increased significantly relative to monthly sales. In short, the real estate market indicators are once again standing at around the historically low levels of spring 2009, the renewed labour market weakness from the summer being one of the contributory factors.

The outlook for the real estate market is negative and the risks are biased to the downside, owing to the weakness of private demand and the restricted scope to introduce new government measures to support this market in the near future. At the same time, the persistent weakness in the labour market may result in more mortgage foreclosures, increasing the already large stock of unsold houses and putting downward pressure on prices, which could lead to an increase in the number of houses whose price is below the outstanding mortgage debt, i.e. with a loan-to-value ratio of more than 100% (so-called underwater mortgages). Panel 4 presents an estimate of the number of houses that could come onto the market, obtained as the sum of the stock of unsold houses, those in the process of foreclos-

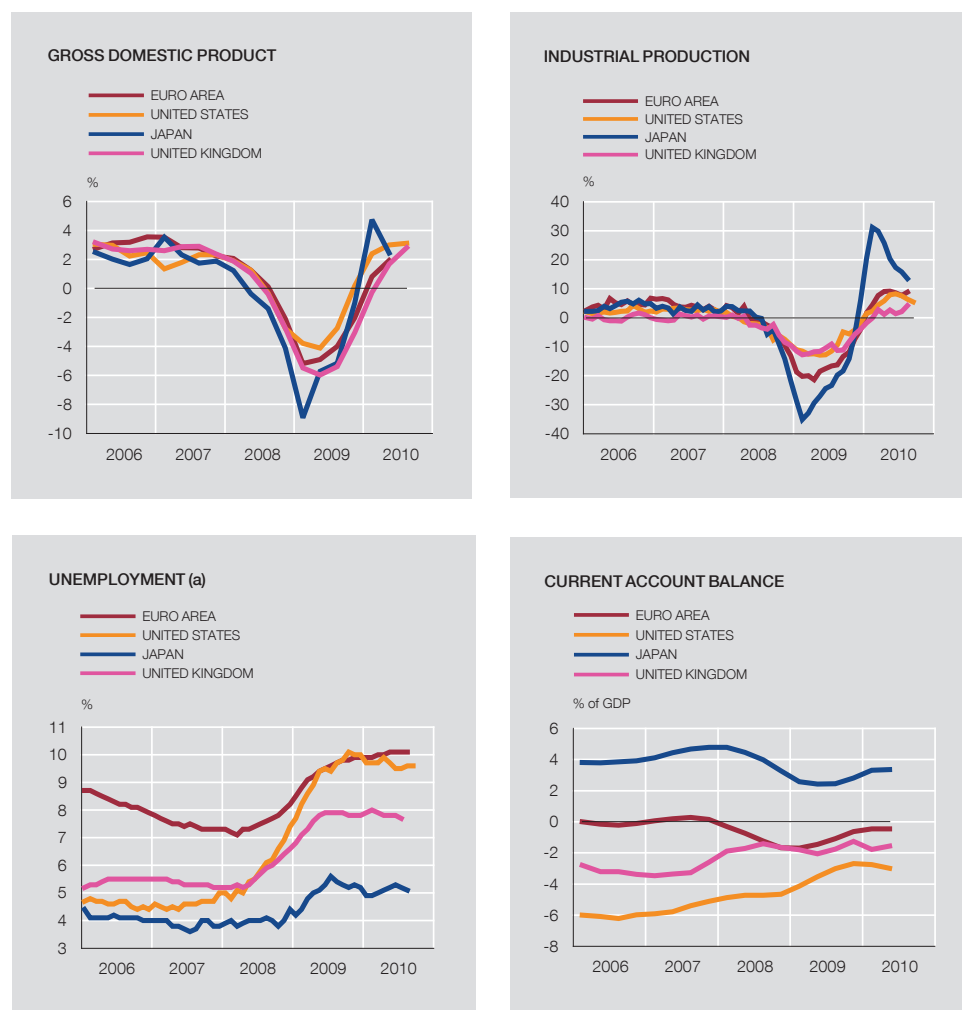
ure and those subject to mortgages with loan-to-value ratios of over 125% (deep underwater mortgages); in total, 10% of all mortgages. This is a very high proportion, although it should be seen as an upper limit, since these three categories overlap.³ Moreover, it should be noted that households with underwater mortgages seem reluctant to abandon their homes, which is what usually happens in the United States when mortgages cannot be paid, as the borrower's liability under the mortgage extends in most cases solely to the mortgaged property. However, the difficulty of knowing whether they would obtain a sufficient volume of financing to purchase a house with similar characteristics is now discouraging such abandonment.

Another element of uncertainty and risk is the pending reform of Fannie Mae and Freddie Mac, which were taken over by the government and are a source of losses, but at the same time are a key element for the support of the mortgage market (see the article cited in Footnote 1). In fact, the reform of these agencies, which will foreseeably restrict their activities, has been delayed owing to the possible negative impact on the market of the consequent more limited access to financing through this channel. The restructuring of these government sponsored enterprises, the broad outline of which is still to be defined, will not begin to be discussed until 2011. Finally, the irregularities recently detected in the documentation for securitised mortgages have led some banks to halt foreclosure procedures. This has generated losses for some holders of asset-backed securities and may have significant consequences for the securitisation entities, if they are eventually obliged to repurchase some of these issues.

To sum up, housing market activity in the United States has been largely sustained by public support, and private demand on its own has not been capable of replacing it following its partial withdrawal. This has led to a significant deterioration in the outlook for this market. The renewal of certain non-standard monetary policy measures (bond purchases by the Federal Reserve System) may help to sustain the mortgage market, against a background of very limited scope for fiscal measures. However, factors such as labour market weakness, which could lead to a further increase in the volume of unsold houses, and the uncertainty surrounding pending mortgage market reform may continue to hold back prospects in the coming months.

2. These tax credits were equivalent to a deduction from net tax payable of 10% of the value of the house, subject to certain restrictions which meant that the actual deduction was much lower than 10%, approximately 3.7% of the average price.

3. In fact, a recent study by the Federal Reserve shows that significant strategic defaults do not occur until the loan-to-value ratio reaches 150%, and only from 162% do half of debtors make a strategic default. See Bhutta et al. (2010), *The Depth of Negative Equity and Mortgage Default Decisions*.

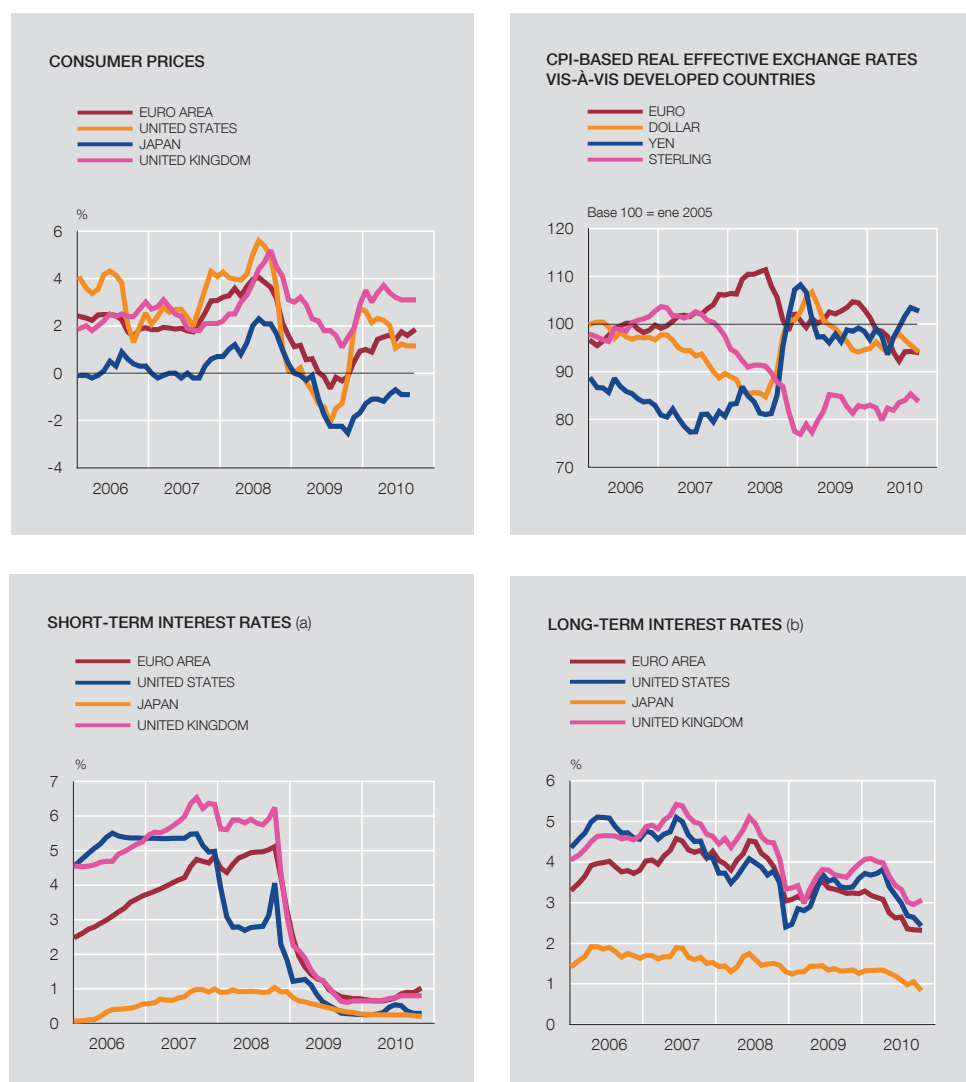


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

situation is notable, owing to the severe fiscal adjustment measures implemented. During the quarter, inflation followed a slightly upward path, but remained at moderate levels; in September it stood on average in the region at 3.4% year-on-year. Against this background, official interest rates were held unchanged.

In China, activity decelerated slightly in Q3, in year-on-year terms (GDP grew by 9.6%, as against 10.3% in Q2), mainly as a result of a less favourable base effect. This figure suggests that the economy was more buoyant than in the preceding quarter, underpinned by the solidity of investment and private consumption, which offset the smaller boost from public investment and the recent moderation in exports. Despite the slowdown in exports, China had a large trade surplus in Q3, fuelling the international pressure for the value of its currency to be appreciated at a faster rate. As for prices, the inflation rate rose slightly to 3.6%. Against this backdrop, the central bank raised its key policy rate by 25 bp in October, having previously temporarily increased the reserve ratio for the country's main banks. Since it became more flexible in mid-June the renminbi has appreciated against the dollar by little more than 2%, most of which has taken place since the beginning of September. In the rest of Asia, the main economies of the region remained very buoyant in Q2 (GDP grew, on average, by 8.4% year-



SOURCE: Banco de España.

a. Three-month interbank market interest rates.

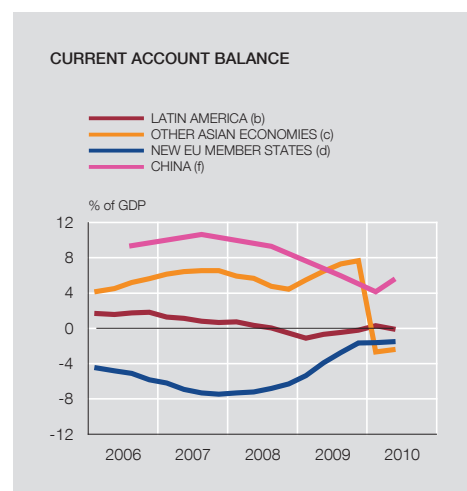
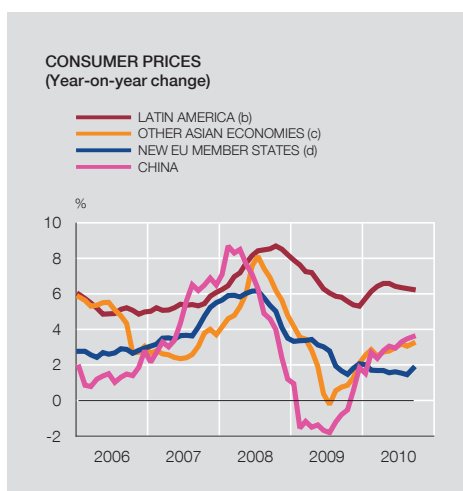
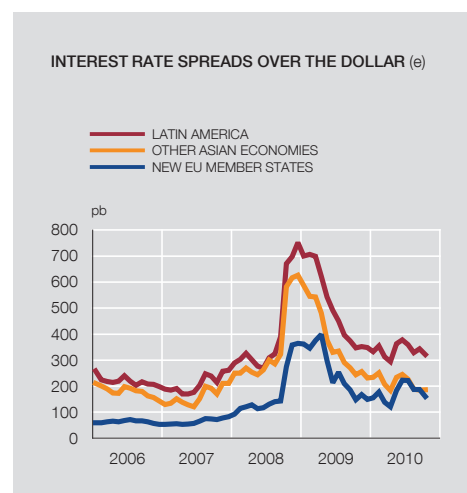
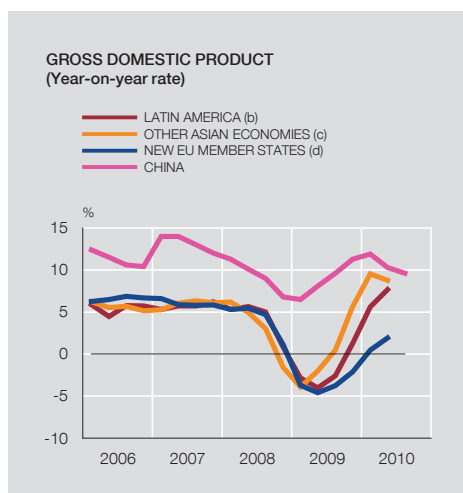
b. Ten-year government debt yields.

on-year, as against 8.7% in Q1), although the latest indicators show a certain deceleration in activity. At the same time, the year-on-year inflation rate rose in South Korea and fell in Thailand, India, Indonesia and the Philippines. Against this background, and given the upward pressures on exchange rates, there were hardly any changes in monetary policy, with the exception of the increase in official rates in Thailand and India, and the widening of the Singapore dollar's fluctuation band.

In Latin America, year-on-year GDP growth was 7.7% in Q2 (5.6% in the previous quarter), the highest rate since the beginning of the 1970s, although this high figure is partly explained by the base effects following previous adjustment. The acceleration in activity took place across the region, except in Brazil which, nonetheless maintained a high growth rate (8.8%, after 9% in Q1). This buoyancy stemmed from the thrust of domestic demand, which contributed around 10 pp, and of investment in particular. However, the Q3 indicators generally point to a mild slowdown in activity, except in Chile and Venezuela. Inflation dropped by 0.1 pp in September, to 6.3% on average, with divergence across countries. The region contin-

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

CHART 7



SOURCES: National statistics and JP Morgan.

- a. The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d. Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Bulgaria and Romania.
- e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
- f. Annual data until 2009

ued to record large inflows of portfolio and direct investment, while the issuance of public and private debt rose to record levels in certain countries, such as Mexico, where the Treasury placed the region's first 100-year bond. Against this background, conducive to exchange rate appreciation, some central banks stopped withdrawing their monetary stimulus (Brazil, Peru), while the central bank of Chile continued to raise interest rates (by 25 bp in October), although at a slower rate than in previous months (50 bp in the preceding four months). The central banks continued to accumulate reserves, so that in all the countries, except Colombia and Venezuela, they reached historic highs. In Brazil, the rate of the financial operations tax for inflows of investment in fixed income was raised on two occasions.

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

Following some months of very moderate growth, economic activity in the euro area picked up in 2010 Q2 as a result of, on the one hand, the strong boost from the external sector and, on the other, certain extraordinary factors centred largely on the German economy which had a positive influence on domestic demand. The most recent information available for Q3 indicates that the recovery continued, albeit at a more subdued rate. The slowdown in growth was due, in addition to the disappearance of transitory factors, to the lower momentum of the external sector and the gradual petering out of economic policy stimuli. In the medium term, the most recently published forecasts of international agencies broadly confirm the latest ECB projections of moderate growth until end-2011, so it will be some time before GDP reaches its pre-crisis levels. Furthermore, this scenario of a slow recovery remains subject to a high degree of uncertainty and downside risks, largely stemming from the external sector, which may have intensified as a result of the recent appreciation of the nominal effective exchange rate of the euro.

The strains on sovereign bond markets, which seemed to have abated at the beginning of summer, resurfaced at end-August, although on this occasion their impact across the area was more limited. The difficulties of redressing Portuguese public finances and uncertainty about the financial solvency of the Irish banking system once again pushed Portuguese and Irish spreads over the German bond higher. Meanwhile, Italy and Spain, which had been affected by contagion from the Greek debt crisis in May, albeit to a varying degree, managed to decouple themselves: their rates were more stable and their spreads were narrower (see Box 2). Despite the more limited impact, the fresh bout of instability on sovereign debt markets is a reminder of the scale of the challenges facing the euro area. It is essential for countries with exceptional difficulties, including Ireland and Portugal, to unequivocally show their determination to undertake the fiscal and structural reforms needed to guarantee the sustainability of their public finances and their long-term growth. As for improving European economic governance (see Box 3), although the report of the Task Force chaired by Van Rompuy represents progress, which in some cases is significant, greater ambition from euro area governments is still lacking. Additionally, during Q3 further headway was made regarding the design of the new European financial architecture with the creation of the European Systemic Risk Board and three more supervisory authorities, and the implementation of the European Financial Stability Facility.

Against this backdrop of a fragile economic recovery and the containment of inflationary pressures, the ECB's monetary policy stance continued to be accommodative. Thus, official interest rates remained at very low levels and non-conventional measures to support credit remained in place; including, most notably, the fixed-rate tender procedure with full allotment in regular liquidity-providing operations and the Securities Market Programme whereby public and private debt is purchased on secondary markets. Nevertheless, the gradual normalisation of financial markets prompted a rise in interbank rates, particularly, at the shorter-dated terms, faced with the prospects of the gradual unwinding of extraordinary monetary policy measures.

3.1 Economic developments

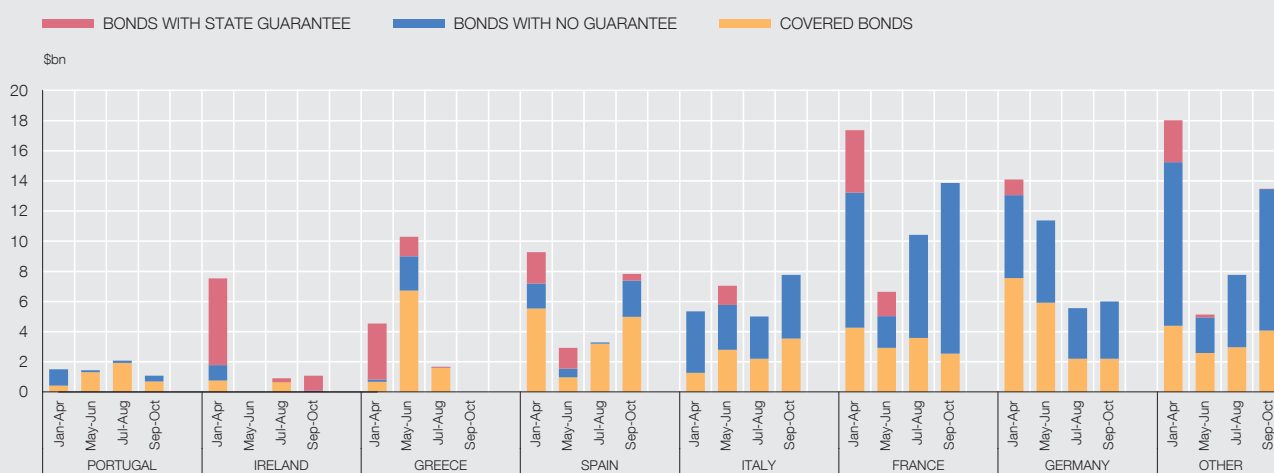
According to the first National Accounts estimate for 2010 Q2, euro area GDP rose by 1% in quarter-on-quarter terms, 0.7 pp up on the figure posted in the January-March period (see Table 1). The increase in GDP was chiefly attributable to strong export and investment growth, while private and public consumption increased more moderately (see Chart 8). As a result,

The economic and financial crisis has prompted high yield spreads between the various sovereign bonds in the euro area, particularly those of Member States with weaker fiscal positions. In May this year, government debt markets experienced spells of extreme instability as a result of the Greek fiscal crisis which turned into a crisis of confidence affecting the euro area as a whole. These tensions filtered through, in turn, to the banking sector which was hit in particular by distrust in the sustainability of public finances. On the one hand, government debt prices, potentially implied high losses, and, on the other, the deterioration of public finances called into question the value of the explicit and implicit guarantees Member States had given to their domestic banks against a backdrop of growing uncertainty regarding banks' net worth position. This was reflected, as shown in Panel 1 by a substantial contraction in medium and long-term debt issuance by banks.

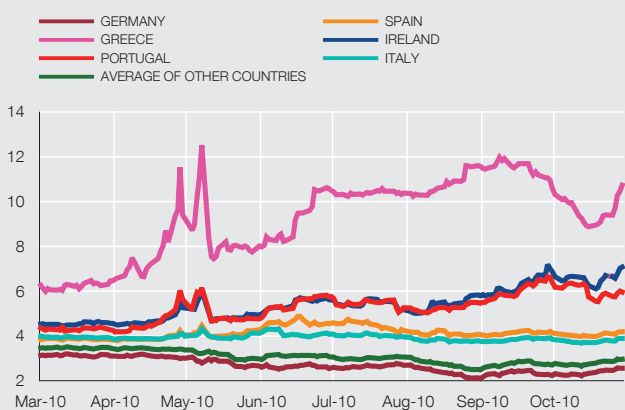
As a result of the emergency measures adopted during the spring by the ECB and EU governments in collaboration with the IMF,¹ the instability tended to decrease in July. This improvement was strengthened, furthermore, by the publication at end-July of the results of the stress tests of EU banks, which enabled an easing of the conditions in which banks access funding markets. However, towards the end of the summer, the tensions returned, this time focusing on the Portuguese and Irish government debt markets, at the same time as the yield on Greek debt held at very high levels and only began to fall off to any great extent in September, following the positive assessment of the implementation of its economic programme. This favourable assessment made possible a fresh disbursement of funds as part of

1. For more details, see Box 3 of the Economic Bulletin of the Banco de España, July 2010.

GROSS ISSUANCE OF MEDIUM AND LONG-TERM BONDS OF FINANCIAL CORPORATIONS. EURO AREA (a)



TEN-YEAR GOVERNMENT DEBT YIELDS



GDP GROWTH PROJECTION FOR 2010 AND 2011 Consensus Forecast



SOURCES: Consensus Forecast, Dealogic and Banco de España.

a. The monthly average was used.

the loan package agreed by the IMF and euro area countries. The further outbreak of uncertainty pushed the German ten-year Bund to minimum levels of 2.1% (see Panel 2), while ten-year Irish and Portuguese bonds climbed, to above 7% in the case of the former, and since summer Ireland's credit rating has been downgraded again by S&P, Moody's and Fitch.

One important difference with respect to events in the first half of the year is that on this occasion the tensions did not spread to countries such as Italy and, especially, Spain, whose performance differed. In the Spanish case, the reason why its sovereign spread performed more favourably lies in the progress made on three fronts: fiscal consolidation, structural reforms and restructuring of the financial system. These advances were boosted further by the exercise in transparency involving the publication of banks' stress tests in a shared format for EU countries as a whole, with a far superior coverage and degree of detail for Spain. These factors were decisive in dispelling the excessive uncertainty which had built up about the sector's soundness. In fact, the gradual narrowing of the yield spread over Germany was coupled with an improvement in banks' access to funding markets, which remained very limited in the case of Portugal, Ireland and Greece.

In the case of Ireland and Portugal, however, the markets did not perceive as strongly this determination to adopt resolute action in terms of economic policy with the two-fold objective of, firstly, safeguarding financial stability in the medium term and, secondly, promoting sustainable growth. This left their government debt highly exposed to an accumulation of bad news about the respective economies. Thus, in the case of Ireland, the widening of the sovereign spread was linked to growing uncertainty about the fiscal implications of the negative outlook for its domestic banking sector, which was subject to a long, far-reaching restructuring process and received a large volume of public aid which, nevertheless, seemed insufficient. In the case of Portugal, the deterioration was also caused by an increase in the risk surrounding public finances, which could have been further fuelled by Irish debt tensions. The downward revision of economic growth for 2011, illustrated in Panel 3, and the relatively unfavourable developments in the budget outturn, threatened the

achievement of the budget deficit targets and substantially raised the effort required to re-join the originally planned path of consolidation.

In this context, the Irish and Portuguese authorities tried to dispel existing uncertainty with their respective announcements at end-September. For instance, Ireland published revised estimates of projected losses and a higher need for capital (foreseeably State-funded), that were going to arise from the nationalised Anglo Irish Bank (which had been excluded from the stress tests of EU banks) and from NAMA's² asset purchase programme. As a result, the impact on the government deficit of the aid in the form of capital to banks during 2010, some of which had already been given, would amount to an estimate of 20% of GDP. Pending the fiscal adjustments which will be announced in November, the Irish Government's initiatives managed to temporarily contain the deterioration of debt, although the spread against German debt once again exceeded 450 bp at end-October. On 30 September Portugal announced new adjustment measures for 2010 and additional proposals for the budget for 2011, which (pending the specification of the outstanding structural reforms) also contributed to a temporary respite in debt tensions.

In short, recent developments in euro area sovereign debt markets illustrate the importance of national economic policies prioritising fiscal consolidation in conjunction with restructuring of the banking sector and ambitious structural reforms to promote growth, in those countries with specific difficulties.

2. The National Asset Management Agency (NAMA) was created to acquire impaired loans (mainly from property developers) and to restructure the balance sheets of five Irish banks, which represent a very large share of the domestic banking system. NAMA exchanges loans for bonds (guaranteed by the Irish State) and a small portion of the loans are exchanged for subordinated securities, issued by NAMA for this purpose. NAMA completed the acquisition of two tranches in April and August 2010, applying an overall haircut of 52% to the book value of the loans, which is considerably higher than the government's initial estimate of 30%. The total loan portfolio it will acquire has a book value of €77 billion, more than 45% of GDP. NAMA is a financial vehicle which is not classified as belonging to the general government sector and, consequently, the repercussion on public finances is in the form of contingent liabilities due to the State guarantee of its bonds.

domestic demand and the external sector contributed 0.5 pp and 0.2 pp, respectively, to GDP growth, since the significant rise in exports was offset by buoyant imports. Stockbuilding added 0.3 pp to GDP growth. The sectoral breakdown shows that value added increased in most sectors, particularly in industry and, to a lesser degree in services. In year-on-year terms, the seasonally adjusted rate of change in GDP stood at 1.9%, compared with 0.8% for the previous quarter.

By country, there was a strong recovery of activity in Germany, where GDP grew 2.2% in Q2 (0.5% in the early months of the year). This quickening was triggered by the same factors mentioned above for the euro area. Thus, to the momentum of the external sector was added

The global crisis has highlighted the considerable shortcomings in the ability of the Stability and Growth Pact (SGP) to sustain fiscal policy discipline and the fact that it is necessary to enlarge the scope of multilateral supervision beyond public finances in order to monitor and correct the build-up of imbalances which can ultimately pose a serious threat for the stability of the euro area. Consequently, European institutions are undertaking an in-depth review of the mechanisms for economic policy coordination and supervision in the euro area.

The most important progress made in specifying this governance reform was the presentation of the report by the Van Rompuy Task Force, a working group created in March within the European Council with the involvement of the EC, the ECB and the EU Member States. The report included the Task Force's specific proposals for reform, approved by the Heads of State and Government on 28 October, and its conclusions complement the proposals for legislative reform which the European Commission had presented on 29 September. In the fiscal realm, these proposals suggest a significant reform of the SGP which will attribute greater importance to the government debt criterion when evaluating the fiscal position of the various countries, at the same time as they defend a broader and more transparent system of sanctions which would be imposed earlier on in the process and with a degree of automaticity, albeit higher than in the past, still subject to the qualified majority procedure governing Council decisions in accordance with the Treaty. This is complemented with a recommendation to set minimum compulsory requirements for national fiscal frameworks. Also, a new mechanism is proposed for detecting, preventing and correcting the build-up of macroeconomic imbalances which might jeopardise the common project of Monetary Union. Furthermore, there is a recommendation for deeper coordination of economic policies – in the shape of the so-called “European semester”, which was already approved by Ecofin in September – and the creation of a crisis management mechanism, approved by the Heads of State and Government on 28 October as well as the strengthening of European institutions.

Specifically, *reforming the preventive arm* of the SGP maintains the requirement of convergence on the medium-term budgetary objectives¹ (MTBO), but proposes the need for swifter convergence if government debt exceeds 60% of GDP. In case of a significant deviation from the adjustment path, which is not corrected, a procedure will begin that will start with the Commission issuing an early warning, it may continue with a recommendation from the Council after one month and conclude five months later, if the appropriate actions are not adopted, with the imposition of a sanction in the form of a non-interest-bearing deposit.

As for the *corrective arm of the SGP*, if the government debt/GDP ratio is higher than 60% and is not decreasing in a way considered

satisfactory, in accordance with criteria and methodology yet to be defined, this would be reason enough for launching an excessive deficit procedure (EDP) or for preventing the latter from closing, even if the government deficit has been reduced to below 3%, following a diagnosis by the Commission of the determinants underlying the changes in the debt. The initiation of an EDP will imply that, if the country in question has already been sanctioned with the imposition of an interest-bearing deposit, the latter will no longer bear interest. If the country has not been sanctioned with the imposition of an interest-bearing deposit, the commencement of the EDP will give rise to a recommendation from the Council for action that must be taken before a deadline. In both cases, if the appropriate actions are not taken to reduce the excessive deficit, a fine would be imposed as a result. Persistent failure to implement the recommendations will give rise to a larger fine, that will include a variable component related to the level of the deficit, which already appears in the SGP as it currently stands. Notably, the latter is the only sanction proposed that would require a qualified majority of the Council. The new sanctions fiscally speaking, and those relating to the prevention of macroeconomic imbalances, will be imposed, by contrast, automatically as proposed by the Commission, unless the Council decides otherwise by a qualified majority within a deadline of ten days. However, it should also be pointed out that in the stage prior to the imposition of sanctions (for example, the assessment of whether or not the deviations are significant) the relevant decisions are still the responsibility of the Council to be adopted by qualified majority. Noteworthy also is that all the new sanctions would only apply initially to euro area member countries.

The Task Force's last proposal referring to fiscal matters defends the need to guarantee minimum requirements which must be met by national financial institutions before the end of 2013 in the following areas: public accounting systems and statistics, numerical rules consistent with the design of the SGP, forecasting systems, medium-term budgetary planning and adequate follow-up of all levels of general government. Furthermore, an improvement is proposed in the quality of statistics.

The new regulation for the prevention and correction of macroeconomic imbalances and divergences in competitiveness will set up an alert system comprising a series of economic and financial indicators which have yet to be defined. Should the Commission consider that a Member State's economic policy may pose a threat for the stability of the area as a whole, it may issue an early warning. At a subsequent stage (in case of a particularly serious threat), the Council will decide whether it declares that Member State to be in an “excessive imbalance position”. As with fiscal matters, the launching of this procedure means that the policies of such countries will be subject to strict monitoring by European institutions and they may ultimately have sanctions imposed, if they persistently fail to comply with recommendations.

In order to increase policy consistency and coordination, all these surveillance arrangements will be included in the “European semester” approved by the Ecofin on 7 September, which will come into operation in January 2011. The “semester” will begin in January

1. These MTBO are included in the Stability and Convergence Programmes that Member States must present, expressed as a percentage of GDP in structural terms. The countries which have not achieved their MTBO must converge towards them at an annual rate of 0.5% of GDP.

each year when the Commission prepares an annual growth report, which will analyse macroeconomic and fiscal developments and progress in achieving the targets of the Europe 2020 strategy. Based on this report, in March the European Council will identify the main economic challenges and will issue economic policy recommendations for the euro area as a whole and for the EU, which will be considered by Member States during April in the preparation of their Stability and Convergence Programmes and their National Reform Programmes. Lastly, in June and July the Council will publish fresh country-specific guidance which must be taken into account by countries in the design of their budgets and economic policy and reform programmes.

Overall, the Working Group's Report to the Council represents progress in the process of improving European governance and is in line with the European Commission's proposals, although some aspects of the report are less clearly defined and, sometimes, are less

ambitious than the latter. Nevertheless, the Eurosystem has raised well-founded concerns about whether the ambition shown by governments suffices to cope with the scale of the challenges facing the euro area as a whole. Accordingly, there are two areas which would require particular attention: first, setting up clear procedures based on rules which minimise as much as possible governments' discretionality and, second, strengthening these procedures by creating a committee of experts or independent fiscal agencies to provide the European institutions with greater technical capacity and independence in the supervision of policies and national statistics.

Lastly, on 28 October the Heads of State or Government agreed to set up a permanent crisis mechanism to safeguard financial stability in the euro area as a whole, which will involve a limited change to the EU Treaty. The design of this mechanism as regards conditionality and the participation of the IMF or the private sector will be spelt out between now and the end of the year.

the recovery of domestic demand, mainly underpinned by certain temporary factors, such as the improvement in the weather and increased purchases of household durable goods. In the other major euro area economies, the pick-up in activity was considerably lower. In particular, GDP climbed 0.7% in France, owing to the strength of all domestic demand components and, especially, to stockbuilding, while in Italy, where GDP moved 0.5% higher, the net external balance was the largest contributor to growth, although government consumption and gross capital formation also expanded.

Based on National Accounts data, for the second consecutive quarter the numbers employed did not change in the April-June period and, consequently, the year-on-year rate of change remained in negative territory at -0.7%. These developments are consistent with the customary lag in employment with respect to the recovery of activity. The hours worked by employees increased slightly which suggests that, at present, faced with uncertainty about the sustainability of the recovery, in order to satisfy rising demand, companies have preferred to use the existing labour force more intensively rather than to resort to new hires. Also, the substantial upsurge of apparent labour productivity in Q2, driven by the notable increase in GDP together with the decline of employment in year-on-year terms, resulted in a further drop in unit labour costs since growth in compensation per employee remained moderate. These developments and the rise in the GDP deflator enabled business margins to expand for the second consecutive quarter (see Chart 8).

The latest conjunctural data generally suggest that activity decelerated in the second half of the year (see Chart 9). On the supply front, in July and August industrial production and orders slowed and production in the construction sector contracted. Industrial and service sector confidence indicators based on purchasing managers' surveys stood at below their June levels in October, although those compiled by the European Commission improved over the same period. On the labour front, the unemployment rate remained unchanged at 10% in Q3 and the qualitative indicators for employment expectations continued to recover between

	2009				2010			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NATIONAL ACCOUNTS (Quarter-on-quarter rates of change, unless otherwise indicated)								
GDP	-2,5	-0,1	0,4	0,2	0,3	1,0		
Private consumption	-0,5	0,0	-0,1	0,2	0,2	0,2		
Public consumption	0,7	0,6	0,5	-0,1	0,2	0,5		
GFCF	-5,2	-2,3	-1,1	-1,2	-0,3	1,5		
Imports	-7,5	-2,8	2,2	1,2	4,2	4,0		
Exports	-8,0	-1,3	2,4	2,0	2,5	4,3		
Contributions to quarter-on-quarter GDP growth (pp)								
<i>Domestic demand (excl. stocks)</i>	-1,3	-0,4	-0,1	-0,1	0,1	0,5		
<i>Change in stocks</i>	-1,0	-0,3	0,5	0,0	0,8	0,3		
<i>Net external demand</i>	-0,2	0,5	0,0	0,2	-0,6	0,2		
GDP (year-on-year rate of change)	-5,2	-4,9	-4,0	-2,0	0,8	1,9		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	-9,2	-1,7	2,7	1,3	2,3	2,4	0,9	
Economic sentiment	71,5	75,6	84,1	91,9	96,6	99,3	102,2	
Composite PMI	37,6	43,2	49,5	53,6	54,4	56,6	55,7	53,4
Employment	-0,9	-0,6	-0,5	-0,2	0,0	0,0		
Unemployment rate	8,8	9,4	9,7	9,9	9,9	10,1	10,1	
PRICE INDICATORS (year-on-year change in end-of-period data)								
HICP	0,6	-0,1	-0,3	0,9	1,4	1,4	1,8	
PPI	-3,3	-6,6	-7,7	-2,9	0,9	3,1	3,6	
Oil price (USD value)	46,8	68,8	67,7	74,4	78,8	75,0	78,4	83,2
FINANCIAL INDICATORS (end-of-period data)								
Euro area ten-year bond yield	4,1	4,2	3,8	4,0	4,0	3,7	3,5	3,4
US-euro area ten-year bond spread	-1,31	-0,63	-0,47	-0,17	-0,08	-0,72	-1,01	-0,85
Dollar/euro exchange rate	1,331	1,413	1,464	1,441	1,348	1,227	1,365	1,393
Appreciation/ depreciation of the NEER-21 (b)	-0,6	-0,9	0,2	-1,0	-4,5	-10,3	-6,3	-4,9
Dow Jones EURO STOXX 50 index (b)	-15,5	-2,0	17,2	21,0	-1,2	-13,2	-7,4	-3,1

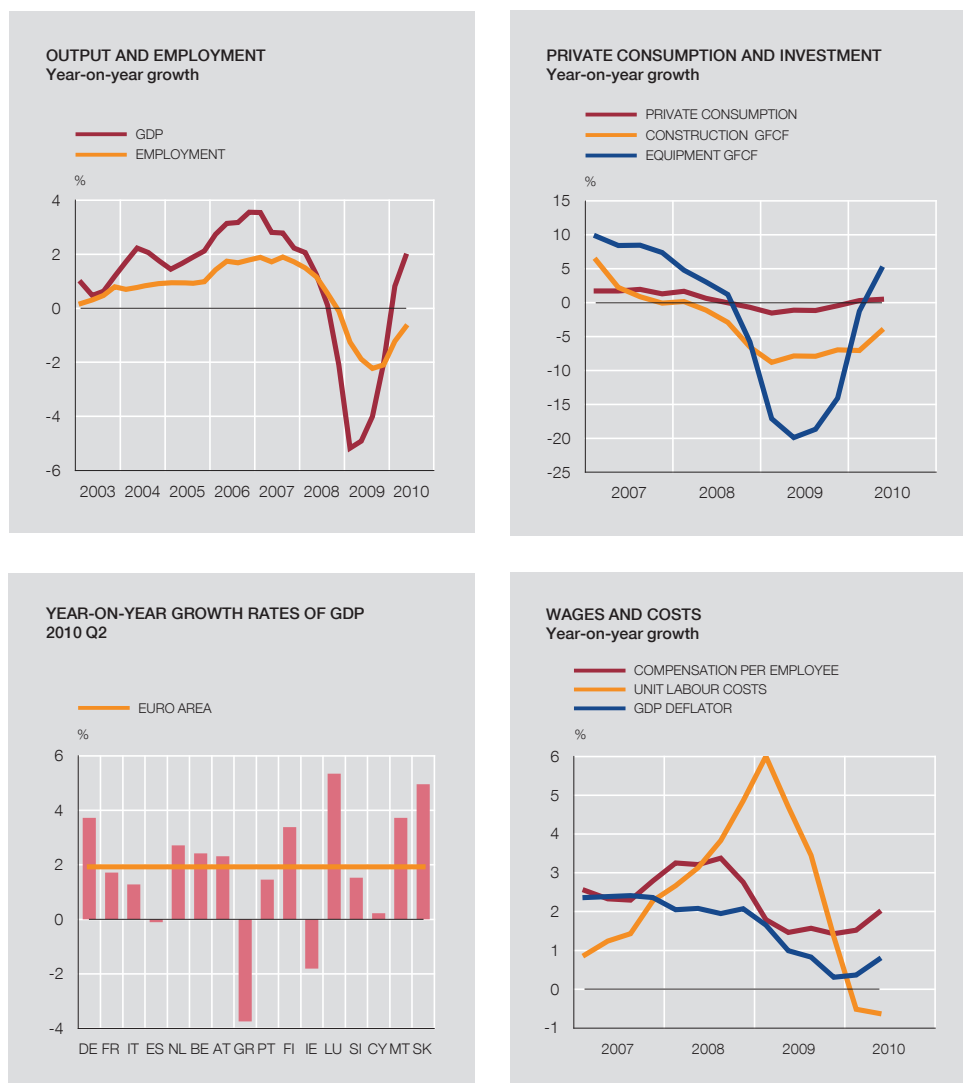
SOURCES: European Commission, Eurostat, Markit Economics, ECB and Banco de España.

a. Information available up to 29 October 2010.

b. Percentage change over the year.

June and October for all sectors, with the exception of services in the purchasing managers' survey which declined.

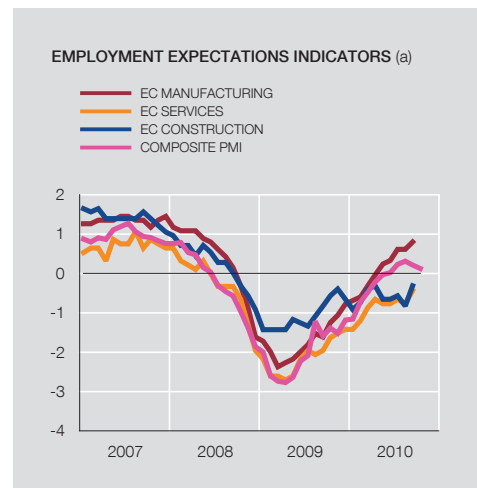
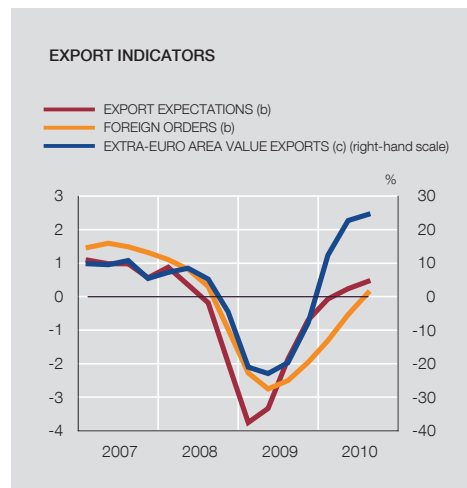
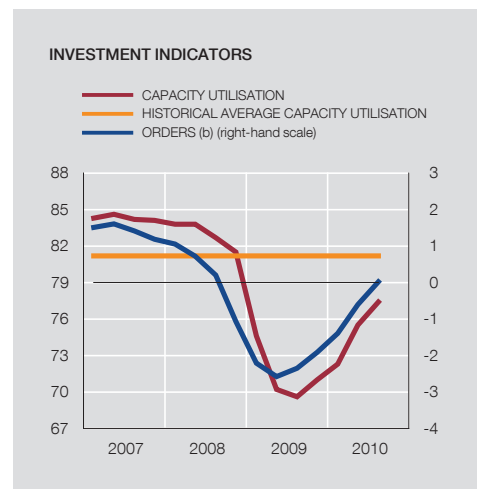
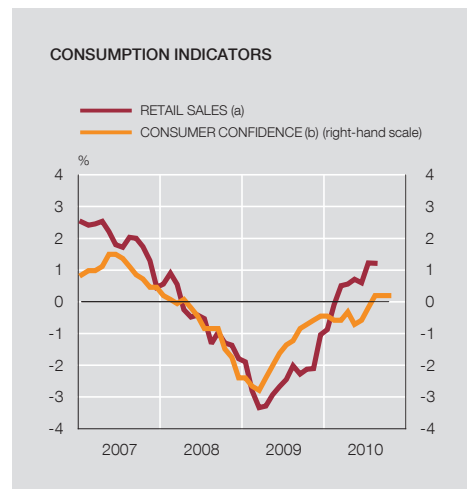
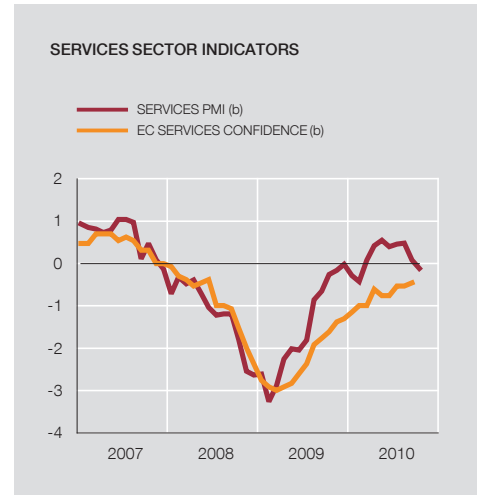
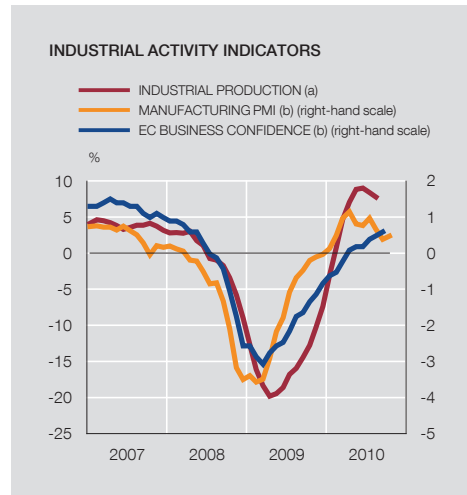
The most recent demand-related indicators are also consistent with the slowdown in output in the second half of the year. Thus, in Q3, retail sales edged up only slightly – on data to August – and new car registrations fell off, albeit at a considerably lower rate than in the two previous quarters. This indicator shows considerable cross-country dissimilarities, which largely reflect timing differences in the introduction and withdrawal of car scrapping schemes. Furthermore, consumer confidence remained flat in October for the third consecutive month. As for the European Commission's indicators of investment in capital goods, in the second half of the year the level of capacity utilisation continued to improve – despite remaining below its long-term average – and the assessment of industrial order books increased. On balance of payments data, exports flagged in July and August compared with the previous quarter, export expectations continued to rise in the second half of the year and the assessment of export order books continued to increase between June and October. Lastly, according to the European Commission's industrial stock level assessment indicator, this component's contribution to GDP growth may have remained flat in Q3 and increased slightly in Q4.



SOURCES: Eurostat and national statistics.

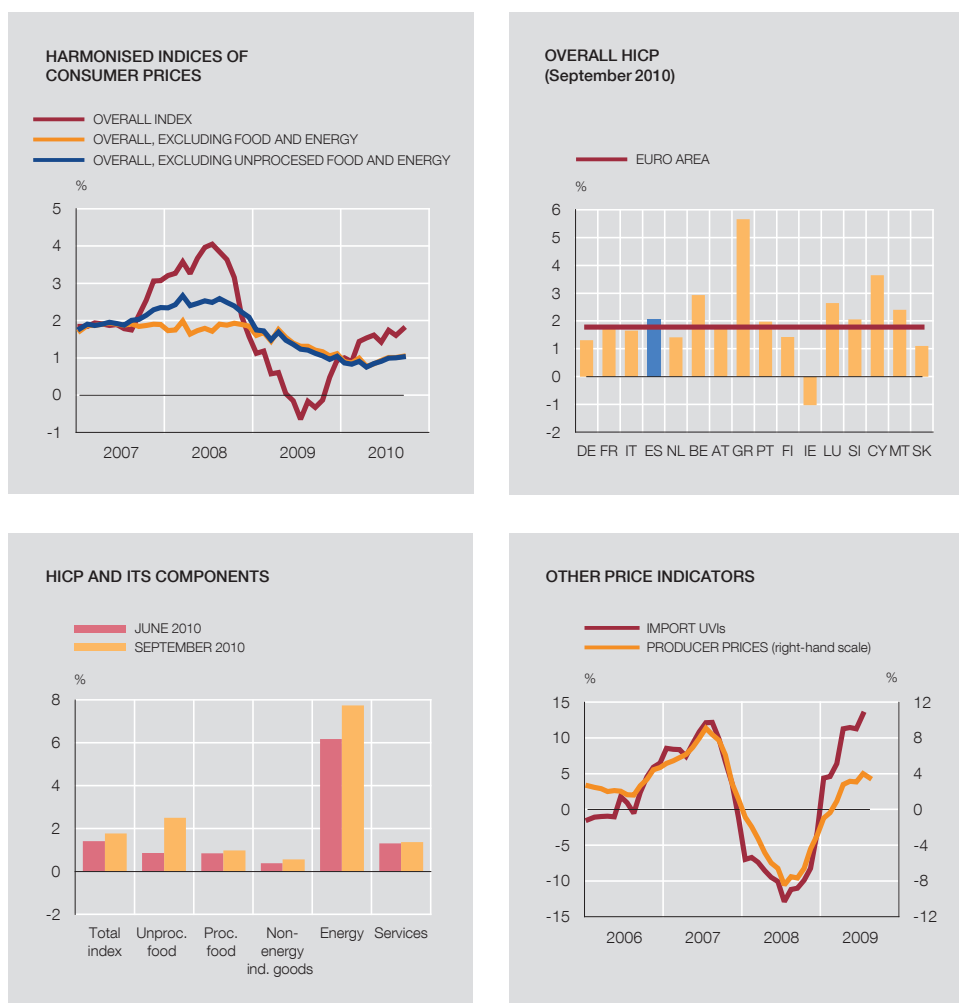
In short, the most recent economic information confirms the slowdown of activity in the second half of the year, following the upturn in Q2. It is estimated that the factors behind this moderation of growth are the slowdown of momentum in the external sector, the disappearance of temporary domestic factors which mainly affected the German economy and the weakening of economic policy stimuli. Thus, domestic demand should remain on a path of slow recovery with the weak labour market and the fiscal consolidation measures adopted in most countries weighing on private consumption and with investment, affected by the tightening of bank lending standards and the low utilisation of installed production capacity, remaining sluggish. In the medium term, the outlook continues to be one of modest growth underpinned by international demand, accommodative monetary policy and a widespread improvement in the functioning of financial markets encouraged by the economic policy measures adopted.

In any event, this scenario is surrounded by a high degree of uncertainty in conjunction with predominantly downside risks. For instance, tensions on sovereign bond markets, which seemed to have eased at the beginning of the summer, resurfaced at end-August with a widening of the spreads of Irish and Portuguese government debt, reflecting the current fragile fiscal



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 data.
- c. Original series year-on-year rates. Quarterly average.



SOURCES: Eurostat and ECB.

and financial situation of the euro area (see Box 2). Furthermore, the business sector is immersed in a process of balance sheet restructuring which, were it to last too long, could ultimately weaken domestic demand by restraining investment plans and wages. Additionally, in the short and medium term in order to ensure that there is a sustained improvement in activity, it is vital that employment recovers firmly and drives domestic demand. Finally, the strong appreciation of the exchange rate in recent months could prevent euro area exports from fully benefiting from the momentum of global economic recovery.

The 12-month inflation rate stood at 1.8% in September, 0.4 pp up on the June figure, essentially driven by changes in unprocessed food prices, while the energy component continued to expand at very high rates driven by its substantial base effect. Thus, core inflation, as measured by the CPI, excluding energy and unprocessed food prices, the most volatile items, remained relatively stable at 1% (see Chart 10). Industrial prices also posted a higher growth rate in the summer months, climbing to 3.8% in August, and there was a particularly significant rise in energy prices also stemming from a strong base effect. In the next few months, as envisaged by various international agencies, there will foreseeably be further rises in commodities prices or increases in indirect taxes and administered prices will only partially feed through to inflation due to the ongoing high economic slack (see Table 2). Against this backdrop, long-term inflation expectations remained modest.

According to information published by the ECB, the euro area current account balance ran a deficit of €52 billion (0.9% of GDP) between January and August 2010, which was slightly down on the €57 billion posted in the same period of the previous year (1% of GDP). This improvement in the total balance was the result of a higher surplus on the services sub-balance and a smaller deficit on the income sub-balance. As for the financial account in the same period, there were more net capital outflows in the form of direct investment which amounted to €89 billion compared with €55 billion in 2009, while net portfolio investment inflows dropped by €64 billion to €112 billion. As a result, the basic balance which is the sum of these two types of investment and the current account balance decreased from a surplus of €63 billion in the January-August period of 2009 to a deficit of –€30 billion in the same period of 2010 (see Chart 11).

The most recent data on budget outturn and certain governments' estimates indicate that, in the euro area as a whole, public deficits will remain practically stable in 2010 at very high levels similar to those of the previous year and in line with the European Commission's forecasts of last Spring (see Table 3). The impact on the deficit of consolidation measures introduced by some economies in recent months was offset by the effect of the automatic stabilisers and, to a lesser degree, by the fiscal stimulus measures that countries such as Germany and France implemented for 2010. There was also a slight rise in interest payments.

At a disaggregated level, the budget outturn in Germany was better than expected at the beginning of the year due to the strength of its economic recovery and the French Ministry of Public Finance slightly reduced its forecast for the general government deficit. In Greece, Eurostat expressed a reservation about the figures for 2009 – which will be published mid-November – although, in any event, the latest available information published by the Ministry of Finance on 20 September points to a notable improvement in public finances in 2010, which has been accompanied by significant progress in the implementation of structural reforms that include, most notably, the restructuring and rationalisation of the public sector and the reform of the pension system.

By contrast, in Ireland public finances have deteriorated notably because they include the aid granted to several financial institutions, which would put the deficit at around 32% of GDP in 2010. However, according to Irish government estimates, if this aid is excluded, the deficit posted in 2010 would be close to the target of 11.6% of GDP set in the stability programme, given the various consolidation measures adopted by the government since December 2008. The government has repeated its commitment for future years of meeting the deficit targets set in the stability programme and has announced that in early November it will present its budget plans for the next four years, with measures amounting to close to €15 billion to take the deficit to 3% of GDP in 2014. In Portugal, the results in terms of the budget outturn indicated certain difficulties in achieving the target of 7.3% in 2010. For this reason, at its cabinet meeting on 30 September, the Portuguese government approved a set of fiscal consolidation measures in addition to those included in the plan presented in May, which will affect the budget for 2011 and will contribute to strengthening the budget outturn for the remainder of the year.

Overall, the improvement in the macroeconomic scenario and the widespread implementation of consolidation measures have curbed the deterioration in public finances in the euro area, although there is still considerable uncertainty about the final impact of plans to help the financial sector. Accordingly, budgets for 2011, which are still being prepared, should move ahead with the introduction of clearly defined and credible consolidation measures that place more emphasis on spending cuts. Likewise, pension reform is a priority which is already underway in many countries as is health reform, given the imminent pressure from the ageing of the population. At EU level, it is necessary to resolutely see through the reform of fiscal and macroeconomic supervisory frameworks already begun in previous months (see Box 3).

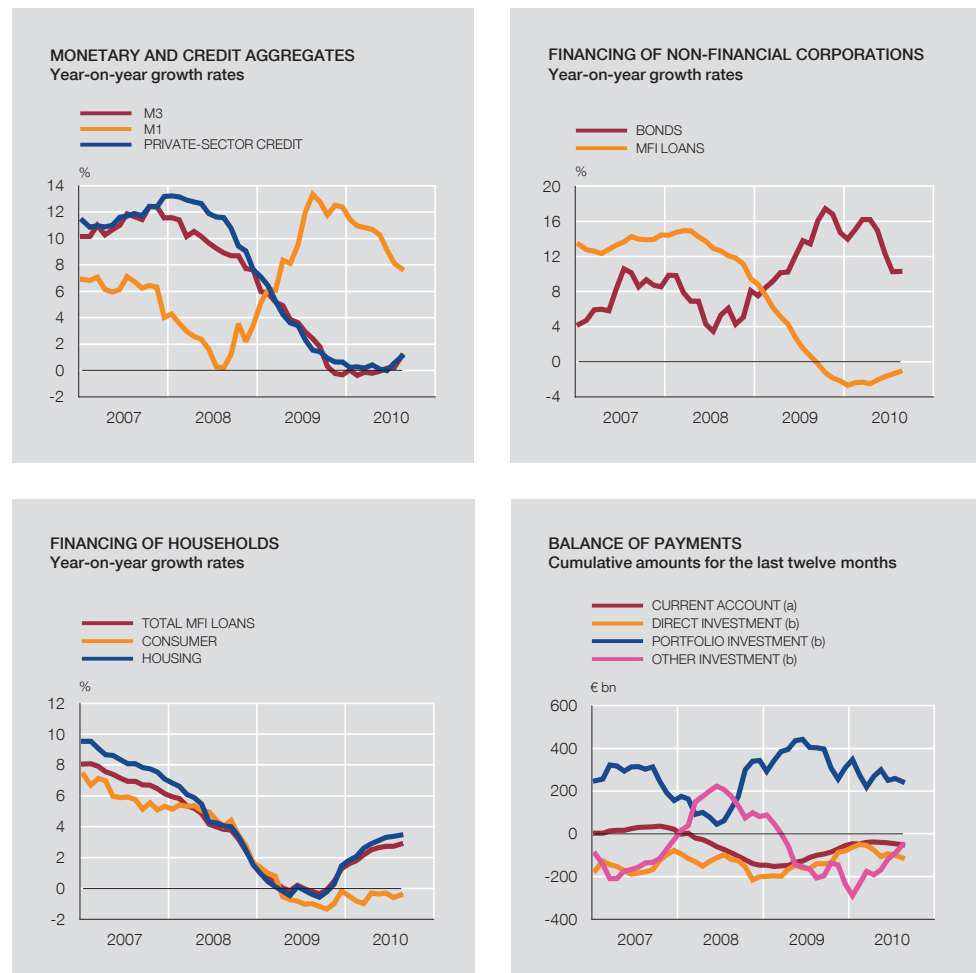
	2010		2011	
	GDP	HICP	GDP	HICP
ECB (September 2010)	1.4-1.8	1.5-1.7	0.5-2.3	1.2-2.2
European Commission (September 2010)	1.7	1.4		
IMF (October 2010)	1.7	1.6	1.5	1.5
OECD (May 2010)	1.2	1.4	1.8	1.0
Consensus Forecast (October 2010)	1.6	1.5	1.4	1.6
Eurobarometer (October 2010)	1.6	1.5	1.4	1.4

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

a. Annual growth rates.

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).

	% of GDP					
	BUDGET BALANCE (a)					
	2008	2009	2010		2011	
	EDP (b)	EDP (b)(e)	IMF (d)	EC (c)	IMF (d)	
Belgium	-1.2	-6.0	-4.8	-4.8	-5.0	-5.1
Germany	0.0	-3.0	-4.0	-4.5	-4.7	-3.7
Greece	-7.7	-15.4	-9.3	-7.9	-9.9	-7.3
Spain	-4.1	-11.1	-9.3	-9.3	-8.8	-6.9
France	-3.3	-7.5	-7.7	-8.0	-7.4	-6.0
Ireland	-7.3	-14.2	-32.0	-17.7	-12.1	-11.2
Italy	-2.7	-5.3	-5.0	-5.1	-5.0	-4.3
Luxembourg	2.9	-0.7	-2.2	-3.8	-3.9	-3.1
Netherlands	0.7	-5.4	-5.8	-5.9	-5.1	-5.1
Austria	-0.5	-3.5	-4.5	-4.8	-4.6	-4.1
Portugal	-2.9	-9.3	-7.3	-7.3	-7.9	-5.2
Finland	4.2	-2.5	-3.3	-3.4	-2.9	-1.8
Slovenia	-1.7	-5.8	-5.6	-5.7	-5.2	-4.3
Cyprus	0.9	-6.0	-5.9	-6.0	-7.7	-5.6
Malta	-4.5	-3.8	-3.9	-3.8	-3.6	-3.6
Slovakia	-2.3	-7.9	-7.8	-8.0	-5.4	-4.7
PRO MEMORIA: Euro area (including Cyprus, Slovakia and Malta)						
Primary balance	1.0	-3.4			-2.9	
Total balance	-2.0	-6.3	-6.6	-6.5	-6.1	-5.1
Public debt	69.4	74.2	79.5	84.1	88.5	87.0

SOURCES: European Commission, Eurostat and IMF.

a. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.

b. Autumn 2010 Excessive Deficit Procedure notification.

c. European Commission forecasts (spring 2010).

d. IMF forecasts (October 2010).

e. In the case of Greece they are the European Commission's spring forecasts since Eurostat has expressed a reservation about the EDP data for autumn 2010.

3.2 Monetary and financial developments

Following a slight stabilisation of euro area sovereign debt markets, due to the deployment of emergency measures by governments and European institutions, together with the IMF, and to the publication of the results of the stress tests of EU banks, tensions resurfaced at the end of the summer although this time they were more localised, with Irish and Portuguese debt being the most clearly affected. The bonds of other countries hit by the sovereign debt crisis in spring 2010 remained relatively isolated from this turmoil, such as Italian and Spanish bonds, and Greek bonds, due to strict compliance with its economic programme. Unlike the sovereign debt crisis in May, the instability did not have major repercussions on the other financial markets in the euro area or on banks' access to financing (except in Portugal and Ireland), which also resulted in lower recourse to Eurosystem liquidity. In fact, financial conditions improved slightly from end-July, since the risk premia on private-sector credit tended to contract, stock prices appreciated and bank credit showed signs of some improvement, despite weak demand and the ongoing restrictive credit conditions.

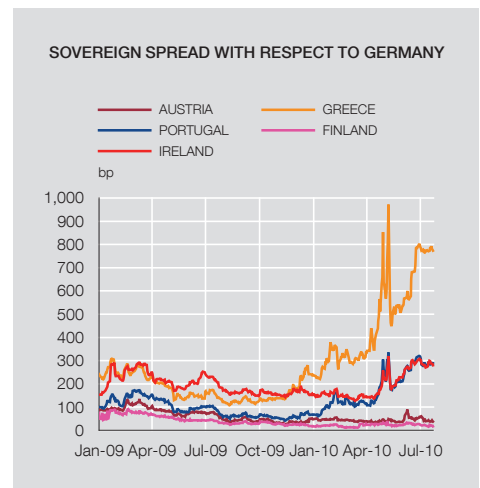
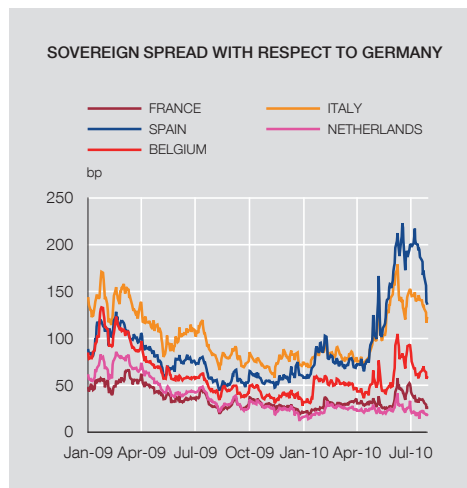
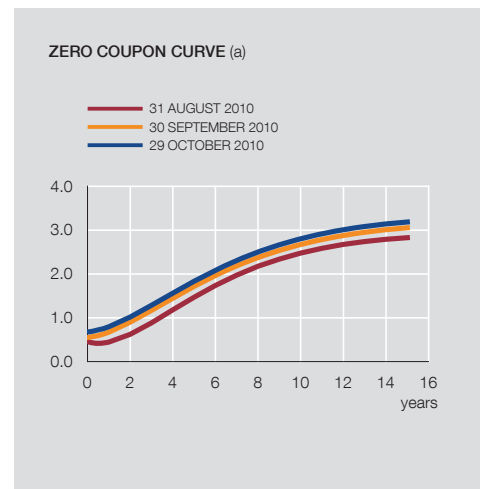
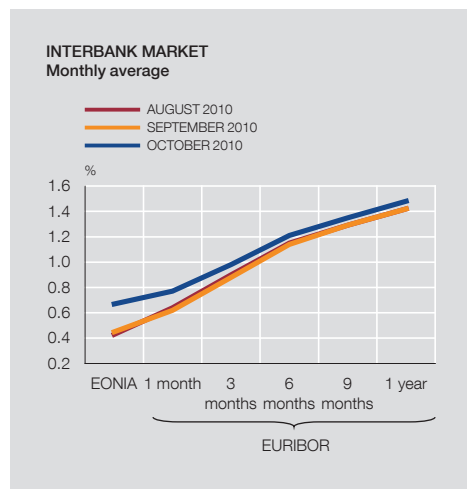
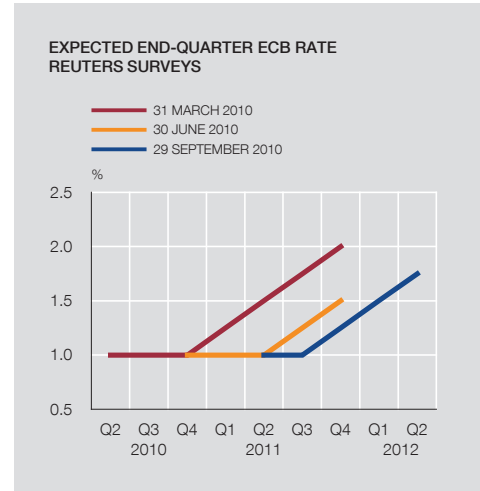
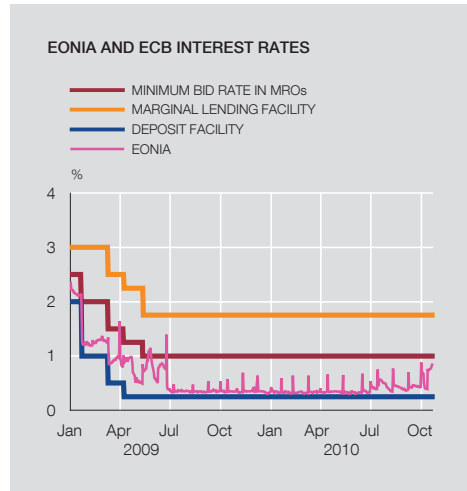
Set against the prevalent fragile economic recovery, in which inflationary pressures continued to be contained and medium-term inflation expectations held at levels compatible with the price stability target, the monetary policy stance remained accommodative. Thus, the Governing Council of the ECB decided to leave official interest rates unchanged at historically low levels at its September, October and November meetings. Rates remained at 1% for the main refinancing

operations and at 1.75% and 0.25%, respectively, for the credit and deposit facilities (see Chart 12). At the same time, the ECB retained the non-conventional credit support measures hitherto in place. As part of these measures, the ECB continued to provide liquidity through fixed-rate tenders with full allotment. At its September meeting, it announced that it will maintain this type of tender until at least the end of 2010, although, in the case of three-month loans, the rate will be adjusted on the basis of the average rate of the main operations. The Securities Market Programme (sterilised debt purchases on secondary markets) remained operational. The ECB's purchases of securities, which had been non-existent in the central weeks of August, recommenced with the renewed tensions on certain government debt markets. However, the very small amounts involved raised the value of the total securities purchased to just over €63 billion. In the three weeks immediately before the cut-off date for this article, purchases once again fell to zero.

In the last quarter, progress was also made with the design and implementation of the previously mooted supervision and financial assistance mechanisms at European level. As a result, on 22 September the European Parliament approved the reform of the European supervisory framework of the financial system, which places particular emphasis on macroprudential aspects as an early-warning system for possible practices which may pose major risks for the financial sector and result in a fresh crisis. The agreement envisages the creation from January 2011 of the European Systemic Risk Board and three European supervisory authorities which will monitor the proper functioning of the bank, insurance and pensions, and securities sectors. The European Financial Stability Facility (EFSF), which had been approved in May by the Ecofin Council, has been operational since the beginning of August when the guarantee commitments approved by the Member States represented more than 90% of the total amount. The EFSF, furthermore, has received the top "triple A" rating from the three main agencies (Standard & Poor's, Moody's and Fitch), although this is contingent upon compliance with certain conditions related to the guarantees offered. In the international arena, the Basel III Accord on the new capital requirements for financial institutions was also a further step forward in the reform of the international financial system.

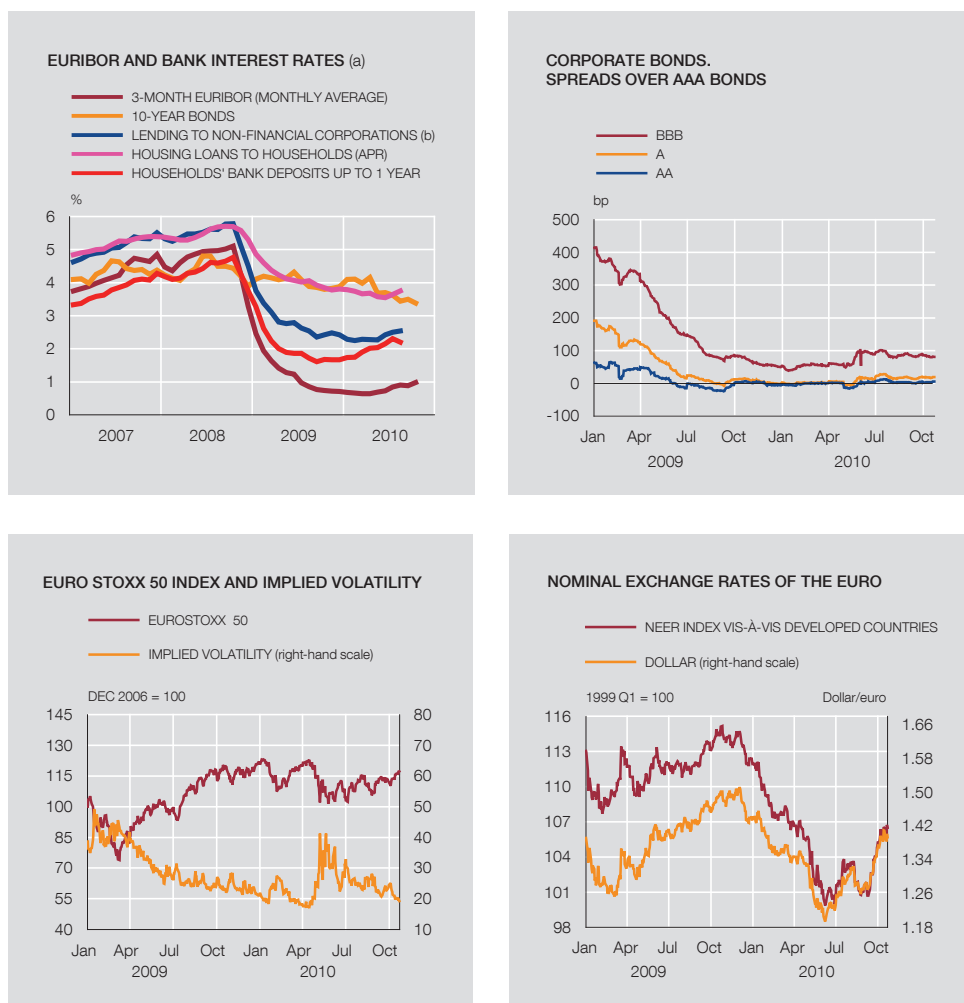
Interest rates on the interbank market generally remained stable between July and September (see Chart 13). However, from October rates rose, particularly short-term ones, partly due to the gradual normalisation of the interbank market and the progressive withdrawal of excessive liquidity as the longer-term Eurosystem loans matured. Thus, at the cut-off date of this bulletin, the EONIA stood at 0.7% and the 3-month and 1-year EURIBOR was at 1.1% and 1.5%, respectively. As explained in greater detail in Box 2, government debt markets were once again subject to tensions at the end of summer, particularly in Ireland and Portugal, where the sovereign bond yield spread over the ten-year Bund rose to more than 460 bp and 410 bp, respectively, at the end of September (see Chart 12). The measures announced by the Irish and Portuguese governments corrected this deterioration temporarily and only partially. In Greece, the long-term government bond yield remained at very high levels and its spread over the German bond reached more than 900 bp, although since the end of September it has dropped substantially thanks to the IMF's positive assessment of the progress of budget consolidation measures and structural reforms. Against this, in Italy and Spain, the sovereign spread over Germany has remained relatively stable since July. Lastly, the rate on US debt has contracted to a greater degree than that in Germany since July – by approximately 30 bp compared with 10 bp in Germany – which led to a narrowing of the positive spread between the two.

The risk premia on private fixed-income markets have not experienced significant changes since June. As for lending, the cost of bank loans extended to the private sector increased in July and August, especially those granted to households for purposes other than house purchase or consumption. Furthermore, the standards for the approval of new loans to house-



SOURCES: ECB and Banco de España.

a. ECB estimate using swap market data.



SOURCES: ECB and Banco de España.

a. On new operations.

b. Floating interest rates and up to 1 year initial rate fixation.

holds and corporations did not ease in Q3 nor will they foreseeably be eased by banks for the remainder of the year according to the Bank Lending Survey. Demand for loans only experienced a slight improvement, although it remains very weak. In this context, bank loans to non-financial corporations posted negative year-on-year rates of change in Q3, although the rate of contraction is lower than in the first half of the year and stood at around 1% in September. Loans to households continued to improve somewhat, posting year-on-year growth of approximately 3% in September, due to the increases in funds granted for house purchase and other purposes, while lending for consumption continued to contract.

Stock markets have picked up since July, especially after the publication of banks' stress tests and the easing of tensions on sovereign debt markets. Although stock market indices posted the occasional decline in August, the EUROSTOXX 50 index has gained approximately 3.8% since end-July. Following its depreciation throughout August, the euro exchange rate has gradually appreciated since September as confidence in financial markets recovered and the Federal Reserve gave signs of possibly easing its monetary policy further (see Chart 13). Thus, since July the common currency has appreciated by 2.6% in nominal effective terms and by 6.4% against the dollar. Lastly, the M3 monetary aggregate, which until July had remained sluggish, picked up notably in Q3, reaching, nonetheless, moderate year-on-year growth rates of 1% in September.

4 The Spanish economy

On QNA estimates, the slow recovery in economic activity continued in 2010 Q2, with a quarter-on-quarter increase in real GDP of 0.2% (as against 0.1% in Q1). National demand increased by 0.7%, buoyed by the strength of private consumption and investment in capital goods, and this was partly translated into higher import growth, which caused net external demand to make a negative contribution to growth. In year-on-year terms, the rate of contraction of GDP moderated significantly, with a decline of 0.1%, as against -1.3% in Q1. This smaller year-on-year decline in activity was passed through to employment, so that productivity continued to grow at a high rate.

On the available information, the process of recovery in activity came to a halt in Q3, given the estimate of nil quarter-on-quarter GDP growth, against a background characterised by factors with opposite signs. On the one hand, the progressive recovery in the world economy boosted activity, while on the other, the reversal of some of the effects on which demand growth was temporarily based in the first half of the year (linked to the rise in VAT rates and the vehicle purchase incentives) and the entry into force of fiscal consolidation measures had a negative effect on spending. Thus, unlike in Q2, national demand declined, at a quarter-on-quarter rate of 1.5%, while the contribution of net external demand to growth was similar, but with the opposite sign (see Chart 14). In year-on-year terms, GDP is estimated to have grown by 0.2% in Q3, 0.3 pp more than in Q2, following seven consecutive quarters of negative growth.

On the supply side, the latest indicators also point to a stagnation in activity in Q3, with a slightly larger quarter-on-quarter decline in employment than in Q2. Year-on-year, the decline in employment moderated by more than GDP, to a rate of -1.7%, as reflected in a slowdown in apparent labour productivity, which stood at somewhat less than 2%. At the same time compensation per employee slowed again primarily due to the effect of the public sector wage cut, which, given productivity developments, enabled unit labour costs to continue to fall. Finally the year-on-year rate of change in the CPI rose in Q3 to 2.1% in September, mainly as a consequence of the increase in VAT rates in July, although the degree of pass-through to prices estimated for this tax did not exceed 50%.

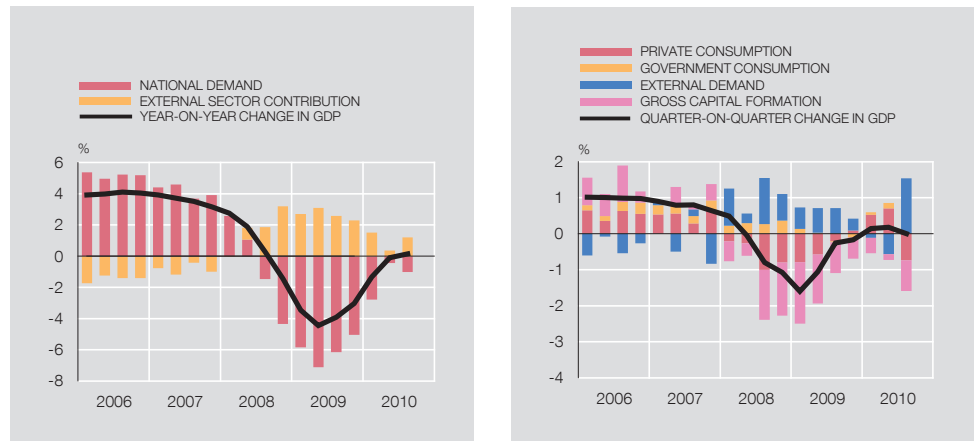
4.1 Demand

In 2010 Q3 private consumption declined rather sharply quarter-on-quarter, following three quarters of positive growth, with a moderation of 1 pp in its year-on-year growth rate (see Chart 15). As mentioned above, these consumption figures should be contrasted with the buoyancy observed in the first half of the year; when the first three quarters of 2010 are considered together, household consumption displays a gradual increase from the end of last year. Purchases of cars and other durable goods, the category most affected by the withdrawal of vehicle purchase subsidies and by the possible bringing forward of spending in response to the rise in VAT, posted negative year-on-year growth rates in Q3, of around -25% in the case of cars. Also, retail sales and the sales of large firms, supplied by the tax authorities, posted significant year-on-year falls. In line with these indicators, retail confidence declined on average in the quarter, while consumer confidence, which should not be affected by these temporary changes in spending patterns, improved slightly.

According to the financial accounts of the institutional sectors, household disposable income contracted by 0.4% in nominal terms in 2010 Q2, as a result of a fall in labour income and the smaller contribution from general government benefits net of taxes. The decline in disposable income and the buoyancy of consumption in Q2 caused the saving rate to decline to 16.2%,

MAIN DEMAND AGGREGATES (a)

CHART 14

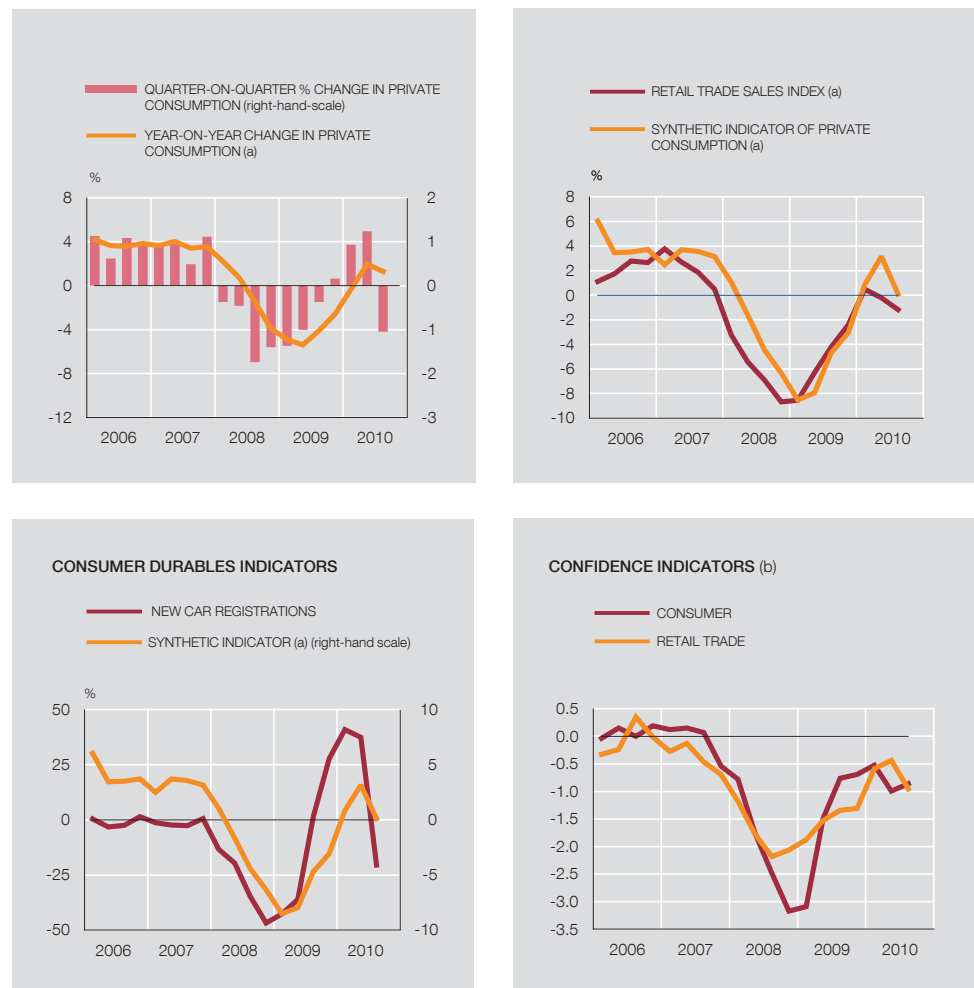


SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION

CHART 15



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

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

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

down 1.5 pp from the preceding quarter. Beyond shifts in consumption decisions which may have taken place between the first half of the year and Q3, it is estimated that the smooth recovery in household spending will continue in the immediate future, based on the scope provided by the still high saving rate, although it will continue to be affected by the uncertain developments in the labour market and in income, the downward trend in house prices, the maintenance of relatively restrictive credit conditions and the negative effects on disposable income arising from the greater budgetary constraint.

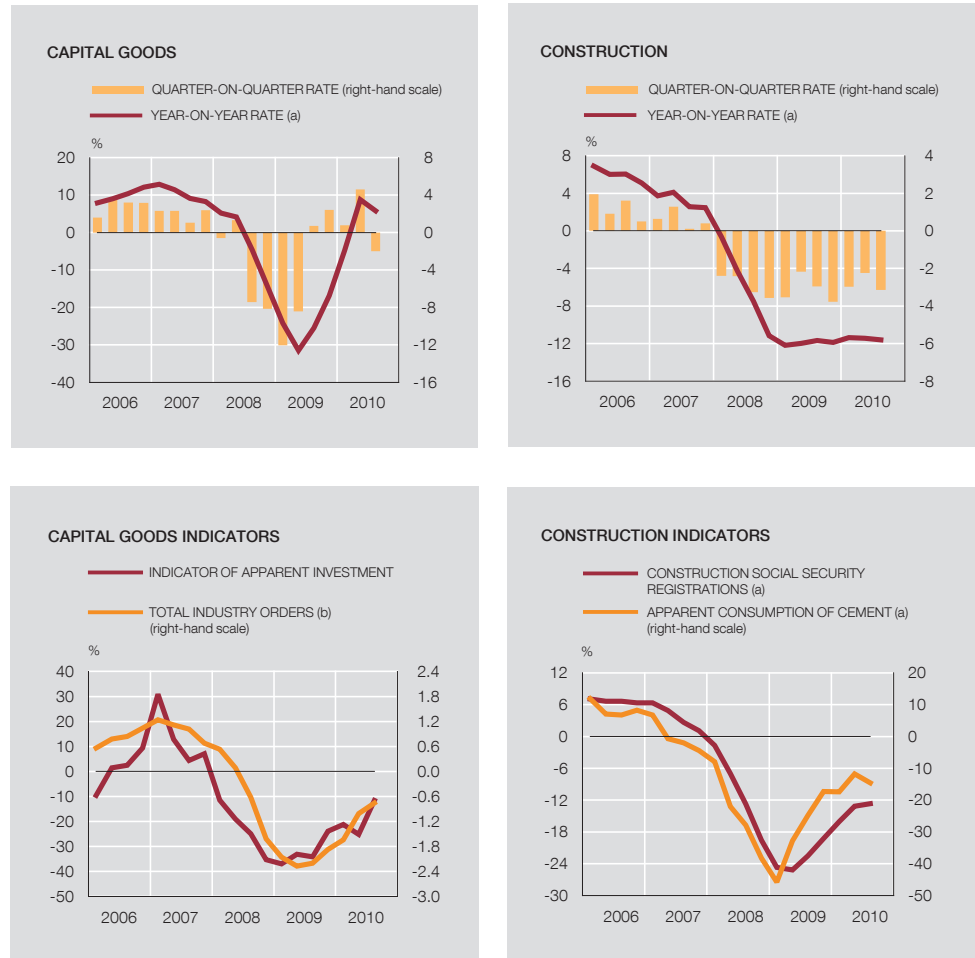
General government final consumption is estimated to have grown at a relatively low year-on-year rate in Q3, similar to the one observed in the previous quarter. According to the budget outturn data, the developments in expenditure on goods and services and wages and salaries would have contributed to this performance.

On the available indicators, investment in capital goods fell in 2010 Q3, in quarter-on-quarter terms, following four quarters of positive growth. Year-on-year, growth remained positive, although lower than in the preceding quarter (see Chart 16). Among the conjunctural data, commercial vehicle registrations (which were also boosted by government incentives for vehicle purchase) contracted sharply in Q3. Also, the year-on-year rates of decline in sales of capital goods by large firms and in the industrial production of these goods intensified in Q3. Only imports of capital goods remained somewhat buoyant in the summer. Among the qualitative indicators, the confidence of capital goods producers rose in Q3, although production expectations deteriorated. Capacity utilisation continued to rise, but is still well below its historical average, which suggests that there is scope for expansion of activity without the need for an immediate expansion of installed capital.

The ongoing uncertainty surrounding the strength of the recovery, along with the prolonging of restrictive bank credit conditions, may be holding back new investment projects by non-financial corporations. In fact, according to cumulative four-quarter data from the non-financial accounts of the institutional sectors, non-financial corporations reduced their investment and increased their saving until Q2, which enabled them to reduce their borrowing. As a result, companies would appear to be rebuilding their balance sheets, reducing their debt and endeavouring to improve their profit prospects.

Also, construction investment is estimated to have contracted in 2010 Q3, so prolonging the adjustment that has been taking place since early 2008. Input indicators for the sector as a whole (such as apparent consumption of cement and the index of industrial production of construction materials) showed an intensification of the contractionary year-on-year trends, while the employment indicators (such as social security registrations) showed slightly more moderate year-on-year falls than in the previous quarter. In addition, business survey indicators for the construction sector reflected a worsening during the summer months in employers' perceptions of the sector's performance and prospects.

As regards the different types of construction, residential investment is estimated to have continued to fall, although the decline in the flow of completed housing is bringing this variable into line with housing starts, indicating that the fall in housing investment will slow during the coming quarters. On the side of the demand for housing, there has been a notable recovery in purchases in recent months, which could be related to the improvement in affordability indicators, as well as the temporary boost stemming from certain tax-related factors, such as the rise in July in VAT and, in certain autonomous regions, in transfer tax, and the partial elimination of tax deductions for house purchases in January next year. There was a significant moderation in the rate of contraction of non-residential building permits in Q3. Finally, investment in



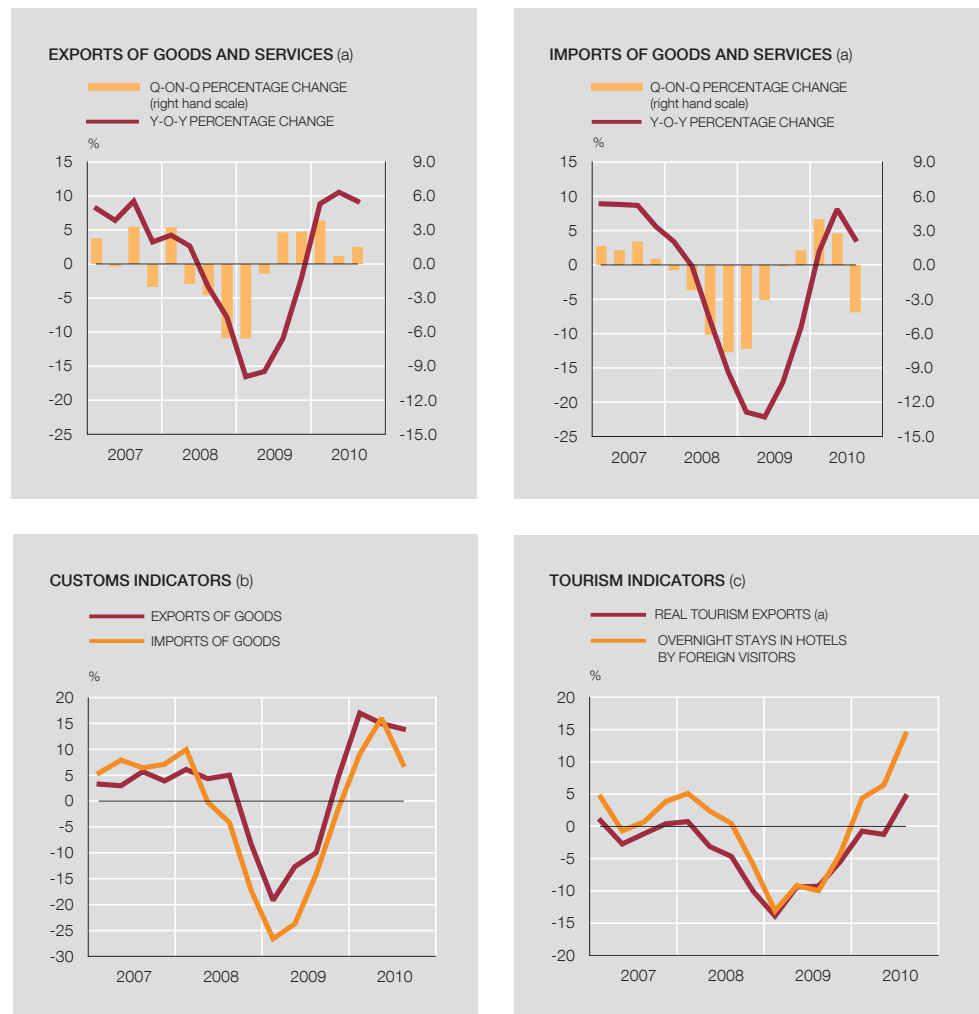
SOURCES: INE, European Commission, Eurostat, OFICEMEN and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series, except in the case of social security registrations, the rates for which are based on the original series.
b. Normalised indicator (difference between the indicator and its mean value, divided by the standard deviation).

public works is expected to deteriorate on account of the budget consolidation commitments that will affect both central government and regional and local government.

As regards foreign trade, the latest data available point to a significant increase in the positive contribution of net external demand to quarter-on-quarter GDP growth in 2010 Q3, to around 1.5 pp, up from -0.6 pp in the previous quarter, as a result of the rise in exports and the decline in imports (see Chart 17). The moderation in imports, following the increases in previous quarters, is in line with the loss of momentum in national demand described above. By contrast, exports remained notably strong in this quarter, against an international background characterised by sustained growth in the emerging economies and the firming of the recovery in the euro area. On average in Q3, the indicators of price competitiveness vis-à-vis the developed countries improved, although in September and in the first few days of October the euro has been appreciating against the main currencies.

On customs data, real goods exports increased on average by 13.5% year-on-year in July and August, down slightly from the Q2 rate of 14.9%. The products that contributed most to the buoyancy of exports in Q3 were inputs and equipment. Exports of consumer durables de-



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

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

clined on average by 5.3% year-on-year in July and August, in contrast to the positive rates observed in the first half of the year, partly due to the ending of the direct subsidies for the purchase of vehicles that had been available in some of the main European countries. Exports outside the euro area were somewhat more dynamic, especially those to China and other emerging economies.

As for real exports of tourism services, the data for the summer months point to an improvement in this item in Q3, following the slightly negative trend in Q2 (influenced by the volcanic ash crisis). In particular, overnight hotel stays by non-resident visitors increased by 13.6% year-on-year (4.3% in Q2), while foreign tourist inflows increased by 4.2%, in contrast to the decline of 3.1% in Q2, with a notable recovery to slightly positive rates in the main countries of origin of Spain's tourists (United Kingdom and Germany). Also, nominal spending by foreign visitors, according to the tourism expenditure survey (EG-ATUR), reached year-on-year growth of 4.3% in Q3, as against a fall of 1.2% in the previous quarter.

Turning to imports, the July and August data suggest that real imports of goods slowed in 2010 Q3. On customs data, real goods imports grew by 8.7% on average in July and August, down from 16.6% in Q2. By product group, the strength of imports of inputs and equipment were notable in this period, as in the case of exports. Imports of durable consumer goods, after increasing by 37% year-on-year in Q2, declined by 15% on average in July and August, an indication of the strong fall in household demand for these goods. Finally, real imports of services appear to have slowed in 2010 Q3, as a result of the lower tourism payments and the weakness of imports of non-tourism services.

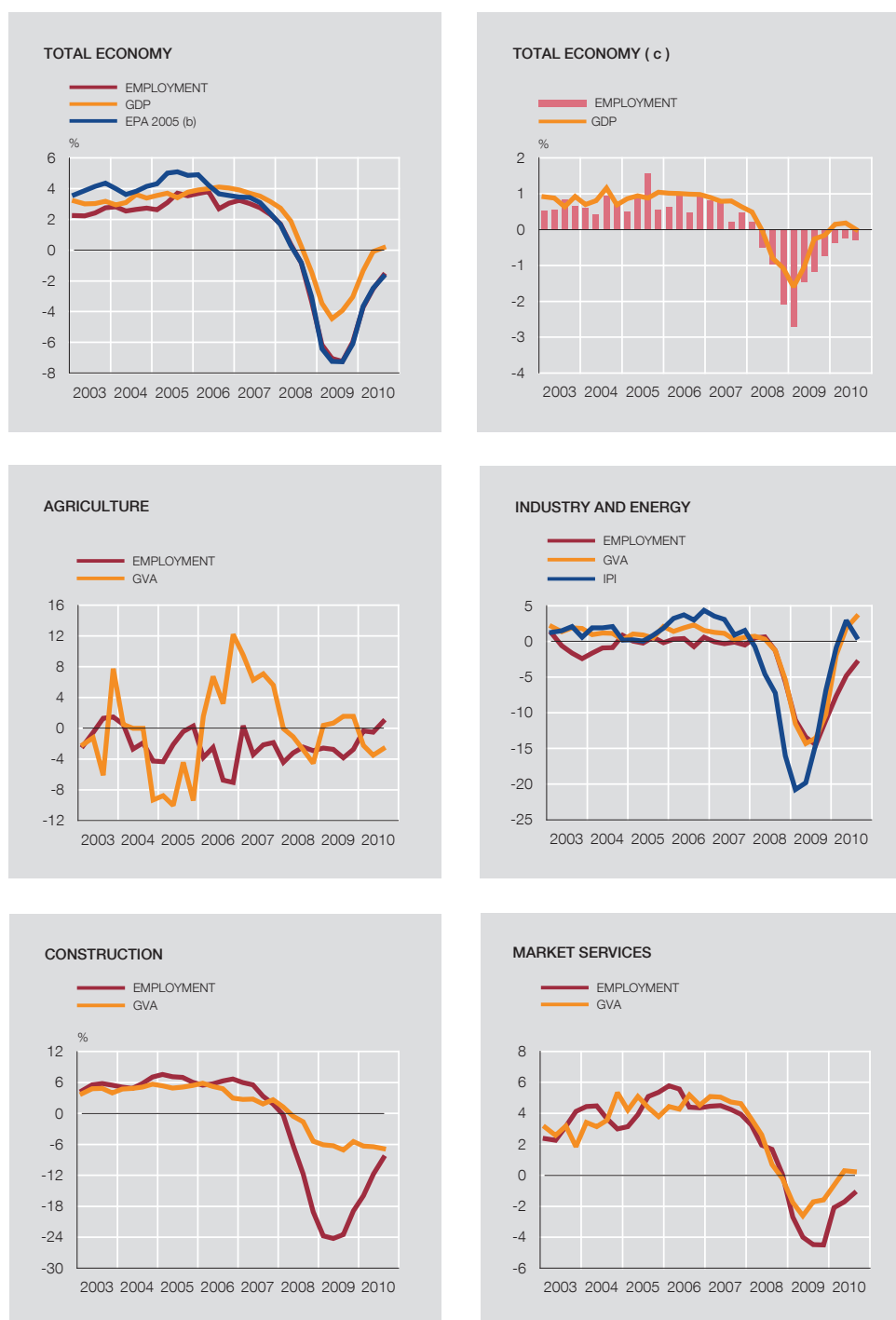
4.2 Production and employment

In Q3, the gross value added of the total market economy contracted slightly in quarter-on-quarter terms, owing to the decline in construction activity and the estimated slowdown in market services, while buoyancy in industry and energy may have been at a similar level to that in Q2 (see Chart 18).

As regards industry, the path of slow recovery in the industrial production index (IPI) that commenced in Q2 was extended. The employment indicators displayed a similar fall to that seen in Q2, in quarter-on-quarter terms, while the sector's sentiment indicators showed a very slight improvement on average in Q3, in the case of the European Commission's survey, but deteriorated, especially in September, in the case of the PMI. In construction, it is estimated that value added contracted more sharply than in Q3, as a consequence of the weakness of residential investment and the impact of the budget austerity plans on infrastructure. Finally, the value added of market services is estimated to have hardly risen in Q3, in quarter-on-quarter terms, partly due to the lower buoyancy of trade activities, which have a significant weight in this sector and which were affected negatively by the slackness of private consumption mentioned above. Among the indicators available for this sector, the figures for average social security registrations in the sector showed a loss of dynamism in quarter-on-quarter terms, while both the index of activity of the services sector and the sales of services by large companies posted more unfavourable year-on-year changes than in Q2. The sentiment indicators for the quarter as a whole highlighted the weakness of the sector: the PMI for services stood once again below the benchmark level of 50, following the rise recorded in the previous quarter, while the opinion-based survey of the European Commission continued to show a deterioration in confidence on average in Q3.

In the labour market, the various conjunctural indicators available point to a moderation in the year-on-year rate of decline in employment in Q3. The average number of social security registrations decreased by 1.6% year-on-year, a slowdown of 0.3 pp with respect to the decline in the previous quarter. However, in quarter on quarter terms, the decline in the number of registrations intensified to 0.4%. The year-on-year growth in INEM-registered hires moderated in Q3 (to 2.6%, from 4.2% in the previous period), the deceleration being similar for permanent and temporary contracts.

The Labour Force Survey for Q3 shows a year-on-year fall in employment of 1.7%, 0.8 pp less than in the previous quarter. The smaller year-on-year decline in employment was apparent in all sectors of the market economy, especially agriculture, where the year-on-year rate even turned positive. The slowdown in the rate of decline in employment only affected dependent employees, whose numbers fell by 1.2%, as against 2.4% in Q2, while the decline in the numbers of self-employed accelerated, from 3% in Q2 to 4%. By nationality, the intensity of job destruction slowed to a greater extent among foreign workers, whose employment fell by 2.1%, although this was still greater than the fall in employment among Spanish workers (-1.7%). With regard to contract duration, the year-on-year rate of decline of temporary workers eased again (-2.4%), although this was still a higher rate of adjustment than in the case of



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

a. Year-on-year percentage rates based on seasonally adjusted series, except in the case of the EPA, the rates for which are based on the original 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 DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

c. Quarter-on-quarter rates based on seasonally adjusted series.

workers with permanent contracts, whose numbers decreased by 0.8%. As a result, the proportion of temporary to total employees increased slightly to 25.6%, 0.7 pp more than in the preceding quarter, but still slightly down on a year earlier (25.9%). Finally, part-time employment continued on the path of growth initiated at the beginning of the year, with an increase of 2.4%, while full-time workers decreased by 2.3%. This left the ratio of part-time to full-time workers at 12.8%, as against 12.3% a year earlier.

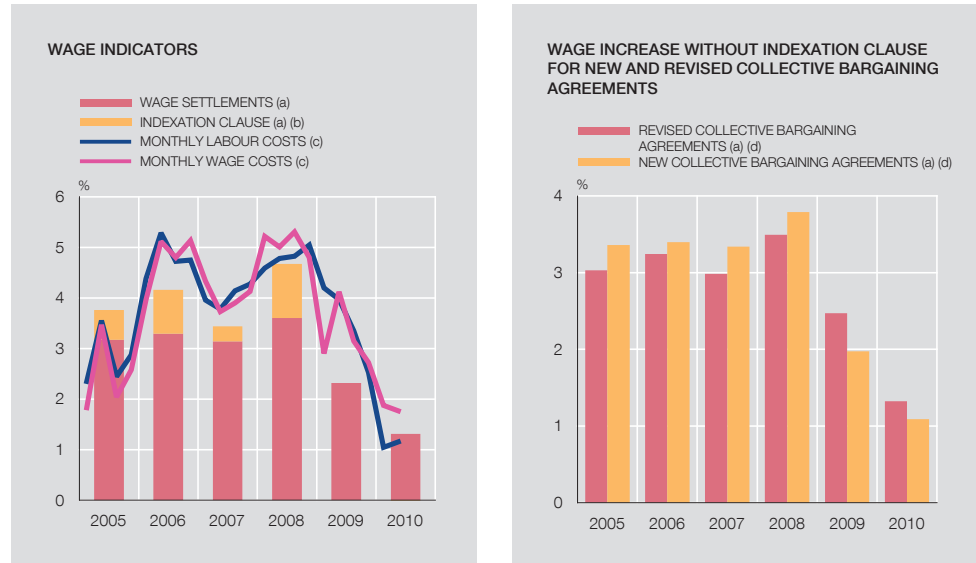
The rate of growth of the labour force accelerated, with year-on-year growth of 0.6%, against a background of stability in the population over 16 years of age (0.1%) and a rise in the participation rate, to 60.1%, up from 59.8% in the same quarter of the previous year. By sex, the female labour force increased slightly in Q2, while the male labour force continued to decline, although at a slower rate (-0.9% in Q2 to -0.4% in Q3). By nationality, the foreign labour force grew by 0.4%, although the foreign population continued to decline, by 4.4% in year-on-year terms. As a result, the participation rate of this group increased to 77.2%. The labour force of Spanish nationality increased by 0.6%, and its participation rate held unchanged at 57.7%.

Finally, total unemployment fell by around 70,000 with respect to Q2, to stand at 4.57 million. In year-on-year terms, the growth in unemployment moderated to a year-on-year rate of 11%, down from 12.3% in the preceding quarter. The rate of unemployment fell by 0.3 pp in Q3, to 19.8% of the labour force. Unemployment as registered by the INEM (National Public Employment Service) also posted a slowdown in its year-on-year growth rate in 2010 Q3, to 9.3% from 12.6% in Q2.

4.3 Costs and prices

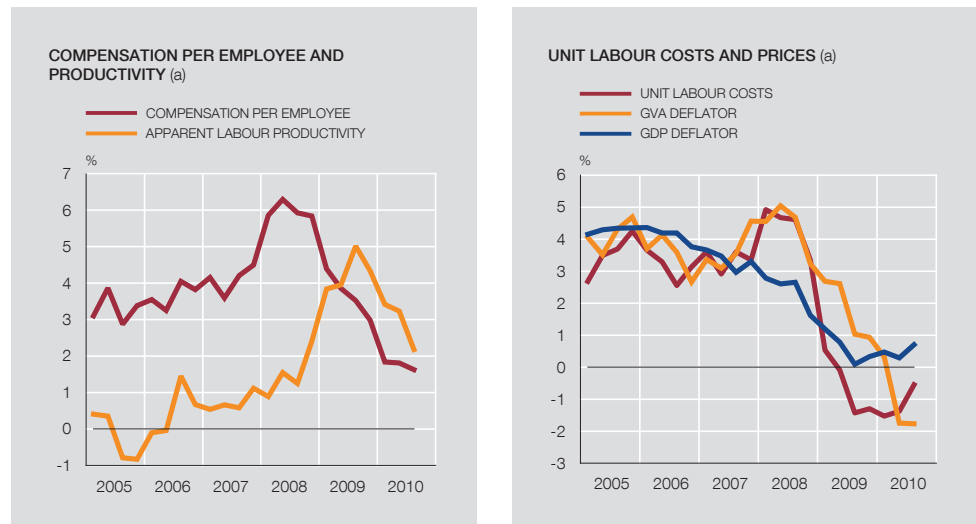
Collective bargaining in recent months has confirmed the path of greater wage moderation seen since the beginning of the year. These developments have been favoured by the low level of inflation in 2009 (0.8% in December), which meant that the wage indexation clauses were not activated, and by the multi-year agreement signed by the social partners in February. However, as yet, the public sector wage cut has had no discernible additional moderating effect on wage growth in the private sector. The agreements signed in the period to Q3 were relatively few, affecting only 5.1 million workers (one-third less than in the same period of 2009). Almost all these agreements are revised agreements from previous years, which incorporate a wage settlement of 1.3% for 2010, more than 1 pp below that agreed in the previous year (see Chart 19), while newly signed agreements contain on average somewhat lower settlements, in line with the upper limit of 1% established in the wage agreement signed in February for the period 2010-2012. In the final part of the year, the wage settlements included in agreements may be somewhat more restrained, following the approval of Law 35/2010 of 17 September 2010 on urgent measures to reform the labour market, which includes the possibility of firms that are in a vulnerable financial situation resorting to get-out clauses. In short, an additional fall in the rate of increase in compensation per employee is to be expected in Q3, both in the market economy and in the non-market economy. Despite the moderation in productivity growth, this wage behaviour would allow unit labour costs in the market economy to continue to adjust (see Chart 20).

The final demand deflator is estimated to have accelerated modestly in Q3, since both the rate of growth of the internal component of inflation (measured by the GDP deflator) and that of the import deflator appear to have increased slightly in relation to the previous quarter. The rise in import prices would basically stem from the increase in commodity prices. By final demand component, the growth rate of the deflator of total gross fixed capital formation seems to have remained unchanged, unlike the private consumption and export deflators, which seem to have risen in Q3.



SOURCES: INE and Ministerio de Trabajo e Inmigración.

- a. The last year, with information from collective bargaining agreements to September 2010.
- 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.



SOURCES: INE and Banco de España.

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

TAX RATES

The increase in value added tax rates approved in the 2010 State budget came into force on 1 July. The standard rate was raised by 2 pp to 18% and the reduced rate by 1 pp to 8%, while the super-reduced rate remained at 4%. This box presents an estimate of the effects of this increase in indirect taxation on consumer prices, using a partial approach based on the analysis of price developments during the three months that have passed since this measure came into force. Obviously, any increase in indirect taxation affects the decisions of the different private agents (households and firms) and public agents in various ways, which may, in turn, generate second round effects on prices, but these have not been considered here.

From a theoretical viewpoint, the degree of pass-through of changes in indirect taxation to consumer prices depends on many factors, which have different effects in different product markets. These factors include the degree of competition, the elasticity of consumer demand, firms' cost structures and the role of expectations in price formation processes. The difficulty of this quantification also relates to the timing of the pass-through, since firms may decide to change their prices before the entry into force of the rate increase, at the time it takes place or in a later period. In practice, measurement of the impact of changes in indirect taxation and their distribution over time is hampered by the difficulty of separating a change in the actual CPI into that part which genuinely reflects a pass-through of tax from that which is attributable to normal seasonal changes or to changes in the proximate determinants of consumer prices (for example, industrial prices and the price of oil).

In any event, the hypothesis of complete pass-through of the tax change enables us to put an upper limit on the impact of the rise in taxes on prices. According to the harmonised index of consumer prices at constant taxes (HICP-CT) published by the INE, the maximum effect of the tax change would be 1.1 pp.

To estimate the impact of VAT, three different approaches have been used. Each approach has its advantages and disadvantages, so that to estimate the impact it is advisable to consider the range of results obtained. Also, it should be noted that the pass-through has probably still not been completed, so that the estimates presented should be treated with due caution. The first two methods considered are unconditional, which is to say that they only use consumer price data, while the third is conditional, insofar as quantitative models are used to remove the effect of the changes in the proximate determinants of consumer prices.

Specifically, the first method is based on the following procedure: the change in consumer prices in July, August and September 2010 has been broken down for each of the 126 sub-indices of the CPI (e.g. fresh fish) into a normal seasonal component (corresponding to the month-on-month rates recorded in the same months of 2009)¹ and a residual term, associated with the increase in VAT. In addition, this residual term has been edited to avoid the estimate for any particular sub-index implying a pass-through of the VAT increase of less than zero or of more than one hundred percent. The results have been aggregated subsequently using the weights of each of the sub-indices in the CPI. The second method uses, for each sub-index of the CPI, a univariate model with intervention analysis,² to try to identify extraordinary changes during these months that may be attributable to the rise in VAT, and applies the same editing and aggregation procedures as the first method. The third procedure is a conditional estimate, which strips out that part of the change in the actual CPI that reflects a change in its proximate determinants (e.g. industrial prices)

1. Alternatively, estimates have been made defining the normal seasonal component as the average of the month-on-month rates of these same months in the period 2005-2009. This box presents only the estimate obtained using the growth in 2009 as reference, since it was a year with similar characteristics to 2010. 2. For simplicity, these univariate models with intervention analysis have been specified automatically.

ESTIMATED EFFECTS OF THE RISE IN VAT ON THE CPI

	ESTIMATED IMPACT (pp)			IMPACT WITH FULL PASS-THROUGH	ACTUAL PASS-THROUGH (%)		
	Method 1 (a)	Method 2 (b)	Method 3 (c)		Method 1 (a)	Method 2 (b)	Method 3 (c)
Overall index	0.57	0.41	0.44	1.10	52.0	37.1	39.6
Unprocessed food	0.25	0.07	0.00	0.49	51.6	14.9	0.0
Processed food	0.30	0.10	0.00	0.77	38.5	12.4	0.0
Non-energy industrial goods	0.77	0.76	0.61	1.37	56.5	55.8	44.7
Energy	0.83	0.83	0.83	1.72	48.1	48.1	48.1
Services	0.51	0.21	0.44	0.97	53.0	22.0	45.4

SOURCES: INE and Banco de España.

- a. Unconditional estimation.
- b. Estimation based on disaggregated univariate models.
- c. Conditional estimation based on models to forecast the main groups.

TAX RATES (cont'd)

using econometric models of the five main components of the CPI that are usually considered.

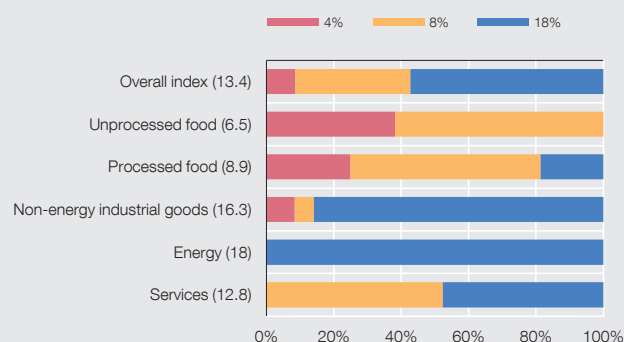
The adjoining table presents the estimates for the whole period July-September.³ Taken together these procedures would indicate that the increase in VAT may explain 0.4-0.6 percentage points of the change in the CPI in July, August and September, the bulk of the impact having occurred in July. The largest effects were recorded in the non-energy industrial goods and services components, the im-

3. The energy component requires a different treatment, since electricity and gas prices are regulated and fuel prices are strongly affected by oil price fluctuations. Specifically, full pass-through has been assumed for electricity and gas prices and partial pass-through for fuel prices.

act on food prices being very limited, reflecting to some extent the fact that some of them are subject to the super-reduced VAT rate, which has not been changed, and almost all the rest to the reduced rate, which has only been increased by 1 pp (see Panel 1). In fact, for processed and unprocessed foods it is not statistically possible to reject the null hypothesis for the increase in VAT.

The estimated degree of pass-through is between 40% and 50% of the total potential impact. This pass-through is smaller than that estimated in other episodes of VAT rises (such as in 1992 and 1995), reflecting the acute weakness of household spending, which would have led firms to absorb part of the tax increase in their margins. Additional lagged effects in October – or even later – cannot be ruled out, but they can be expected to be small.

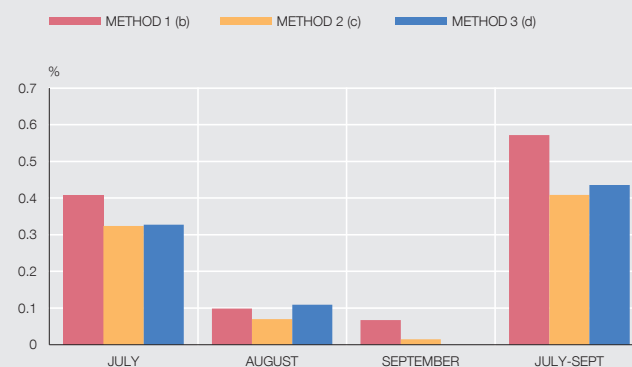
1 DISTRIBUTION OF VAT RATES BY CPI COMPONENTS (a)



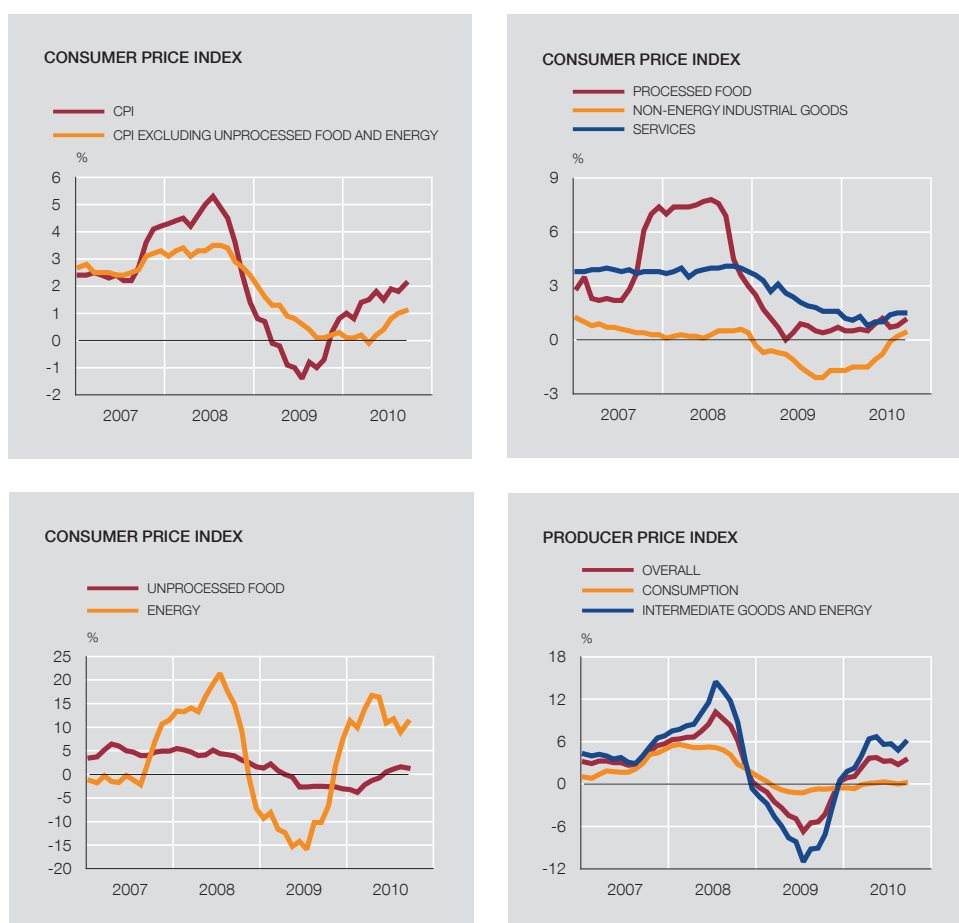
SOURCES: INE and Banco de España.

- a. In brackets, average rate of VAT (%).
 b. Unconditional estimation.
 c. Estimation based on disaggregated univariate models.
 d. Conditional estimation based on models to forecast the main groups.

2 ESTIMATED EFFECTS OF THE RISE IN VAT ON THE CPI



In fact, the main consumer price indicators accelerated in Q3, largely due to the rise in VAT rates in July, as explained in detail in Box 4. Over the course of the quarter, the CPI grew by 2%, as against 1.6% in the period April-June (see Chart 21). By component, the rise in the overall index took place across the board, with the exception of energy. Specifically, during these three months, unprocessed food prices rose significantly, leaving behind the negative rates of previous quarters. In addition, the prices of non-energy industrial goods rose to 0.1%, from -1.1% in the previous quarter, this being partly linked to the increase in car prices. Also, services prices accelerated again, following the slowdown in previous quarters, to an average rate of 1.5%. In contrast, the growth of energy prices slowed by 4 pp to 10.6%, owing to the large price increases recorded a year earlier. As a result, the CPI excluding energy and unprocessed food prices rose by 0.7 pp to an average year-on-year rate of 0.9% in Q3, extending the upward path of the last few quarters.



SOURCE: INE.

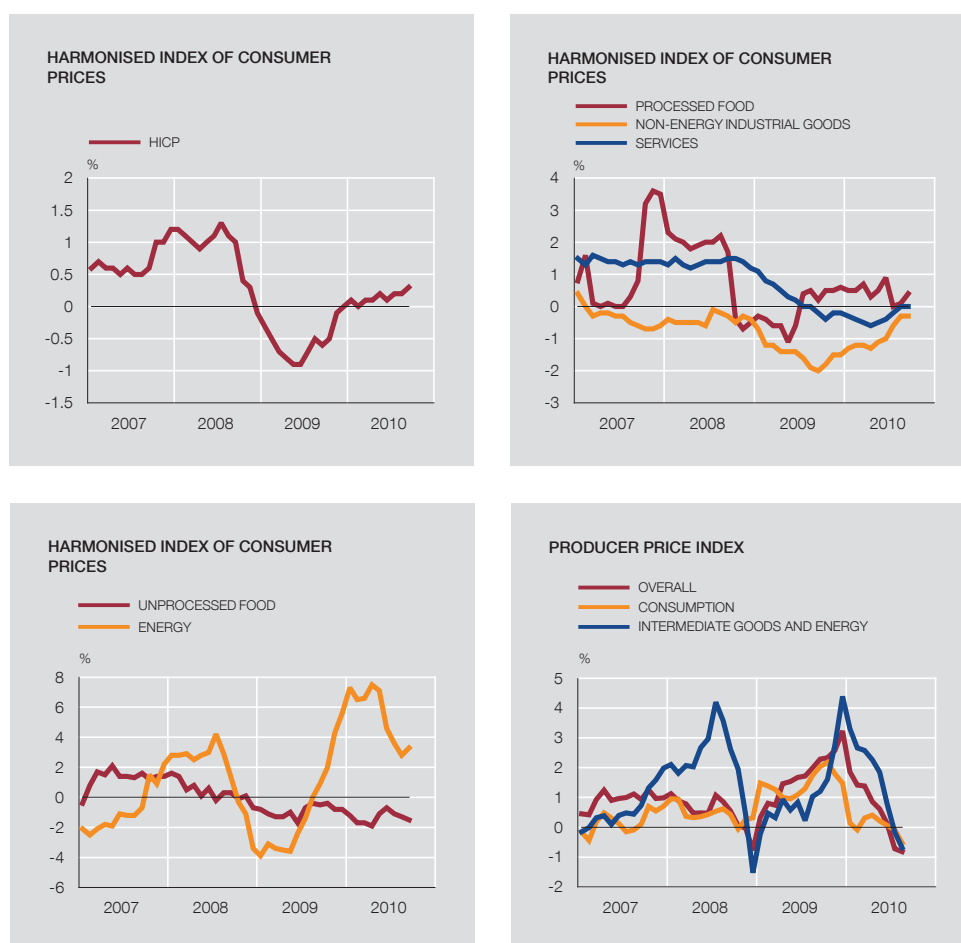
a. Twelve-month percentage change based on the original series.

Inflation in Q3, as measured by the harmonised index of consumer prices (HICP), rose by 0.3 pp in Spain and by 0.2 pp in the euro area, so that the differential widened by 0.1 pp to 0.2 pp (see Chart 22). Inflation was lower in Spain than in the euro area in services, non-energy industrial goods and unprocessed food. As a result, the core inflation differential remained favourable to Spain, although it narrowed by 0.5 pp with respect to the previous quarter, to -0.1 pp. The year-on-year rate of the leading indicator of the HICP for October rose by 0.1 pp, to 2.2%, a similar rate to that estimated for the euro area, whose HICP would have risen to 1.9%.

The rate of growth of the producer price index fell to 3.1% in Q3, down 0.4 pp from the previous quarter. This decline stemmed from the fall in the year-on-year growth rate of energy prices and the fall in the prices of non-durable goods. In contrast, the prices of consumer durables, inputs and equipment accelerated. Finally, the growth rates of the import and export price indices eased, to rates of 8.5% and 5.3% respectively in August.

4.4 The State budget

At the Council of Ministers meeting on 24 September the government approved the draft State budget for 2011, setting an overall general government deficit target of 6% of GDP, which confirmed the budgetary stability targets approved in June. The breakdown by sub-sector envisages a central government deficit of 2.3% of GDP, down 3.6 pp from 2010, an improve-



SOURCES: Eurostat and Banco de España.

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

ment of 0.2 pp of GDP in the social security system's surplus, taking it to 0.4%, and a deterioration of 0.4 pp in the deficit of regional and local governments, which would take it to 4.1% of GDP.

On the revenue side, the 2011 budget includes a rise of 1 pp in the state tranche of personal income tax for ordinary tax bases over €120,000 (up to 22.5%) and of 2 pp for those above €175,000 (up to 23.5%), as well as the elimination of the tax credit for the purchase of a principal residence, for taxpayers with a taxable base of more than €24,170.20, and the tax relief for the birth or adoption of children.

On the expenditure side, the measures announced in May this year (such as an average 5% cut in the salaries of public sector employees and a significant reduction in public investment), along with cuts in other budget items, have made it possible to set the ceiling on State spending at €150,056 million in 2011, around 6% down from the 2010 budget (or 5%, when comparing with the outturn projection for that year), once the distortion caused by the new system for financing the regional (autonomous) governments has been eliminated. In terms of its composition, a fall of 3.2% has been budgeted for State current primary spending (excluding the transfers to the regional (autonomous) governments), with respect to the outturn projection, an increase in the debt burden of almost 25% and a reduction in public investment of around 31%.

	€m and %							
	Outturn 2009	Percentage change 2009/2008	Budget outturn projection	Percentage change 2010/2009	Outturn			
					Outturn Jan- Jun. Percentage change 2010/2009	2009 Jan-Sep	2010 Jan-Sep	Percentage change
1	2	3	4 = 3/1	5	6	7	8 = 7/6	
1 REVENUE	102,038	-21.1	121,551	19.1	19.5	70,701	92,676	31.1
Direct taxes	54,096	-27.0	58,270	7.7	11.1	37,833	42,320	11.9
<i>Personal income tax</i>	30,432	-29.9	39,950	31.3	21.4	20,739	28,090	35.4
<i>Corporate income tax</i>	20,188	-26.1	14,648	-27.4	-14.5	14,404	11,334	-21.3
<i>Other (a)</i>	3,476	2.8	3,672	5.7	6.1	2,690	2,896	7.6
Indirect taxes	28,664	-26.9	48,769	70.1	60.6	20,159	40,131	99.1
VAT	15,784	-36.7	35,032	121.9	94.8	10,742	30,090	180.1
<i>Excise duties</i>	10,141	-9.6	10,884	7.3	8.9	7,349	7,818	6.4
<i>Other (b)</i>	2,739	-11.2	2,853	4.1	5.8	2,068	2,223	7.5
Other net revenue	19,277	20.4	14,511	-24.7	-28.5	12,709	10,225	-19.5
2 EXPENDITURE	189,319	27.8	183,654	-3.0	3.6	133,501	130,616	-2.2
Wages and salaries	26,570	5.3	26,973	1.5	2.4	18,918	19,420	2.7
Goods and services	4,860	7.2	4,409	-9.3	3.3	2,893	2,827	-2.3
Interest payments	17,650	10.8	22,237	26.0	23.0	15,317	16,712	9.1
Current transfers	112,412	35.8	105,297	-6.3	7.3	77,090	74,875	-2.9
Investment	10,468	-1.6	8,458	-19.2	-6.2	6,916	6,157	-11.0
Capital transfers	17,360	94.1	16,280	-6.2	-22.7	12,367	10,624	-14.1
3 CASH-BASIS BALANCE (3 = 1 - 2)	-87,281	—	-62,103	—	—	-62,800	-37,939	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)								
TOTAL	116,779	-15.9	133,578	14.4	13.3	84,971	101,785	19.8
Personal income tax	63,857	-10.5	67,601	5.9	3.6	46,839	49,453	5.6
VAT	33,573	-30.1	45,625	35.9	31.4	23,816	37,410	57.1
Excise duties	19,349	-1.1	20,352	5.2	7.2	14,316	14,923	4.2

SOURCE: Ministerio de Economía y Hacienda.

a. Includes revenue from the tax on the income of non-residents.

b. Includes taxes on insurance premiums and tariffs.

Also, the budget envisages a general government deficit of 9.3% of GDP in 2010. By sub-sector, central government is projected to record a deficit of 5.9% of GDP this year (-9.4% in 2009), while the social security funds surplus is projected to fall by almost 0.6 pp, to 0.2% of GDP, and the regional and local government deficit is projected to worsen by 1.2 pp, to -3.7% of GDP.

According to the outturn projection included in the State budget, the State will post a deficit in cash terms of €62.1 billion in 2010, which is slightly below the level initially projected in the budget for 2010, owing to a small improvement in revenue and a cut in spending. The budget outturn to September was a deficit of €37.9 billion, notably lower than the €62.8 billion deficit recorded in the same period of the previous year (by contrast, the outturn for the social security system shows a reduction in the surplus, as detailed in Box 5). In Q3 the strength of revenue increased, with an increase of 31.1% in cumulative terms, while expenditure continued to slow, to reach a negative rate of -2.2% in cumulative terms to September, down from 3.6% in the first half of the year.

The Social Security System posted a non-financial surplus of €6,931 million to August 2010, down 32% on the same period of the previous year. The rate of decline in non-financial revenues continued to moderate, albeit very gradually, to reach -0.4% in the period to August, as against the fall of 3.4% projected in the budget. Payments grew by 4.2%, as against the 1.9% growth budgeted for the year as a whole, with a slight acceleration in the last month, in step with contributory pensions, the main item of spending.

By component, revenue from social security contributions contracted slightly in the period to August, by 0.1%, reflecting the trend in employment and social security registrations. Spending on contributory pensions maintained a relatively stable trend, rising by 5.1% to August, in line with the growth in the number of pensions. Spending on sickness benefits declined at a rate of 5%, less sharply than was projected in the budget.

With respect to the National Public Employment Service (SPEE, by its Spanish abbreviation), the data for which are not included in the adjoining table, the contributions received have been growing slightly in recent months. As regards expenditure, the rebates on contributions in respect of employment-promoting contracts have also accelerated recently, while the bulk of spending on unemployment benefits continued to slow to September, in line with the trends in unemployment, so that a substantial moderation is to be expected in 2010 as a whole, with respect to 2009. Despite these developments in total spending, the slowdown in the number of unemployment benefit recipients has been checked and they grew by slightly more than 11% year-on-year in August, in line with non-agricultural registered unemployment. As a result, the coverage rate fell only slightly, to stand at 79%, which was still higher than a year earlier. The latest information available indicates an additional moderation in the rise in registered unemployment in September.

SOCIAL SECURITY SYSTEM (a)

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

EUR m and %

	Budget			Outturn JAN-AUG		
	2009	2010	% change	2009	2010	% change
	1	2	3 = 2/1	4	5	6 = 5/4
1 REVENUE	123,726	119,481	-3.4	80,150	79,793	-0.4
1.1 Social security contributions	113,324	108,358	-4.4	71,155	71,115	-0.1
1.2 Current transfers	7,439	8,357	12.3	6,127	6,120	-0.1
Other	2,963	2,765	-6.7	2,868	2,558	-10.8
2 EXPENDITURE	114,476	116,601	1.9	69,917	72,863	4.2
2.1 Wages and salaries	2,453	2,483	1.2	1,571	1,547	-1.5
2.2 Goods and services	1,995	2,032	1.9	1,031	1,020	-1.1
2.3 Current transfers	109,465	111,557	1.9	66,939	70,166	4.8
<i>Contributory pensions</i>	93,339	95,320	2.1	57,519	60,466	5.1
<i>Sickness</i>	8,144	7,373	-9.5	3,703	3,516	-5.0
<i>Other</i>	7,982	8,864	11.0	5,717	6,184	8.2
2.4 Other	563	529	-6.1	376	130	-65.4
3 BALANCE	9,250	2,880	-68.9	10,232	6,931	-32.3

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.

EUR m		January-August		RATE OF CHANGE 2010/2009 (b)
		2009	2010	
CREDITS	Current account	198,526	215,505	8.6
	<i>Goods</i>	103,120	120,467	16.8
	<i>Services</i>	59,279	61,402	3.6
	— Tourism	26,117	26,830	2.7
	— Other services	33,162	34,573	4.3
	<i>Income</i>	26,630	24,180	-9.2
	<i>Current transfers</i>	9,497	9,455	-0.4
	Capital account	4,267	5,845	37.0
	Current + capital accounts	202,792	221,350	9.2
	DEBITS	Current account	238,001	250,125
<i>Goods</i>		131,604	151,467	15.1
<i>Services</i>		41,339	42,351	2.4
— Tourism		7,763	8,038	3.5
— Other services		33,576	34,313	2.2
<i>Income</i>		48,933	39,421	-19.4
<i>Current transfers</i>		16,125	16,886	4.7
Capital account		1,460	1,103	-24.4
Current + capital accounts		239,461	251,228	4.9
BALANCES		Current account	-39,476	-34,620
	<i>Goods</i>	-28,484	-31,000	-2,515
	<i>Services</i>	17,940	19,052	1,111
	— Tourism	18,354	18,792	437
	— Other services	-414	260	674
	<i>Income</i>	-22,303	-15,241	7,062
	<i>Current transfers</i>	-6,629	-7,431	-803
	Capital account	2,807	4,742	1,935
	Current + capital accounts	-36,669	-29,878	6,791

SOURCE: Banco de España.

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

Overall, direct tax revenues are being boosted by a certain recovery in tax bases, but above all by the impact of certain discretionary measures. Among the latter should be highlighted the elimination of the deduction of up to €400, which is already affecting the withholdings of personal income tax this year, and the rise in the investment income tax rates. As regards indirect taxes, VAT continued to post the sharpest increases in revenue, which rose by 57.1% in the first three quarters of 2010, after a notable acceleration in Q3. This was mainly a consequence of the sharp decline in rebates applied for by firms, which was largely attributable to the new system of monthly rebates introduced in 2009, which entailed an extraordinary, and temporary, volume of rebates that year. Also, revenues may have been affected by a certain bringing forward of consumption in the months preceding the rise in VAT rates in early July and by the rise in rates itself. Excise duties, for their part, grew by 4.2%.

4.5 The balance of payments

In the first eight months of 2010, the combined current and capital account balance was a deficit of €29.9 billion, 19% lower than in the same period of the previous year. Most of this correction is basically attributable to the reduction in the income deficit and, to a lesser extent, the increase in the services surplus, which offset the rise in the current transfers deficit and, in

particular, in the trade deficit. At the same time, the surplus on capital transactions increased substantially.

The trade deficit increased by almost 9% year-on-year in the period January-August, to reach €31 billion. Between January and August 2010, goods exports and goods imports both grew significantly, by 17% and 15% respectively. The rise in the deficit was due to the notable increase in its energy component, affected by the rise in oil prices, which increased by 31% over the period, while the non-energy deficit fell by 17%. The services balance posted a surplus of €19 billion, 6% more than in the same period of 2009, as a consequence of the notable improvement in the non-tourism services balance and the increase in the tourism surplus. The income deficit fell by 32% year-on-year in the period January-August 2010, with payments falling much more sharply than income (by 19% and 9% respectively). The current transfers deficit rose by 12% year-on-year in the first eight months of the year, with a slight decline in income and an increase in payments (of 0.4% and 5% respectively).

5 Financial developments

5.1 Highlights

International investor confidence in the Spanish economy recovered in 2010 Q3 in response to the progress made in fiscal consolidation, in structural reforms (most notably in the labour market) and in financial system restructuring. Additionally, the exercise in transparency represented by the publication in July, at the Banco de España's initiative, of the results of the stress tests conducted on euro area credit institutions enhanced the effects of the reforms, improving the perception of soundness of the Spanish financial system (see Box 6). Against this background, stock market prices rose, their volatility decreased and the risk premiums on fixed-income securities issued by the public and private sectors declined (see Chart 23). Thus at the end of October the IBEX 35 had climbed by 16.7% from its end-June level, compared with increases of 10.6% in the EURO STOXX 50 and of 14.8% in the S&P 500. This reduced the cumulative fall in the year so far to 9.4% for the Spanish index and 4.1% for the European one, while the US index was up by 6.1%.

The yield on Spanish 10-year government bonds with respect to the end of June decreased more sharply than that on German bonds with the same maturity (39 bp, compared with 2 bp), and, as a result, the interest rate spread between them narrowed by 36 bp to 165 bp at the end of October, after which it edged up somewhat in early November. At the end of September, the credit rating of the Kingdom of Spain's long-term debt was reduced by one level (from AAA) by Moody's. This downgrade, which was in line with market expectations and thus did not have a significant impact on prices, brought Moody's rating into line with those of other agencies which had already revised their ratings similarly. Q3 brought an improvement in credit institutions' access to wholesale funding, as illustrated by the increased activity in the markets which had been most affected by the tensions of the preceding months (particularly the fixed-income and repo markets), although the yield spreads remained high. Interest rates on interbank loans again rose, albeit moderately, and pushed 12-month Euribor at the end of the period to 1.54%, up 23 bp on June.

In the real estate market, the latest data published by the Ministry of Housing indicate that unsubsidised housing prices continued to fall in 2010 Q3. In this period, the quarter-on-quarter rate of decline held slightly below 1%, which resulted, in year-on-year terms, in a somewhat smaller drop than that seen three months earlier (3.4% or 0.3 pp less than in June).

Between June and September 2010, the cost of bank borrowing by households and firms moved upward in line with the benchmark market rates, so that the spreads between the two did not generally show significant changes (see Chart 23). Also, the cost of short-term fixed-income security issuance by firms increased, while that of long-term securities decreased and that of equity held at levels similar to those that at mid-year. In accordance with the October bank lending survey, credit standards remained unchanged in 2010 Q3, thus contrasting with the slight tightening which institutions expected to apply in this period.¹ This was probably due mainly to the significant improvement in access to wholesale funding sources. According to this survey, demand by firms and households (particularly for house purchase) decreased. For the last few months of 2010, institutions envisaged a slight tightening in corporate lending and no change in that to households.

1. For more details, see the article "Bank Lending Survey in Spain: October 2010" by Maristela Mulino, in this Economic Bulletin.

In 2010 Q2 the Spanish markets were among those most affected by the European sovereign debt crisis, and this was reflected in the greater cost and difficulty of financing for public and private sector issuers (see Box 7 of the “Quarterly Report on the Spanish Economy” in the July *Economic Bulletin* of the Banco de España). However, since the end of June there have been some signs that international investor confidence in the Spanish economy is recovering. And that situation has continued in subsequent months despite further tensions, which this time did not affect Spain. The creation of the European Financial Stabilisation Mechanism and of the European Financial Stability Facility helped to dissipate the tension. However, the different behaviour of Spanish sovereign risk in this period evidences the positive effects of the measures taken at national level in three complementary areas: fiscal consolidation, structural reform (particularly in the labour market) and financial system restructuring, notably focused on savings banks. Against this background, the publication at the end of July, at the initiative of the Banco de España, of the stress tests on credit institutions was an exercise in transparency which proved very useful in improving the perception of soundness of the Spanish financial system.

In the last four months the Spanish government debt market has been characterised by declining yields: from 4.9% in mid-June to around 4.2% at end-October in the case of 10-year bonds (see Chart 1).¹ The yield spread vis-à-vis German bonds of the same maturity narrowed in that time from 220 bp to 165 pp, widening somewhat in early November. This improvement is particularly significant if it is taken into account that it took place in a period in which fresh out-breaks of financial tensions pushed up interest rates on the debt of

1. At the end of September Moody's downgraded by one notch the credit rating of Spanish long-term government debt, falling into line with what had already been done by the other two main agencies. This movement had already been discounted by the market, so it barely affected prices.

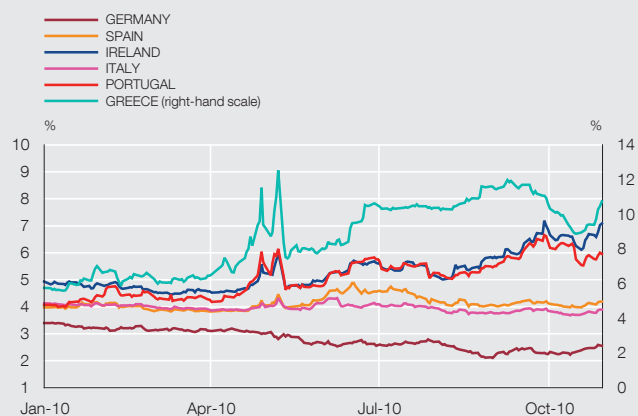
countries such as Ireland, Portugal and Greece. The recovery of international investor confidence in Spain can also be clearly appreciated in the flows of investment by non-residents in government debt, which turned positive again from June, following the disinvestments of the preceding two months (see Chart 2).

The improved perception of sovereign risk and the sounder financial system have made it easier for financial institutions to obtain funding from non-residents through repo transactions, a market which in Q2 was severely affected because the high correlation between the risk of these two sectors reduced the value of the collateral provided (government debt securities). Additionally, the access of some Spanish institutions to the international clearing houses (LCH in London and Eurex Repo in Frankfurt), either as members or through intermediaries, and the acceptance of Spanish securities in the LCH have added to the ways in which they can raise funds through these transactions.

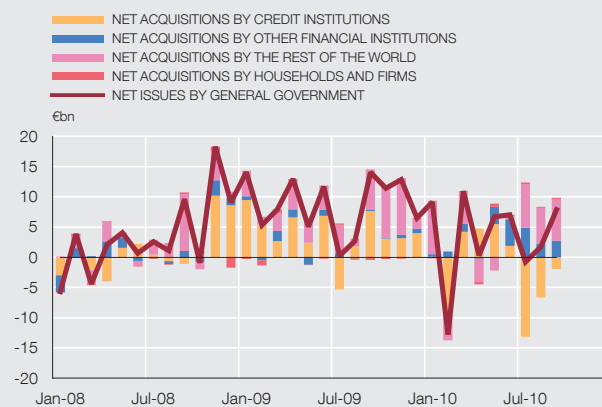
The primary debt markets of financial institutions have also recouped their activity following the subdued levels of May. As a result, these intermediaries have again been raising funds in net terms since July (see Charts 3 and 4). The increased funding opportunities in the markets have been reflected in a decrease in the net loan from the Eurosystem to resident institutions in recent months, which in October stood below the levels prior to the sovereign debt crisis (see Chart 5).

The resumption of capital flows from non-residents has reduced the risk of contraction of credit in Spain. Nevertheless, the risk premiums set by the market on Spanish securities continued to be high compared with the levels prior to the sovereign debt crisis (see Chart 6), which adds an element of pressure on deposit funding costs. If this situation persists, it could end up feeding through to lending interest rates.

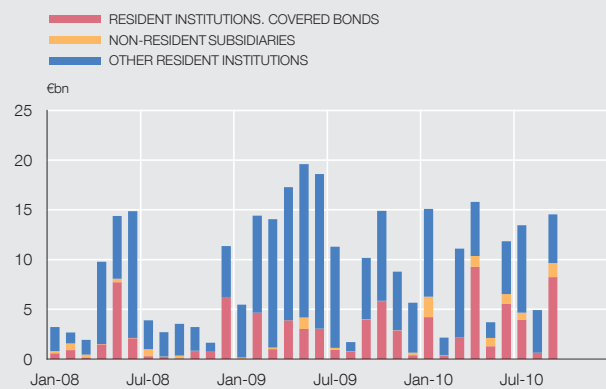
1 10-YEAR GOVERNMENT DEBT YIELD



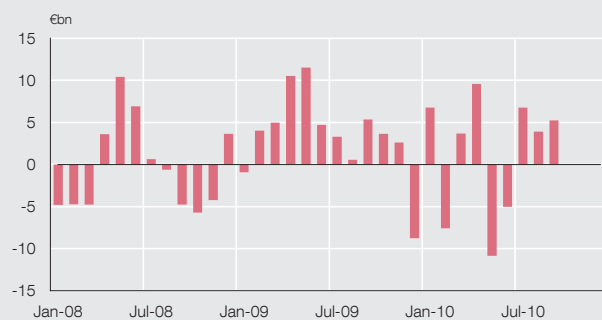
2 ISSUES AND ACQUISITIONS OF GOVERNMENT DEBT SECURITIES



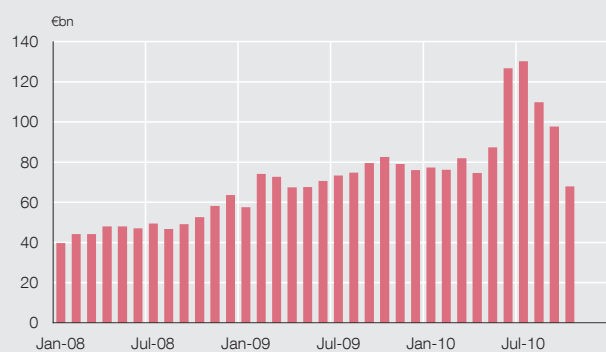
3 GROSS ISSUANCE OF MEDIUM- AND LONG-TERM FIXED-INCOME SECURITIES BY CREDIT INSTITUTIONS AND THEIR SUBSIDIARIES (a)



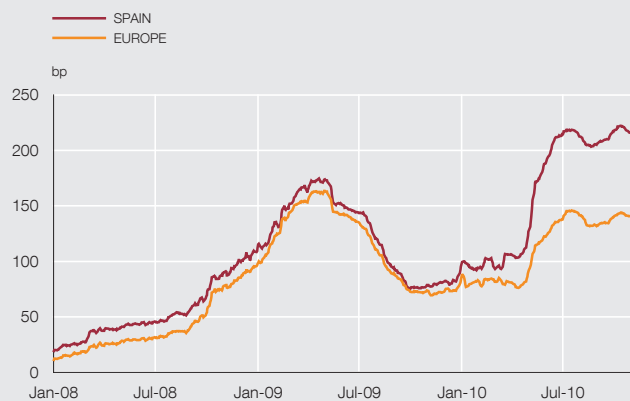
4 NET ISSUANCE OF MEDIUM- AND LONG-TERM FIXED-INCOME SECURITIES BY CREDIT INSTITUTIONS AND THEIR SUBSIDIARIES (a)



5 EUROSYSTEM NET LOAN TO RESIDENT CREDIT INSTITUTIONS
Monthly average of daily data

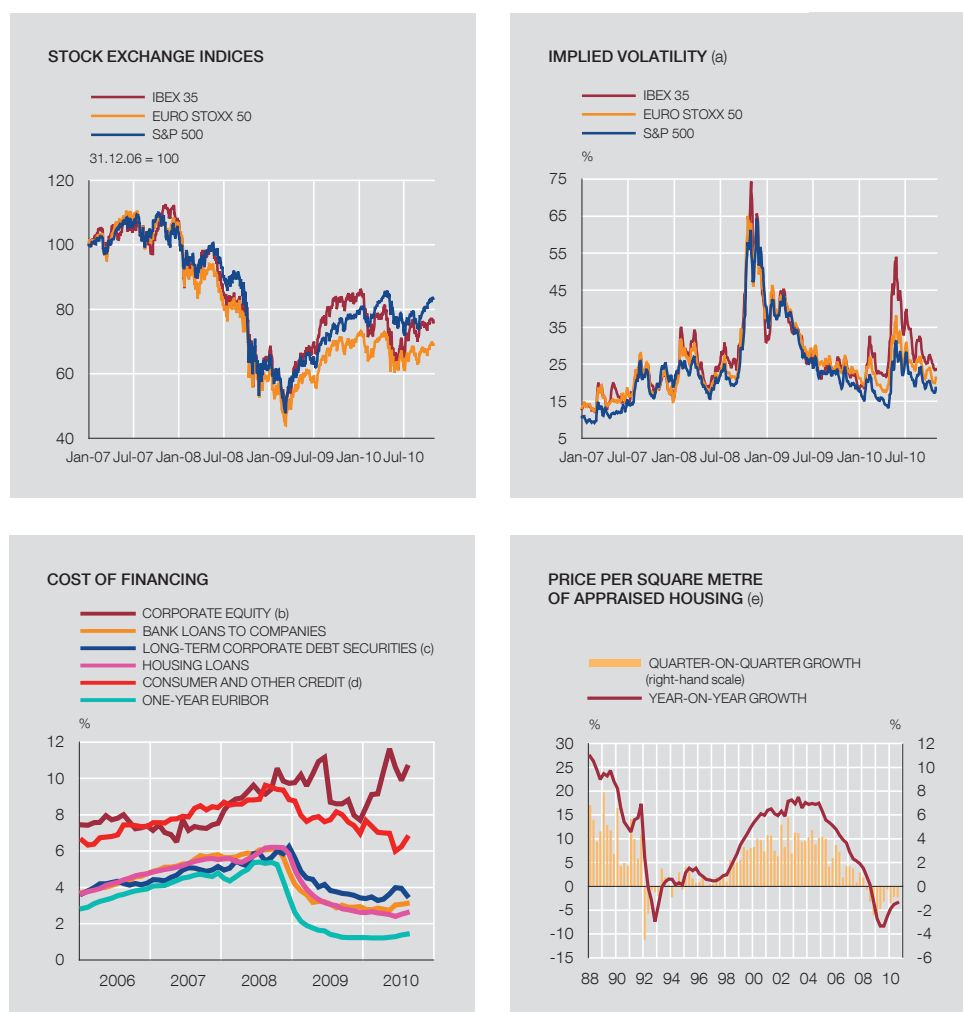


6 COVERED BONDS BETWEEN 5 AND 7 YEAR MATURITIES. ASSET SWAP SPREAD (b)



SOURCES: Reuters, Bloomberg, Datastream and Banco de España.

a. September figure is provisional.
b. 5-day moving average.



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

a. Five-day moving averages.

b. The cost of equity is based on the three-stage Gordon dividend discount model.

c. The cost of market-based long-term debt is calculated as the sum of the average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.

d. In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to customers were changed, potentially causing breaks in the time series. Particularly significant was the change in the interest rate on consumer credit and other lending, as a result of which from that month onwards it does not include credit card transactions.

e. The base year is 2001 until December 2004, after which it is 2005.

The latest information available on credit to the private sector, which relates to August, shows few changes in the momentum of household and corporate debt. Thus credit to households continues to expand slowly at rates below 1%, while, the contraction of corporate borrowing remained at nearly 2%. The most recent provisional data indicate that in September the growth rate of household liabilities decreased slightly and that the fall in banks' corporate lending moderated further.

The modest rise in household liabilities between March and June 2010, along with the stability of income, led to a slight increase in the debt to gross disposable income (GDI) ratio. The debt burden continued to fall due to the lower average cost of outstanding debt. However, as in the opening months of the year, there were also decreases in the gross savings ratio and in household's saving after debt service. The provisional information on Q3 points to a continuation of the previous trends, except for the debt ratio, which remained steady.

% GDP	2005	2006	2007	2008	2009			2010	
					Q2	Q3	Q4	Q1	Q2
					National economy	-6.5	-8.4	-9.6	-9.2
Non-financial corporations and households and NPISHs	-8.4	-11.1	-13.4	-6.8	-0.4	2.4	4.6	6.0	5.4
<i>Non-financial corporations</i>	-7.1	-9.5	-11.5	-7.1	-4.6	-2.7	-1.2	1.0	1.7
<i>Households and NPISHs</i>	-1.3	-1.7	-1.9	0.2	4.2	5.1	5.8	4.9	3.7
Financial institutions	0.9	0.7	1.9	1.8	1.7	1.5	1.4	1.2	1.1
General government	1.0	2.0	1.9	-4.2	-8.4	-9.8	-11.1	-11.5	-11.0
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-11.4	-17.8	-15.9	-11.9	-6.7	-3.9	-1.3	1.3	2.0

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.

In the case of firms, the debt ratio scarcely varied between March and June, while the debt burden continued to decrease, although more slowly, as a result of the drop in the average cost of outstanding debt. On the provisional data available, these same trends seem to have continued in subsequent months. For the sample of firms responding to the quarterly Central Balance Sheet Data Office survey (CBQ), among which the biggest have a considerable weight, the data for 2010 Q2 show that profitability recovered.

Doubtful loans continued to rise, although less quickly than in previous months. Since debt remained steady, this meant that the doubtful assets ratio continued upward. Specifically, for other resident sectors as a whole (which, in addition to households and firms, include financial intermediaries other than credit institutions), this indicator stood at 5.6% in August, up 0.3 pp on June.

The slowdown in general government debt continued, although the rate of expansion remained very high (17.9% in August, against 20.5% in May). This buoyancy in the raising of funds, along with the weak GDP growth, was reflected in fresh increases in the sector's debt ratio, which stood at nearly 57% of GDP in June 2010, and also represented an increase, albeit more moderate, in the associated debt burden.

The latest Financial Accounts information, relating to 2010 Q2, shows that the downward path since mid-2008 in the nation's net borrowing was interrupted in this period, in which it held steady at 4.4% of GDP in cumulative 12-month terms (see Table 6).

The sectoral breakdown of financial transactions vis-à-vis non-residents reflects the difficulty in raising funds abroad in this period. Thus, between March and June only general government managed to raise funds in net terms from the rest of the world, although the amount was lower than in the previous half. Accordingly, since the funds raised by this sector were insufficient to cover the excess of the nation's spending over revenue, the net assets of the Banco de España vis-à-vis non-residents underwent a significant reduction. The incomplete balance of payments information for Q3 indicates that this pattern seems to have reversed in summer, reflecting the improved access to funding from the rest of the world.

In short, in 2010 Q3 international investors regained confidence in the Spanish economy. This allowed the credit conditions of public and private agents to ease somewhat, thereby reducing the risk that these shocks would end up producing a significant contraction in lending to households and firms. Nevertheless, the risk premiums that institutions have to pay to obtain funds continue to be higher than before the sovereign debt crisis, so if this situation continues it could ultimately lead to an increase in the cost of bank borrowing. These developments are set against a background of some stabilisation in the indicators of financial pressure on the private sector, mainly as a consequence of the scant momentum of net borrowing and of the improved macroeconomic situation. However, the weakness of revenue is preventing a reduction in debt to income ratios, which are remaining at high levels. In the case of general government, its liabilities have continued to rise briskly, although more moderately than in the previous months.

5.2 Households

Between June and September 2010 the cost of bank borrowing by households increased (by 26 bp in house purchase loans and 67 bp in consumer credit and other lending, this latter segment showing more variable interest rates, partly due to seasonal factors). However, according to the October bank lending survey, credit standards seem to have remained unchanged in 2010 Q3, thus contrasting with the slight tightening envisaged by institutions. This seems to have been mainly due to improved access to wholesale funding sources and will, according to the survey respondents, persist in the last few months of the year. Meanwhile, household demand for finance, particularly that for house purchase, seems to have fallen, in line with what financial institutions expected in July.

Against this background, household debt increased slightly between June and August. Its year-on-year growth held slightly below 1%, as a result of that of house purchase funds remaining at around 1%, and of the slight decrease in that of lending for consumer and other purposes, which became zero, compared with slightly positive figures (0.3%) at the end of H1.

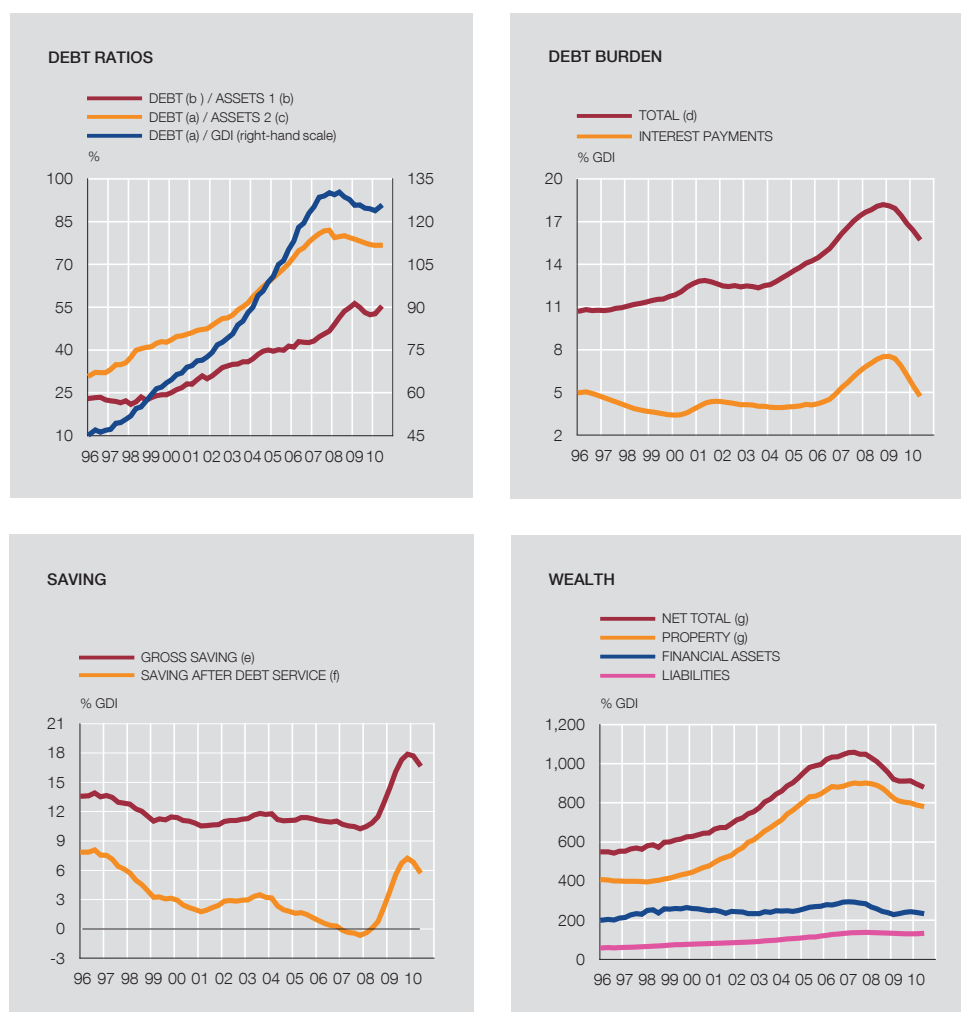
The slight growth in liabilities of the sector, taken together with the steadiness of income, led to a mild increase in the debt ratio between March and June, to 127% of GDI (see Chart 24). By contrast, the debt burden ratio kept falling (this time by 0.5 pp) to stand slightly below 16% of GDI, due to the decline in the average cost of outstanding loans. The sector's saving after debt service and its net lending again fell for the second consecutive quarter (see Table 6). In this period net household wealth fell off slightly as a result of the decrease in the real estate component (associated with the fall in house prices) and the loss of value of financial assets in the midst of stock market price falls.

Turning to portfolio decisions, the latest Financial Accounts information, relating to 2010 Q2, shows that household investment in financial assets, measured in cumulative annual terms and as a percentage of GDP, increased slightly with respect to March (up 0.3 pp to 4.2% of GDP; see Table 7). Analysis by instrument showed most notably a fall-off in the flow of cash and cash equivalents which, in GDP terms, decreased by 1.5 pp, with a corresponding rise in other deposits (the interest rate on which increased) and shares.

The latest data on the household doubtful assets ratio, for 2010 Q2, show a slight decrease; the factors which may have contributed to this are an easing of the debt burden and a slower rate of job destruction. Thus this indicator decreased in the case of both house purchase loans (down 0.14 pp to 2.6%) and consumer credit and other lending (down 0.32 pp to 6.89%).

5.3 Non-financial corporations

Between June and September 2010 the cost of bank borrowing by firms for loans below €1 million increased by 14 bp, while it remained unchanged for loans exceeding this amount. There was also an increase in the cost of short-term fixed-income security issuance by firms



SOURCE: Banco de España.

- a. Includes bank credit and off-balance-sheet securitised loans.
 b. Assets 1 = total financial assets - "other".
 c. Assets 2 = assets 1 - shares (excluding mutual fund shares) - shares in FIM.
 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.

(54 bp), while that of longer-dated terms decreased by 50 bp, after a significant rise in the preceding months. By contrast, the cost of share issuance remained similar to that at the end of Q2. In line with the October bank lending survey, banks' credit standards in their corporate lending seemed to hold steady in summer, while firms' demand for funds seemed to decrease, thereby departing from the stability seen in the previous three quarters and from the expectations of expansion expressed by banks. In the last few months of 2010, banks envisage a slight tightening in the supply of credit to this sector.

Corporate debt continued to shrink, as its year-on-year growth remained at -1.8% in August, the same as in July. However, behaviour differed across instruments. Thus the moderating path of the rate of decline in lending by resident banks initiated in May (2.2%, against 2.9% in June) persisted, while the funds raised through fixed-income securities, an alternative used basically by large firms and which accounts for a small proportion of total borrowings, slowed significantly to a rate of expansion of 26.6%, against 43.9% at mid-year.

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

TABLE 7

% GDP	2006	2007	2008	2009		
				2010		
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	11.1	7.2	2.7	4.5	3.9	4.2
Cash and cash equivalents	3.1	-1.0	-0.4	4.1	3.3	1.7
Other deposits and fixed-income securities (a)	5.9	7.5	6.8	-1.2	-0.8	0.3
Shares and other equity (b)	-1.1	0.5	-0.2	1.2	1.0	1.5
Mutual funds	0.2	-1.1	-3.4	0.0	0.0	-0.4
Insurance technical reserves	1.8	0.9	0.2	1.0	0.9	0.7
<i>Of which:</i>						
Life assurance	0.6	0.2	-0.2	0.6	0.5	0.3
Retirement	1.0	0.4	0.3	0.3	0.4	0.4
Other	1.1	0.4	-0.3	-0.5	-0.4	0.3
Financial transactions (liabilities)	12.7	9.1	2.4	-1.3	-1.0	0.4
Credit from resident financial institutions (c)	13.0	9.4	3.4	-0.5	-0.1	0.6
House purchase credit (c)	10.0	7.1	2.7	0.1	0.3	0.7
Consumer and other credit (c)	3.0	2.1	0.8	-0.4	-0.2	0.1
Other	-0.2	-0.3	-1.0	-0.8	-0.8	-0.1
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	25.1	14.3	5.1	-7.3	-5.0	1.6
Cash and cash equivalents	2.3	-0.4	-1.1	-0.2	0.1	1.0
Other deposits and fixed-income securities (a)	2.3	2.0	2.3	-0.5	-0.5	-0.5
Shares and other equity	11.3	7.8	3.2	-0.6	-0.5	0.1
<i>Of which:</i>						
Vis-à-vis the rest of the world	8.3	6.6	3.1	0.0	0.2	0.6
Trade and intercompany credit	8.3	3.4	0.1	-6.3	-3.8	1.3
Other	0.9	1.5	0.6	0.3	-0.3	-0.3
Financial transactions (liabilities)	34.5	25.8	12.1	-6.1	-6.0	0.0
Credit from resident financial institutions (c)	17.6	13.8	5.5	-3.0	-3.7	-2.7
Foreign loans	3.3	2.8	2.8	-0.1	-0.9	-1.8
Fixed-income securities (d)	1.8	0.5	0.3	1.3	1.3	1.7
Shares and other equity	2.9	4.8	2.6	1.3	1.0	1.1
Trade and intercompany credit	8.4	4.3	-0.1	-6.3	-3.8	1.3
Other	0.6	-0.5	1.0	0.7	0.1	0.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	24.2	15.5	6.4	-1.0	-1.5	-0.8
Households and NPISHs	19.6	12.5	4.4	-0.3	0.1	0.9
Non-financial corporations	27.9	17.7	7.9	-1.5	-2.6	-2.0

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. Including 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.

The latest breakdown of credit by type, relating to 2010 Q2, reflects a moderation in the fall-off of bank lending to most sectors (real estate services was the only exception, since its year-on-year rate of decline remained at nearly 0.5%, similar to that three months earlier). The largest contraction was once again in construction, the year-on-year growth rate of which stood at -8% (3.9 pp above that in March), while non-real estate services were the only sector to show positive growth compared with the same period a year earlier (1.8%, against -1.1% in March).

In line with this picture, the Financial Accounts information for 2010 Q2 shows that the outstanding balance of net financial transactions by the non-financial corporations sector became positive again, accounting, in cumulative 12-month terms, for a value equivalent to 1.7% of GDP, up 0.7 pp on March. Similarly, the financing gap, an indicator which proxies the funds needed to cover the difference between firms' gross saving and gross capital formation plus permanent investment abroad, also again posted a negative amount, this time somewhat higher in absolute terms than in June (2%, against 1.3% in March).

The latest National Accounts estimates of business surpluses, for 2010 Q2, show that these surpluses remained, in cumulative 12-month terms, at levels similar to those in March. As a result of this behaviour of revenue, and the steadiness, in quarter-on-quarter terms, of the sector's liabilities, the corporate debt ratio scarcely altered (see Chart 25). Nonetheless the fall in the average cost of debt on-balance-sheet was once again reflected in a decline in the debt burden ratio.

The data for 2010 Q2 on the sample of corporations reporting to the CBQ, among which the biggest have a notable weight, shows a continuation of the pattern of income recovery which began at the end of 2009. Thus in 2010 H1 the ordinary net profit of these firms grew by 9.3% with respect to the same period of the previous year, contrasting with the contraction of more than 25% in the first six months of the previous year. In line with these developments, the return on equity increased (particularly notably in industry) to 7%, up 0.6 pp on June 2009, and the percentage of firms for which this ratio was negative decreased by more than 5 pp. These events were accompanied by a moderate rise in debt levels, so the debt ratio was up slightly, despite which the debt burden decreased. The overall result of these changes was that the indicators of financial pressure on investment and employment fell (in the case of the former, for the third quarter running), this fall being particularly sharp in industry. According to analysts, the outlook is that this positive performance of income will continue in the coming months, since their expectations for the short-term, and more importantly the long-term, path of listed firms' profits have been revised upward (see Chart 26).

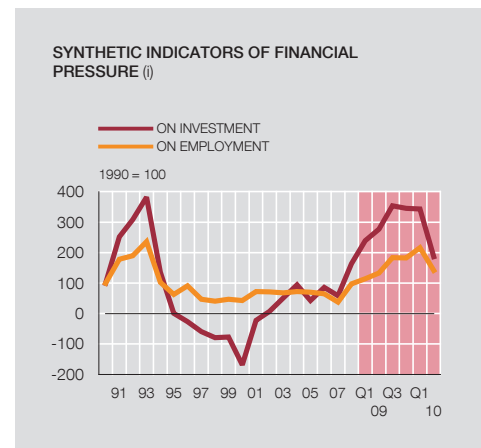
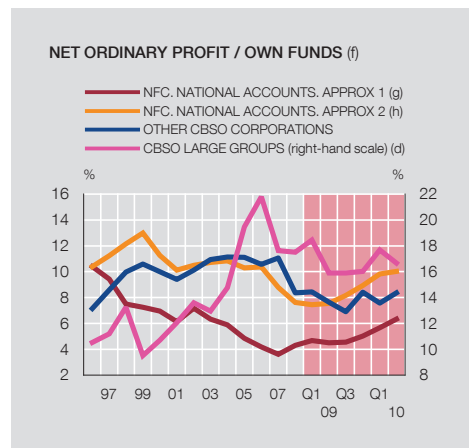
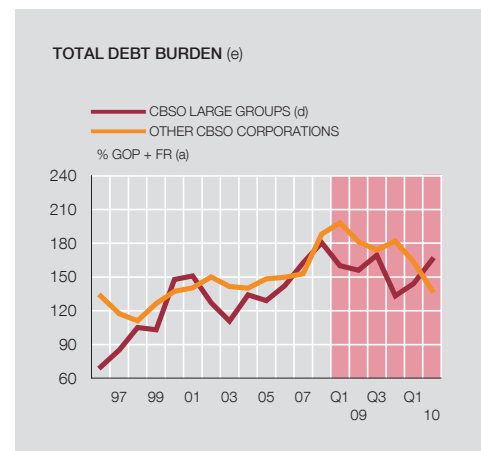
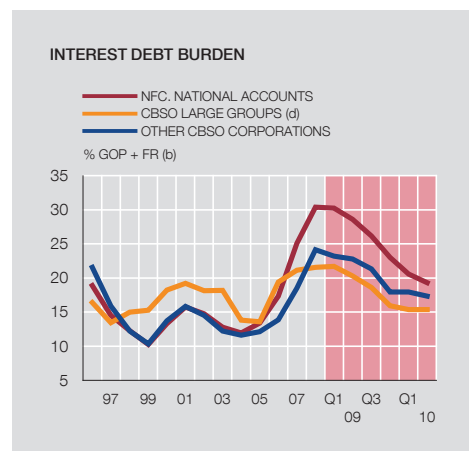
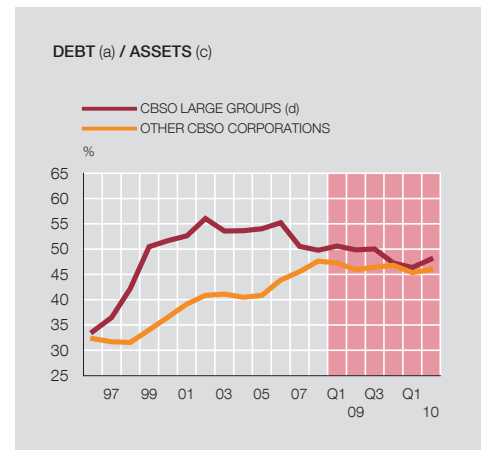
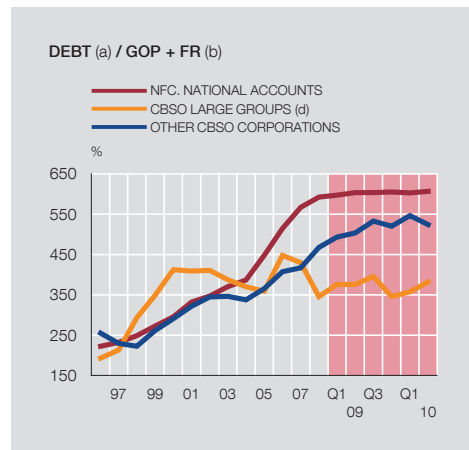
The doubtful assets ratio of non-financial corporations continued to rise in 2010 Q2. This increase is explained by the behaviour of credit to construction and real estate services companies, whose ratio rose by 27 bp to 10.8%, and to firms in other sectors, for which this indicator increased by 12 bp to 3.8%.

5.4 General government

In 2010 Q2 general government net borrowing decreased slightly in cumulative annual terms to stand at 11% of GDP, down 0.5 pp on March (see Table 6).

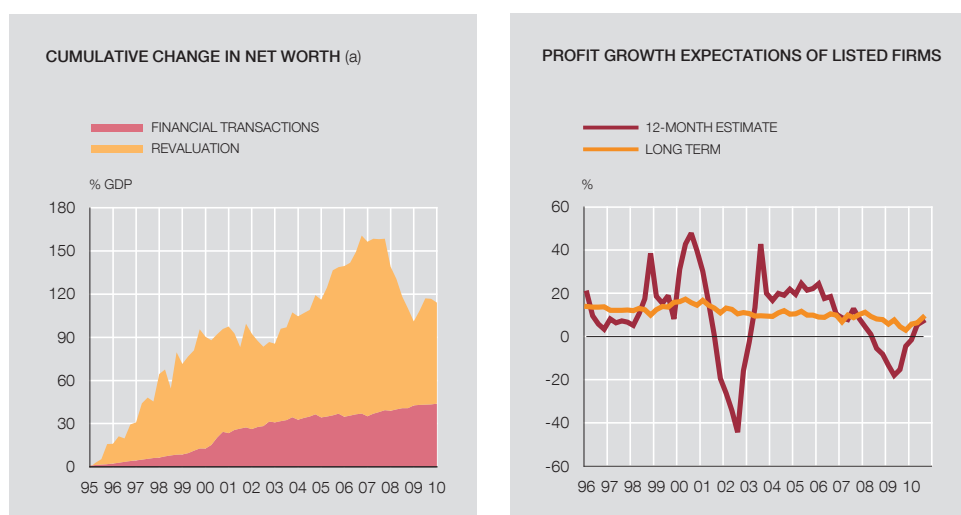
The main means of financing the general government deficit continued to be through the issuance of fixed-income securities, as a result of which a net volume of funds equivalent to 9% of GDP (see Chart 27) was raised in 2010 Q2 in cumulative annual terms. Once again, the bulk of these placements was in securities maturing at over one year, while the relative weight of short-term bonds fell once again. The funds obtained through loans continued to account for a modest amount, slightly above that in the previous quarter (somewhat more than 0.7% of GDP). On the assets side, deposit flows again decreased in year-on-year terms.

Although the growth rate of general government indebtedness eased, it remains high (17.9% in August). This, along with the scant momentum of output, made for a further increase in the debt/GDP ratio, which was somewhat below 57% in June, up 2 pp on March. Nonetheless, the lower level of borrowing costs helped to contain the increase in the debt burden associated with these liabilities, which stood at around 1.9% of GDP at mid-year.



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 Enesa, 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 + interest and dividends received - interest paid - fixed capital consumption.
- g. Own funds valued at market prices.
- 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 (less) financial pressure than in the base year.



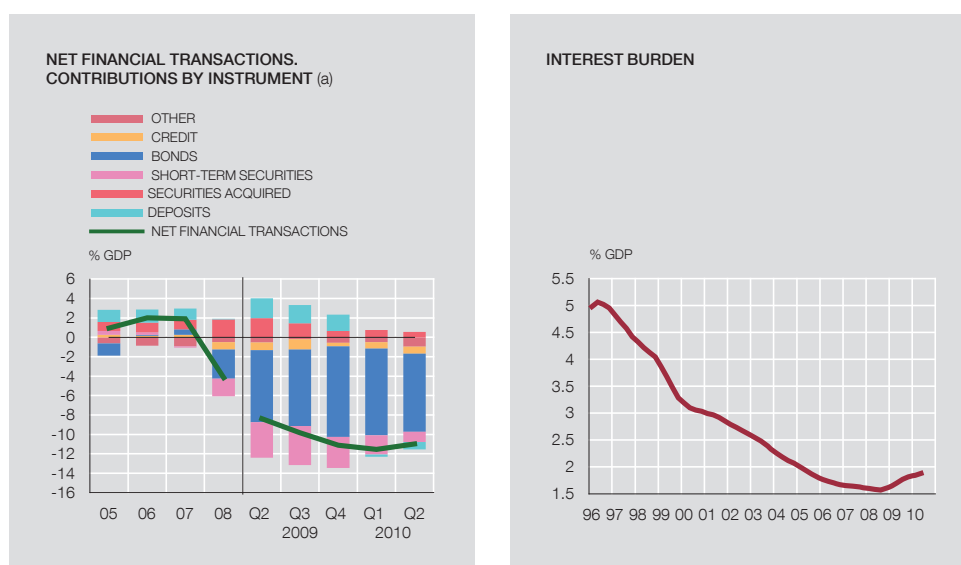
SOURCES: I/B/E/S and Banco de España.

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

GENERAL GOVERNMENT

CHART 27

Four-quarter data



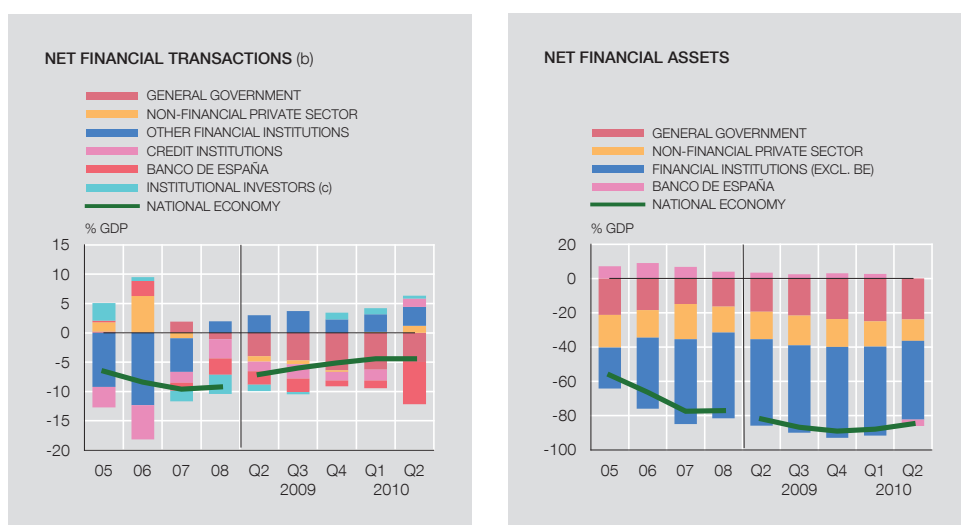
SOURCE: Banco de España.

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

5.5 The rest of the world

2010 Q2 brought an end to the downward course of the nation's net borrowing since mid-2008, which held at 4.4% of GDP in cumulative 12-month terms. This development was due to an increase in the credit balance of non-financial corporations and a decrease in the debit position of general government, which were offset by the decrease in household net lending, while that of financial institutions scarcely changed.

The sectoral breakdown of financial transactions vis-à-vis the rest of the world shows that in 2010 Q2 only general government managed, in net cumulative 12-month terms, to raise funds abroad, albeit for a low amount than in the previous half (see Chart 28). By contrast,



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.

credit institutions, which have traditionally channelled funds from the rest of the world to the Spanish economy, had great difficulty in raising capital on international markets as a result of the tensions derived from the sovereign debt crisis, and their net financial transactions vis-à-vis non-residents changed to a credit balance equivalent to 1.5% of GDP. Hence, since the funds raised by general government were insufficient to cover the nation's excess of spending over revenue, the net assets of the Banco de España vis-à-vis the rest of the world decreased significantly by the equivalent of 7.2% of GDP (in cumulative 12-month terms), the largest fall recorded since the time series became available (mid-1990s). On the incomplete information for Q3 drawn from the balance of payments (which covers up to August), this trend is estimated to have reversed in subsequent months, against a background of recovery of international investor confidence in the Spanish economy.

The information on financial flows vis-à-vis the external sector for 2010 Q2 shows that the Spanish economy found it difficult to raise funds in the rest of the world in this period in which significant tensions erupted in the markets. Thus capital inflows barely amounted to 2.3% of GDP (in cumulative 12-month terms), 2 pp less than three months earlier (see Table 8). By instrument, the bulk of these funds was channelled through deposits, specifically by credit institutions' recourse to the Eurosystem, which accounted for an annual flow of 6.7% of GDP, thereby offsetting the drop in funding from the interbank market. Along the same lines, foreign direct investment in Spain took on a slightly negative value equal to 0.3% of GDP, signifying a fall of 1 pp with respect to March.

Capital outflows were again negative in cumulative 12-month terms, amounting to -2.1% of GDP (against -0.1% in March). Most notable in the breakdown by instrument was the net disinvestment in fixed income securities for an amount equal to 3.9% of GDP. The flows of Spanish foreign direct investment were also negative, as in the previous quarter, and of similar amount (-0.7% of GDP).

% GDP						
	2006	2007	2008	2009	2010	
				Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-8.4	-9.6	-9.2	-5.1	-4.4	-4.4
FINANCIAL TRANSACTIONS (ASSETS)	18.1	14.7	2.4	-0.2	-0.1	-2.1
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	5.2	2.1	-0.3	-1.8	-1.5	-0.7
<i>Of which:</i>						
<i>Interbank (a)</i>	3.4	4.2	-0.5	-1.7	-1.6	-1.0
Securities other than shares	-1.2	1.6	1.3	0.0	-0.3	-3.9
<i>Of which:</i>						
<i>Credit institutions</i>	-2.0	1.8	1.6	1.3	0.7	-2.0
<i>Institutional investors (b)</i>	0.7	0.0	-1.3	-0.4	-0.1	-1.0
Shares and other equity	10.8	8.8	1.9	1.5	1.3	1.7
<i>Of which:</i>						
<i>Non-financial corporations</i>	8.3	6.6	3.1	0.0	0.2	0.6
<i>Institutional investors (b)</i>	1.2	-1.1	-1.6	0.3	0.7	1.0
Loans	2.1	1.2	0.8	0.2	0.0	-0.7
FINANCIAL TRANSACTIONS (LIABILITIES)	26.5	24.3	11.6	4.9	4.3	2.3
Deposits	0.3	7.3	9.0	0.9	0.6	2.2
<i>Of which:</i>						
<i>Interbank (a)</i>	0.6	6.7	6.2	0.7	-0.6	-4.8
Securities other than shares	21.3	8.1	-2.6	3.8	3.3	0.6
<i>Of which:</i>						
<i>General government</i>	1.0	-1.3	1.2	5.1	5.5	4.1
<i>Credit institutions</i>	8.0	3.6	-1.9	1.1	0.9	-0.4
<i>Other non-monetary financial institutions</i>	12.3	5.8	-1.9	-2.4	-3.0	-3.2
Shares and other equity	0.5	4.6	3.3	0.9	1.4	0.9
<i>Of which:</i>						
<i>Non-financial corporations</i>	0.1	4.7	2.4	0.1	0.4	0.4
Loans	3.5	3.1	2.7	0.3	-0.5	-1.2
Other, net (c)	-0.4	0.3	0.5	-0.8	-1.0	-1.5
MEMORANDUM ITEMS						
Spanish direct investment abroad	8.4	9.5	4.7	0.6	-0.9	-0.7
Foreign direct investment in Spain	2.5	4.5	4.6	0.5	0.7	-0.3

SOURCE: Banco de España.

a. Correspond only to credit institutions and include repos.

b. Insurance corporations and portfolio investment institutions.

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

As a result of the developments in financial flows with the rest of the world and of the changes in asset prices and in the exchange rate, the value of net liabilities incurred by the Spanish economy amounted to 85% of GDP in June 2010, down 3 pp on March (see Chart 28). By institutional sector, this change was basically due to the decrease in the debit balance vis-à-vis non-residents of financial institutions (excluding the Banco de España), of the non-financial private sector and of general government, which was offset only partly by the decrease of 6.4 pp in the credit position, which became a debit balance, of the Banco de España.

29.10.2010.