

QUARTERLY REPORT ON THE SPANISH ECONOMY

## 1 Overview

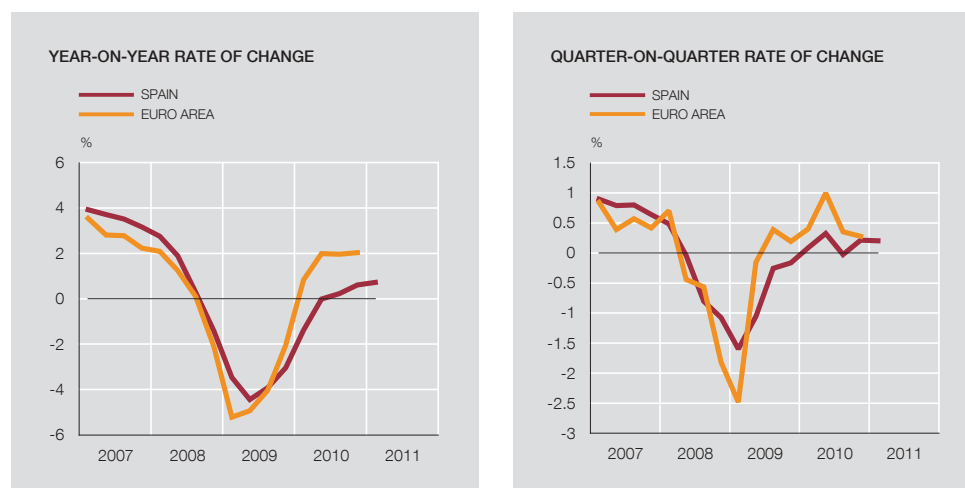
In the opening months of 2011, the Spanish economy continued growing at a weak rate against the background of the progressive recovery in the world economy, but one not free from the emergence of fresh causes for uncertainty. The estimates made drawing on the conjunctural information available suggest that GDP posted a quarter-on-quarter increase of 0.2% in 2011 Q1, unchanged on the previous quarter. In terms of the year-on-year rate, output continued on the path of slow recovery seen in previous quarters, its pace accelerating by 0.1 pp to 0.7%. This was the outcome of a negative contribution by national demand, on a similar scale to that of the previous quarter, and of the increase in the positive contribution of net external demand, which resumed the role of the main source of expansion of expenditure, with a contribution of 1.4 pp. Under national demand, the moderate pick-up in household consumption and the increase in investment in equipment partly countered the fall-off in the public components of spending, affected by the ongoing austerity measures and the decline in residential investment. In tune with this outlook, all the non-agricultural productive branches except construction posted moderately positive growth rates, and there was a particularly salient rise in industrial activity. Notwithstanding, employment fell further, by an estimated year-on-year rate of around 1.3%, which was slightly more moderate than in the previous quarter (and in line with the EPA employment figures for that period). The unemployment rate rose by 1 pp to 21.3% in Q1, against the backdrop of a slight easing in the rate of expansion of the labour force.

Despite the cyclical sluggishness the Spanish economy continues to evidence, inflation remained on a rising course. Driving it, as had been the case in the closing months of 2010, are factors that are, in principle, temporary, including most notably dearer energy. The year-on-year rate of change in the CPI rose to 3.6% in March (3% in December last year), while the attendant rate of the CPI excluding unprocessed food and energy was lower, at 1.7%. However, as the year unfolds, the pressures on costs and prices are stepping up (the CPI leading indicator for April increased to 3.8%), with the risk of inflation expectations worsening therefore greater.

Internationally, the economic recovery was widespread. That said, the worsening of geopolitical tensions in the North African and Middle Eastern countries, doubts about the impact of the earthquake in Japan on 11 March, rising energy prices on international markets and the continuation of the sovereign debt crisis in the euro area added further factors of uncertainty. As is habitually the case, output growth rates were uneven across the different geographical areas. The emerging and developing economies showed greater dynamism, underpinned by domestic demand, while activity in the developed economies, though gathering strength, was tempered by the ongoing financial deleveraging in which they are immersed.

Commodities prices increased markedly in the face of persistently strong demand pressures, exacerbated on the supply side by political tensions in the oil producing countries. Oil prices reached a new high (\$127 per barrel) in the closing days of April, and precious metal and food prices likewise continued on a rising course, albeit at a decelerating rate. As a result, global inflation increased further and the future inflation outlook worsened across the board, more so in the emerging countries that are ahead in the cycle.

International financial markets were affected by the greater uncertainty generated by the above-mentioned events; but on the whole, they tend to be gradually stabilising. Nonetheless, tensions persisted on the sovereign debt markets in some euro area countries, especially in



SOURCES: ECB, INE and Banco de España.

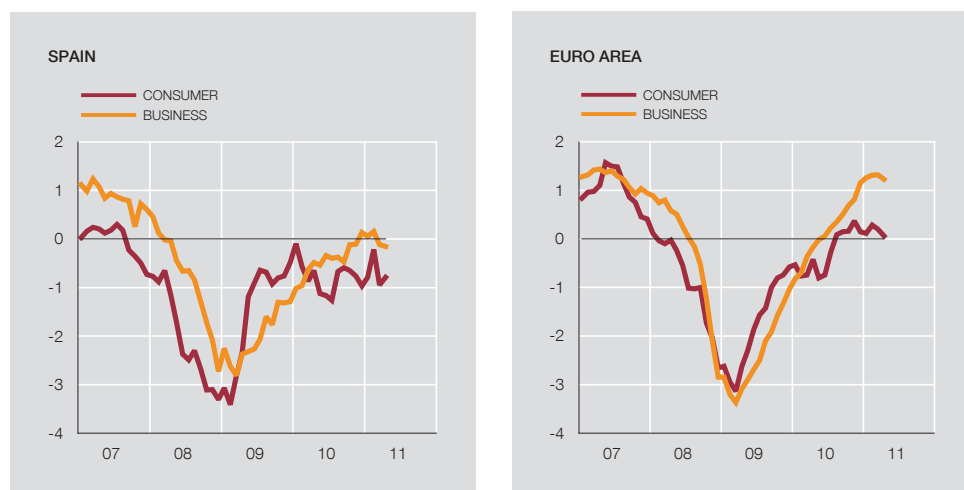
a. Seasonally adjusted series.

Greece, Ireland and Portugal. The request by the Portuguese government for financial assistance in early April and progress in recapitalising the Irish banking system paved the way for an improvement, which was curtailed in mid April by the uncertainty arising over the possibility of Greek debt being subject to some form of restructuring.

During the quarter major steps were taken in reforming European governance, reinforcing the institutional elements that had shown signs of most weakness during the breaking and subsequent development of the crisis: namely, the Stability and Growth Pact, the framework for the prevention of macroeconomic imbalances and the crisis resolution mechanism. Specifically, the European Summit on 23 and 24 March endorsed the operating principles of the European Stability Mechanism, which will come into force in June 2013 for financial assistance to Member States that need it, replacing the current temporary mechanisms. The Summit further laid down the so-called Euro Plus Pact, which strengthens the commitment of euro area and certain EU member governments to the implementation of policies more conducive to growth and financial stability in the euro area.

GDP quickened in the opening months of 2011 in the euro area, underpinned by the strength of exports and the rise in investment, and by the reversal of certain temporary factors, linked mainly to bad weather, which depressed activity in the final months of 2011. The gap between the countries most ahead in the cycle (Germany and France) and those most behind, where the recovery has not yet begun (Portugal, Ireland and Greece), widened further. As regards prices, there was a notable deterioration in the year-on-year rate of the HICP, caused mainly by the rise in energy prices. This latter factor has meant a notable deterioration in the short-term inflationary outlook and has raised medium-term inflationary risks. Against this background, the ECB decided at its April meeting to increase its main refinancing operations rate by 25 bp to 1.25%, and at the May meeting the Council held it unchanged at this level.

Over the course of the quarter, Spain decoupled from the group of countries most affected by the tensions on sovereign debt markets. Market perceptions came round to drawing this distinction thanks, among other reasons, to the new measures adopted to strengthen Spanish credit institutions' solvency and to the headway made in structural reform, following the approval of the draft bill on pension reform. Less mistrust made for a reduction in 10-year



SOURCE: European Commission.

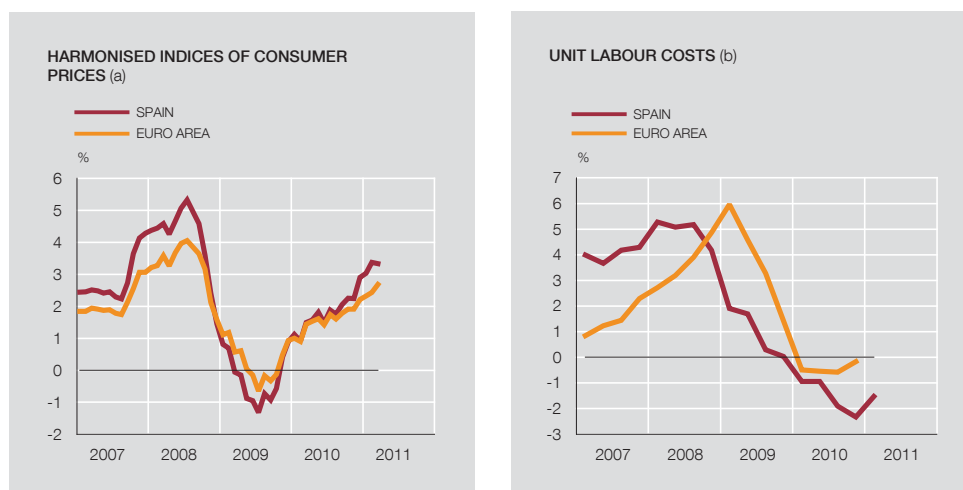
a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

Spanish government bond yields and in the related spread over the German *Bund* to around 190 bp, for a cut in corporate credit risk premia and for improved access by Spanish investors to wholesale funding. However, in mid-April the heightening of tensions on sovereign debt markets prompted a fresh rise in Spanish bond yields, to 5.3% at the end of the month, and to a widening of the spread over the German benchmark to 205 bp. The IBEX 35 posted a gain of around 7% in Q1, a trajectory which was interrupted in April by fresh oscillations. On the real estate market, house prices continued to fall at a year-on-year rate of 4.5%, up on the previous quarter.

Despite the lesser tension on capital markets, accessibility by the resident private sector to funding became somewhat tighter. Although the rise in interbank interest rates will take some time to feed through fully to lending rates, banks began to pass through to margins the higher cost of their liabilities that came about as a result of the tensions on wholesale markets in 2010. The opening months of 2011 therefore saw a moderate increase in the interest rates on corporate and household loans. Lending standards, interest rates aside, also tightened slightly.

In these circumstances, household spending continued to show signs of a weak recovery. The scant improvement in households' perception of the overall economic situation, coloured by labour market difficulties, the decline in the value of household wealth and the slide in incomes are checking spending plans, in a setting in which household purchasing power is being further reduced by the rise in inflation. The buffer provided by available saving to finance consumption has diminished considerably following its rapid decline during 2010. Overall, consumption is estimated to post a quarter-on-quarter growth rate similar to that in the final months of 2010, which will place it at around 1%. Foreseeably, this moderate pattern will continue over the rest of the year.

Residential investment is expected to have continued on a course furthering its correction, albeit with diminishing intensity, with a decline in its year-on-year rate of close to 9% being estimated (-11.4% in 2010 Q4). The completion of the adjustment still to be made will require that housing transactions resume a clearer path of recovery, something which might be hampered in the opening months of 2011 by the effect of purchases being brought forward to the previous year, given the change in how house purchases are treated for personal income tax purposes. The lesser



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

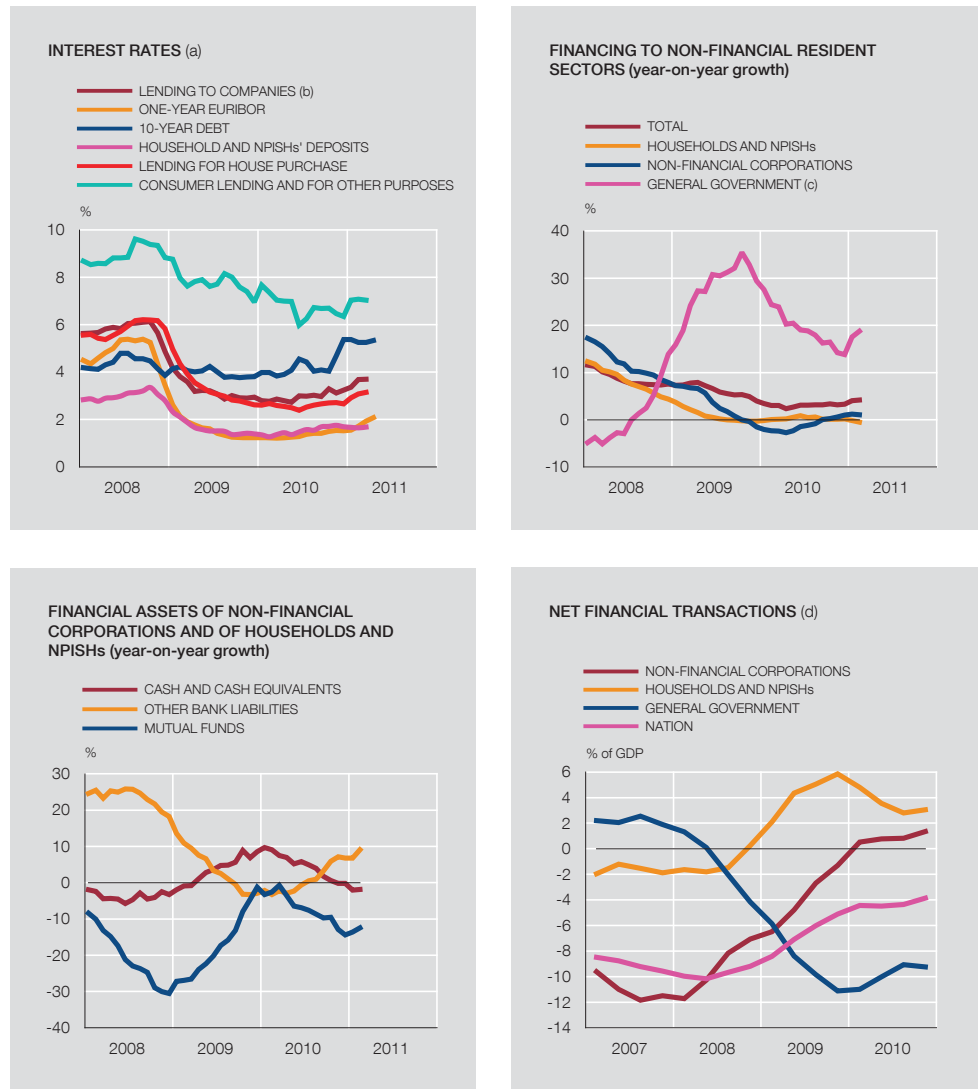
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

affordability of housing, now that interest rates have begun to rise, will not be of any help either. Against this background of markedly sluggish household spending and tighter lending standards, household debts fell by 0.5% in year-on-year terms in February, largely as a result of the loss of momentum of loans for house purchases, although consumer credit also contracted.

Business investment also showed a moderate rate of increase similar to that of the previous quarter, despite the fact that the improvement in non-financial corporations' financial position, further to the increase in business saving in 2010, might have been conducive to the greater dynamism of this domestic demand component. However, the relative strength of investment in equipment is perceptibly greater, possibly due to some pick-up in industrial activity, while investment in non-residential construction is being slowed by the effect of the fiscal austerity plans on the projects being undertaken jointly with general government, principally in infrastructure. Corporate debt also stood at low values, while still showing positive growth rates (1.1% in year-on-year terms in February). Yet on the information available to December, developments across the productive branches were uneven: while there were marked declines in the financing of construction and real estate development activities, the funds made available to other services and to industry picked up somewhat.

General government conduct continued to be marked by the fiscal adjustment, which is being felt both in the course of revenue (with the favourable performance of VAT proceeds, due in part to the effect of the rise in this tax in July last year) and in that of expenditure, where under the State caption substantial cuts are being seen in goods and services purchases and public investment (details on regional government spending are not yet available). Judging by the macroeconomic projections published by the Banco de España in March, these data are consistent with the achievement at the end of the year of an overall general government deficit around the official estimate for 2011 (6% of GDP). From the standpoint of the sustainability of public finances in the medium term, the swift application of the reforms envisaged in the draft bill on the reform of the public pensions system, approved last January, will be crucial.

On 29 April, the government released a new Updated Stability Programme covering the period 2011-2014. The Programme confirms the already known budgetary consolidation path to



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.

2013, when the general government deficit is expected to stand at 3% of GDP and the public debt ratio to stabilise at slightly below 70% of GDP. It also presents the deficit target for 2014, at 2.1%, and a reduction in public debt to 68.9% of GDP is projected.

Turning to external demand, the buoyancy of goods exports and the notable recovery in tourism are underpinning this demand component. Imports increased at a slow pace, in step with the sluggishness of domestic demand. Clearly, some of the improvement in net exports is due to the diversification drive by Spanish companies abroad, along with the greater quality and competitiveness of the tourist offer. But, at the same time, benefit is being drawn from more temporary factors that may ultimately lose momentum, such as the extraordinary intensity of international trade flows and the renewed international flows of tourists towards Spain induced

by the political instability in North African and Middle Eastern tourist destinations. To ensure the continuity of this process, perseverance with the strategies geared to increasing penetration in foreign markets and improvements in productivity will be necessary, all the more so given that further headway must be achieved in reducing the nation's net borrowing. And this in a setting in which oil prices will likely hold at high levels for some time and in which the downward trend in the net balance of investment income has been flattening out.

On the supply side, the keynote for the quarter was the recovery of some momentum in industrial activity, underpinned by the strength of exports, following a long period of scant growth. Value added in the services branches, which were more resilient during the downturn, once again showed positive growth rates, albeit on a markedly slack course which is in line with the weakness of domestic demand and, in particular, with that of consumption. Lastly, activity in the construction sector continued to fall off, at a similar rate to the previous quarters, as a result of the growing weight that non-residential construction, affected by the fiscal consolidation plan, represents in the adjustment of the sector. The modest rise in value added in the market economy was once again insufficient to generate employment in net terms, and a fall of 1.5% in employment has been estimated for this sector, a somewhat smaller figure than that for the previous quarter. Three years after this long episode of job destruction began, staffing adjustments are thus continuing to play a very significant role in productivity gains, relegating to a secondary plane other factors that should be playing a more active role in this phase of the cycle. This reveals the existence of structural rigidities that are hampering the adjustment of the Spanish economy to a growth model less reliant on construction.

The presence of these rigidities is also - at least temporarily - adversely affecting labour costs and inflation, as earlier stated. It would be premature to draw firm conclusions about the impact on labour costs of the wage settlements reached in collective agreements signed in the opening months of the year. It should be borne in mind that what is involved here is a very small number of collective agreements which are, moreover, those that are most closely linked to recent inflation. That said, the 3.1% growth in wage rates to March (compared with 1.4% in 2010) is excessive in light of the aforementioned slackness of the labour market. Indeed, the year-on-year rate of expansion of compensation per employee in the market economy is estimated to have increased by around 1.5% in Q1, tempering the declines recorded in unit labour costs. The above-mentioned wage dynamics are sufficiently illustrative of the problems entailed by the continuing existence of inflation-adjustment clauses when prices are rising as sharply as they are at present. Such clauses fuel the generation of second-round effects that tend to hamper attainment of the gains in competitiveness and the employment generation needed to bolster a sounder recovery.

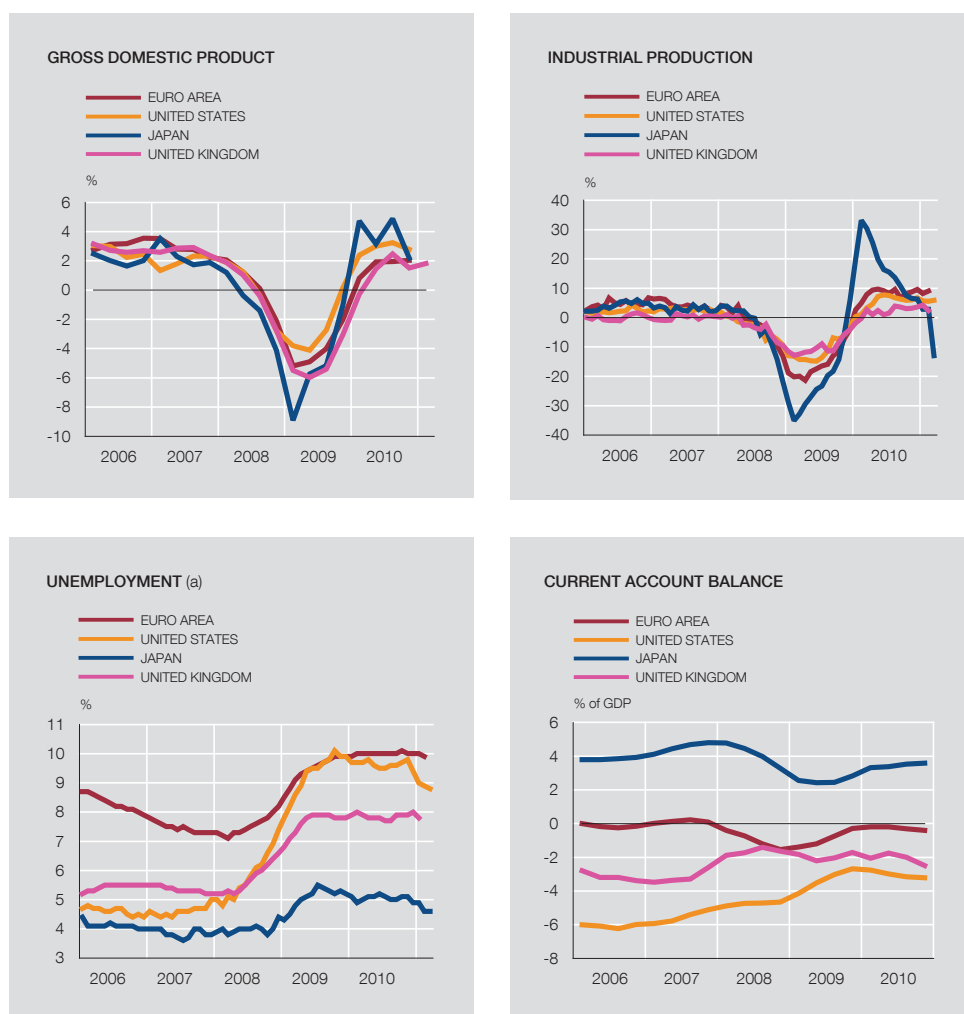
## 2 The external environment of the euro area

Despite the extent of the shocks throughout the quarter, the international financial markets were able to absorb them without serious alterations and the global economy performed relatively well. The euro area sovereign debt problems impinged only temporarily on the financial markets outside the countries directly affected by the crisis. The impact of the geopolitical tensions in the Arab countries was limited to the markets in the area in conflict, although globally they reinforced the upward trend in oil prices. Finally, the earthquake in Japan (with the subsequent nuclear crisis) had significant, but brief, effects on the main market prices. On the upside, there were signs that the recovery was firming in the developed countries, with advances in private demand, although significant economic policy support was still in place. Against this background, there is evidence for a forthcoming change of cycle towards the gradual normalisation of economic policies, which is not exempt from risk. Thus, as the recovery seems to gather force in the advanced economies, concerns about inflation are beginning to gain in relative importance and a progressive tightening of monetary conditions is in the offing within the more or less near future. Also, the recent change in the rating of US debt to a negative outlook underlines the need to address fiscal consolidation in that country. For their part, the emerging economies continued recording inflationary pressure and signs of overheating, while the trends towards appreciation and capital inflows persisted, as evidenced by the movements of fixed-income securities (and, in April, also of shares). Hence the monetary policy dilemma faced by these economies during the past year remains current.

The international financial markets responded more strongly to the positive data on economic performance (mainly in the United States) than to the aforementioned negative shocks. In the quarter as a whole, the stock exchanges of the main developed economies showed gains and volatility diminished, although the Nikkei index lost around 15% in the days following the earthquake, which it largely recouped later on. In the foreign exchange markets, the dollar depreciated against the euro from near \$1.35 per euro to levels exceeding \$1.45 per euro. The yen, which following the earthquake reached highs that prompted coordinated action by the G7 and the Bank of Japan in the exchange markets, traded at highly volatile prices and now stands around ¥82 per dollar. The yield on the US Treasury 10-year bond scarcely changed significantly in the quarter despite the improved growth outlook, the inflation risks and the heightened concern about the fiscal situation, particularly following the downward revision of the debt outlook announced by the S&P credit rating agency. The emerging markets saw a widening of sovereign spreads, with bouts of volatility, derived from the tensions in the Arab countries and from the Japanese earthquake. Also apparent was a sustained withdrawal of the more volatile capital flows (shares) until the beginning of April, which caused the stock markets to fall, with a subsequent recovery in both. Commodity prices continued on their upward course, driven by the strength of demand from emerging countries in particular. In the case of oil, the instability of the Middle East and North African countries aggravated the fears of supply shortages, and the price of Brent oil topped \$120 per barrel. The potential impact of this rise on demand helped to moderate the upward movement in metal and food prices since mid-February.

In the United States, the 2011 Q1 GDP growth estimate was for annualised quarter-on-quarter growth of 1.8% (2.3% year-on-year), compared with 3.1% in 2010 Q4, as a result of lower contributions from private consumption and net exports and of the contraction of public expenditure, in spite of which the change in inventories again made a positive contribution to growth. The latest supply indicators show positive signs, being somewhat weaker on the demand





SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

side. Also, the housing market continues to show signs of weakness despite the advances seen in March, while prices have decreased further. The labour market brought the most positive news of the quarter, since the rate of job creation rose to 159,000 jobs per month, on average in the quarter, while the unemployment rate fell from 9.4% of the labour force in December to 8.8% in March. Inflation, as measured by the CPI, rose from 1.5% year-on-year in December to 2.7% in March, although the core rate was up from 0.8% to 1.2%. Against this backdrop, the Federal Reserve maintained its expansionary policy stance, leaving the official interest rate in the range 0-0.25%, and confirmed its commitment to finalise Treasury bond purchases for an amount of \$600 billion and to reinvest the proceeds of maturities of the assets held by it. In the fiscal area, the draft budget bill for fiscal 2012 put to Parliament in February included the expansionary package approved in December, although in April a medium-term proposal was announced to consolidate the public finances in 12 years.

In Japan, GDP fell by 0.3% quarter-on-quarter in 2010 Q4 (+2.2% year-on-year), due to the contraction of private consumption and the deterioration of exports. The Q1 indicators prior to the 11 March earthquake pointed to an improvement in activity, but the serious consequences of this event suddenly halted the recovery by restricting firms' production capacity and nega-

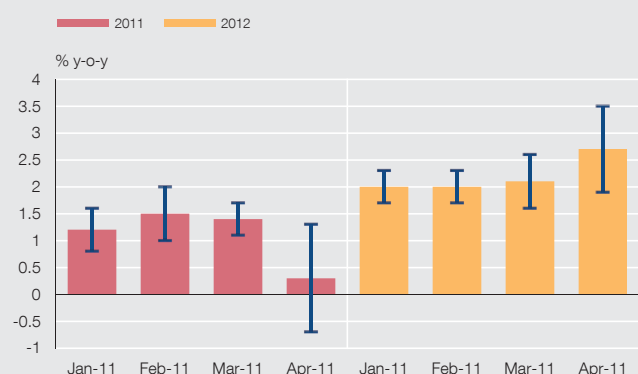
The earthquake which ravaged the north-east of Japan on 11 March and its ruinous consequences, in addition to inflicting a human tragedy of enormous dimensions (around 27,000 people dead or missing), dealt a heavy blow to the country's incipient economic recovery. This box assesses the economic impact of this event and reviews the main channels of transmission to the Japanese economy and, more generally, to global activity.

The initial estimates of the Japanese government point to a destruction of capital stock ranging from ¥16 trillion to ¥25 trillion (3.3% to 5.2% of GDP). The high uncertainty (derived mainly from the serious situation of the Fukushima nuclear power station) hinders enormously the quantification of the impact on economic activity. Unlike other natural disasters in the past (such as the earthquake which affected the region of Kobe in 1995) in which activity was generally interrupted briefly and subsequently rebounded as reconstruction tasks got under way, this time a sharper and more prolonged impact is expected. The growth forecasts for 2011 (according to the Consensus Forecast panel) have decreased by around 1 pp on average (their dispersion has also increased notably,

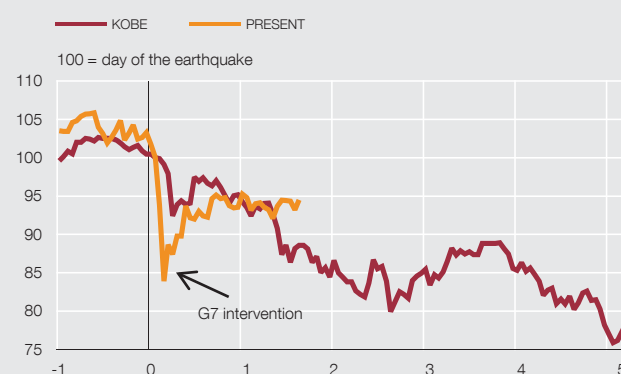
see Chart 1) to an annual average of 0.3%, while the forecasts the 2012 have been revised upward due to the impact of reconstruction activities, although here there is also notable uncertainty.

With regard to the effects on the Japanese economy, a distinction may be made between those acting on supply or productive capacity and those operating through demand. With regard to the impact on supply, the worsening of the nuclear problems and the supply restrictions at electric power stations (around 25% of the total in the Tokyo region) reduced the production capacity of firms (including automobile, electronics, chemicals and steel companies), many of which had to close their plants for several weeks. Moreover, according to estimates of the electric utility TEPCO (the owner of the nuclear power station affected by the earthquake), the electric power problems may last until the beginning of summer. In this connection, it is estimated that each month of restricted electric power supply may reduce annual GDP growth by 0.2 pp, although this effect may be magnified by cuts in manufacturing production lines, as has already occurred in certain industries.

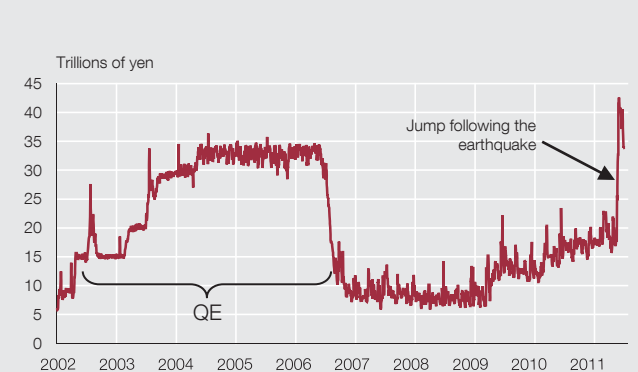
GROWTH FORECASTS FOR JAPAN (CONSENSUS)



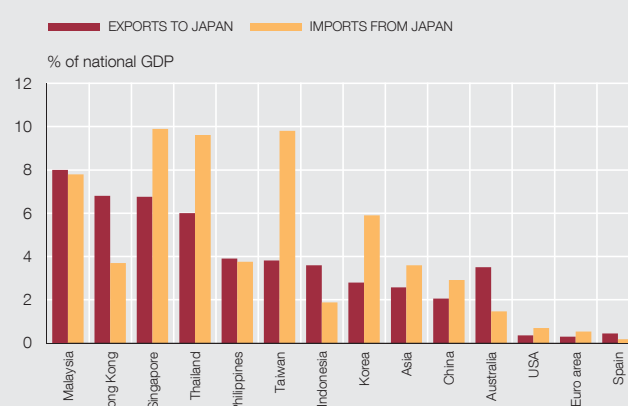
STOCK MARKET FOLLOWING THE EARTHQUAKE (a)



CURRENT ACCOUNT DEPOSITS WITH THE BANK OF JAPAN



TRADE EXPOSURE TO JAPAN



SOURCES: Datastream and Bank of Japan.

a. Scale in months, where t = 0 represents the day of the earthquake.

On the demand side, the high uncertainty and the destruction of wealth caused a sharp deterioration in sentiment amongst households and firms, the extent of which exceeds that in past crises. In line with this subdued sentiment, and given the problems in distribution systems, the initial qualitative data following the earthquake indicate a decrease in consumption –particularly of leisure (especially tourism) and luxury goods– although the stocking of food by households may have partly mitigated this deterioration. At the same time, it seems likely that, in this setting of uncertainty, firms will postpone some of their investment plans. By contrast, it is expected that the investment drive needed to reconstruct the devastated capital stock will spur the recovery of demand from the second half of 2011.

These factors and, in particular, the high uncertainty associated with the nuclear problems, seemed to explain the stronger reaction of the stock markets compared with previous occasions (see Chart 2). Thus the Nikkei index lost more than 15% in the days following the earthquake and the yen appreciated by 5% against the dollar due to the risk of capital being repatriated to finance reconstruction costs, and also due to a certain anticipatory effect, given the experience of the previous earthquake. However, the coordinated intervention of the G7 in the foreign exchange markets managed to reverse these developments, and subsequently the yen stabilised and the stock markets recovered partially.

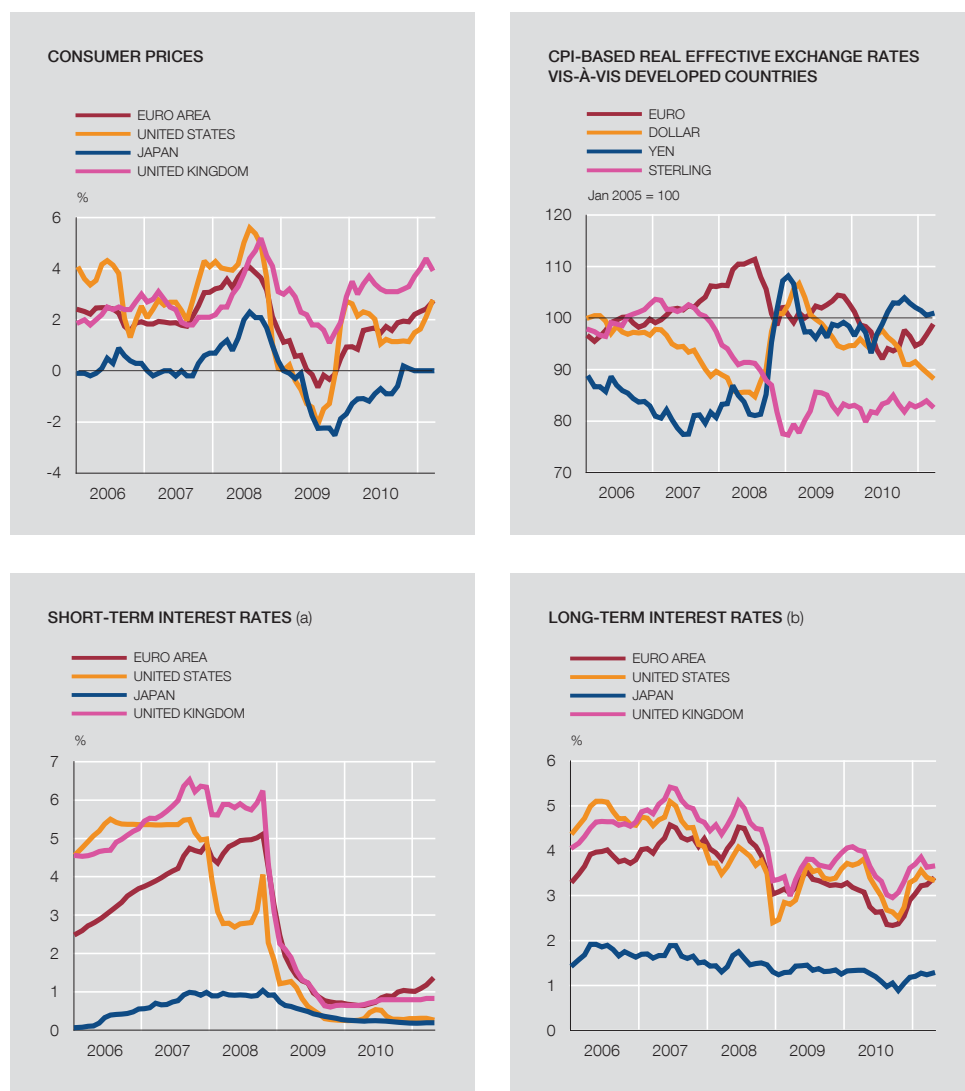
Against this background, there was a rapid and resolute response by the Bank of Japan, which made numerous injections of liquidity into the money markets in the form of very short-term funds. As a result, its balance sheet increased notably (to the equivalent of 5% of GDP), exceeding the volume reached in the quantitative expansion stage in the period 2002-2006 (see Chart 3). Also, the Bank of Japan extended the asset purchase programme from ¥5 trillion to ¥10 trillion (from 1% to 2% of GDP) to cope with the increased risk aversion in the financial markets and with the deteriorating confidence of both consumers and firms. In addition, it approved a new collateralised credit facility (one-year loans at a rate of 0.1%) for a total amount of ¥1 trillion (0.2% of GDP) to provide funds to financial institutions in the disaster area. In the fiscal sphere, the government has prepared a first supplementary budget to cover reconstruction costs for an amount of ¥4 trillion (0.9% of GDP) and another budget for a larger amount is expected to be approved in the coming months. Given the deterioration of Japanese public finances, this new fiscal stimulus signifies an additional risk, since it could accentuate the doubts as to their sustainability and put upward pressure on interest rates.

The main transmission mechanism by which the events in Japan feed through to the global economy is the trade channel, although its direct impact is expected to be limited except in certain emerging Asian economies whose trading ties with Japan are particularly close (see Chart 4). However, Japan's key role as global provider of certain intermediate goods (particularly those related to the chemicals, automobile and high technology industries) may magnify this effect through possible interruptions to manufacturing production lines throughout the world: for example, Japan produces nearly 50% of the car parts imported by China and the United States. The size of this affect depends on the duration of the constraints on Japan's production capacity, on the stockpiles of intermediate goods inventories (which act as a buffer in the event of a supply shortage) and on how easy it is to find substitutes for the Japanese suppliers (which could have a positive impact by inducing higher demand from competitors in other countries).

Another possible global transmission channel is that associated with changes in capital flows, given the high net credit position of the Japanese economy with respect to the rest of the world (52.9% of GDP). In this respect, the main risk lies in a significant repatriation of capital or in smaller Japanese capital outflows (particularly from insurance companies, although the partial reinsurance by the government has lightened their burden) due to the need to finance reconstruction work, which would put upward pressure on the yen. Nevertheless, despite expectations, to date there is little evidence that these movements have in fact taken place.

The international financial markets have so far withstood this shock fairly well. However, against a background of incipient economic recovery and of persistence of other sources of instability, such as geopolitical tensions in the Middle East countries or sovereign debt problems in the euro area, a prolongation and deterioration of the situation in Japan (particularly the nuclear crisis) could end up triggering a greater risk aversion of economic agents at global level.

Lastly, the natural disaster may increase tensions in the oil market, since Japan is the world's third-largest oil exporter, and negatively affect confidence in the safety of nuclear energy. Thus, although the contraction in activity may reduce the demand for oil in the very short term, the reconstruction activity and electricity generation problems have led the International Energy Agency to revise upwards its projections for oil demand in Japan for 2011 as a whole (by 0.15 million barrels per day). This impact may be substantially higher if the recent events lead to a revision of Japanese (or even world) nuclear strategy which ends up affecting energy prices, steepening their upward trend since mid-2009.

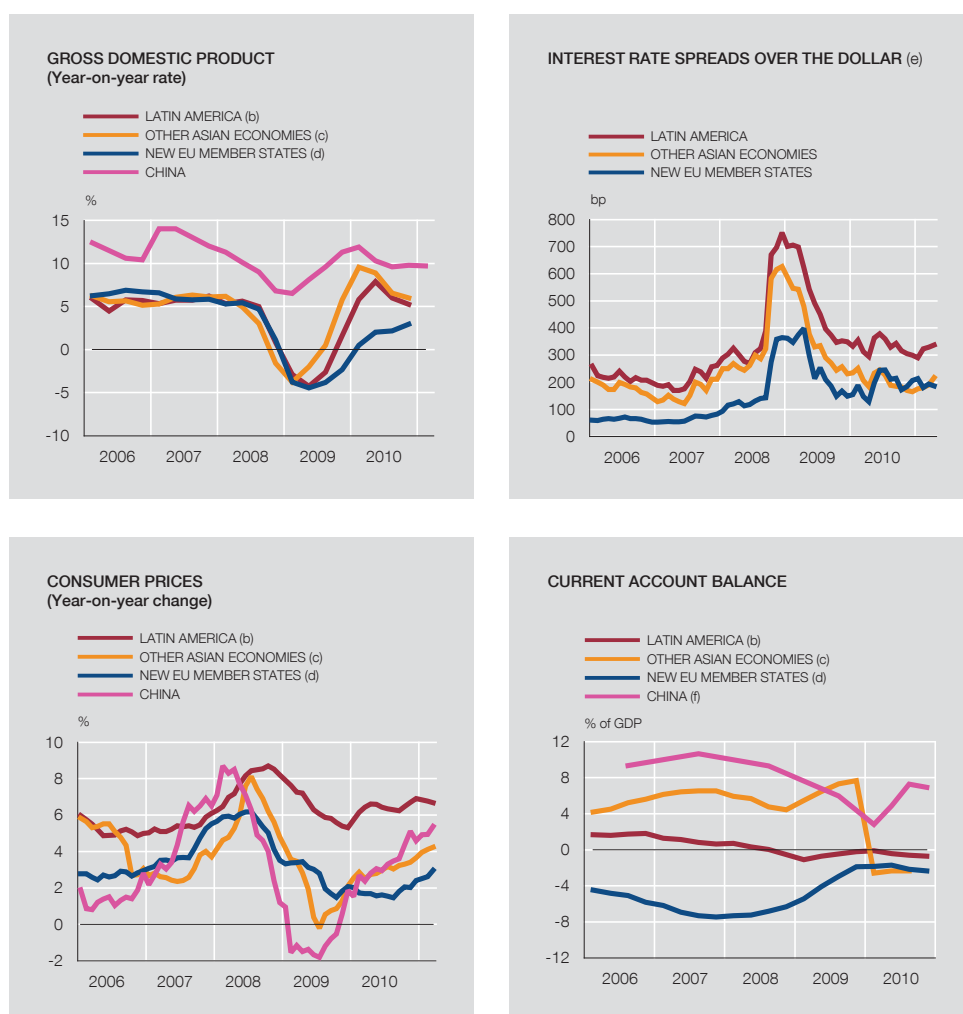


SOURCE: Banco de España.

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

tively affecting the sentiment of economic agents (see Box 1). Industrial production contracted by 15% in March (mainly affecting the automobile sector), negatively affecting the performance of exports (which fell by 7.7%); on the demand side, retail sales fell by 7.8%. In addition, the qualitative indicators for April point to additional deterioration in activity. In the labour market, the unemployment rate fell by 0.3 pp in the quarter as a whole to 4.6%, although the upward trend in employment reversed in March as a result of the halt in activity. Consumer prices showed zero growth in March and the core inflation rate stood at -0.7%. Following the earthquake, the Bank of Japan acted resolutely by offering abundant short-term liquidity and intervened in the foreign exchange markets as part of coordinated action by the G7, as mentioned above. Lastly, the government prepared a first supplementary budget for ¥4 billion (0.9% of GDP) to finance reconstruction costs and another budget for a larger amount is expected to be approved around mid-year.

In the United Kingdom, GDP grew by 0.5% quarter-on-quarter (+1.8% year-on-year) in 2011 Q1, according to the preliminary estimate, following the contraction of 0.5% (+1.5%) recorded in the previous quarter. The indicators show that the mild expansion of activity in the early



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, Slovak Republic, 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.

months of the year was driven by manufacturing production and the surge in exports and, to a lesser extent, by services. In contrast, the domestic demand indicators (such as retail sales and consumer confidence) continue to show a certain sluggishness, since they have been weakened by the fiscal adjustment plan and the loss of household purchasing power. Real estate market activity is stagnant and house prices have stabilised. The labour market showed a certain improvement until February: the unemployment rate decreased by 0.1 pp (7.8%), while employment grew significantly and wage moderation held steady. In March, inflation decreased by 0.4 pp to 4%, and the core rate stood at 3.2%, although the Bank of England, which considers that this high inflation reflects temporary factors, held the official interest rate at 0.5%, having decided to wait until the recovery is on a firmer footing before tightening its policy stance. Finally, the government unveiled a budget for 2011 in line with the pattern of fiscal consolidation announced in 2010.

In the new non-euro area EU Member States as a whole, GDP increased on average by 2.9% year-on-year in Q4. This exceeded the Q3 growth of 2.3% and left the region's growth at 1.9% in 2010. Although the improvement was across the board and underpinned by the growing dynamism of exports and of industrial production, there are notable differences between countries, including most notably the solid recovery of Poland compared with the weak situation of Romania. Throughout the quarter, inflation behaved unevenly, although it increased in most countries in the last two months, rising on average by 4.4% year-on-year in March. The growing inflationary pressure prompted an increase of 25 pp in Poland's official interest rate to 4%, while official rates remained unchanged in other countries. Finally, in the fiscal area, 2010 saw an improvement in budget balances (except in Poland) and a deterioration in gross debt. The budget deficit stood, on average, at 6.7% of GDP and gross debt at 47.7%.

In China GDP grew by 2.1% quarter-on-quarter (9.7% year-on-year) in 2011 Q1, showing a solid pace of expansion despite the tighter monetary policy. Inflation reached 5.4% in March (well above the target of 4%), while the real estate market is adjusting timidly. Against this background, the authorities increased the reference interest rates twice in the quarter (four times since last October) and the bank reserve requirement four times, while expanding the measures taken to cool down the housing market. In the rest of Asia, the economic expansion continued apace in 2010 Q4, with average growth of 6.9% year-on-year (7.8% in 2010 as a whole), while inflation rose gradually and practically across-the-board during the quarter to stand at 6.7% in March, reflecting growing pressure from food and energy prices and, in some cases, from the dynamism of activity itself. Monetary policy took some time to adopt a more restrictive stance, partly because of the fear that it might lead to greater capital inflows, but the rising inflation finally forced an across-the-board monetary tightening.

In Latin America, GDP rose by 1.2% quarter-on-quarter in 2010 Q4, twice as much as in Q3, leaving the year-on-year rate at 5.3%. GDP growth in 2010 was 6.3%, nearly 2 pp above the average for the five years prior to the crisis, driven mainly by domestic demand. The indicators for 2011 Q1 suggest that the dynamism of late 2010 will continue. Inflation in the area stood at 6.7% in March, and inflation expectations have risen in Brazil, Chile and Peru, so all the central banks of the region with inflation targets, except Mexico, raised the official rates during the quarter. In Peru reserve requirements were also raised, while in Brazil the tax base of the tax on financial transactions was broadened. In the fiscal area, budget balances in the area tended to stabilise, although primary expenditure continued to grow rapidly. Finally, the rating agencies increased the rating of Brazilian sovereign debt (*Fitch*, to BBB, the same rating as Mexico). The half-yearly report on the Latin American economy in this Economic Bulletin contains more detailed information on the recent performance of the economies in the region.

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

Despite the context of moderate economic recovery in the euro area as a whole, the sovereign debt crisis that has been afflicting certain countries continued during the first quarter of 2011. Unlike previously, during most of this period the turmoil was largely confined to Greece, Ireland and Portugal, with barely any repercussions for other euro area financial markets. Portugal's request for financial assistance at the beginning of April, following the announcement of general elections owing to the lack of Parliamentary support for new fiscal adjustment initiatives, and the progress made in restructuring the Irish banking system allowed tensions to ease somewhat. However, this trend came to a halt in mid-April and sovereign spreads widened again, this time across a broader range of countries, with Spain in particular affected. Although it is always complicated to identify which factors are responsible for renewed outbreaks of tension like this one, the time sequence of the events would seem to suggest that increased concern about the possibility of a restructuring of Greek government debt may have played an important role. In addition, the difficulty involved in implementing the assistance to Portugal, as a result of the country's complicated political situation and greater uncertainty regarding the outcome of Parliamentary procedures for ratification of the commitments made by the euro area governments in relation to the financial support mechanisms for countries in difficulty, may have also contributed to investors' doubts. These episodes highlight once again the need to step up the twofold strategy of fiscal consolidation and structural reforms in those countries that have been shown to be more vulnerable, on one hand, and strengthening governance mechanisms in the euro area as a whole, on the other.

At the summit of euro area heads of state and government of 11 March the principles were established that will govern the operation of the future European Stability Mechanism (ESM), due to come into effect in June 2013, to provide financial assistance to those Member States that need it, replacing the current temporary mechanisms. With respect to the latter, it was agreed to increase the effective lending capacity of the European Financial Stability Facility (EFSF), although the specific details were postponed until June, and the interest rate charged on loans to Greece was reduced by one percentage point. All these agreements were endorsed by the European Council of 24 and 25 March, which also established the so-called Euro-Plus Pact. This pact strengthens the commitment of the governments of the area and of certain EU countries to implement policies more conducive to growth and financial stability in the euro area. Finally, the legislative proposals for governance reform (relating to reform of the Stability and Growth Pact and its sanctioning mechanisms, the establishment of the vigilance procedure for macroeconomic imbalances and the fiscal frameworks directive) are currently being debated in the European Parliament, which has until June to reach its final conclusion (see Box 1).

Against this background, the conjunctural information available is compatible with somewhat more dynamic output growth in the euro area in the first quarter of 2011 than in the final quarter of 2010, buoyed by the external sector, the monetary policy stimulus and the reversal of certain temporary factors that depressed activity in the final part of last year. More in the medium term, the available projections suggest a scenario in which the economic recovery will continue to gain momentum this year and next year, supported by growth in external demand and the progressive normalisation of the financial situation. However, this scenario is subject to considerable uncertainty and is not free from downside risks, such as those arising, principally, from a possible prolongation of tensions in sovereign debt markets, which may eventually lead to a general tightening of financial conditions in the area as a whole, and from the in-



Since spring 2010 the European Union has been addressing the reform of governance, which particularly affects the way in which the surveillance and coordination processes of national economic policies are structured within the euro area and the setting up of financial assistance mechanisms which ensure financial stability in the euro area. The most recent progress includes, firstly, the commencement of the European semester which, for the first time, encompasses all the items of euro area economic surveillance and will conclude with country-specific recommendations at the European Council meeting in June. Also, the new permanent instrument for financial assistance, i.e. the European Stability Mechanism (ESM), has been defined, and a general agreement reached on the basic principles of the six legislative proposals presented by the Commission and discussed by the Van Rompuy Task Force. The European Parliament is expected to approve this governance reform in June 2011 and, to this end, it is necessary to make further progress on certain specific details of these agreements. Lastly, a new development is the Euro Plus Pact which was designed and approved to improve the economic policy coordination mechanism.

In January 2011, on the basis of the Annual Growth Survey published by the Commission, the European semester of ex ante budgetary and economic policy coordination began. For the first time, countries are simultaneously preparing their National Reform Programmes, which are to specify measures aimed at meeting the targets and guidelines of the Europe 2020 Strategy, along with their Stability and Growth Programmes, which will contain the measures that will be included in their respective national budgets for 2012, and medium-term fiscal consolidation plans, detailing their strategy to meet these targets. These plans will be discussed during May and June, concluding with specific economic policy recommendations for each country at the European Council meeting in June. This whole process will make it possible to successfully harness synergies and avoid inconsistencies between national policies.

The European Council meeting in March 2011 approved the creation of the new ESM and a limited amendment to the EU Treaty so that the mechanism has full legal certainty. The ESM will come into force in June 2013 and will replace the financial assistance mechanism currently in effect, the EFSM. The mechanism will be activated at the request of a Member State and the aid, which will be conditional, as in the case of the EFSM, will be subject to unanimous agreement. It will have a total lending capacity of €500 billion, with subscribed capital of €700 billion, and assistance will be provided through loans and, exceptionally, interventions on primary government debt markets. An agreement was also reached to ensure that the current temporary mechanism increases its effective lending capacity to €440 billion, although the decision as to how this will be put into practice will be delayed until June.

Following a year of intensive work, at the European Summit in March 2011 the basic principles of the six legislative proposals aimed at ensuring and strengthening budgetary discipline and avoiding excessive macroeconomic imbalances were accepted. They include a reform of the Stability and Growth Pact – SGP – (the most noteworthy agreements of which are shown in Panel 1) which is directed at strengthening surveillance of budgetary policies and applying sanctions earlier and more consistently, as well as new provisions on national budgetary frameworks and a new tool for the surveillance of macroeconomic imbalances. Another change is the agreement reached on observing the political principle that the Council, as a general rule, shall follow the Commission's recommendations and explain its position in writing if it fails to do so. Also envisaged are the transposition in full of the Services Directive and fresh impetus for the Single Market Act. To this end the Commission will prepare a report this summer on the reduction of administrative and regulatory barriers especially for SMEs.

A new development was the design and approval of the Euro Plus Pact, which represents an additional political commitment at the

## STABILITY AND GROWTH PACT

### PREVENTIVE ARM

Annual growth of public spending should not exceed medium-term GDP growth or should be clearly lower if the medium-term objectives (MTOs) have not been achieved.

Public spending growth may exceed medium-term GDP growth if the MTOs have been comfortably achieved or if the surplus spending is offset with discretionary increases in revenue.

Possibility of applying sanctions if a country does not achieve the MTOs and there are significant deviations from public spending growth.

A more rapid adjustment path is proposed, which has not yet been quantified, for countries with debt of more than 60% or with high risks in terms of debt sustainability.

### CORRECTIVE ARM

If the public debt/GDP ratio is higher than 60%, it must decrease - over the course of the three years prior to the assessment- by one-twentieth with respect to the amount by which it differs from the reference value in order to avoid the initiation of an Excessive Deficit Procedure (EDP).

In order to determine whether or not to initiate an EDP, in addition to the numerical benchmark, other important factors will be considered: implicit liabilities related to the level of private debt, the ageing of the population and the net cost of implementing the pension reform.

### ENFORCEMENT STRUCTURE

New political and reputation sanctions.

New financial sanctions: non-interest earning deposit amounting to 0.2% of GDP under the corrective arm.

Greater automaticity with the introduction of reverse voting procedures in the decision-making process.

SOURCE: Banco de España.



highest level to improve the economic policy coordination mechanism between euro area countries. Furthermore, this pact is open to non-euro area Member States, with the result that certain countries have decided to sign up (Denmark, Poland, Latvia, Lithuania, Bulgaria and Romania). The Euro Plus Pact selected four specific targets which represent the priorities set in the Annual Growth Survey. Achieving these targets will be assessed by using a set of easy-to-measure variables. Under the Pact, countries shall have the discretion to decide the best way of achieving these targets (see Panel 2).<sup>1</sup>

1. Spain, France, Belgium and Germany have already announced their commitments for the next twelve months and the other countries must do the same, at the latest in time for them to be included in the Stability and Growth Programmes and in the National Reform Plans.

The governance review under way undoubtedly strengthens the current framework in the EU, but the challenges faced by the euro area are also considerable. Accordingly, the Eurosystem has demanded the inclusion of tougher criteria to correct imbalances and, especially in the fiscal realm, more automaticity for supervision and sanction procedures. For its part, the IMF considers that there is a need to make further progress in the area of macroeconomic supervision and various analysts from the OECD and the Commission emphasise that the reform is not balanced since they think that difficulties continue to exist in relation to the functioning of the enforcement structures under normal circumstances and that the rules may be excessively strict in really problematic times such as those at present.

### CONCRETE OBJECTIVES AND ACTIONS PROPOSED IN THE EURO PLUS PACT

OBJECTIVES	VARIABLES TO BE MONITORED	ACTIONS PROPOSED
Competitiveness	Unit labour costs	Adaptation of costs to productivity Promotion of productivity
Employment	Long-term unemployment Youth unemployment Participation rate	Flexicurity Hidden economy Occupational training Employment-promoting tax reforms
Fiscal sustainability	Sustainability gap indicators	Pensions Health care Social benefits
Financial stability	Private debt of banks, households and non-financial firms	Regular EU-wide bank stress tests Winding up of non-viable banks

crease in energy prices on international markets. This latter factor has in fact entailed a notable deterioration in the short-term inflation outlook and has increased the risks to medium-term inflation. That was what the ECB considered at its meeting in April, at which it decided to increase official rates by 25 basis points to 1.25% for main refinancing operations, having held them unchanged for almost two years. Previously, in March, the Governing Council had decided to continue to use during the second quarter the fixed interest rate tender procedure with full allotment in the various liquidity providing operations.

### 3.1 Economic developments

In 2010 Q4, euro area GDP grew by 0.3%, down 0.1 percentage points from the increase recorded in the previous quarter (see Table 1). This growth was based on the strength of exports and investment in capital goods and, to a lesser extent, consumption. In contrast, the positive contribution of fiscal policy disappeared, as the negative growth in government consumption shows; construction spending fell again, affected by adverse weather conditions; and the contribution from changes in inventories was slightly negative. The sectoral breakdown shows that value added accelerated in industry and agriculture, moderated in services and declined more steeply in construction. In year-on-year terms, the rate of change in seasonally adjusted GDP was 2%, similar to the level recorded in the two preceding quarters.

By country, activity in France and Germany again grew at above the average European rate, by 0.4% in both cases, albeit based on different components. In Germany, as in the euro area as a whole, the growth was driven by exports and investment in capital goods, while the better

	2009		2010				2011	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.4	0.2	0.4	1.0	0.4	0.3		
Private consumption	-0.2	0.3	0.3	0.2	0.2	0.4		
Government consumption	0.5	0.0	-0.1	0.2	0.4	0.1		
GFCF	-1.3	-1.1	-0.2	2.1	-0.2	-0.5		
Imports	1.8	1.1	3.6	4.2	1.5	1.0		
Exports	2.7	2.2	3.0	4.5	2.1	1.5		
Contributions to quarter-on-quarter GDP growth (pp)								
<i>Domestic demand (exc. stocks)</i>	-0.2	0.0	0.1	0.5	0.1	0.1		
<i>Stockbuilding</i>	0.3	-0.2	0.4	0.3	0.0	-0.1		
<i>Net external demand</i>	0.2	0.3	-0.1	0.2	0.3	0.4		
GDP (annual growth)	-4.0	-2.1	0.8	2.0	2.0	2.0		
ACTIVITY INDICATORS (quarterly average)								
IPI (working day- and seasonally adjusted)	3.0	1.1	2.6	2.4	1.0	1.8	1.0	
Economic sentiment	84.2	92.0	96.4	99.1	102.3	105.6	107.3	
Composite PMI	49.5	53.6	54.4	56.6	55.7	54.9	57.6	57.8
Employment	-0.5	-0.2	0.0	0.1	0.0	0.2		
Unemployment rate	9.7	9.9	10.0	10.0	10.0	10.0	9.9	
PRICE INDICATORS (annual change in end-period data)								
HICP	-0.3	0.9	1.6	1.5	1.9	2.2	2.7	
PPI	-7.7	-2.9	0.9	3.1	4.3	5.4	6.6	
Oil price (USD)	67.7	74.4	78.8	75.0	78.4	92.3	115.4	124.0
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yields	3.8	4.0	4.0	3.7	3.5	4.1	4.6	4.7
US-euro area ten-year bond spread	-0.45	-0.17	-0.08	-0.72	-1.01	-0.78	-1.14	-1.26
Dollar/euro exchange rate	1.464	1.441	1.348	1.227	1.365	1.336	1.421	1.458
Appreciation/ depreciation of the NEER-20 (b)	0.3	-0.9	-4.5	-10.3	-6.3	-8.2	3.5	4.2
Dow Jones EUROSTOXX 50 index (b)	17.2	21.0	-1.2	-13.2	-7.4	-5.8	4.2	5.1

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

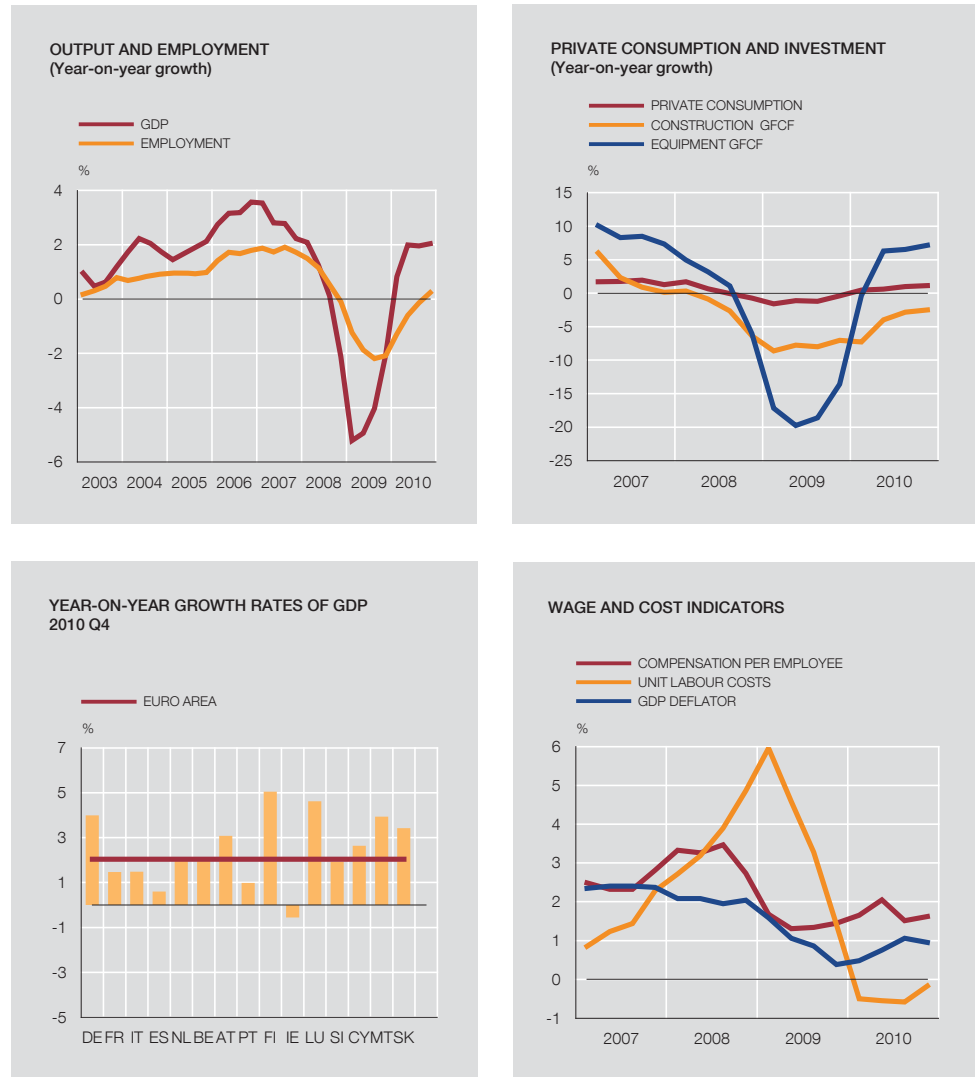
a. Information available up to 25 April 2011.

b. Percentage change over the year.

fiscal position was reflected in growth in government consumption. In France, the contribution of changes in inventories to output was very negative but was offset by the strength of private consumption and a high contribution to GDP from external demand, owing to the growth in exports and also the decline in imports. For its part, GDP in Italy grew by a mere 0.1%, against a background of stagnant domestic demand and minimal growth in exports. Finally GDP continued to decline in 2010 Q4 in Portugal, Greece and Ireland, by 0.3%, 1.4% and 1.6%, respectively.

On national accounts data, the recovery in employment in the area as a whole was confirmed, with a quarter-on-quarter increase that translated into the first positive year-on-year rate (0.2%) since September 2008. In contrast, hours worked per employee decelerated. This slower recovery in employment than in GDP caused the rate of growth of productivity to stand at around 2% again, which was higher than the rate of growth of compensation per employee, so that unit labour costs contracted further and – given that the GDP deflator increased – profit margins continued to expand (see Chart 8).

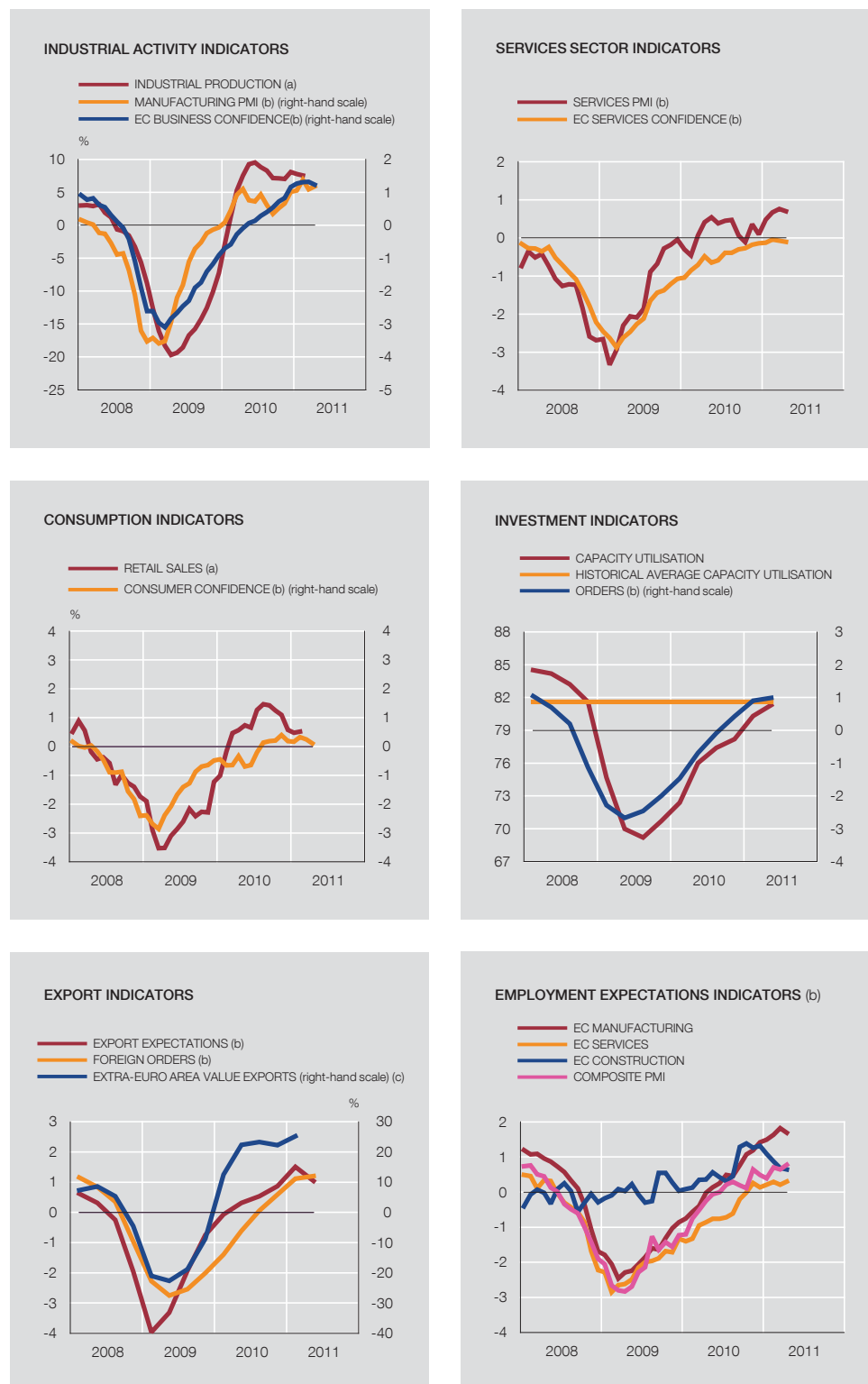
The latest conjunctural information suggests that activity continued to expand during the first quarter. On the supply side, industrial production and new industrial orders increased in Janu-



Sources: Eurostat and national statistics.

ary and February (see Chart 9). Also, the indicators of confidence in industry and services compiled by the European Commission and those based on surveys of purchasing managers grew on average in the first quarter, although some of them declined slightly in March and April, probably as a result of the uncertainty generated by the geopolitical crisis in North Africa and the natural and nuclear disaster in Japan. In the labour market, the unemployment rate stood at 9.9% in March, below the December figure, and the indicators of job creation expectations improved substantially in industry and more moderately in services.

The growth of world trade was accompanied by improvements in export expectations and in the assessment of export order books, which rose in the first quarter of 2011. In parallel, the indicators of investment, the assessment of order books and capacity utilisation increased between January and March, with the second indicator drawing very close to its historical average. However, the conjunctural information relating to private consumption still shows no clear signs of improvement. Retail sales contracted in the first quarter, while new car registrations grew at a more moderate rate than in the previous quarter. The index of consumer confidence remained stable in the first quarter, at similar levels to those recorded in autumn 2010. Also, the growth in real disposable income has been very limited, owing to the slow recovery in employment and the notable deterioration in inflation (see Box 3). This, along with the pro-



SOURCES: European Commission, Eurostat and Markit Economics.

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

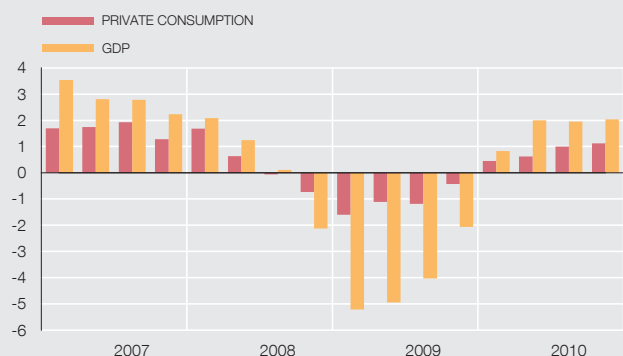
b. Normalised data.

c. Non-centered year-on-year rates based on the original series. Quarterly average.

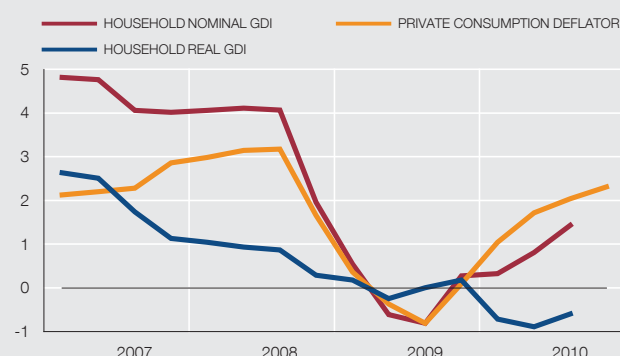
The recovery of activity in the euro area, which began mid-2009, has been essentially based on the strength of the external sector and on the expansionary effect of economic policies. The stimulus from the economic policy measures has petered out in the most recent period and, consequently, in order to entrench the recovery, domestic demand and consumption, in particular, would need to gain strength and offset the waning of this expansionary effect.

As shown in Panel 1, the year-on-year rate of change in private consumption gradually quickened throughout 2010 to 1.1% in Q4, which was considerably lower than the increase of 2% posted by GDP. Private consumption increased despite the fall in real disposable income (since growth in household nominal revenue was not sufficient to counterbalance the effect of inflation as shown in Panel 2) which meant household saving declined.

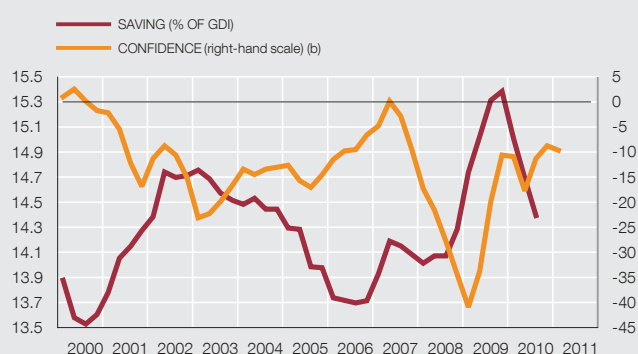
**1 PRIVATE CONSUMPTION AND GDP**  
Year-on-year rates of change



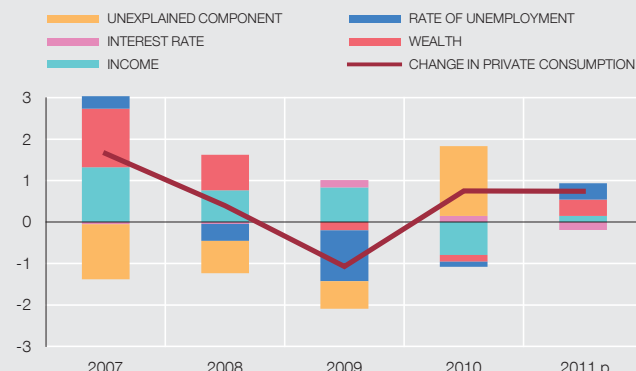
**2 HOUSEHOLD INCOME AND PRIVATE CONSUMPTION DEFLATOR**  
Year-on-year rates of change



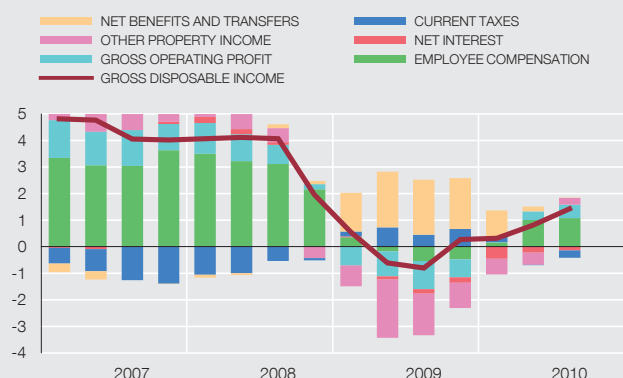
**3 HOUSEHOLD SAVINGS AND CONFIDENCE**



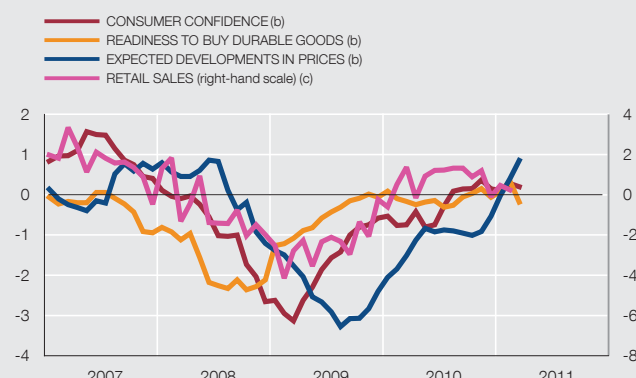
**4 CONTRIBUTIONS OF DETERMINANTS OF PRIVATE CONSUMPTION**



**5 CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF CHANGE IN HOUSEHOLD NOMINAL GDI**



**6 CONSUMPTION INDICATORS**



SOURCES: European Commission, Eurostat and ECB.

- a. Opinion on the general economic situation in the next 12 months from the European Commission consumer confidence survey.
- b. Normalised series.
- c. Year-on-year rates of change

The decrease in saving throughout 2010 could be related to the improvement in consumer expectations about the economic situation and the consequent upward revision of future income expectations (see Panel 3). Accordingly, when the contribution of the various determinants (income, wealth, unemployment rate and interest rate) to changes in private consumption is analysed by using an equation estimated for the euro area as a whole,<sup>1</sup> in 2010 a high positive unexplained component is discernible, which could be linked to the above-mentioned improvement in consumer expectations (see Panel 4). The rise in nominal disposable income was fundamentally based, as can be observed in Panel 5, on the behaviour of employee compensation and of the gross operating surplus, while the positive boost to income from the operation of the automatic stabilisers – through government benefits and transfers, and taxes – diminished.

Recent developments in private consumption indicators point to this variable continuing to flag in early 2011. As indicated in Panel 6, the

<sup>1</sup> The consumption equation of the area-wide model for the euro area is used. See Fagan, Henry and Mestre (2001), *An area-wide model (AWM) for the euro area*, ECB Working Paper no. 42.

year-on-year rate of change in retail sales has eased in recent months and consumer confidence in the European Commission survey has been slightly flat in the most recent period, as has too the survey component on the readiness of consumers to buy consumer durables. Consumer opinions on the developments expected in consumer prices has experienced a rapid deterioration and stands at levels similar to those reached in 2008, during the previous episode of rising inflation. That may lead households to adopt a more prudent attitude towards their spending decisions.

The available forecasts on private consumption in the euro area point to a smooth quickening in line with the slight increase expected in household disposable income (which combines a contained increase in employment and wage moderation). A noteworthy downside risk to this scenario is the recent rise in inflation, which is expected to continue in the immediate future. Thus, for example, according to Consensus Forecast, expected euro area inflation for 2011 increased from 1.6% in December to 2.4% in April, significantly denting the spending capacity households derive from their nominal income. Conversely, the favourable developments in household wealth and the comparatively high level of household confidence, should they be sustained, could trigger a further reduction in the saving rate.

gressive withdrawal of fiscal stimuli, means that domestic demand probably made a limited contribution to economic growth in the first quarter.

Finally, the available indicators by country point to the continuity of heterogeneous rates of recovery in the euro area. For instance, activity in Greece, Ireland and Portugal is expected to have continued to deteriorate in the early months of the year, while in countries such as France, Germany and Austria, its growth path is estimated to have strengthened.

In the medium term the forecasts of international organisations coincide in anticipating rates of recovery that will increase as the contribution of domestic demand to GDP grows stronger; however, when considered overall, these rates will remain relatively modest. Thus, on the available forecasts, the rate of increase in GDP should average approximately 1.7% for 2011 and range from 1.7% to 2.0% for 2012 (see Table 2). However, this scenario is subject to considerable uncertainty and is not free from downside risks linked to the instability on sovereign debt markets and its potential pass-through to firms' and households' financing costs; upward pressures on energy prices; and the effects that the natural and nuclear disaster in Japan may have on the global distribution chain.

Over the quarter, the 12-month inflation rate quickened, according to the Eurostat preliminary estimate, to 2.8% in April, 0.6 pp up on its level at end-2010 (see Chart 10). The origin of this deterioration of inflation in recent months is the ongoing rise in commodity prices, particularly oil, although the prices of other components rose, such as processed food, services and non-energy industrial goods, which were notably volatile due to the effects of sales campaigns and a change in methodology applied to seasonal items. Although second-round effects on prices and wages are not yet identifiable, the repercussions of the rise in oil prices on the prices of certain items of transport-related services can be seen. That said, core inflation measured by the CPI excluding energy and unprocessed food prices stood in March at 1.5% which, albeit low, is 0.4 pp higher

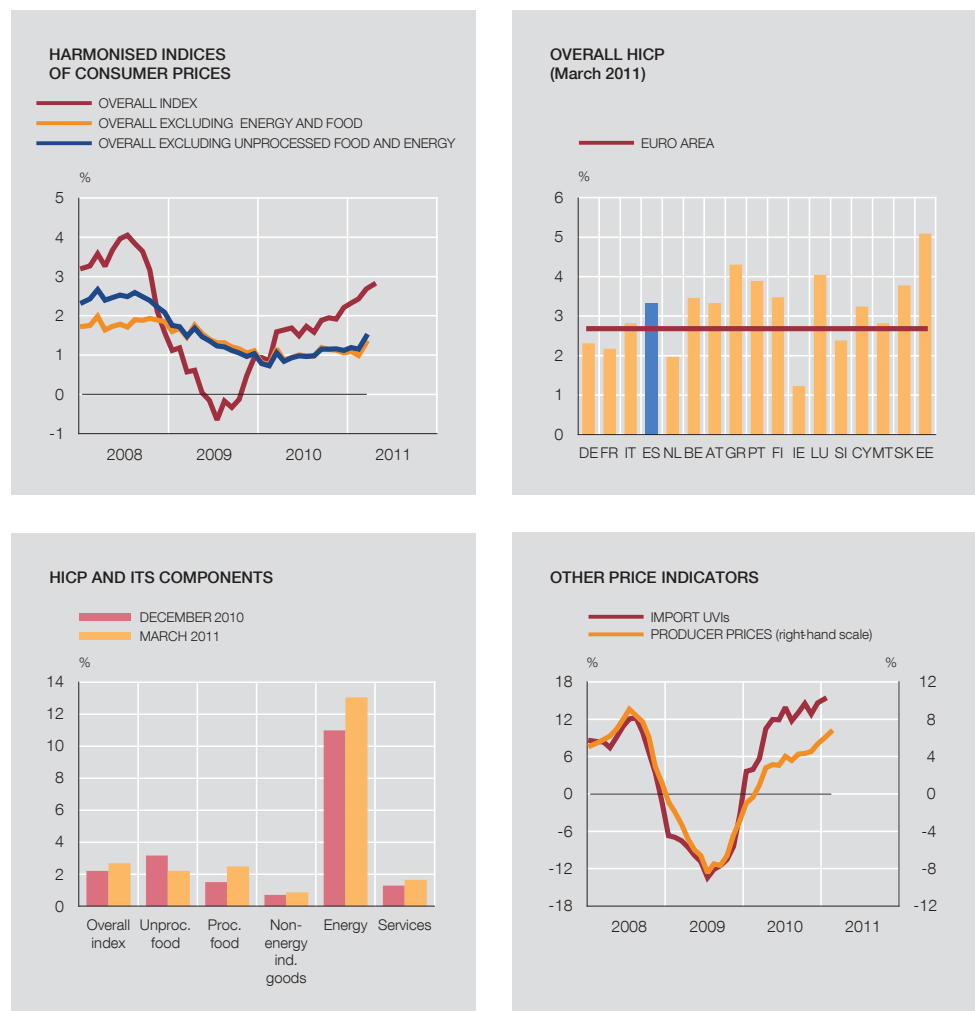
	2010		2011		2012	
	GDP	HICP	GDP	HICP	GDP	HICP
ECB (March 2011)	1.7	1.6	1.3-2.1	2.0-2.6	0.8-2.8	1.0-2.4
European Commission (March 2011)	1.7	1.6	1.6	2.2	1.8	1.7
IMF (March 2011)	1.7	1.6	1.6	2.3	1.8	1.7
OECD (November 2010)	1.7	1.5	1.7	1.3	2.0	1.2
Consensus Forecast (April 2011)	1.7	1.6	1.7	2.4	1.7	1.8
Eurobarometer (April 2011)	1.7	1.6	1.7	2.4	1.7	1.8

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

a. Annual rate of change.

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

CHART 10



SOURCES: Eurostat and European Central Bank.

than in December. Industrial prices grew by 6.6% in January and February, 1.6 pp up on last December. All the components quickened in Q1 but the rise in energy prices was higher.

The short-term inflation outlook deteriorated significantly, as reflected by the forecasts of various international organisations, although beyond the current year, inflation is expected to return to rates clearly below 2% (see Table 2). Thus, the IMF's latest forecasts estimate that inflation should stand in 2011 and 2012 at 2.3% and at 1.7%, respectively. The possible upside risks for this scenario could stem from higher increases in oil prices, prompted by continuous political tension in North Africa and the Middle East, as well as from possible second-round effects on prices and wages which trigger pressure on medium-term inflation.

On estimates published by the ECB, the euro area ran a current account deficit between January and February 2011 of €30.3 billion (2% of GDP), which was €12 billion higher than the deficit in the same period of the previous year (1.2% of GDP). This deterioration was the result of a higher deficit on the goods sub-balance despite the improvement in the surplus on the services sub-balance. As for the financial account, in the same period there was an increase in net capital inflows, underpinned by the rise in portfolio investment, while net outflows were recorded in the form of direct investment. As a result, the basic balance, which is the sum of these two types of investment and the current account balance, recorded a surplus of €29.3 billion between January and February 2011, compared with a deficit of €1.5 billion in the same period of 2010 (see Chart 11).

The latest information available from the spring communiqué relating to the Excessive Deficit Procedure shows that the general government deficit of the euro area as a whole stood in 2010 at 6% of GDP, as envisaged by the stability programmes prepared at the beginning of the year. However, this aggregate performance hides deviations in some countries. For instance, in the case of Greece, the deficit was higher than that agreed in the financial assistance programme as a result of the revision of historical statistics in autumn, although it is also facing discernible difficulties in adhering to its fiscal adjustment commitment, given the scant growth of tax revenue amid an economic recession. Ireland's deficit exceeded 30% of GDP, reflecting the losses linked to the bail-out of certain of its banks. Finally, Portugal also revised upwards its deficit figures to 9.1% and, after Parliament rejected its fourth budgetary adjustment plan, it was forced to request financial assistance from the European institutions and the IMF. By contrast, in France and Germany the results of the general government accounts were better than expected due to the favourable economic context.

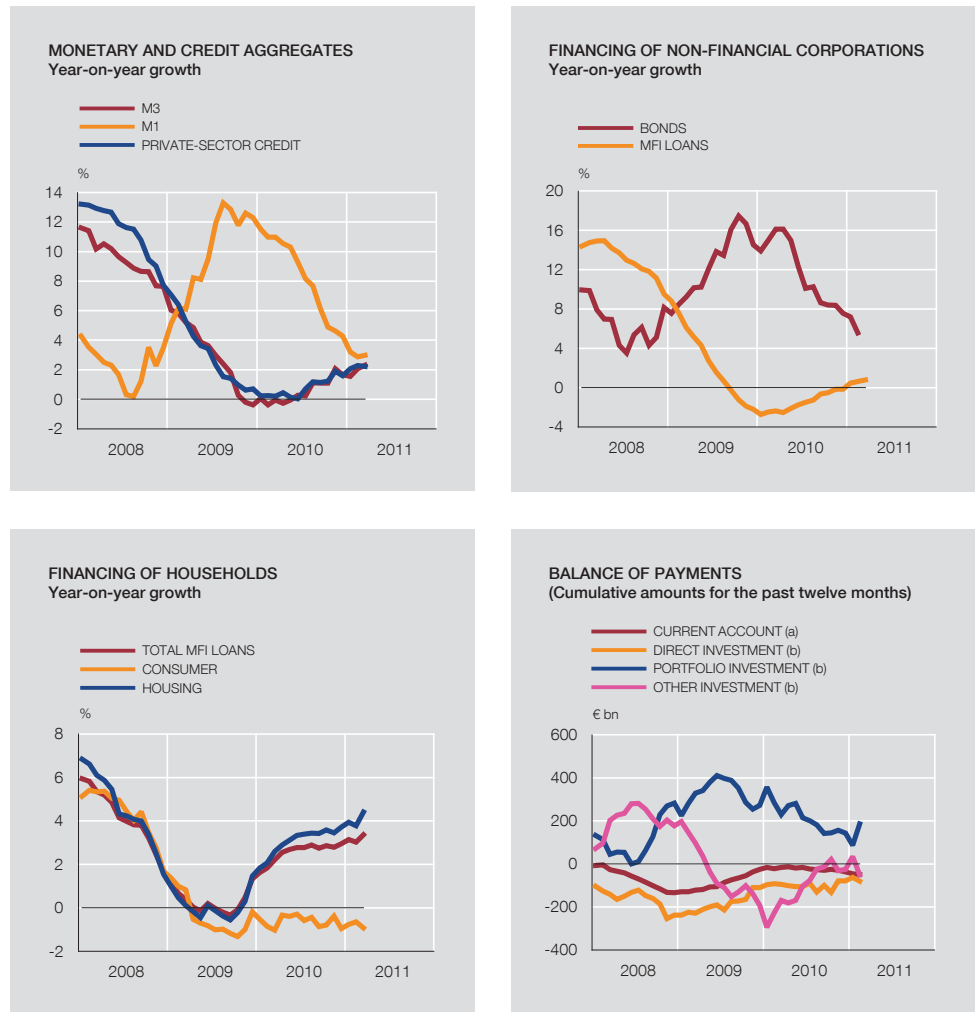
According to the measures included in the budgets (see Table 3), in 2011 the fiscal policy stance in the euro area will become markedly contractionary. During April the Member States must submit their stability plans to the European Commission.

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

Strains on government debt markets in the euro area continued throughout the first four months of 2011 accompanied by further downgrades in sovereign credit ratings. Unlike previous episodes, during most of the period the strains were concentrated in the markets of Greece, Ireland and Portugal, where bond yields once again peaked. The Portuguese government's difficulties in implementing its adjustment and reform plans meant that early general elections were called and that conditions on financial markets worsened, prompting the request for financial support at the beginning of April. However, the assistance had not yet been formalised at the cut-off date for this report.

Until April, the instability in Greece, Ireland and Portugal did not feed through to the euro exchange rate or to the financial markets of other euro area countries. In the case of Ireland,





SOURCES: ECB and Banco de España.

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

pressures on the debt markets abated slightly at the beginning of April following the ECB's decision to ease the conditions for accepting collateral issued or guaranteed by the Irish government and after progress made in relation to the reorganisation and further strengthening of Irish banks' capital – totalling €24 billion, which will be covered to a large extent by funds contributed by the Irish State as part of its allocation to the financial assistance programme. This trend, however, was interrupted in mid-April after Moody's downgraded Ireland's rating to Baa3, just one notch above speculative grade. Furthermore, growing concern about the possibility of a restructuring of Greek debt and uncertainty stemming from the elections in Finland regarding its participation in the aid programme for Portugal contributed to a fresh rise in sovereign spreads in the area, which was more widespread on this occasion.

In April the European Central Bank decided to adjust its monetary policy stance, which continues to be very accommodative against a background of recovering economic activity, in order to prevent the recent rise in inflation from causing inflationary pressures in the medium term. Thus, the Governing Council of the ECB decided to raise official rates by 25 bp at its meeting on April 7, the first change since May 2009. The rate on the main refinancing operations stood at 1.25% and the rate on credit and deposit facilities was 2% and 0.5%, respectively (see Chart 12). In turn, the Eurosystem maintained its generous supply of liquidity to the banking

	% of GDP				
	BUDGET BALANCE (a)				
	2008	2009	2010	2011	
			EC (b)	IMF (c)	
Belgium	-1.3	-5.9	-4.1	-4.7	-3.9
Germany	0.1	-3.0	-3.3	-2.7	-2.3
Estonia	-2.8	-1.7	0.1	-2.0	-1.0
Ireland	-7.3	-14.3	-32.4	-10.3	-10.8
Greece	-9.8	-15.4	-10.5	-7.4	-7.4
Spain	-4.2	-11.1	-9.2	-6.4	-6.2
France	-3.3	-7.5	-7.0	-6.3	-6.0
Italy	-2.7	-5.4	-4.6	-4.2	-4.3
Cyprus	0.9	-6.0	-5.3	-5.7	-4.5
Luxembourg	3.0	-0.9	-1.7	-1.3	-1.1
Malta	-4.5	-3.7	-3.6	-3.0	-2.9
Netherlands	0.6	-5.5	-5.4	-3.9	-3.8
Austria	-0.9	-4.1	-4.6	-3.6	-3.1
Portugal	-3.5	-10.1	-9.1	-4.9	-5.6
Slovenia	-1.8	-6.0	-5.6	-5.3	-4.8
Slovakia	-2.1	-8.0	-7.9	-5.4	-5.2
Finland	4.2	-2.6	-2.5	-1.8	-1.2
PRO MEMORIA: Euro area					
Primary balance	1.0	-3.5	-3.2	-1.6	
Total balance	-2.0	-6.3	-6.0	-4.6	-4.4
Public debt	69.9	79.3	85.1	86.5	87.3

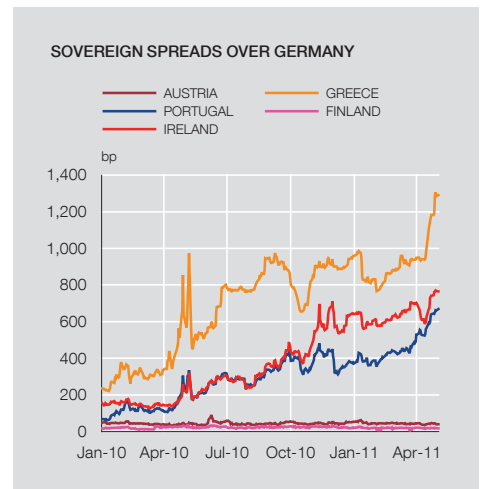
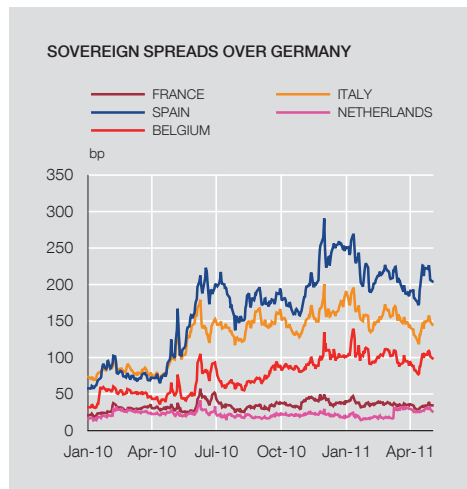
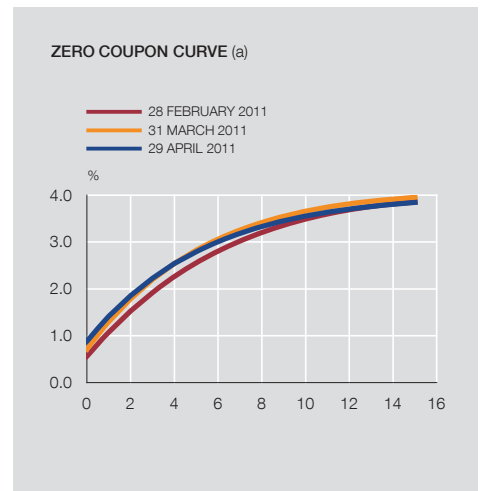
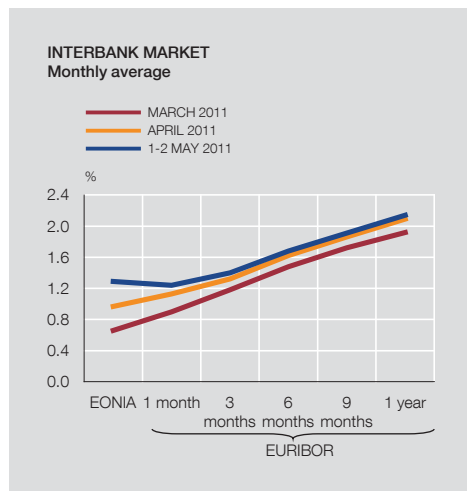
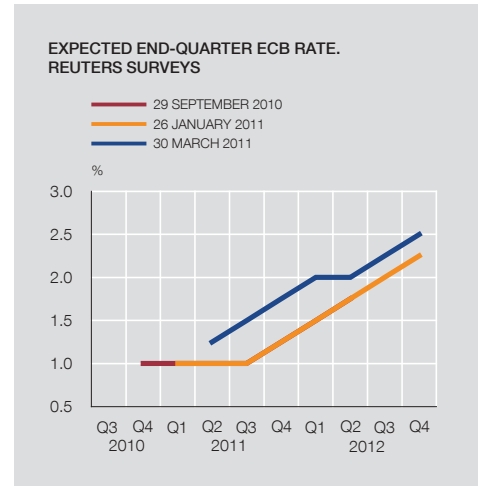
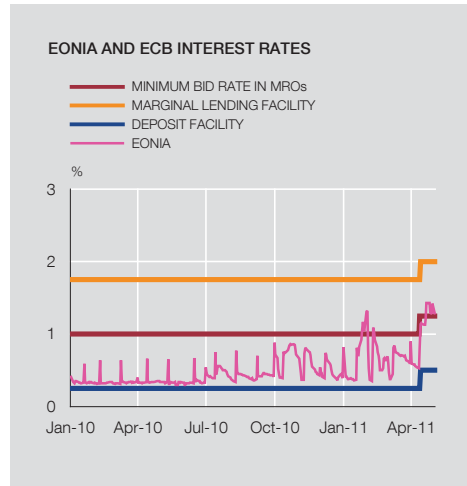
SOURCES: European Commission, Eurostat and IMF.

- a. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.  
b. European Commission forecasts (autumn 2010).  
c. IMF forecasts (April 2011).

system and at its March meeting, the Council extended the arrangements for the fixed-rate tender procedure with full allotment in liquidity-providing operations during 2011 Q2. There were occasional purchases, for a lower amount from February, of government debt under the Securities Market Programme and the total portfolio acquired amounted to approximately €77 billion. Finally, following a positive assessment of the implementation of the economic and financial adjustment programme to which the Irish government is committed, the Governing Council of the ECB decided not to apply the rating threshold to debt instruments issued or guaranteed by the Irish government.

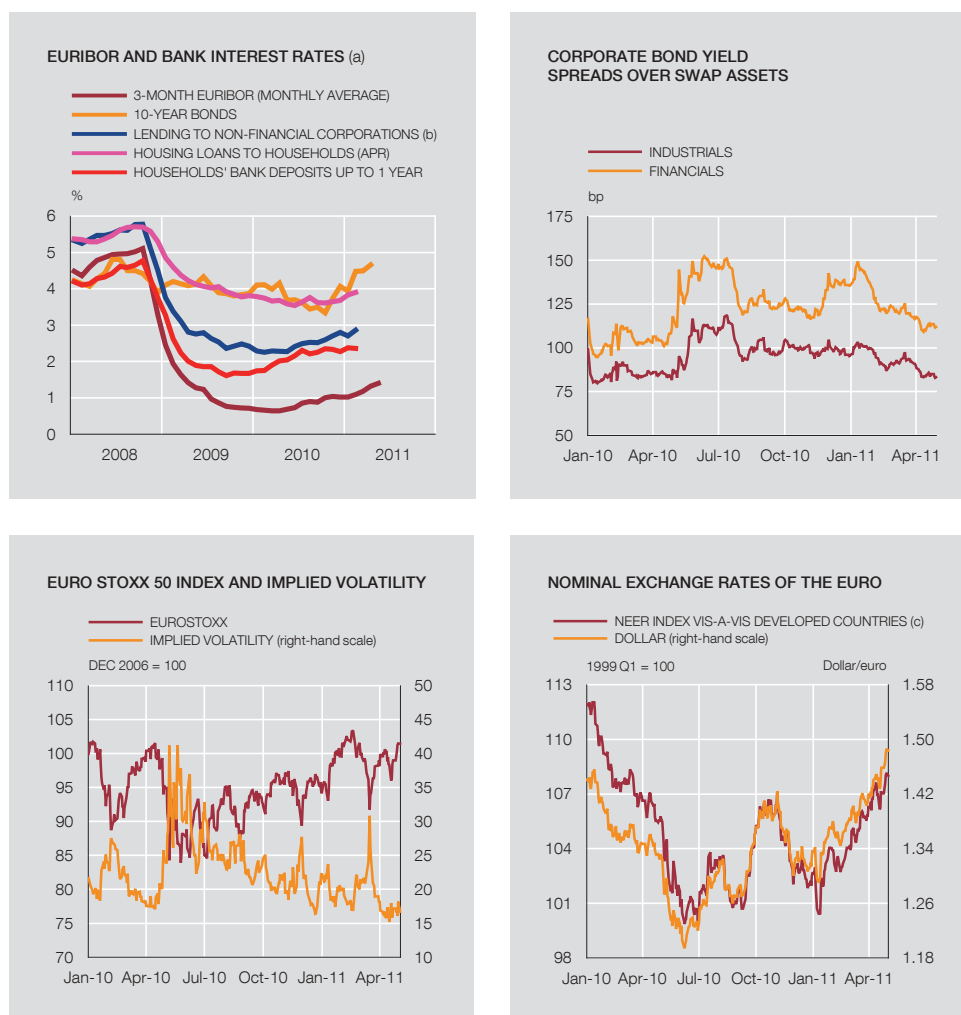
Interbank market interest rates held on the growth path on which they embarked last year. The three-month and one-year EURIBOR stood, respectively, at around 1.3% and 2.1% in April, approximately 30 bp and 50 bp above their levels in December. The EURIBOR yield spread over repo operations decreased slightly in the one-year segment, fluctuating within a band of 50 bp and 60 bp. Ten-year bond rates in the euro area continued to rise during the first four months of the year to more than 4.6% on average, and were close to 3.5% for the German *Bund*.

The rise in interest rates on interbank markets also fed through to the financing conditions of the non-financial private sector, which tightened slightly. Thus, on private fixed-income markets the cost of debt continued to move on a smooth rising trend, which had begun at the end of 2010, and the cost of bank loans increased from historically low levels, moderately so for



SOURCES: ECB and Banco de España.

a. Estimated by the ECB using swap market data.



SOURCES: ECB and Banco de España.

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

non-financial corporations and more markedly for households in the case of house purchases, which reached 4%. The Bank Lending Survey (BLS) for Q1 did not indicate any changes in credit standards for new loans for non-financial corporations, whereas a slight tightening was perceived in loan contracts for households. These developments occurred in a setting in which, according to the BLS, banks continued to perceive an increase in demand for financing from non-financial corporations while demand from households weakened, essentially in applications for home loans.

Growth in the outstanding balance of fixed-income securities issued by non-financial corporations continued to slow to 5% year-on-year in February, whereas bank loans to corporations remained on a path of smooth recovery with a year-on-year increase of slightly less than 1% in March, compared with a moderate fall of 0.2% in December 2010. The growth rate of loans to households rose to 3.4% year-on-year in March, although consumer lending continued to contract in year-on-year terms at rates of approximately 1%.

Stock markets have performed relatively favourably in 2011 to date, although they experienced a temporary substantial correction after the earthquake in Japan and, more recently, with the renewed strains on markets in the area (see Chart 13). The EUROSTOXX-50 has

appreciated by more than 4% since January and the Spanish and Italian benchmark indices posted gains of more than 7%.

The interest rate rises in the area also contributed to the appreciation of the euro exchange rate, despite the situation on sovereign markets. The nominal effective exchange rate of the euro (NEER-20) appreciated notably, by more than 4% in 2011 to date, and specifically by more than 8% and 10% against the dollar and yen, respectively.

Finally, the growth rate of the M3 monetary aggregate rose slightly to 2.3% in year-on-year terms in March, due to the higher growth of less liquid assets.

## 4 The Spanish economy

On Quarterly National Accounts (QNA) estimates, GDP posted quarter-on-quarter growth of 0.2% in 2010 Q4, thereby resuming the path of slow recovery in economic activity shown in the first half of the year, following zero growth in Q3. In 2010 Q4, quarter-on-quarter growth in both private consumption and investment in capital goods moved once more into marginally positive territory. Net external demand made a positive contribution of 0.6 pp to the increase in GDP, attributable above all to the favourable course of exports, but also to the moderate increase in imports, which was contained by the sluggishness of national demand. In year-on-year terms, output grew by 0.6%, 0.4 pp up on the previous quarter.

On the latest available information, the Spanish economy is estimated in 2011 Q1 to have continued its modest recovery, posting quarter-on-quarter GDP growth of 0.2% (see Chart 14), unchanged on the previous quarter. National demand is estimated to have scarcely slipped, while the contribution of net external demand remained positive, thanks to the strength of exports, favoured by the notable expansion in foreign markets. In year-on-year terms, GDP is expected to have grown by 0.7%, 0.1 pp up on the previous quarter.

In line with these developments in activity, the fall in employment was very similar to that in the previous quarter, with an estimated year-on-year rate of decline of 1.3%, 0.1 pp less pronounced than in the preceding three months. Given the estimated trend of output and employment, apparent labour productivity growth remained sharp, at around 2% year-on-year. Compensation per employee increased, following the decline in the previous quarter, owing to its expansionary course in the market economy, which offset the impact of the cut in public-sector wages. As a result, there was a slowdown in the pace of decline of economy-wide unit labour costs, which had been falling since the closing months of 2009. Finally, the rate of change of the CPI continued on a rising path during Q1, meaning that year-on-year inflation stood in March at 3.6%, 0.6 pp up on end-2010. Chiefly behind this was the energy component, since the CPI excluding energy and unprocessed food prices rose to a lesser extent during the quarter (to 1.7%, 0.2 pp up on end-2010).

### 4.1 Demand

In 2011 Q1, private consumption is expected to have posted modest quarter-on-quarter growth, on a similar scale to that of the final quarter of 2010 (see Chart 15). The relative sluggishness of private consumption is due to the rather unpropitious circumstances for household spending, characterised as they are by: the still-negative labour market performance; the reduction in the value of real estate wealth; relatively tight credit conditions; the loss of purchasing power due to higher inflation; and the unfavourable trajectory of disposable income, which is expected to remain on the declining course already seen in 2010 according to the non-financial account of the household sector. Together, these factors explain why the decline in the consumption of durable goods steepened compared with the situation in late 2010. In particular, new car registrations fell at a year-on-year rate of 32% in 2011 Q1, and the decline in quarter-on-quarter terms was also more acute (see Box 4). Retail sales also fell off more sharply in Q1 (-5.7% year-on-year, 3 pp down on the rate for the previous quarter). Conversely, with data to February, the year-on-year rate of decline of large corporations' domestic sales eased slightly in Q1, with consumer services performing more favourably. Among the qualitative indicators, the European Commission's consumer confidence index held in Q1 at a similar average level to that of the closing months of 2010, although it is below its historical average level. Retail traders' confidence was fairly stable in this period. Into April, both the consumer and retail trade confidence indicators improved slightly.

The impact of the economic crisis on the automobile sector prompted a series of schemes in several European countries, including Spain, based on direct aid for new car purchases. The aim was to encourage the demand for vehicles at a time when the sector was undergoing its sharpest decline, helping maintain employment in the car industry until the recovery arrived. A further aim was to encourage the replacement of old vehicles by new, less polluting ones, since a condition of most schemes was to scrap a vehicle of a certain age in parallel with the purchase of the new vehicle. The impact of these schemes on new car registrations is difficult to assess, since that would require knowing how many cars would have been sold in the absence of such schemes. A priori, the net inter-temporal effect might have been low, insofar as this economic support were to lead only to the bringing forward of spending decisions which, in any event, would have been taken at a later point in time. On the other hand, the aid represents an actual reduction in the purchase price of the vehicles that meet the requirements of the scheme, which might have boosted net demand – in such a way that the average frequency of vehicle replacement would have increased – or which might have seen certain consumers decide to purchase a car that they would not otherwise have bought in the absence of aid. In any event, the impact of these schemes on car purchases has conceivably differed from country to country depending on the specific characteristics of each scheme, including how long they run for and the total amount of aid provided. This box offers information allowing for a comparison of the impact in Spain of Plan 2000E, the scheme involving direct aid for car purchases, with that of other schemes in the main euro area countries (Germany, France and Italy).

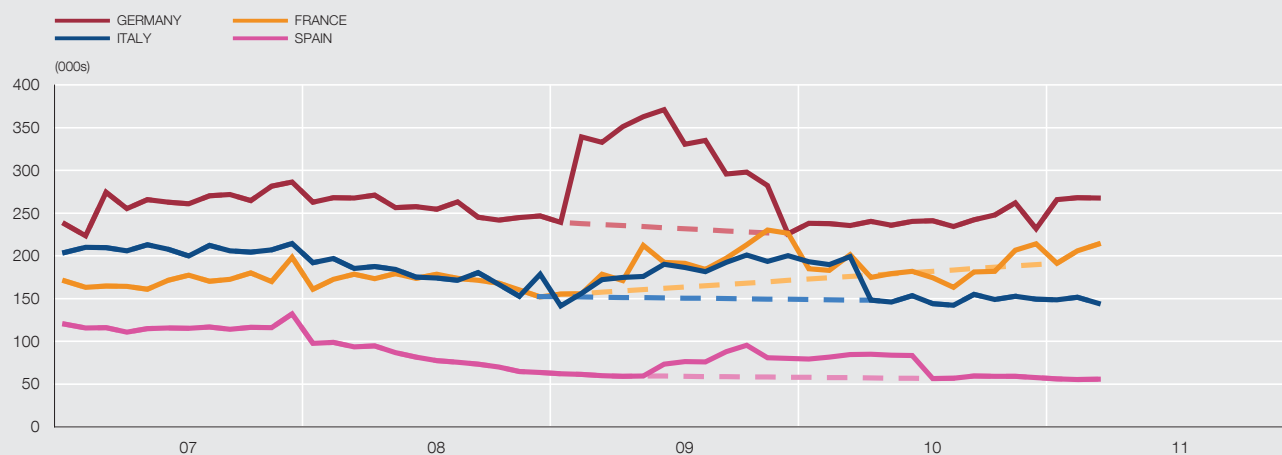
Scrappage programmes in these three countries were introduced at the start of 2009. Their total duration, including extensions, was for one year in Germany and in Italy (with the possibility of registering

until March 2010), and for longer in France, whose scheme was in force, albeit with progressively diminishing amounts, until the end of 2010. In Spain, the direct aid scheme (Plan 2000E) was launched in May 2009, and extended in January 2010 for nine months, or until the funds earmarked for the scheme ran out (which is what happened three months before the end of the extension). In almost all cases, aid was conditional upon the purchaser scrapping a vehicle of a certain age. The amount of aid per vehicle was €2000 in Spain<sup>1</sup>, between €1500 and €4500 in Italy, between €1000 and €5000 in France, and €2500 in Germany. The actual amount generally depended on the level of polluting emissions from the vehicle being purchased. In some countries, the government set a maximum total amount to be earmarked for this aid. This was the case of the scheme in Germany, where the total allocation was €2.5 billion, and in Spain, with a total of €200 million.

To assess the impact of the schemes on each country, an assumption has been made about vehicle sales in the absence of subsidies, taking into account the fact that, in the three cases in which aid ended longest ago (Germany, Italy and Spain), the number of new registrations has been seen to return to a similar level to that when the programmes were launched (see accompanying chart). On the basis of this, a linear interpolation of the figures for vehicle registrations in the months prior to the entry into force of the aid and in the months following the end of the scheme may conceivably provide a reasonable approximation to the hypothetical number of registrations that would have been made in the absence of the aid schemes. The difference between the actual level and this

1. In Spain, this is the amount in the case of the purchase of new vehicles, the result of government aid of €1000 plus a similar discount paid by the manufacturer. The aid amounted to €500 in the case of second-hand vehicles.

#### MONTHLY CAR REGISTRATIONS



SOURCES: ANFAC, Eurostat and Banco de España.

hypothetical level may provide an approximation to the impact of each scheme. The fact that the number of registrations returns to very similar levels to those at the start of the programmes suggests that the predominant impact has been a temporary stimulus to the demand for vehicles, owing to their lower purchase price during the period in which the aid programmes were in force.<sup>2</sup> Under this hypothesis, the estimated extraordinary increase in registrations ranges between 20% and 30% of the annual figure recorded in 2007 (see accompanying table). In Spain's case, this increase was 22%, with somewhat more than 300,000 extra vehicle purchases. If it is borne in mind that cars account for around 5% of total private consumption in these four countries, and if 2007 is taken as the consumption base year, the aid may have accounted for a temporary stimulus of around 1.5 pp of annual private consumption in Germany, and of around 1 pp in the other three countries.

The time at which the schemes were launched reflects different starting positions, since the onset of the crisis influenced car purchases to differing degrees of intensity in each of the countries examined. In 2008, new car registrations fell at an annual rate of 30% in Spain, and of 14% in Italy. In France and in Germany, in contrast, the related rate was less than 3%. The path of registrations during the period in which the scrappage schemes were in force followed more or less similar patterns: an initial period of two or three quarters, in which quarter-on-quarter rates rose sharply, followed by another period in which the number of vehicle registrations returned to the levels prior to the introduction of

the programmes, with strongly negative quarter-on-quarter rates. In Italy and Spain, the reversal came about very quickly, in the space of a quarter, while in Germany it was somewhat more staggered, as can be seen in the accompanying chart.<sup>3</sup> In Spain's case, the effect of the aid having ended or been used up was influenced by the increase in VAT in July 2010, which provided an incentive to take advantage of the aid in the months prior to this tax increase. Accordingly, the end of the schemes had a substantially adverse impact on private consumption, although it should be considered that this decline was relative to a higher level of consumption, thanks to the aid. Subsequently, the path of registrations has differed depending on the underlying consumption situation in each country; there has been greater dynamism in Germany, where the pre-crisis level of registrations has been attained, and greater sluggishness in Spain, with a far lower number of car purchases than in 2007.

In sum, in Spain and in the main euro area countries, the car scrappage schemes substantially boosted new registrations in 2009 and, in some cases, in 2010, stimulating private consumption at the height of the recession. Following the end of the aid, the level of registrations has not perceptibly fallen below that seen before such aid was introduced, although there was some slippage in relation to the period in which the schemes were in force. The schemes therefore provided temporary relief, which does not appear to have entailed a change in the underlying trend in the demand for cars in the countries analysed.

2. In Spain, for example, there is some evidence that car dealers supplemented the aid with additional discounts on car prices.

3. This has to do with the administrative procedure used: in Germany the formalisation of the purchase order sufficed to qualify for the aid, despite the fact that the delivery of the car took place months later.

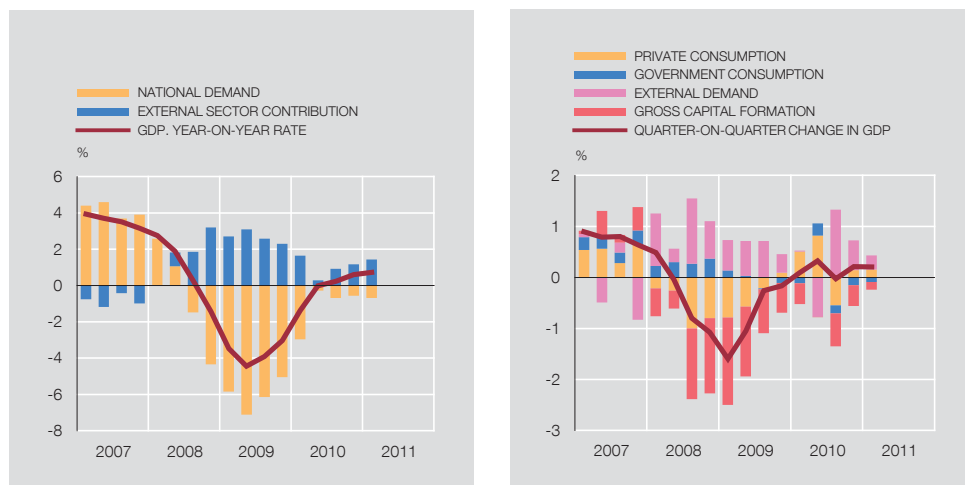
VEHICLE REGISTRATIONS 000s	GERMANY	FRANCE	ITALY	SPAIN	
2007	3,155	2,065	2,494	1,404	
2008	3,080	2,042	2,144	977	
2009	3,764	2,308	2,166	872	
2010	2,888	2,227	1,922	846	
IMPACT OF SCHEMES					
Additional registrations (000s)	975.4	404.8	521.0	313.8	
% of 2007 registrations (a)	30.9	19.6	20.9	22.4	
% of 2008 registrations (a)	31.7	19.8	24.3	32.1	
CHANGE ON 2007 %					
Before aid	2008	-2.4	-1.1	-14.0	-30.4
After aid	2010 (b)	-9.8	18.3	-28.2	-50.8
Currently	2011 Q1	1.6	18.3	-28.7	-52.3

SOURCES: ANFAC, Eurostat and Banco de España.

a. Percentage of total vehicles registered in 2007 and 2008 accounted for by additional vehicles registered as a result of aid under the schemes.

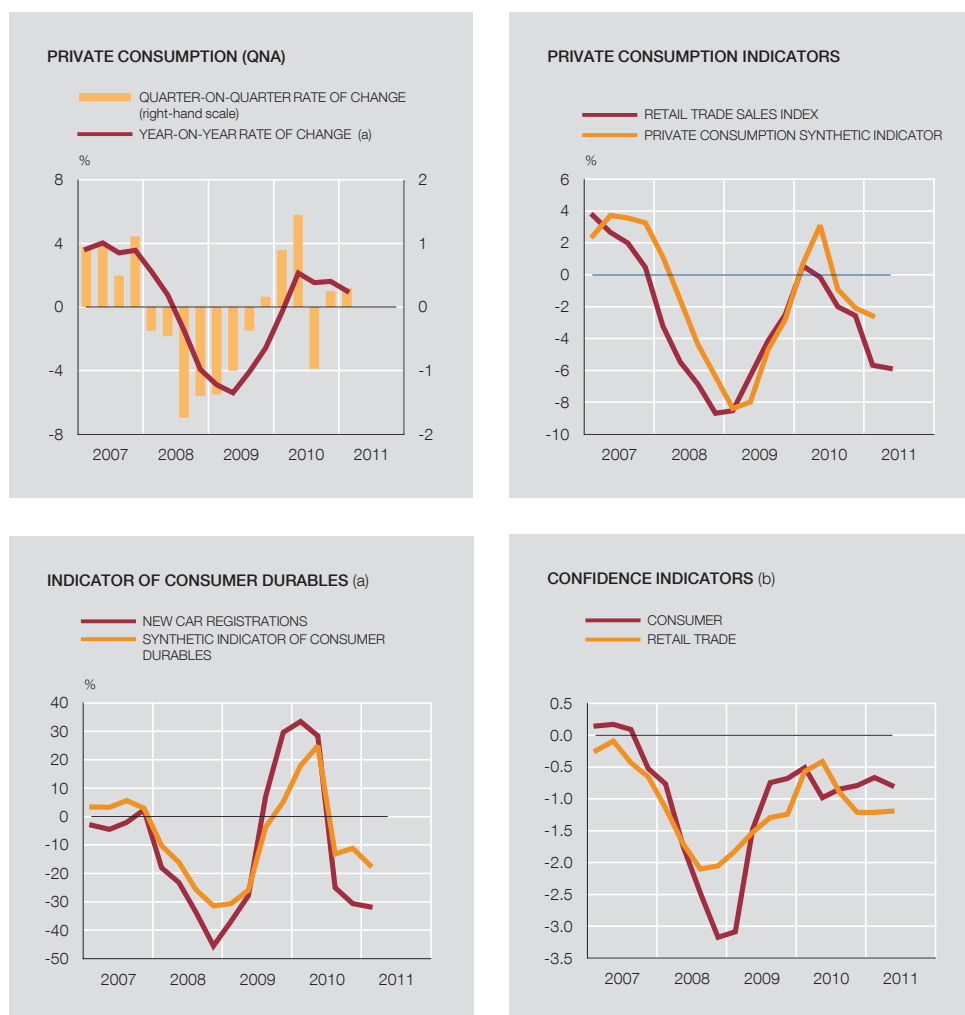
b. Comparison with 2007 of the situation in the quarter following the end of aid under the schemes. Thus, in Germany the comparison is with 2010 Q1, in Italy with 2010 Q2, in France with 2011 Q3 and in Spain with 2010 Q3.





SOURCES: INE and Banco de España.

PRIVATE CONSUMPTION



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).

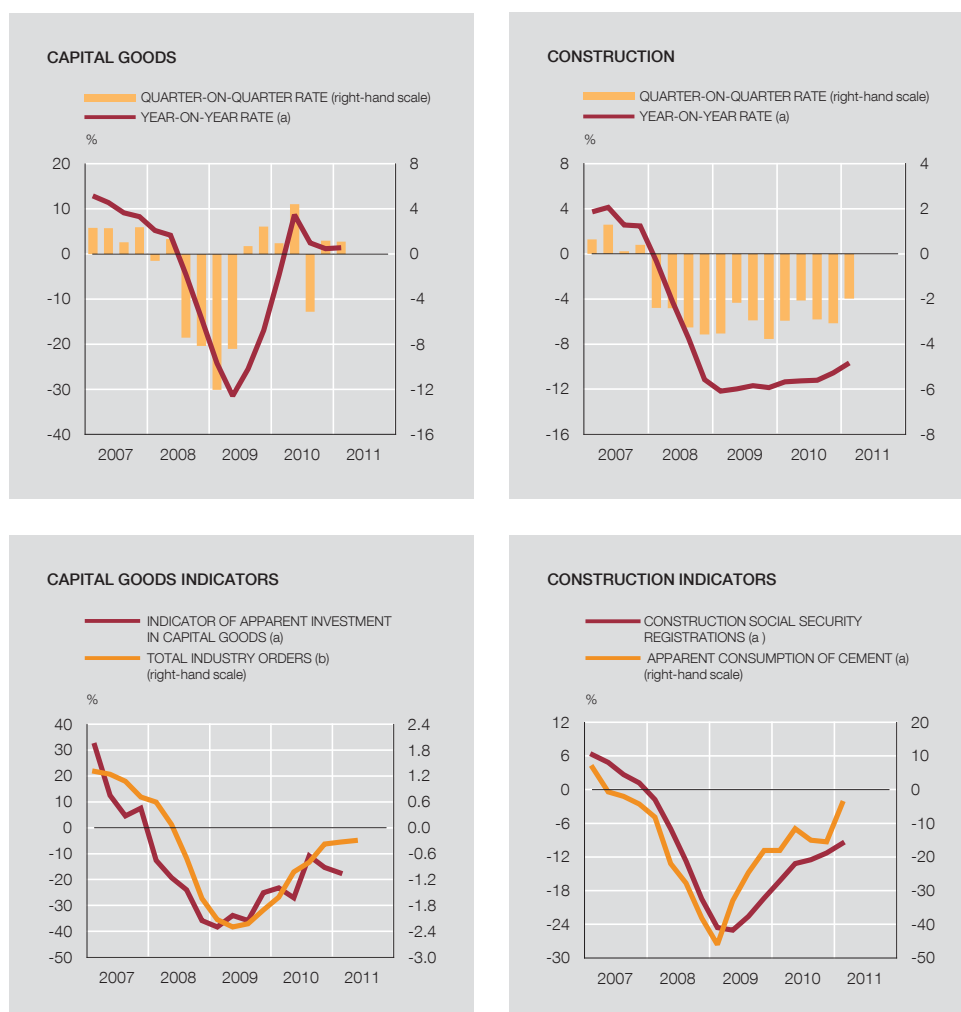
As previously indicated, household disposable income fell by 1.8% in nominal terms in 2010, according to the non-financial accounts of the institutional sectors. In four-quarter cumulated figures, the year-on-year rate of decline in household income steepened in the closing months of the year. This was due above all to the decline in general government contributions and in net income on property (in particular, from the interest component). The improved contributions of compensation per employee and the surplus in respect of the self-employed, income components whose rates of decline slackened, were unable to offset the above-mentioned development. The fall in disposable income in nominal terms and the increase in the rate of inflation reduced household purchasing power in the second half of the year, although their potential impact on consumption was softened by the reduction in the savings ratio, which fell by almost 5 pp in 2010 to 13.1% of household disposable income.

Investment in capital goods recorded positive quarter-on-quarter growth in 2011 Q1, of a similar magnitude to that of the previous quarter (see Chart 16). The year-on-year rate is expected to have remained roughly stable. This behaviour might be linked to the favourable trajectory of exports and to the need to replace productive equipment after the sharp adjustment made during the crisis. The industrial production of these goods improved in year-on-year terms in the first two months of the year, although the rate of increase of imports slackened in this period and the rate of decline of commercial vehicle registrations steepened in Q1. In quarterly average terms, business confidence, both industry-wide and in the capital goods segment, rose slightly. However, it moved on a declining path over the course of the quarter, suggesting that the recovery in this demand component might be checked in the coming months. Lastly, capacity utilisation in manufacturing industry continued to increase, up to 73.5%, although it is still below its historical average.

The financial position of companies might also have a bearing on the rate of recovery of their investment. In this respect, the non-financial accounts of the institutional sectors show that non-financial corporations ended 2010 with a net lending capacity of 0.4% of GDP, compared with net borrowing needs of 2% of GDP in 2009. That might denote the existence of suitable conditions for a take-off in investment, although it may also be the result of companies' difficulties in raising external borrowing and, therefore, of the wish to preserve internal sources of financing. This improvement in the financial position of corporations was due to the increase in business saving (with a recovery in the surplus that benefited from staffing adjustments) and to more temporary factors, such as the fall in interest payments and in taxes. The weight of investment by non-financial corporations increased slightly as a percentage of GDP in 2010 as a whole, after having diminished in the two previous years.

The contractionary behaviour of investment in construction eased in Q1. It is, however, still substantially weak, reflecting the ongoing downsizing in the residential segments and the fiscal adjustment in the area of civil engineering works (see Chart 16). In recent months the indicators for the sector as a whole relating to inputs, such as the apparent consumption of cement and the industrial production index for construction materials, and the employment indicators, too, posted more moderate year-on-year declines than those in the previous quarter. Conversely, the business confidence indicators drawn from the European Commission's surveys reflected a significant deterioration in these agents' perception of the direction and outlook for the sector during the closing months of the year.

Across the different types of works, the contraction in residential investment continued in Q1, both in year-on-year and in quarter-on-quarter terms, albeit at a less marked rate than in late 2010. The reduction in the number of housing completions has meant that this figure is drawing gradually closer to that of housing starts. Accordingly, in the coming quarters the number of



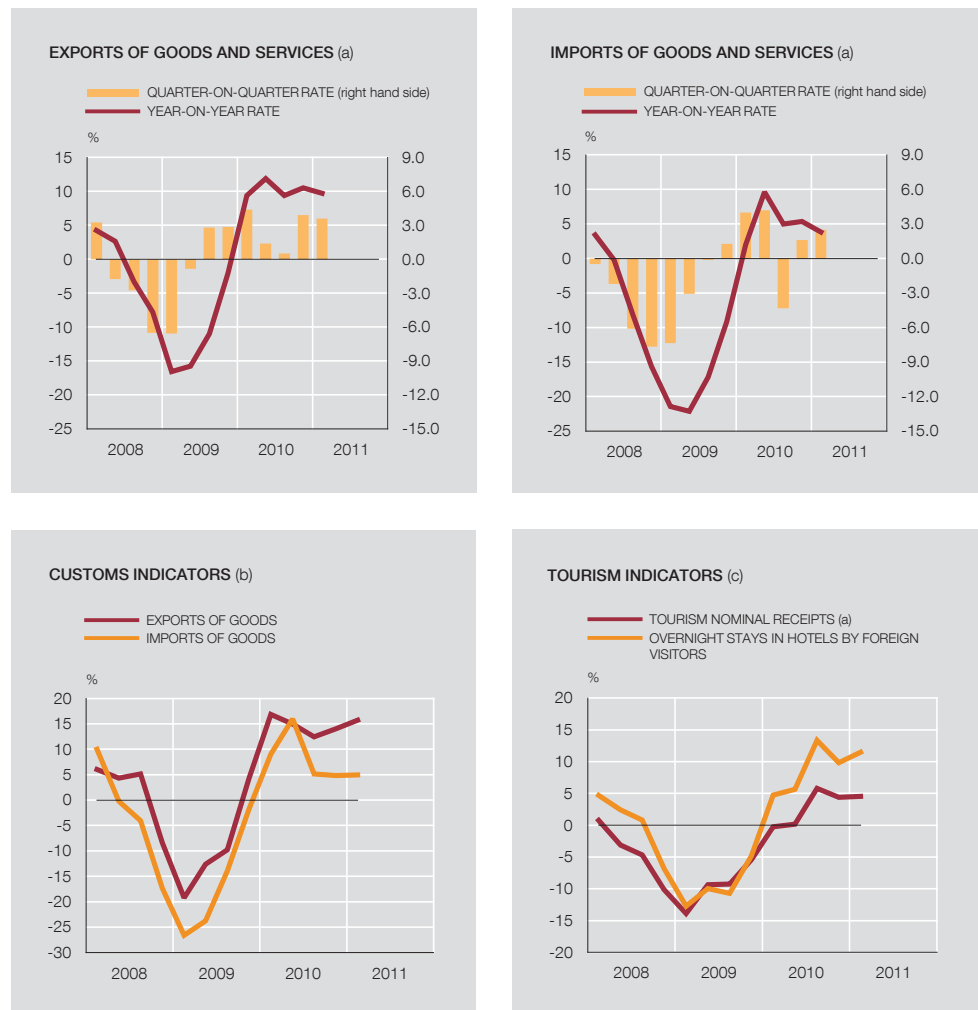
SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, INEM and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series except for registrations, which are based on the original series.

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

houses under construction will stabilise. On the demand side of residential assets, the latest available figures on the number of housing market transactions, for January and February, show a notable recovery. However, it should be clarified that this is related to the time lag between the formalisation of transactions and their official registration, meaning that the rise is actually due to the buoyancy of transactions in the closing months of 2010, as a result of the change in the treatment of house purchases under personal income tax as from 1 January 2011. This change in tax regulations might lie behind a significant decline in housing transactions in the opening months of the current year, as a consequence of such transactions being brought forward to the previous year. Data on building permits to February, in respect both of non-residential building and of the procurement of civil engineering works, remained markedly slack.

Net external demand contributed positively once again to GDP growth in 2011 Q1, adding 0.3 pp in quarter-on-quarter terms. The contribution in year-on-year terms is expected to have been approximately 1.4 pp, 0.2 pp up on 2010 Q4, in a setting in which exports performed more dynamically than imports (see Chart 17). The strength of exports was underpinned by the continuing high growth rate of international trade, boosted chiefly by the demand for imports by the United States and the emerging economies. Also conducive to exports was the im-



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

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

provement in the price-competitiveness indicators. Indeed, in real terms the share of exports on international markets may have increased in 2011 Q1. Spanish imports increased at a slow pace, in step with the sluggishness of domestic demand. They were largely sustained by the growth of exports, whose import content is relatively high.

According to Customs data, real goods exports increased by almost 20% year-on-year in the January-February period, compared with 14% in 2010 Q4. The acceleration was across the board, with a notably strong rise in sales of capital goods, which grew 32% (underpinned by exports of land transport equipment and of machinery), and the continuing high growth of intermediate goods, which rose 23%. Exports of food and of certain consumer manufactures were also considerably buoyant. By geographical area, both exports to the EU – in particular to Germany and Italy – and to non-Community countries, especially the United States, Russia, China and Latin America, all rose.

Turning to real exports of tourist services, the information available points to the favourable performance of this item in Q1, firming the path of recovery begun in 2010. The year-on-year

rates of foreign tourist inflows and of overnight hotel stays quickened by somewhat more than 1 pp on 2010 Q4, to grow, respectively, at 2.9% and 11% in 2011 Q1. Nominal spending by incoming foreign tourists also rose in this period, posting year-on-year growth of 2.4% according to EGATUR (the tourism expenditure survey), while the Balance of Payments information, with data to February, confirms the positive trajectory of nominal tourism revenue. In Q1, the geopolitical instability in North Africa and the Middle East appears to have prompted a shift in international tourist flows towards Spain. As for non-tourist services exports, their rate of increase slackened in Q1.

Goods imports grew, according to Customs information, by 8.5% year-on-year in the January-February period. This rate exceeds the increase in 2010 Q4 by almost 4 pp. By product group, imports of non-energy intermediate goods and of capital goods proved most robust, growing by 12% and 9%, respectively. Conversely, although consumer goods imports continued to fall, they did so at a more moderate rate than in the previous months, owing to the more expansionary momentum of non-durable consumer goods and to the slackening in the rate of decline of car purchases. Lastly, the growth of real services imports slowed in 2011 Q1, reflecting an appreciable moderation in purchases of non-tourist services.

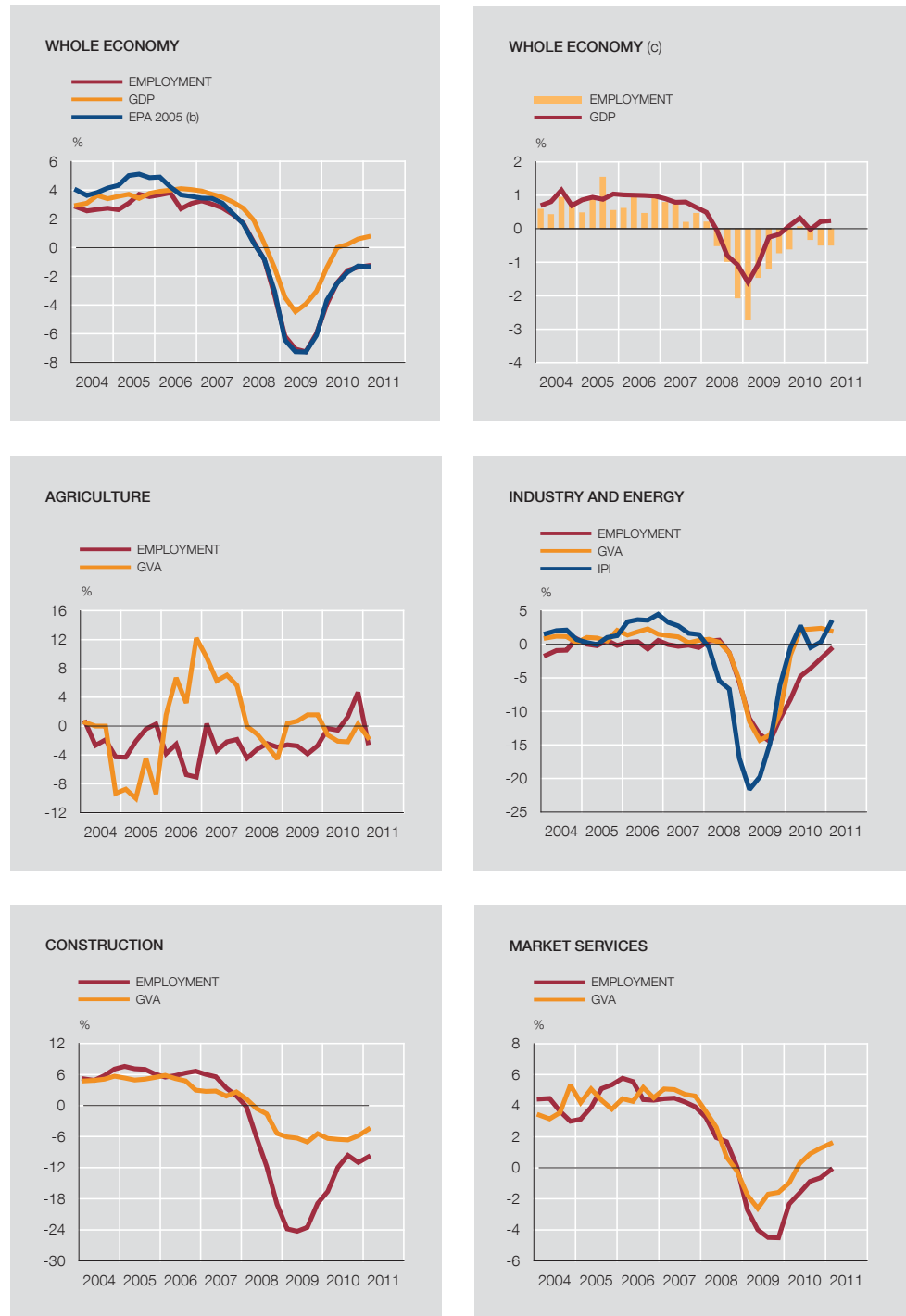
## **4.2 Output and employment**

During 2011 Q1, gross value added in the market economy increased modestly in quarter-on-quarter terms, marginally up on the previous quarter (see Chart 18). Among the market branches, it is estimated that services and, above all, industry showed some improvement compared with the previous three months.

In the case of the industrial branches, the estimated strengthening of the quarter-on-quarter growth rate of GVA over the quarter as a whole is supported by the course of the industrial production index, whose performance in the first two months of 2011 was expansionary. Nonetheless, manufacturing industry orders progressively slowed during the quarter, while the European Commission's survey-based indicator and the PMI fell, suggesting an easing off in the recovery.

The market services indicators point to a slight strengthening in the sector's GVA growth in Q1, in both quarter-on-quarter and year-on-year terms, although it remains somewhat lacklustre. In the first two months of the year the path of the services sector turnover indicator has remained one of slow recovery. This was the case across practically all the branches and was accompanied by somewhat more favourable employment. The survey-based data revealed rather divergent trends. On one hand, the PMI indicator improved in quarterly average terms, although the marked deterioration in March returned it to its December 2010 level. Mention should be made of the expansionary behaviour of business expectations reflected in the survey. On the other hand, the average level of services confidence in the European Commission's survey in Q1 held at the level recorded in the October-November 2010 period. However, in April confidence in this sector slipped.

In the labour market, the monthly indicators show that job destruction continued during Q1. Average Social Security registrations fell by 1.2% compared with the same period a year earlier, a decline which is scarcely 0.1 pp less marked than the average figure for the final quarter of 2010. In quarter-on-quarter terms, the rate of decline of registrations, at 0.3%, was identical to that of the previous quarter. The growth rate of new hires registered at the National Public Employment Service (SPEE by its Spanish abbreviation) slowed in Q1, posting a year-on-year increase of 0.4%, with falls in February and March. This diminished buoyancy of new hires has affected both temporary and permanent employment; the weight of the latter in total employment contracts has fallen slightly (to 9.4%). December 2010 marked the expiry of the deadline



SOURCES: INE and Banco de España.

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

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

c. Quarter-on-quarter rates base on seasonally adusted series.

set by the labour reform so that the temporary contracts in force before approval of the reform might be converted into employment-promoting permanent contracts. That explains the strong loss of momentum seen in such conversions since the start of the year.

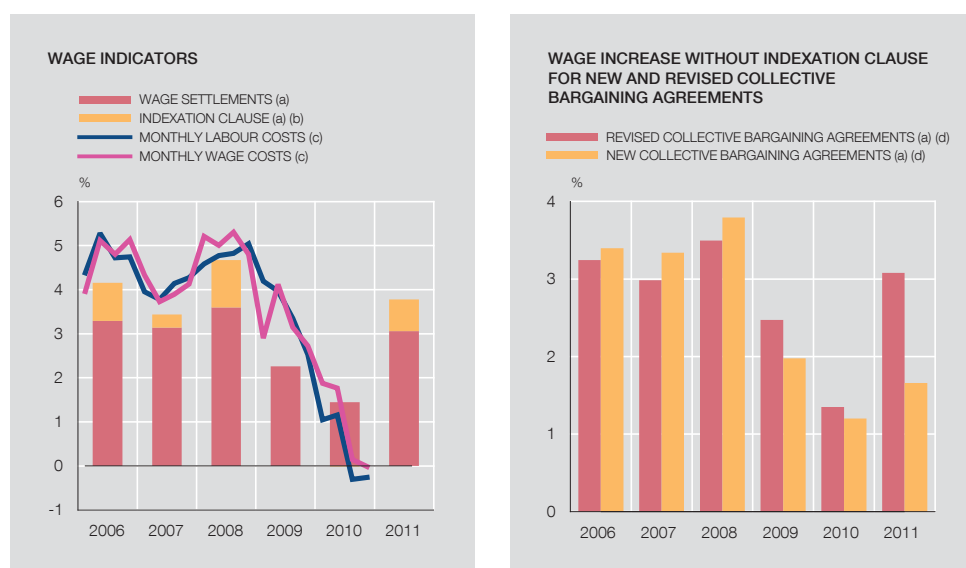
The EPA figures for Q1 show a year-on-year decline in employment of 1.3%, unchanged on the previous quarter. Agriculture, industry and non-market services are the branches that performed worse than in the preceding quarter. The behaviour of the remaining branches was better, and a positive year-on-year rate was posted in market services for the first time since 2008 Q3. Among the self-employed, the rate of decline of employment steepened, falling by 3.5% compared with 1.9% the previous quarter. Meantime, the intensity of the related rate of decline in employment among wage-earners eased slightly, from 1.2% to 0.9%. By nationality, job destruction was concentrated among foreign workers, where there was a 4.5% cut in employment, compared with a 0.8% decline for Spanish nationals. As regards contract duration, the year-on-year rate of change among temporary wage-earners was positive (0.7%) for the first time since 2006, while the rate of decline for permanent employees worsened by 0.6 pp to 1.4%. As a result, the proportion of temporary to permanent employees held at 24.8%, unchanged on the previous quarter and 0.4 pp higher than a year earlier (24.4%). Finally, part-time hires rose strongly in year-on-year terms, climbing from 0.2% in 2010 Q4 to 4.7% in 2011 Q1, while full-time employees declined by 2.2%, 0.7 pp more than in the previous quarter. These developments placed the ratio of part-time to total employees at 14.1%, against 13.3% a year earlier.

The labour force increased at a lesser pace than in the previous quarter (0.2% against 0.6%), against the background of the stability of the working population aged over 16 (0.2%) and of the participation rate, which stood at 59.9%, against 59.8% in 2010 Q1. In terms of the breakdown by sex, the rate of change of both the female and male labour forces eased. Female workers increased by 1.5% in 2011 Q1, compared with 2.1% the previous quarter, while the rate for males was negative at -0.8%, 0.2 pp less than in the previous period. By nationality, the rate of decline in the foreign labour force (both total numbers and the population aged over 16) stepped up: the former declined by 2.8%, compared with -0.6% the previous quarter, and the latter fell by 0.1% (against -0.7%). As a result, the participation rate of foreign workers stood at 75.9%, 1.4 pp down on a year earlier. Spanish nationals, for their part, increased by 0.8% and their participation rate held at 57.7% for the fourth quarter running.

Finally, the numbers of unemployed increased by 213,500 compared with 2010 Q4, placing the total number of jobless at 4.9 million. In year-on-year terms, the rise in unemployment eased to a year-on-year rate of change of 6.4%, around 2 pp down on the figure for the previous quarter. The unemployment rate increased by 1 pp during the quarter to 21.3% of the labour force. Similarly, the SPEE registered unemployment figures confirmed the easing in the recovery of the labour market, with a 4.2% increase in the number of unemployed in 2011 Q1, compared with 6% the previous quarter, checking to some extent the decelerating path that marked the whole of the previous year.

### **4.3 Costs and prices**

The average rise in wage rates agreed for 2011 in the collective bargaining agreements recorded to March stands at 3.1%, marking a substantial increase on the figure of 1.4% for 2010 on average (see Chart 19). These developments in wages are a cause for concern, since they do not appear to be in line with the unfavourable labour market situation. Foreseeably, however, the average settlement rate will tend to ease as collective bargaining advances. In this respect, the information available may be considered to skew upwards the increase in wage rates, since almost all the agreements recorded in the January-March period are revisions of multi-year agreements entered into in previous years, in which the increases in wage rates are



SOURCES: INE and Ministerio de Trabajo e inmigración.

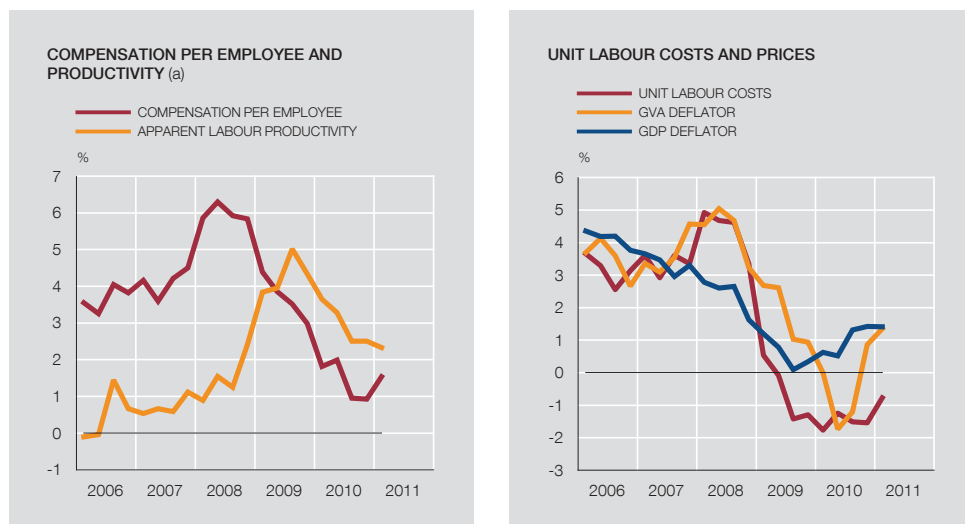
- a. Settlement in year to March 2011.  
 b. Previous year's indexation clause.  
 c. Quarterly labour costs survey. Year-on-year rates of change.  
 d. Revised: agreements with economic effects for the current year, but which were entered into in previous years, and are in force for more than one year. New: agreements entered into during the year with economic effects in the same year, this being the same or only year in which it is applicable.

mostly referenced to the CPI as at December 2010. Further, within these revised agreements, those entered into before February 2010, when the Agreement on Employment and Collective Bargaining (AENC by its Spanish initials) was signed, contain an average increase in wage rates of 3.4%, compared with the 2.1% rise in those signed after this Agreement. There have been few newly signed agreements in 2011, but they reveal a more modest increase (1.7%) in wage rates. The recent rise in inflation has activated the indexation clauses, whose presence, though less than in prior years, is still significant, as it affects almost 50% of workers (70% as at December 2009). On the basis of this information, the year-on-year rate of expansion of compensation per employee in the market economy is estimated to have increased to 1.5% in the January-March 2011 period, against 0.9% the previous quarter (see Chart 20). The trajectory of wages and the slight slowdown in productivity are expected to lead to a more moderate decline in unit labour costs in the market economy.

In 2011 Q1, the deflators of most demand components continued to post high year-on-year growth rates, albeit somewhat lower than those of the previous quarter. There was a marked reduction in the government consumption deflator, reflecting the cut in public-sector employee compensation. Imported goods and services prices slowed moderately, although their growth rate held at around 7%. Domestic producer prices – measured by the GDP deflator – increased at a more moderate rate of 1.4%, similar to that of the previous quarter.

The main consumer price indicators continued to quicken during 2011 Q1, although a more detailed analysis of the inflationary phenomenon leads to the conclusion that underlying pressures remain, for the moment, contained. The year-on-year change in the CPI in March was 3.6%, 0.6 pp up on the related December 2010 figure (see Chart 21). The uptrend in inflation is largely attributable to the energy component, whose rate in March was 18.9%, 3.3 pp up on December. Dearer oil on international markets pushed the prices of vehicle fuel and other liquid

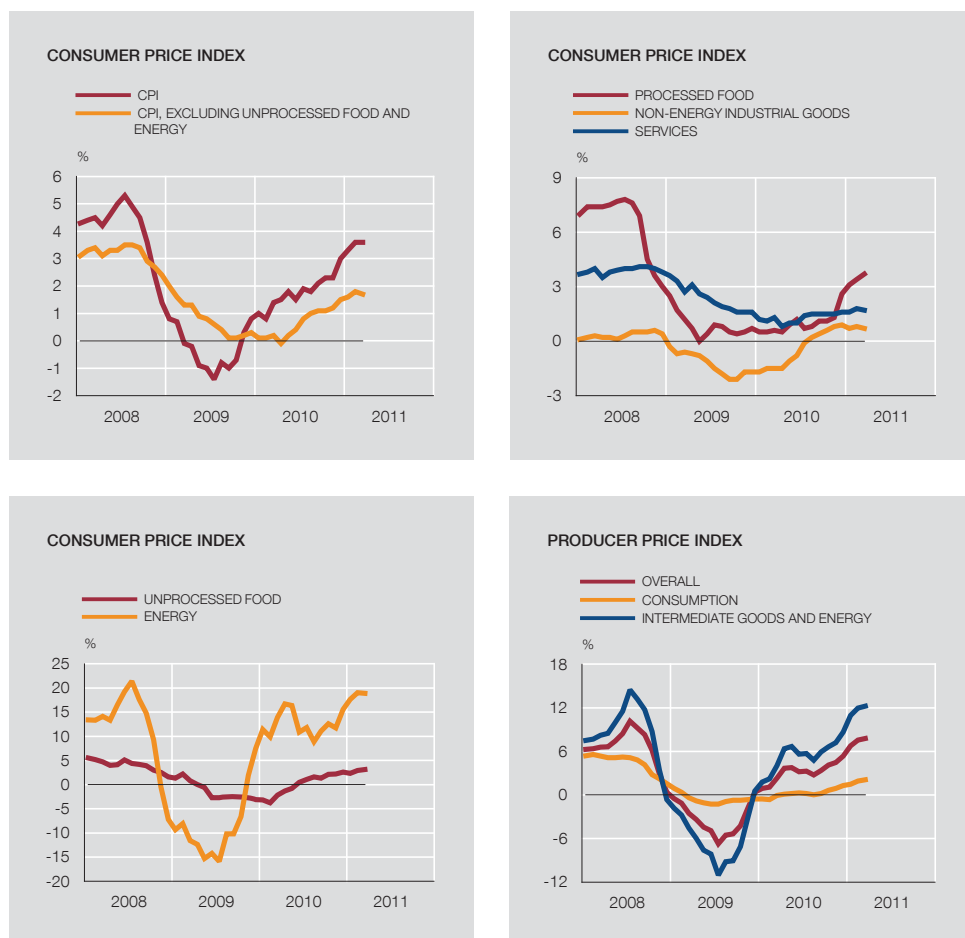




SOURCES: INE and Banco de España.

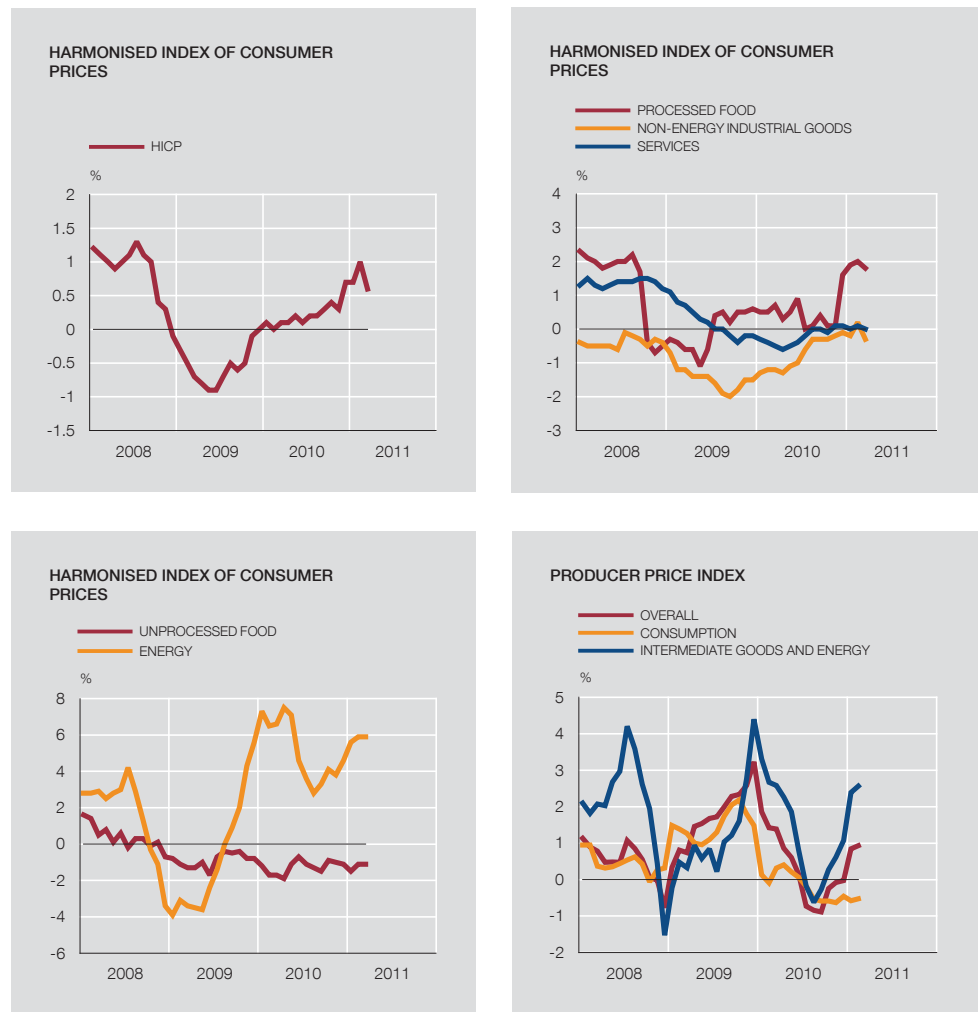
a. Year-on-year rates based on seasonally adjusted QNA series.

**PRICE INDICATORS (a)**  
Spain



SOURCE: INE.

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



SOURCES: Eurostat and Banco de España.

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

fuel, such as heating gas-oil, upwards. Moreover, the performance of this component also evidenced the rise in electricity and gas prices. In contrast, the rate of change of the CPI excluding energy and unprocessed food prices increased by only 0.2 pp to 1.7%. Within this indicator, processed food prices climbed at a year-on-year rate of 3.7% in March, 1.1 pp above the related rate in December 2010, due partly to dearer food prices on international markets. The rise was more moderate in the case of services (0.1 pp), while the year-on-year growth rate of non-energy industrial goods dipped by 0.2 pp. A significant portion of the CPI index excluding energy and fresh food prices reflects the impact of the increases in VAT and tobacco prices, which should prove temporary. Finally, the leading indicator of the CPI, released since January by INE, posted an increase of 3.8% in April.

The rise in inflation in 2011 Q1, measured by the harmonised index of consumer prices (HICP), was somewhat less in Spain than in the euro area. As a result, the inflation spread in March was, at 0.6 pp, 0.1 pp less than that recorded in December 2010 (see Chart 22). However, the increase in energy prices in Spain was far greater than in the euro area, widening the spread to 5.9 pp in March. Spanish processed food prices also outgrew those in the euro area, and the related spread widened by 0.2 pp to 1.8 pp. In the case of services and of non-energy

EUR m and %

	Outturn 2010	Percentage change 2010/2009	Budget outturn projection	Percentage change 2011/2010	Outturn		
					2010 JAN-MAR	2011 JAN-MAR	Percentage change 2011/2010
					1	2	3
<b>1 REVENUE</b>	127,337	24.8	106,020	-16.7	32,759	27,452	-16.2
Direct taxes	59,262	9.5	55,239	-6.8	14,516	11,559	-20.4
<i>Personal income tax</i>	39,326	29.2	35,494	-9.7	12,924	10,411	-19.4
<i>Corporate income tax</i>	16,198	-19.8	16,008	-1.2	693	397	-42.7
<i>Other (a)</i>	3,738	7.5	3,737	-0.0	899	751	-16.4
Indirect taxes	51,825	80.8	36,142	-30.3	14,314	11,844	-17.3
VAT	38,486	143.8	24,968	-35.1	11,311	9,716	-14.1
<i>Excise duties</i>	10,338	1.9	8,179	-20.9	2,292	1,364	-40.5
<i>Other (b)</i>	3,001	9.5	2,995	-0.2	712	765	7.5
Other net revenue	16,251	-15.7	14,639	-9.9	3,929	4,049	3.0
<b>2 EXPENDITURE</b>	179,572	-5.1	150,056	-16.4	48,305	36,613	-24.2
Wages and salaries	26,975	1.5	26,982	0.0	6,017	6,068	0.8
Goods and services	4,632	-4.7	3,384	-26.9	954	855	-10.4
Interest payments	19,638	11.3	27,421	39.6	7,579	5,819	-23.2
Current transfers	104,656	-6.9	74,598	-28.7	26,348	18,354	-30.3
Contingency fund	—	—	2,668	—	—	—	—
Investment	8,782	-16.1	5,793	-34.0	2,883	2,155	-25.3
Capital transfers	14,890	-14.2	9,208	-38.2	4,522	3,362	-25.7
<b>3 CASH-BASIS BALANCE (3 = 1-2)</b>	-52,235	—	-44,036	—	-15,546	-9,161	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)							
TOTAL	135,862	16.3	141,538	4.2	38,451	39,944	3.9
Personal income tax	66,977	4.9	71,761	7.1	19,212	19,672	2.4
VAT	49,079	46.2	48,952	-0.3	14,584	15,748	8.0
Excise duties	19,806	2.4	20,825	5.1	4,655	4,524	-2.8

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.

goods, the positive spreads were very small, and even changed sign once adjusted for the effect of tax changes. Lastly, the growth of unprocessed food prices remained lower in Spain and the spread held at -1.1 pp. As a result of the developments in these various components, the difference in core inflation narrowed to 0.1 pp, after having widened to 0.3 pp in December. According to the leading indicator of the HICP for April, the spread of the overall index widened by 0.1 pp in April to 0.7 pp, since Spain's HICP increased to 3.5%, and that of the euro area to 2.8%.

The producer price index also moved on a rising course during Q1, climbing from 5.3% in December to 7.8% in March. Component by component, rates rose across the board, but did so particularly sharply in the case of intermediate goods and, above all, in energy products, which were greatly affected by oil prices in this period. The rise in inflation along the whole production chain suggests upside risks to consumer prices. On data to February, the difference between the respective growth rates of producer prices in Spain and in the euro area widened to 1 pp. Growth in the import and export price indices for industrial products also quickened, rising in February to rates of 11.1% and 7.4%, respectively.

EUR m and %	2009	2010	2011	Rates of change		
				2009/2008	2010/2009	2011/2010
<b>1 REVENUE</b>	135,716	124,559	123,241	-2.1	-8.2	-1.1
Current revenue	126,539	116,628	114,472	-2.7	-7.8	-1.8
– Direct taxes	28,553	22,834	31,083	17.4	-20.0	36.1
– Indirect taxes	34,671	28,459	40,671	-20.0	-17.9	42.9
– Charges, prices and other revenue	3,751	3,971	3,987	4.1	5.9	0.4
– Current transfers	59,040	60,878	38,257	1.2	3.1	-37.2
– Interest and dividends	523	486	474	6.3	-7.1	-2.5
Capital	9,177	7,931	8,769	7.7	-13.6	10.6
– Disposal of investments	633	518	1,760	2.0	-18.1	—
– Capital transfers	8,544	7,413	7,009	8.2	-13.2	-5.5
<b>2 EXPENDITURE</b>	143,338	142,248	132,536	3.8	-0.8	-6.8
Current expenditure	114,592	115,658	111,189	4.8	0.9	-3.9
– Wages and salaries	46,759	47,542	44,951	5.6	1.7	-5.4
– Goods and services	21,095	21,120	20,231	3.3	0.1	-4.2
– Interest payments	1,808	2,470	2,955	5.0	36.6	19.6
– Current transfers	44,831	44,438	42,975	4.6	-0.9	-3.3
– Contingency fund	99	87	78	51.8	-11.7	-10.8
Capital	28,746	26,590	21,347	-0.2	-7.5	-19.7
– Investment	14,260	11,658	8,807	-1.7	-18.2	-24.5
– Capital transfers	14,486	14,932	12,540	1.2	3.1	-16.0
<b>BALANCE</b>	-7,622	-17,689	-9,295	—	—	—
% of GDP	-0.7	-1.7	-0.9	—	—	—
<b>MEMORANDUM ITEMS (% of GDP):</b>						
BALANCE (all regional governments)	-1.0	-2.3	—	—	—	—
NAT. ACCOUNTS BALANCE	2.0	-3.4	-3.3	—	—	—
NAT. ACCOUNTS BALANCE with deferrals (% of GDP)	2.0	-2.8	-1.3	—	—	—

SOURCE: Ministerio de Economía y Hacienda, Regional (Autonomous) Communities and Banco de España.

a. For 2011, the Catalanian and Balearic regional governments have rolled over the 2010 budget.

#### 4.4 The State budget

The latest statistical information available for the overall general government sector refers to end-2010. In terms of agents, more recent information on the budget outturn in 2011 Q1 for the State and Social Security sub-sectors (see Tables 4 and 6, respectively) is available. In the case of the regional governments, there is no uniform data available on the budget outturn in respect of overall regional government spending that enables the degree of compliance with the initial budget (which is detailed in aggregate form in Table 5) to be assessed.

In National Accounts terms, and according to the budget outturn figures to March 2011, the State is expected to have recorded a deficit of €6.9 billion, €1.8 billion less than the same period a year earlier. Expressed in cash-basis terms, the State posted a deficit of €9.2 billion in 2011 Q1, a figure below that observed in the same period in 2010, which amounted to €15.6 billion (see Table 4). While both revenue and spending moved on a declining course in Q1, the year-on-year rate of change in spending in cash-basis terms (-24.2%) comfortably offset the slowing pace of revenue, which declined by 16.2%. Nonetheless, the significance of these rates is limited, since the revenue and spending figures for this year are not comparable with those for 2010. Specifically, State revenue and spending will be affected throughout the year by the full application of the new regional government financing arrangements. The regional governments will receive a bigger share in taxes (the counterpart to which will be that

	EUR m and %						
	Initial budget 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010	Outturn		
					2010 JAN-FEB	2011 JAN-FEB	Percentage change 2011/2010
1	2	3	4 = 3 / 1	5	6	7 = 6 / 5	
<b>1 REVENUE</b>	119,481	-3.4	123,405	3.3	19,760	19,581	-0.9
Social security contributions	108,358	-4.4	111,778	3.2	17,800	17,564	-1.3
Current transfers	8,357	12.3	8,154	-2.4	1,140	1,203	5.5
Other	2,765	-6.7	3,473	25.6	821	814	-0.7
<b>2 EXPENDITURE</b>	116,601	1.9	118,826	1.9	15,537	16,125	3.8
Wages and salaries	2,483	1.2	2,378	-4.2	324	319	-1.5
Goods and services	2,032	1.9	1,719	-15.4	146	165	13.1
Current transfers	111,557	1.9	114,279	2.4	15,054	15,633	3.8
Contributory pensions	95,320	2.1	99,090	4.0	13,319	14,012	5.2
Sickness	7,373	-9.5	7,009	-4.9	371	326	-11.9
Other	8,864	11.0	8,181	-7.7	1,364	1,294	-5.2
Other expenditure	529	-6.1	450	-15.0	13	8	-35.2
<b>3 BALANCE (3 = 1 - 2)</b>	2,880	—	4,579	—	4,224	3,456	—

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

State revenue is lower) and obtain fewer transfers from the State (i.e. there will be a reduction in State payments).

In the case of spending, declines were observed in capital expenditure and in goods and services purchases, while interest payments, which also declined, are expected to quicken in the coming months. On the revenue side, in respect of total tax takings (see Table 4), which take into account the share of both the State and that of the territorial governments, VAT revenue performed notably well, posting a growth rate of 8%, due in part to the effect of the rise in VAT rates in July 2010. Excise duties revenue eased in Q1, with a rate of decline of 2.8%. Under direct taxation, personal income tax revenue was contained. In the case of corporate income tax, the figures for Q1 for each of the two years under comparison are not very informative, since the information on the first partial tax payment for the year in April is not included.

The latest outturn figures for the Social Security system are for March 2011 (although the full breakdown of these is only available to February, as can be seen in Table 6). These figures show a surplus of €6.1 billion, entailing an improvement of €0.2 billion compared with the surplus accumulated to March last year. On the revenue side, Social Security contributions declined by 0.9% (against a fall of 1.3% in February; see Table 6), the results of the still-unfavourable behaviour of Social Security registrations in Q1. There was an increase of 2.7% in expenditure owing to the 5.1% rise in the contributory pensions item, which was partly offset by the reduction in spending under other current transfers.

Turning to the SPPE (State Public Employment Service), the latest available figures to February suggest a significant reduction – of around 7% – in unemployment benefit payments compared with the same period in 2010. This is in step with the fall in the number of beneficiaries under the unemployment insurance system. In this respect, given the observed course of the number of unemployed, the unemployment coverage rate is expected to have declined by 4 pp from December 2010 to February 2011, and by somewhat more than 7 pp since February 2010.

EUR m		January-February		Percentage change 2011/2010 (b)
		2010	2011	
CREDITS	Current account	46,615	53,462	14.7
	<i>Goods</i>	26,644	33,510	25.8
	<i>Services</i>	12,591	12,914	2.6
	– Tourism	4,531	4,834	6.7
	– Other services	8,060	8,080	0.3
	<i>Income</i>	5,262	4,939	-6.1
	<i>Current transfers</i>	2,118	2,100	-0.9
	Capital account	1,776	1,622	-8.6
	Current + capital accounts	48,391	55,084	13.8
	DEBITS	Current account	58,112	65,438
<i>Goods</i>		33,762	40,920	21.2
<i>Services</i>		10,203	10,280	0.8
– Tourism		1,787	1,825	2.1
– Other services		8,416	8,455	0.5
<i>Income</i>		8,444	8,723	3.3
<i>Current transfers</i>		5,703	5,516	-3.3
Capital account		237	183	-22.8
Current + capital accounts		58,349	65,621	12.5
BALANCES		Current account	-11,497	-11,976
	<i>Goods</i>	-7,118	-7,410	-292
	<i>Services</i>	2,388	2,634	246
	– Tourism	2,744	3,009	265
	– Other services	-356	-375	-18
	<i>Income</i>	-3,182	-3,784	-602
	<i>Current transfers</i>	-3,585	-3,416	169
	Capital account	1,539	1,439	-99
	Current + capital accounts	-9,958	-10,537	-579

SOURCE: Banco de España.

a. Provisional data.

b. Absolute changes for balances.

#### 4.5 Balance of payments

In the first two months of 2011, the Spanish economy's net borrowing was slightly higher than that for the previous year (see Table 7). The overall current and capital account balance showed a deficit of almost €12 billion, 4% up on the same period in 2010. The increase is due to the widening of the merchandise and income deficits, which offset the narrowing of the deficits on current transfers and the widening of the surplus on services. The surplus on capital transactions decreased moderately.

The deficit on the trade balance rose by 4% to €7.4 billion in the January-February 2011 period, owing to the increase in the energy bill, which countered the improvement in the non-energy balance. The surplus on the services balance amounted to €2.6 billion, 10% higher than in the first two months of 2010, as a result of the increase in the tourism balance. Counter to this, the deficit on the income balance increased in the first two months to €3.8 billion, compared with €3.2 billion in the same period in 2010. The deficit on current transfers fell by 5% to €3.4 billion.

## 5 Financial developments

### 5.1 Overview

In 2011 Q1 Spain tended to distance itself from the group of countries most severely affected by the sovereign debt crisis, this separation being aided by diverse measures of the national authorities and by agreements of the EU heads of state or government to reform European economic governance. Financial market developments during this period were also influenced by the heightened uncertainty stemming from the geopolitical crises in northern Africa and the Middle East and, more recently, by Japan's earthquake and nuclear crisis and the consequent fall in market prices (which subsequently reversed) and the rise in volatility.

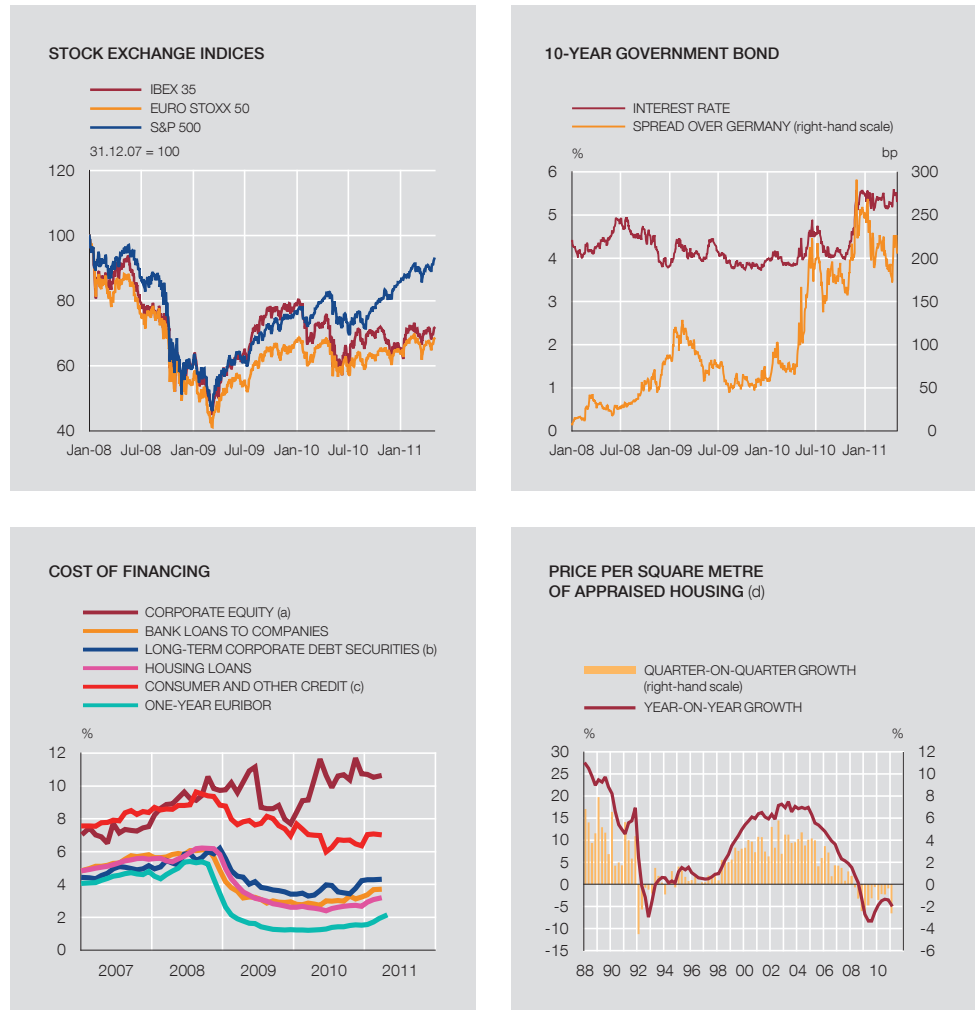
Thus, in the Spanish public debt market, despite the 10 March downgrade by one level of Moody's long-term credit rating from Aa1 to Aa2, the first three months of 2011 saw the 10-year yield fall by 20 bp and the spread with respect to the 10-year German bond narrow by around 60 bp (to around 190 bp). Also, the credit risk premia of Spanish firms traded in the derivatives markets followed a downward path, steeper for credit institutions than for non-financial corporations. As a result of this climate of recovery of investor confidence in the Spanish economy, the access of resident issuers to wholesale funding improved, a development reflected in an increase in activity in the primary fixed-income markets and in the EU-REPO markets with a central counterparty. However, April saw a fresh rise in sovereign debt interest rates in some euro area countries which this time also affected Spanish sovereign debt. At the end of April the 10-year yield stood at around 5.3% and the spread with respect to the 10-year German bond was around 205 bp. Meanwhile, the IBEX 35 gained 7.3% in Q1, compared with increases of 4.2% in the EUROSTOXX 50 and of 5.4% in the S&P 500 (see Chart 23). At the data cut-off date of this report, the Spanish index was nearly 3% higher than a month earlier.

Interest rates in the interbank market tended to rise as a result of expectations of official interest rate hikes, which were confirmed on 7 April with an increase of 25 bp. Thus, at the end of that month, one-year EURIBOR stood at 2.1% (more than 60 bp higher than in December).

In the real estate market, according to the latest data published by the Ministry of Infrastructure and Transport, unsubsidised housing prices continued to fall in the first three months of 2011, more quickly than in the previous quarter. This sharper fall was probably induced to some extent by the partial abolition in January 2011 of tax credits for purchase of principal residence. The year-on-year rate of decrease in March stood at 4.7%, compared with a fall of 3.5% in December (see Chart 23). The cumulative fall from the highs reached at the beginning of 2008 is 15% (20% in real terms).

The latest available information on the cost of bank financing to the private sector, which relates to March, shows that in the early months of 2011 banks tended to raise the margins applied, suggesting that they had already begun to transfer to their customers the rise experienced in the cost of their liabilities during the past year as a result of the financial tensions in the wholesale markets. To this was added the effect of the increase in interbank yields, which are normally used as a benchmark for loans (see Box 5).

Meanwhile, according to the April Bank Lending Survey (BLS), credit standards in the first three months of the year were slightly tighter for households, while they remained unchanged



SOURCES: Bloomberg, Reuters, Datastream, MSCI Blue Book, Ministerio de la Vivienda and Banco de España.

- a. The cost of equity is based on the three-stage Gordon dividend discount model.  
 b. 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.  
 c. In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to their customers were changed, which may cause breaks in the series. Particularly significant was the change in the interest rate on consumer credit and other lending, since, as a result, from that month it no longer includes credit card operations.  
 d. Base 2001 until December 2004 and base 2005 thereafter.

for firms.<sup>1</sup> Firms' demand for funds increased moderately, while loan applications by households decreased, particularly for house purchase.

The most recent data on private sector financing, relating to February, reveal a lower momentum of lending to households, the growth rate of which turned slightly negative, while the rate of expansion of corporate debt remains low, although some significant differences across instruments are appreciable (see Chart 4). Thus loans by resident institutions contracted somewhat more sharply, while other borrowing continued to show more expansionary behaviour. Provisional information for March points to a continuation of these trends.

1. For more details, see the article entitled «Encuesta sobre Préstamos Bancarios en España: abril de 2011», by Maristela Mulino, in the April *Boletín Económico*.



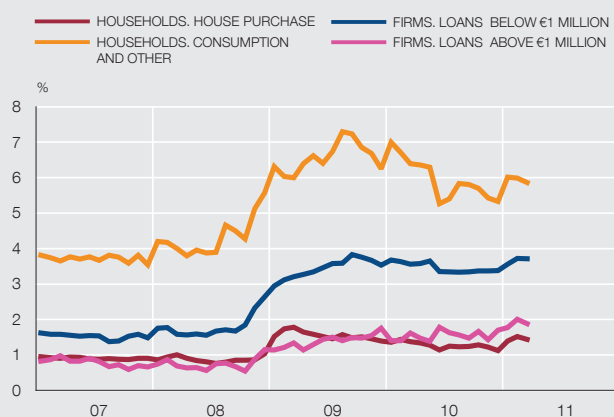
In Spain, interest rates on loans granted by credit institutions are mostly referenced to, or closely track, interbank market yields.<sup>1</sup> However, the difference between the cost of new business and the reference rates, i.e. the margin applied, is not constant, but rather fluctuates over time. The top left panel shows how, since mid-2008, these margins generally tended to rise, although how quickly they did so differed from one case to another. This increase in the margin reflected both temporary factors (such as the lag with which falls in reference interest rates are transmitted to the rates applied in bank

lending operations) and a revision of the required premia due to the economic crisis and to the general reassessment of risk at national and international level after a long period of very low premia. Thus, for example, in house purchase loans to households, following an initial rise at the beginning of 2009, the average margin applied to new business tended to decrease progressively in the ensuing months, and at end-2010 reached levels similar to those before the crisis. By contrast, in segments with a higher probability of default (such as consumer credit or SME financing, proxied here by corporate loans of less than €1 million) the increase was sharper and more lasting.

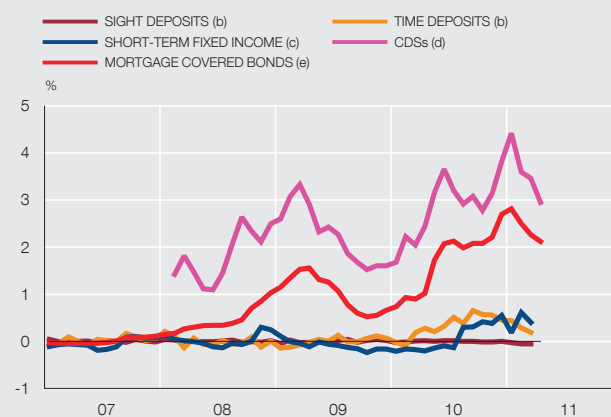
1. See, for example, the article entitled «La relación entre los tipos de interés del crédito bancario y los del mercado interbancario» by F. Sáez in the Banco de España's *Boletín Económico*, May 1996.

In 2010, mainly as a result of the tensions in the euro area sovereign debt markets, the cost of funding rose substantially for Spanish

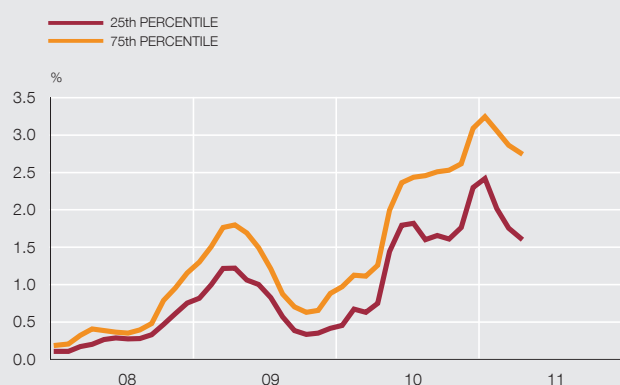
1 INTEREST RATE SPREADS ON BANK LOANS (a)



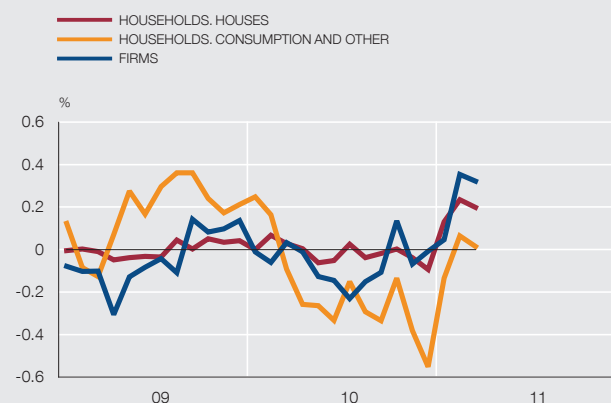
2 INTEREST RATE SPREADS ON BANK LIABILITIES



3 DISTRIBUTION OF MORTGAGE COVERED BOND SPREAD BY INDIVIDUAL ISSUE (e)



4 SURPRISES IN LOAN INTEREST RATE BEHAVIOUR (b)



SOURCE: AIAF, Datastream, JP Morgan and Banco de España.

a. Calculated with respect to 1-year EURIBOR in the case of house purchase loans and with respect to 3-month EURIBOR for others. In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to their customers were changed, which may cause breaks in the series. Particularly significant was the change in the interest rate on consumer credit and other lending, since, as a result, from that month it no longer includes credit card operations.  
 b. Difference between the observed figure and that predicted by a model estimated until December 2009. The explanatory variables included in this model are interbank market yields and the unemployment rate as an indicator of the stage of the business cycle.  
 c. Average AIAF interest rate less 1-year EURIBOR.  
 d. Obtained from the arithmetic mean of the individual data of seven institutions for which information is available.  
 e. 3 to 5-year asset swap spread.

credit institutions (see Chart 2). Practically all their sources of borrowing were affected. The premia required of Spanish institutions in the wholesale medium- and long-term debt markets rose on average to levels above 250 bp for mortgage transactions and to 400 bp for unsecured transactions (proxied by the price of CDSs). The increases were smaller in the short-term securities segment, but also significant. As a result, Spanish institutions stepped up their efforts to attract time deposits from customers and the interest rate on them increased above what would be expected on the basis of interbank yields. Only the interest rates on sight deposits kept moving in line with their historical pattern. Although the tensions –and the related premia– tended to moderate in the early months of 2011, they still remain high. Also, as shown by the bottom left-hand panel, there is a significant dispersion between institutions in the cost of funding on the markets. This increase in the cost of liabilities has introduced a new element of pressure on the income statements of Spanish credit institutions. According to some calculations, in which the various sources of funding were weighted in accordance with their relative weight, it is estimated that the average increase in the cost of borrowed funds used to finance bank lending was around 60 bp in 2010.

The bottom right-hand panel shows the difference between the observed loan interest rates and the values predicted by a model in which the explanatory variables include both interbank market yields and the business cycle, but not the higher cost of institutions' liabilities due to financial market tensions. As can be seen, until end-2010 institutions do not transfer their higher funding costs to the interest rate on their lending to households and firms, since the observed

behaviour was largely consistent with that of the determinants included in the equation, although in household loans for consumption and other purposes the differences were greater as a result of the more volatile behaviour of this segment and the consequent worse fit with the model.

However, the persistence of the tensions and the consequent impact on income statements seem to have led to a change in the opening months of 2011. The bottom right-hand panel shows that between December 2010 and March 2011 the interest rates on loans to non-financial corporations and to households for house purchase underwent an increase (not explained by the determinants other than the cost of funding) of some 30 bp. In the case of consumer credit and other lending, a notable increase is also observed, although its starting point is at a negative level.

This evidence suggests that in the first quarter of the year Spanish credit institutions began to pass their higher funding costs on to their lending business, doing so to a significant, but still incomplete, extent. Additional increases in the coming months cannot therefore be ruled out, although future developments will depend on financial market tensions, on competition for deposits and on the ability of lenders to pass their higher costs on to their lending operations. The divergences within the sector in the degree of access to markets mean that the need to pass on these costs to lending operations differs. This may limit, first, the degree of transfer in a competitive environment and, second, put greater pressure on the income statement of some institutions.

The stability of household liabilities in 2010 Q4, along with the stagnation of income, kept the ratio of debt to gross disposable income (GDI) of this sector unchanged, so it remains high. However, the debt burden continued to decrease thanks to the smaller interest payments, which reflect with a certain delay the changes in the cost of new lending and in interbank yields. The gross savings ratio and the sector's saving after debt service continued to decrease. Household net wealth decreased slightly as a result of the moderate growth in the value of their holdings of financial instruments and of the decrease in that of their real estate assets. The available preliminary estimates point to a continuation of these trends in the early months of 2011.

In the case of firms, the debt ratio decreased slightly in 2010 Q4, so it remains high. By contrast, the debt burden ratio began to rise slightly, in line with the increase in the cost of funds in recent months. These trends seem to have persisted in the early months of 2011. The figures on the sample firms reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ) for 2010 Q4 reveal a certain recovery in corporate income in 2010 compared with 2009. However, the dynamism of the results gradually lost force as the year progressed.

The volume of doubtful loans continued to grow in the early months of 2011. As a result of this growth and of the stability of the debt, the doubtful assets ratio kept rising. Specifically, for other resident sectors (which include, in addition to households and firms, intermediaries other than credit institutions) as a whole, this indicator stood at 6.2% in February, 0.4 pp above the figure for December 2010.

% GDP	2005	2006	2007	2008	2009		2010			
					Q4	Q1	Q2	Q3	Q4	
National economy	-6.5	-8.4	-9.6	-9.2	-5.1	-4.4	-4.5	-4.4	-3.9	
Non-financial corporations and households and NPISHs	-8.4	-11.1	-13.4	-6.8	4.6	5.3	4.3	3.6	4.4	
<i>Non-financial corporations</i>	-7.1	-9.5	-11.5	-7.1	-1.3	0.5	0.8	0.8	1.3	
<i>Households and NPISHs</i>	-1.3	-1.7	-1.9	0.2	5.9	4.8	3.5	2.8	3.1	
Financial institutions	0.9	0.7	1.9	1.8	1.4	1.2	1.2	1.1	1.0	
General government	1.0	2.0	1.9	-4.2	-11.1	-11.0	-10.0	-9.1	-9.2	
MEMORANDUM ITEM:										
Financing gap of non-financial corporations (a)	-11.4	-17.8	-15.9	-11.9	-1.3	0.7	0.9	-0.8	-0.8	

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.

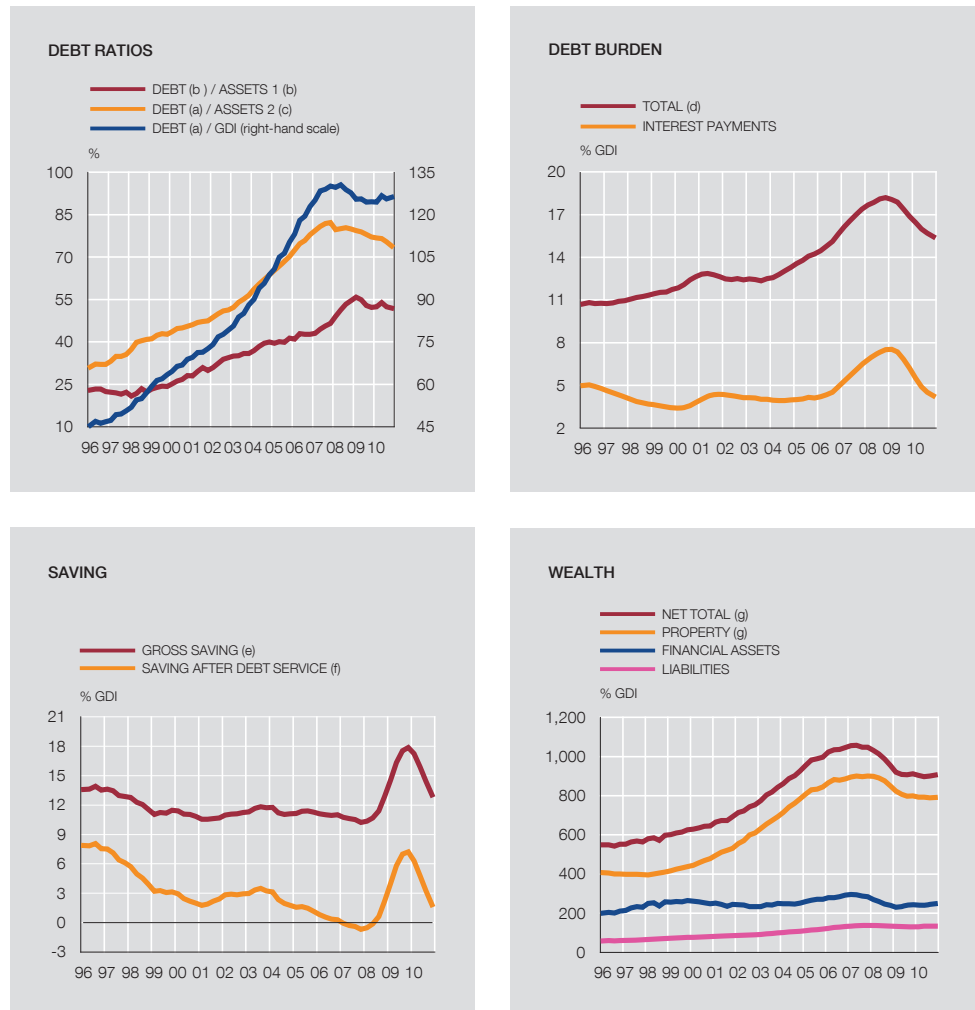
In the case of general government, the year-on-year growth of its debt rose in the early months of 2011, with net issues being concentrated in long-term instruments. The rapid expansion of general government liabilities, along with the weakness of GDP growth, lead to fresh increases in the debt ratio.

The latest Financial Accounts information, relating to end-2010, reflects a further decrease in the nation's net borrowing, which represented 3.9% of GDP in cumulated 12-month terms (0.5 pp below the September level; see Table 8). This development resulted from an increase in net lending by households and non-financial corporations, which was partly offset by an increase in the general government deficit and by a slight decrease in saving by financial institutions. Analysis by instrument shows that external financing was partly covered by capital inflows (particularly those in the form of securities issued by general government, which offset the net contraction in non-residents' holdings of securities issued by other Spanish issuers) and also through the reduction of the foreign assets of resident sectors (particularly institutional investors). The available balance of payments information points to a continuation of these trends in January and February.

In short, in 2011 Q1 Spain distanced itself from the group of countries most strongly affected by the sovereign debt crisis in the euro area, which allowed a certain relaxation of the financing conditions of resident sectors in the wholesale markets. However, the risk premia remained high from a historical perspective and were subject to fresh fluctuations linked to changes in market perceptions of the various events influencing the course of the sovereign debt crisis in the countries concerned. Also, the interest rate rises in the money markets and the widening spreads applied by credit institutions to households and firms are giving rise to increased private sector borrowing costs. These developments, along with the necessary deleveraging of these agents, are limiting the growth of bank lending, which tended to contract slightly in the early months of this year.

## 5.2 Households

Between December 2010 and March 2011 interest rates on new loans to households increased by 49 bp and 70 bp for house purchase loans and for consumer credit and other lending, respectively (see Chart 23). Also, according to the April BLS, credit standards in the first three months of the year tightened slightly, while the demand for funds by households decreased, particularly that for house purchase loans.



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

- a. Includes bank credit and off-balance-sheet securitised loans.  
 b. Assets 1 = total financial assets - "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.

Against this background, the growth rate of household debt in February was slightly negative in year-on-year terms (-0.5%), compared with 0.2% in December. This development basically resulted from the loss of vigour of house purchase loans (-0.4%), which were affected by households bringing forward their house purchase decisions to 2010 following the abolition, from the beginning of 2011, of the tax rebate for middle and high income earners. Consumer credit and other lending also contracted (by 0.8% in year-on-year terms). The seasonally-adjusted quarter-on-quarter rates, in turn, became negative in both cases.

As a result of the relative stability shown by this sector's liabilities and of the stagnation of its income, in 2010 Q4 the ratio of debt to GDI scarcely changed, standing at 126% (see Chart 24). However, owing to the lower interest payments, which reflect with a lag the behaviour of new business and of interbank yields, the debt burden continued to decrease, reaching nearly 15% of GDI. The gross savings ratio and the sector's saving after debt service also contin-

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

TABLE 9

% GDP	2007	2008	2009	2010		
				Q2	Q3	Q4
<b>HOUSEHOLDS AND NPISHs</b>						
Financial transactions (assets)	7.2	2.4	4.5	4.4	4.1	4.4
Cash and cash equivalents	-1.1	-0.4	4.2	1.8	0.6	-0.1
Other deposits and fixed-income securities (a)	7.5	6.8	-1.1	0.6	2.0	3.5
Shares and other equity (b)	0.6	-0.3	1.2	1.4	1.0	0.6
Mutual funds	-1.1	-3.4	0.0	-0.4	-1.2	-1.7
Insurance technical reserves	0.9	0.2	0.9	0.6	0.6	0.9
<i>Of which:</i>						
Life assurance	0.2	-0.2	0.6	0.3	0.2	0.3
Retirement	0.4	0.3	0.3	0.3	0.4	0.5
Other	0.3	-0.5	-0.6	0.4	1.0	1.4
Financial transactions (liabilities)	9.1	2.2	-1.4	0.9	1.3	1.4
Credit from resident financial institutions (c)	9.4	3.4	-0.5	0.6	0.0	0.0
House purchase credit (c)	7.1	2.7	0.1	0.7	0.5	0.5
Consumer and other credit (c)	2.1	0.8	-0.4	0.1	-0.4	-0.3
Other	-0.3	-1.2	-0.9	0.3	1.3	1.3
<b>NON-FINANCIAL CORPORATIONS</b>						
Financial transactions (assets)	13.4	1.8	-8.1	-1.9	5.0	7.1
Cash and cash equivalents	-0.4	-1.1	-0.3	1.0	0.2	-0.1
Other deposits and fixed-income securities (a)	2.0	2.3	-0.6	-0.7	0.0	1.5
Shares and other equity	8.1	3.0	-0.5	0.2	2.0	2.6
<i>Of which:</i>						
Vis-à-vis the rest of the world	6.6	3.1	0.1	0.6	1.9	2.3
Trade and inter-company credit	2.1	-3.0	-6.9	-1.9	2.3	3.0
Other	1.5	0.7	0.1	-0.5	0.6	0.0
Financial transactions (liabilities)	24.9	8.9	-6.8	-2.7	4.2	5.7
Credit from resident financial institutions (c)	13.8	5.5	-3.0	-2.6	-1.3	-0.9
Foreign loans	2.8	3.0	-0.1	-1.6	-0.6	0.8
Fixed-income securities (d)	0.5	0.3	1.3	1.7	1.3	0.7
Shares and other equity	5.3	2.3	1.6	1.5	1.6	1.7
Trade and inter-company credit	3.3	-3.3	-7.0	-1.9	2.4	3.3
Other	-0.9	1.1	0.2	0.1	0.8	0.2
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (e)	15.5	6.4	-1.0	-0.5	0.1	0.7
Households and NPISHs	12.5	4.4	-0.3	0.9	0.1	0.2
Non-financial corporations	17.7	7.9	-1.5	-1.5	0.1	1.0

SOURCE: Banco de España.

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

ued to fall. Household net wealth decreased slightly as a result of the moderate growth in financial instrument value and of the decline in the component linked to real estate assets.

On Financial Accounts data, relating to 2010 Q4, the sector's net lending increased by 0.3 pp to 3.1 % of GDP. Against this background, investment in financial assets recovered slightly with respect to the previous three months to 4.4 % of GDP in cumulated annual terms, and the trends by instrument of prior periods remained in place (see Table 9). More specifically, time deposits continued to grow apace, as did, to a lesser extent, insurance technical reserves, while saving invested

in shares continued to decrease, as did, less sharply, that held in the form of investment fund shares/units and payment instruments (cash, sight deposits and savings deposits), items in which the negative investment reflected a shift towards time deposits due to the higher yields offered.

The latest data on the household doubtful asset ratio, relating to 2010 Q4, show a further decrease (3.2% in December, against 3.4% in September) as a result of the fall in both house purchase loans (2.44%, against 2.62%) and consumer credit and other lending (6.56%, against 6.89%).

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

In the early months of 2011, firms' financing costs tended to increase in most instruments. Thus, between December 2010 and March 2011 the interest rate on new loans of less than €1 million rose by 50 bp and that on new loans of higher amount increased by 33 bp (see Chart 23). The cost of issuing securities also increased in short-term fixed-income instruments (by 24 bp) and in long-term ones (by 8 bp), while it decreased in equity instruments (by 15 bp). Nevertheless, according to the April BLR, the credit standards applied by banks to firms remained steady, while the demand for funds increased slightly.

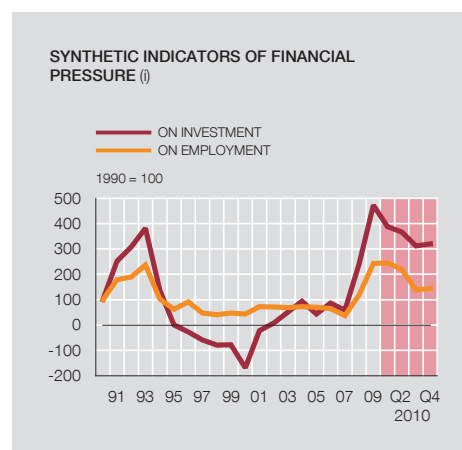
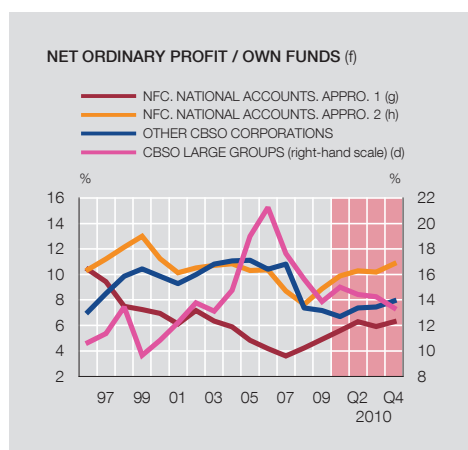
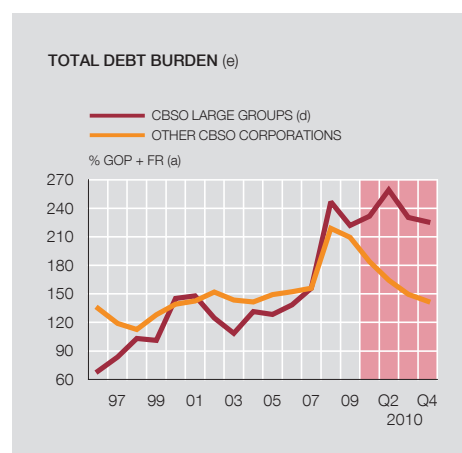
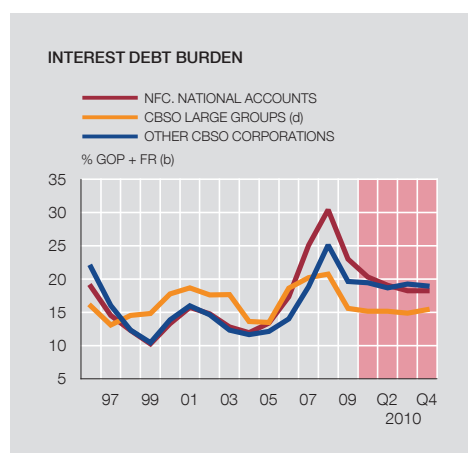
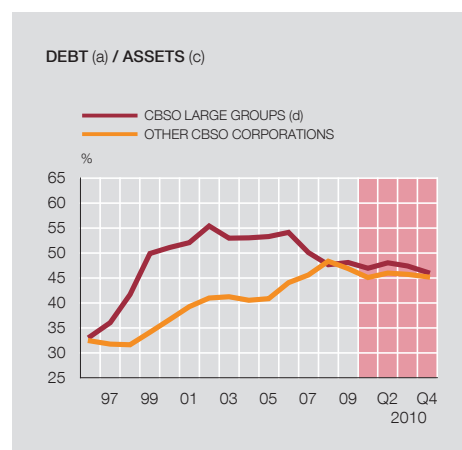
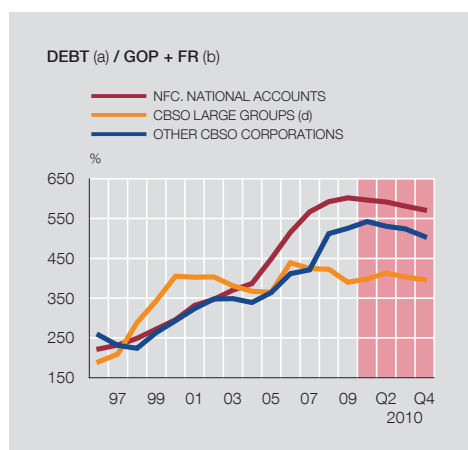
The growth rate of corporate borrowing remained low (1.1% in February), although significant differences across instruments were discernible. Thus loans from resident institutions contracted somewhat more sharply both in year-on-year terms (1.4%, against a fall of 1% in December) and, to a greater extent, in quarter-on-quarter terms (2.4%, annualised and seasonally adjusted, against 1.5% two months earlier). By contrast, other financing (used by larger firms) continued to show more expansionary behaviour.

The latest information on lending by loan type, relating to 2010 Q4, shows that the year-on-year fall in these liabilities had steepened in construction and real estate services (12% and 2%, respectively), while it moderated in agriculture and showed positive growth in industry and, to a greater extent, in non-real estate services (4.6%, against 3.5% in September).

On the latest Financial Accounts data, relating to a December 2010, the balance of net financial operations of the corporate sector (in cumulated four-quarter terms) again showed a credit sign, and reached an amount equivalent to 1.3% of GDP (0.5 pp more than in September). However, the financing gap, which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, continued to be negative (-0.8%), as a result of the increase in Spanish firms' investment in equities abroad.

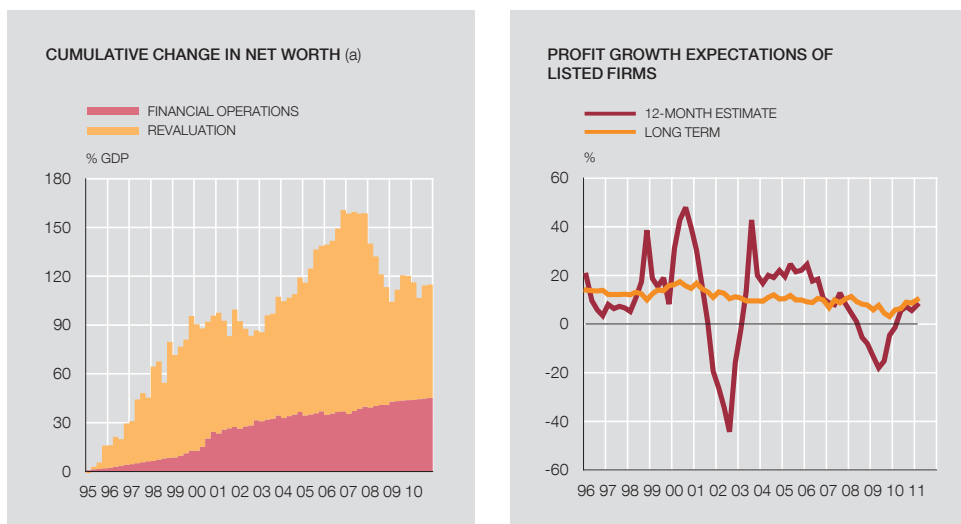
The debt ratio decreased slightly in 2010 Q4 to stand at 570% of the sum of gross operating profit and financial revenue (see Chart 25). It thus remains high both from a historical perspective and in comparison with other economies. By contrast, the debt burden ratio began to rise slightly, as a reflection of the increasing cost of funds in recent months. The latest data on the sample firms reporting to the CBQ, relating to the same period, reveal a certain recovery in corporate income. In particular, the ordinary net profit of these firms grew by 6.5% in 2010, which contrasts with the decrease of 7.6% in 2009, although the improving trend tended to lose momentum as the year advanced. This development, together with the steady debt levels, allowed the debt ratio and the debt burden ratio to decrease slightly for these firms. However, the indicators of financial pressure on investment and employment remained the same as three months earlier. Meanwhile, analysts have revised upward their expectations as to listed firms' profits in the short term and, to a lesser extent, in the longer term (see Chart 26).

The doubtful assets ratio of non-financial corporations continued to increase in the closing months of 2010, reaching 8.1% in December, 0.8 pp more than in 2010 Q3. This increase is explained by the behaviour of lending to construction and real estate services firms, the ratio



SOURCES: INE and Banco de España..

- a. Interest-bearing borrowed funds.
- b. Gross operating profit plus financial revenue.
- c. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
- d. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
- e. Includes interest plus interest-bearing short-term debt.
- f. NOP, using National Accounts data, is defined as GOS + 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.



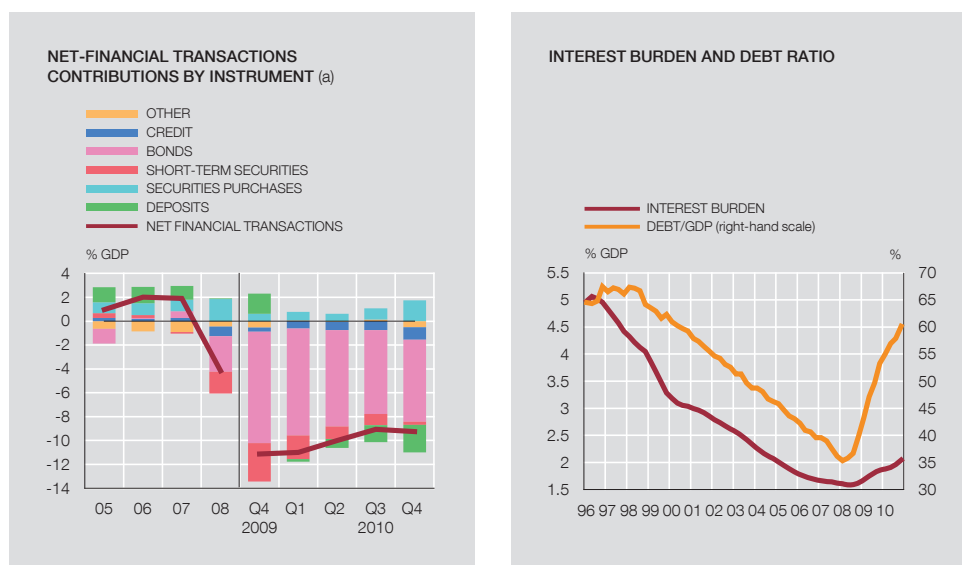
SOURCES: I/B/E/S and Banco de España.

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.

of which rose from 11.4% to 13.5%, since in other sectors it declined for the first time since December 2007, showing a fall of 0.1 pp to stand at 3.9%.

## 5.4 General government

The Financial Accounts show that in 2010 Q4 general government borrowing increased slightly in cumulated annual terms and thus continues to be high (9.2% of GDP; see Table 8).

Once again, the main method of financing this deficit was the issuance of fixed-income securities, a channel through which funds equivalent to 7.1% of GDP in cumulated four-quarter terms were obtained (see Chart 27), 0.8 pp less than three months earlier. Most of the place-



% GDP	2007	2008	2009	2010		
				Q2	Q3	Q4
NET FINANCIAL TRANSACTIONS	-9.6	-9.2	-5.1	-4.5	-4.4	-3.9
FINANCIAL TRANSACTIONS (ASSETS)	14.1	0.7	-0.2	-1.7	-2.8	-3.3
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	1.4	-1.3	-3.2	-1.4	-2.3	-1.4
<i>Of which:</i>						
<i>Interbank, credit institutions (a)</i>	4.2	-0.5	-1.7	-1.1	-1.8	-1.3
Securities other than shares	1.6	1.3	0.0	-3.9	-5.8	-7.0
<i>Of which:</i>						
<i>Credit institutions</i>	1.8	1.6	1.2	-2.0	-2.7	-3.0
<i>Institutional investors</i>	0.0	-1.3	-0.5	-1.4	-2.4	-3.3
Shares and other equity	8.8	1.9	1.5	1.7	2.7	2.3
<i>Of which:</i>						
<i>Non-financial corporations</i>	6.6	3.1	0.1	0.6	1.9	2.3
<i>Institutional investors</i>	-1.1	-1.6	0.3	1.0	1.0	0.8
Loans	1.2	0.8	0.2	-0.5	0.0	0.4
FINANCIAL TRANSACTIONS (LIABILITIES)	23.7	9.9	4.9	2.8	1.6	0.6
Deposits	6.7	8.0	-0.5	1.6	-0.2	-0.5
<i>Of which:</i>						
<i>Interbank, credit institutions (a)</i>	6.7	6.2	0.7	-4.7	-2.9	-7.3
<i>Repos, credit institutions (b)</i>	0.1	0.2	0.1	0.1	1.8	5.7
<i>Interbank, BE (intra-system position)</i>	-0.3	1.9	-0.8	6.0	0.5	0.2
Securities other than shares	8.1	-2.7	3.8	0.6	0.6	-1.5
<i>Of which:</i>						
<i>General government</i>	-1.3	1.1	5.4	4.2	3.4	2.0
<i>Credit institutions</i>	3.6	-1.9	1.1	-0.4	-0.6	-1.1
<i>Other non-monetary financial institutions</i>	5.8	-1.9	-2.6	-3.2	-2.2	-2.4
Shares and other equity	4.6	3.2	1.1	1.3	0.8	0.8
<i>Of which:</i>						
<i>Non-financial corporations</i>	4.7	2.4	0.3	0.9	1.0	1.1
Loans	3.1	2.9	0.3	-1.1	-0.2	1.2
Other, net (c)	0.2	0.4	-1.1	-2.0	-2.1	-1.9
MEMORANDUM ITEMS						
Spanish direct investment abroad	9.5	4.7	0.7	-0.5	1.2	1.6
Foreign direct investment in Spain	4.5	4.8	0.6	0.0	0.5	1.5

SOURCE: Banco de España.

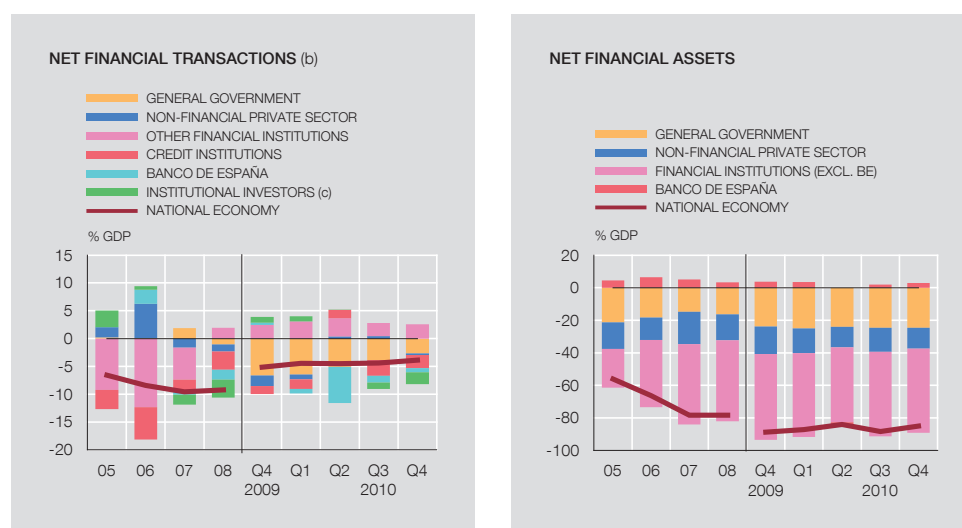
a. Excluding repos.

b. Including transactions with central counterparty clearing houses.

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

ments were of long-term securities (6.9%), as against a smaller volume of short-term securities (0.2%). As in the previous period, loans also contributed another 1% of GDP, while, on the assets side, net securities purchases grew (1.7% of GDP, 0.8 pp more than in September) and deposits decreased (2.3% of GDP, 0.9 pp more than in Q3).

The rapid expansion of general government liabilities, along with the weak GDP growth, resulted in the debt ratio increasing further to 60.1% of GDP in December, more than 2 pp above the September figure. Meanwhile, the debt burden associated with these liabilities remained relatively low (2% of GDP), since the rise in market-traded interest rates scarcely



SOURCE: Banco de España.

a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.

b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.

c. Insurance companies and collective investment institutions.

affected the average cost of financing, given the lag with which changes in financing conditions are incorporated into this indicator.

### 5.5 The rest of the world

In 2010 Q4 the nation's net borrowing decreased further to stand at 3.9% of GDP in cumulated 12-month terms, 0.5 pp below the level in September and 1.3 pp less than at end-2009 (see Table 8). In line with the lesser net borrowing and with the greater difficulty in raising funds due to the market tensions, the funds received from abroad decreased in the last three months of 2010, being limited to the equivalent of 0.3% of GDP (0.6% in cumulated 12-month terms, against 1.6% in September; see Table 10). By instrument, the bulk of capital inflows were securities issued by general government (0.7% of GDP and 2% in annual terms), which offset the net contraction in non-residents' holdings of securities issued by other Spanish issuers. Also, there was an increase in the funds raised by credit institutions on the interbank market, with a shift towards collateralised funding through central counterparty clearing houses. However, the loans granted by this sector to the rest of the world increased to a larger extent, so the debit net interbank position of these financial institutions decreased. Foreign direct investment in Spain rose by 1 pp to 1.5% of GDP in annual terms.

Other borrowing requirements were covered by reducing the portfolio of foreign assets held by resident sectors by an amount equivalent to 0.4% of GDP (3.3% in annual terms). The contraction of asset holdings, which was concentrated in securities other than shares, was carried out particularly by institutional investors and, to a lesser extent, by credit institutions, against a background of greater preference for instruments issued by Spanish agents. Net acquisitions of shares were practically zero, despite which Spanish foreign direct investment was slightly positive, amounting to 1.6% in annual terms.

Despite the negative net sign of the nation's financial operations, the price trend (upward in assets and downward in liabilities) meant that the stock of net liabilities to the rest of the world

decreased by somewhat more than 3 pp compared with September to 85 % of GDP in September 2010 (see Chart 28). The breakdown by sector shows a decrease (by 2 pp of GDP) in the debit balance vis-à-vis private-sector non-residents and, to a lesser extent, in that of financial institutions (excluding the Banco de España), no change in the net liabilities of general government and an increase in the Banco de España's credit position vis-à-vis the rest of the world.

29.4.2011.