1 Overview

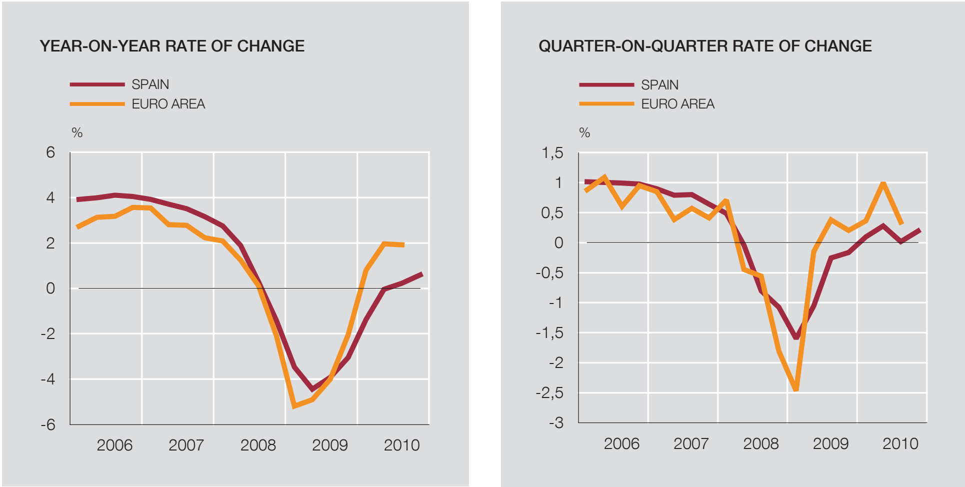
During 2010 the Spanish economy moved onto a mildly recovering path subject to some fluctuations as a result of the effect that certain temporary measures had on the course of domestic spending. Estimates based on the conjunctural information available suggest that the recovery continued in Q4, posting a quarter-on-quarter increase in GDP of 0.2%, entailing a rise of 0.6% in the year-on-year rate (see Chart 1). On the expenditure side, national demand fell off slightly (0.7% year-on-year) while the contribution of net external demand to GDP increased by 0.3 pp to 1.3 pp.

Despite this gradually improving pattern, GDP fell by 0.1% over the whole of 2010 owing to the effect of the significant fall-off in output in 2009 (-3.7%). The sluggishness of economic activity throughout the year is in contrast to the higher rates recorded in other euro area countries, which highlights the sharper effect of the crisis in Spain and the impact that the adjustment is exerting on growth rates in the short run. The decline in output in 2010 was the result of the fall in national demand (-1.2%), although this was far lower than the rate observed in 2009 (-6%) owing to the more favourable behaviour both of household consumption and of business investment, which posted positive growth rates for the year on average. Conversely, the public components of domestic demand fell back as a result of the budgetary consolidation measures, while the rate of decline of residential investment eased. Net external demand softened the impact of the contraction in domestic spending on activity, for the third year running, with an export-led, positive contribution of 1 pp, down on that of the previous year (2.7 pp).

On the supply side, services were more sustained. Adding to this was the slight rise in manufactures in the closing months, while the contraction in the value added of construction intensified owing to the more unfavourable behaviour of the non-residential construction segment. Overall, the subdued increase in output did not suffice to generate net employment, which continued to contract for the tenth consecutive quarter with a fall of 2.3%, weighed down by the unfavourable performance of non-residential construction but also by the difficulties in generating jobs in other activities. The labour supply rose somewhat during 2010, which also contributed to the increase in the unemployment rate, up to 20.3% in Q4 according to EPA figures. In this sluggish labour market setting, the increase in labour costs adjusted downwards in 2010, following a pattern of moderation which intensified in the second half of the year in the wake of the cut in public-sector wages. Lastly, inflation quickened during the year, up to a rate of change of 3% in December and placing the average increase in the CPI at 1.8% (compared with a decline of 0.3% in 2009) (see Chart 3). This was due to dearer oil prices in the final stretch of the year and to the effect of the tax rises under the set of fiscal consolidation measures adopted. In these circumstances, the increase in core inflation was somewhat less, standing at 1.6% year-on-year in December, while the inflation differential with the euro area widened to 0.7 pp that same month. According to the leading indicator for the CPI, the increase in consumer prices is expected to stand at 3.3% in January.

On the international economic front, tensions on European public debt markets worsened in the closing months of 2010 and the opening weeks of 2011. The epicentre of this episode was in Ireland, in light of the growing concerns over the consequences for Irish public finances of the prevailing extreme weakness of its financial system. But the effects spread rapidly to other euro area countries and interfered in the behaviour of the area's financial markets, widening sovereign spreads, raising volatility on equity markets and prompting a fresh depreciation of the euro, which has been partially reversed in recent weeks. At the end of November, the

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

granting by the European authorities, in conjunction with the IMF, of the financial assistance requested by the Irish government (see Box 2) failed to dispel the uncertainty. As a result tensions have continued, though there has been some relief in recent weeks. The repercussion of these tensions on financial markets in the rest of the world was nevertheless limited, in contrast to the episode witnessed last spring.

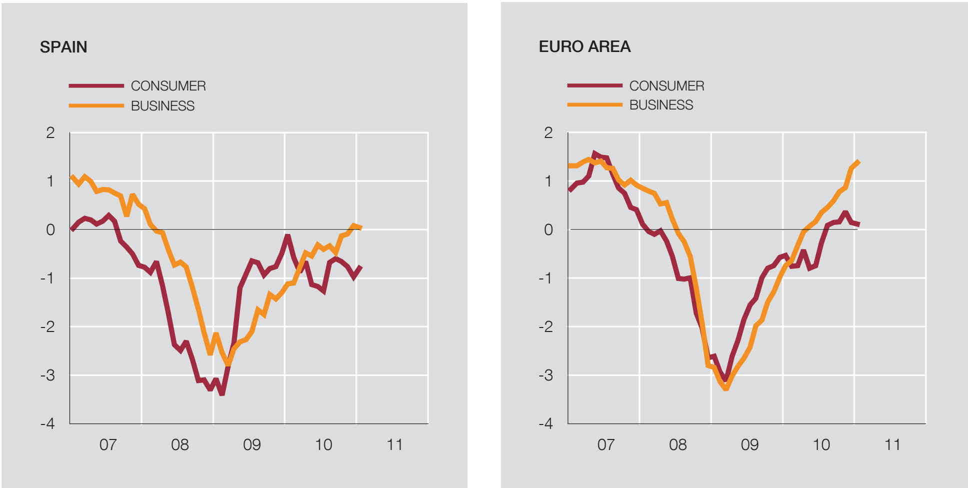
The rising course of commodity prices steepened in late 2010 and the opening weeks of 2011. Oil prices at the end of January reached a two-year high ($100 per barrel), as was the case with metal and food prices. In these circumstances, there has over recent quarters been a relatively widespread increase in inflation globally and a worsening outlook for the future course of prices in those countries most ahead in the cycle.

Global economic activity continued to recover, led by the strength of the emerging countries. Although the economic situation in the developed countries improved, doubts remain about the medium-term robustness of the recovery in numerous economies. In the euro area the pick-up proceeded at a moderate and uneven pace, in terms both of components (since it remained export-based) and of countries (where the momentum of the German economy contrasted with the slackness of the countries most affected by the sovereign debt crisis). Inflation rose significantly in the closing months of 2010, climbing to a year-on-year rate of 2.2% in December, the result of the increase in food and energy prices, meaning the core inflation rate held stable at a rate of close to 1%. Foreseeably, the temporary factors contained in the rise in inflation in recent months will not translate into underlying inflationary pressures given the substantial slack still existing in the economy and the moderation of wage increases.

The absence of inflationary pressures over the horizon relevant for economic policy led the ECB to maintain an accommodative monetary policy stance: official interest rates held at low levels and the non-conventional credit-support measures remained in place. The rise in debt market tensions meant that purchases of public debt on secondary markets were stepped up, through the Securities Market Programme.

As regards improving governance, the European Summit on 16-17 December agreed on the general principles of the future European Stability Mechanism, the permanent crisis-manage-

CONFIDENCE INDICATORS (a) CHART 2



SOURCE: European Commission.

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

ment instrument that will come into force from 2013. It will function in a similar fashion to the current European Financial Stability Facility, which it will replace, and its ultimate goal will be to safeguard financial stability in the euro area, granting assistance to member countries facing difficulties raising financing on the market. Such assistance will be subject to strict conditionality, as stipulated in the reformed article 136 of the Treaty approved at this same Summit (see the article on the reform of governance included in the January edition of the *Boletín Económico*).

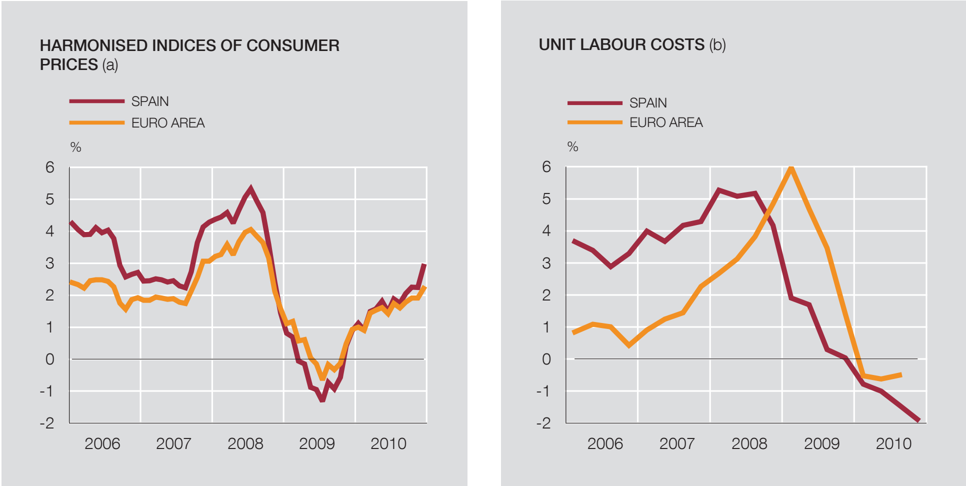
In Spain, financial instability was manifest in sharp falls in equity prices in 2010 Q4 (taking losses on the IBEX 35 over the whole of 2010 to 17.4%), increases in the risk premia on public debt, which raised the spread over German public debt to 250 bp at certain times, and increases in the risk premia on bonds issued by the private sector, especially by financial firms. On the real estate market the rate of decline of house prices slackened, with the related year-on-year rate falling by 3.5% in 2010 Q4 (-6.3% a year earlier). This places the cumulative correction from the peak reached in March 2008 at 13% in nominal terms.

In recent weeks some of these tensions have abated in part, with the IBEX 35 rising and the public debt spread narrowing to a level somewhat below 200 bp. But uncertainty and volatility continue to be considerable, and risk premia remain at very high values. The prolongation of this situation might ultimately affect the cost of credit to the private sector, and its access to it.

In these circumstances, and once the contractionary effects bearing on consumption in the previous quarter (the end of the car purchase incentive scheme and the rise in indirect tax) were overcome, household spending plans resumed the mildly recovering path on which they had embarked in the first half of the year. Consumption is estimated to have increased at a rate of 1.2% in 2010, a figure that contrasts favourably with its marked decline in 2009 (-4.2%). This pick-up came about against the background of diminished household disposable income, as a result of the increasingly smaller contribution of the income components that had upheld it during the most acute phase of the recession (that arising from general government measures and the decline in the interest burden), and of lost purchasing power owing to the rise in inflation. Wealth also diminished, albeit less sharply than in 2009, in both its financial and

PRICES AND COSTS

CHART 3



SOURCES: Eurostat, ECB and INE.

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

real estate components. Against this backdrop, the household saving ratio fell sharply during the year to stand at 14.4% of disposable income in Q3, 3.6 pp below the peak (18%) reached at the close of 2009.

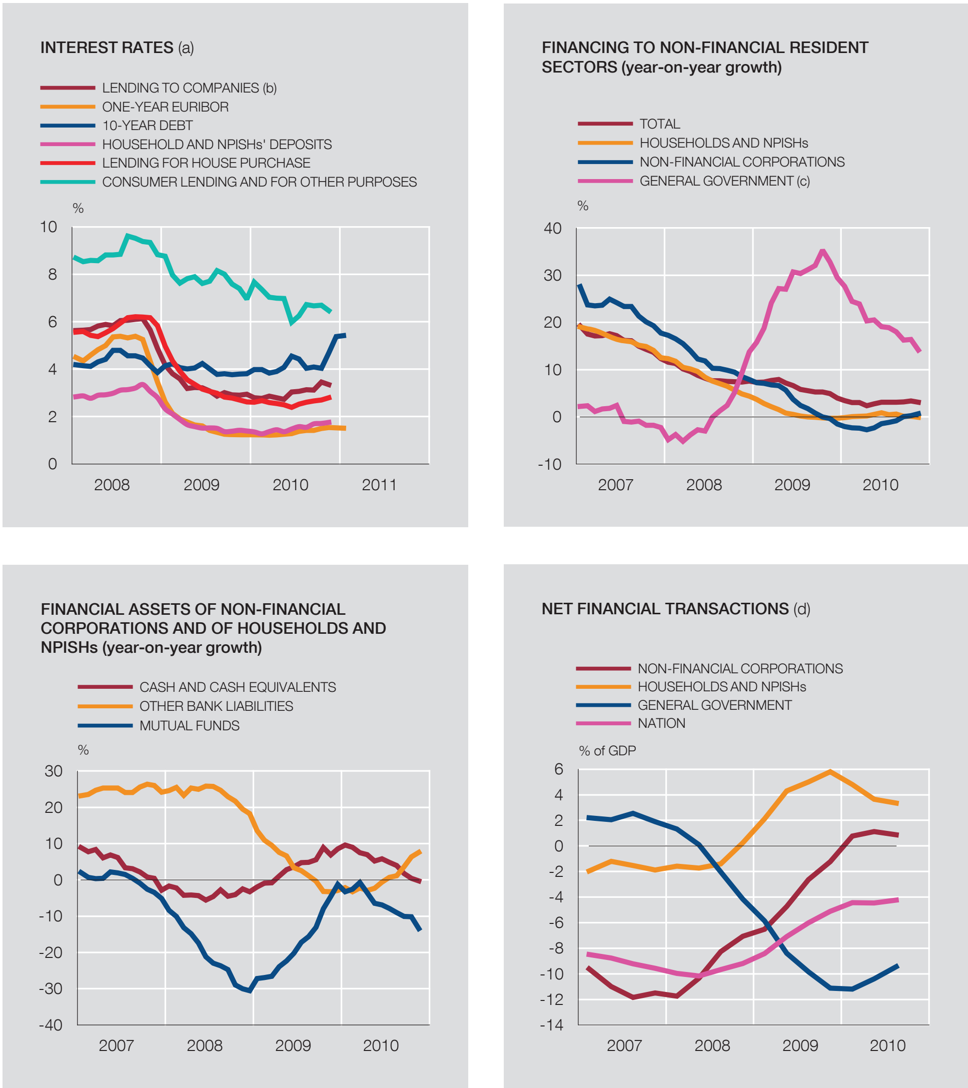
In the closing months of 2010, residential investment underwent a further decline although, as has been habitual over the past year, this was on a lesser scale than in the preceding quarters. Residential investment in 2010 is estimated to have declined at a rate of close to 18%, which would place the cumulative fall in residential investment from its peak, which was reached in 2007, at 45%, and its weight in GDP at 4%, below the low recorded in the previous real estate cycle. This information is compatible with some stabilisation in the stock of unsold housing over the course of 2010, following a long period of stockbuilding, which paints a somewhat more encouraging picture for the recovery in residential investment.

In this environment of sluggish spending and tense financial conditions, household debt tended to slow in the closing months of the year. Its year-on-year rate of change stood at a slightly negative level in November (-0.1%, against 0.3% in September) (see Chart 4). This development, along with the expected course of income in the final months of 2010, suggests the debt ratio will have stabilised in Q4 at levels similar to those of the past two years. Drawing on data from the non-financial accounts for Q3, the household sector is expected to have had a net lending capacity equivalent to 4.8% of GDP in four-quarter cumulated terms, confirming the mildly declining trajectory it has shown since 2009 Q4.

Business investment projects also picked up in the closing months of the year, centred especially on the capital goods component. Driving this was the strength of external demand and the improvement in the financial position of companies during the year. Investment in equipment is estimated to have posted a year-on-year rate of change of 2.4% in Q4, which would place its average growth in 2010 at around 2% (compared with a decline of almost 25% in 2009). Conversely, investment in other construction shrank owing to the intensification of the fiscal consolidation process in the public works arena, naturally affecting those projects involving partnership with private enterprise.

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



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. APR for loans (includes commissions and other expenses) and NDER for deposits.
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.

Overall, the non-financial corporations sector quickened its recourse to debt – albeit very moderately – in the final stretch of the year, posting a year-on-year rate of change of 0.7% in November. On information to Q3, the branches not linked to the real estate market showed greater dynamism, which was extensive to smaller companies, whose access to external borrowing had become considerably tougher at the height of the crisis. Both the debt ratio and, to a greater extent, the debt burden ratio had fallen during Q4. This relative improvement in the financial position of companies is also apparent in their financing requirements, which changed sign in the closing months of the year, to the extent they showed net lending equivalent to 0.2% of GDP on four-quarter cumulated figures, an unprecedented development in the attendant time series.

General government conduct in the final months of 2010 was once again marked by the effect of the consolidation measures under way, meaning that the contribution of both government consumption and public investment to activity declined. Information on the budget outturn as at the date of this article going to press suggests that the general government deficit target envisaged for 2010 (9.3% of GDP) is achievable, especially in light of the headroom provided by the favourable State outturn, which ended the year showing a deficit of 5.1% of GDP, 0.8 pp better than budgeted. Turning to the regional governments, uniform data relating to their budget outturn to September 2010 were published for the first time in December. These figures showed that the deficit at the end of Q3 stood at 1.2% of GDP (compared with a forecast of 2.4% for the year as a whole). Previously, the Fiscal and Financial Policy Council had reached an agreement to enhance both the transparency of the economic and financial information presented by the regional governments and the criteria under which authorisation for debt transactions is processed.

As regards trade with the rest of the world, the as yet incomplete information available indicates that net external demand in the closing months of 2010 once again cushioned the impact of the contraction in domestic spending on activity, with a positive contribution of 1.3 pp, and one more expansionary than in the two previous quarters, against the background of a marked recovery in goods exports. The external sector once again played a key role in softening the decline in domestic activity but, unlike the pattern of the past two years, in which this improvement came about essentially due to the collapse in imports, in 2010 this effect was dominated by the thrust of exports, which were able to benefit from the recovery in global trade with an adjustment in export prices and the design of more ambitious strategies regarding the diversification of our markets. Perseverance in furthering this strategy is required in order to make the sector a source of stronger and more stable growth.

In this setting, the nation's net borrowing is expected to have continued falling in the closing months of the year, after having stood at 4.2% of GDP in Q3 (5.1% in 2009). However, the process is slowing to some degree owing to the adverse impact of the energy bill on the merchandise trade balance. From the standpoint of the contribution of the institutional sectors, this fresh reduction in net borrowing would be a reflection of the trimmed general government deficit and the improved position of non-financial corporations.

On the supply side, there were increases during Q4 in the value added of industry and market services, while declines were posted in agriculture and, above all, in construction. Over the year as a whole, the recovery turned on manufacturing activities (1.4%) and market services (0.6%), set against an intensifying decline in the value added of construction (-6.9%) which entails, compared with the past two years, a fall in the non-residential construction component. The pace of job destruction rose to 2.3%, as a result of the reduction in employment in the market economy, of approximately 3% (-8.4% the previous year), and of a subdued rise in non-market services (0.8%). Given the estimated trend of output and of employment, apparent labour productivity growth remained relatively sharp (2.2%), albeit down on 2009.

Labour costs continued on the path of moderation on which they embarked at the start of 2010, driven in the second half of the year by the cut in public-sector wages. For 2010 as a whole, an increase in employee compensation of close to 1% is estimated, a figure that compares very favourably with the 4% rise in labour costs in 2009. A significant portion of this slowdown is due to the turnaround in public-sector wages, which are expected to have fallen by around 2% compared with the average increase of 6% in the three previous years. The rest is due to the slowdown in compensation per employee in the market economy, for which a rate of increase of 1.8% is estimated, almost 2 pp down on 2009 (3.7%) and 4 pp on 2008

(5.9%). The smaller increase in wage rates under collective bargaining agreements, which stood at 1.3% for the year on average, influenced by the recommendations of the multi-year agreement signed in February and by the absence of inflationary pressures, lay behind this result which has allowed for a decline in unit labour costs in the market economy for the second year running.

It is vital that such wage restraint should continue in the coming quarters. In this respect, the upcoming process of collective bargaining should consider the temporary nature which, in the absence of additional shocks, will characterise the rise in inflation in the coming months. A highly significant portion of the increase in the growth rate of the CPI between December 2009 and December 2010 is attributable to tax changes and regulated prices (VAT, excise duties on tobacco products, electricity and gas prices) and to the upward course of commodity prices. All these factors have a direct and significant effect on the level of prices and on the inflation rate but, in the absence of a pass-through to other prices, the effect drops out of the annual inflation rate after 12 months. A recent example of the temporary nature of the rise in inflation in the face of a significant hike in oil prices was between 2008 and 2009 (see the article in the January edition of the *Boletín Económico* for more details). But for this to occur, specific circumstances must prevail; in particular, the indirect effects on companies' costs must be limited and the changes in prices must not give rise to a widespread revision of inflation expectations that feed through to final prices through the prices set by producers or through wage bargaining.

The outlook for 2011 in Spain, but also in the euro area, is for a slow recovery highly dependent on the external sector, and one conditioned by the fiscal adjustment and the restructuring process facing the private sector. This scenario is, moreover, subject to great uncertainty and to the risks associated with the tensions on sovereign debt markets which, should they continue, might prompt further tightening of financing conditions and a deterioration in economic agents' confidence.

During the month of January, additional measures have been announced on reforms to key areas in the economy, aimed at dispelling uncertainty and reaffirming the commitment by the economic policy authorities to the adjustments needed. On 28 January the Council of Ministers addressed the Draft Social Security Reform Bill, which envisages far-reaching measures to ensure the sustainability of the pensions system. In the face of the tightening of the conditions of access by Spanish financial institutions to external markets as a result of the worsening of the sovereign debt crisis, new steps were announced to accelerate and deepen the bank restructuring process, by means of a raft of measures geared to boosting the increase in banks' capitalisation levels to a degree that ensures that market confidence is regained.

In 2010 Q4, the economy and the international financial markets trended favourably. The introduction of new expansionary measures in the United States gave further support to the global recovery, despite the worsening sovereign tensions in the euro area. Against this background, the latest indicators point to the continuity of the recovery, with a dichotomy persisting between the relative sluggishness of growth in some advanced economies and the robustness of many emerging countries which, in some cases, show signs of overheating. The additional US monetary and fiscal expansionary measures, which entail a widening of the divergences in policy stance across the advanced economies, have given rise to a brighter short-term outlook in this economy and have bolstered the optimism prevailing in the financial markets in this period. Nonetheless, doubts about the medium-term sustainability of private demand in the United States, once the public stimuli are withdrawn, have not been dispelled. Furthermore, the strong increase in commodity prices during the quarter has been conducive to a generalised rise in inflation (see Box 1). Although inflation rates are holding at moderate levels in most advanced economies, in many emerging countries and in some developed ones too – such as the United Kingdom – the greater intensity of inflationary pressures has raised the risk of inflation expectations becoming disanchored. Against this backdrop, the main emerging economies have tightened their monetary policies, resuming the cycle of interest rate rises that had been interrupted as capital inflows stepped up, and they have continued building up reserves. Depending on the countries involved, such developments have been accompanied by macroprudential measures and by capital controls.

In this setting, *international financial markets* were little affected by the worsening of the European sovereign crisis. The positive sentiment on markets was reflected in across-the-board stock market gains, in developed and emerging countries alike, and in improved financing conditions outside the euro area. Another factor worth highlighting is the increase in US long-term bond yields during the quarter, although the US 10-year bond yield has held stable at around 3.5% since mid-December. This trend, witnessed also – albeit to a lesser extent – in other economies, would be the outcome of the ongoing normalisation of interest rates, from their lower levels in previous months, in keeping with the improved economic outlook and the change in the fiscal policy stance in the United States; in any event, the trend is not in response to any substantial revision of inflation risks. On the foreign exchange markets, the strong movements in the previous quarter were corrected to some extent, and the dollar appreciated against the main currencies. Moreover, in the case of the emerging economies, the favourable behaviour of the financial markets translated into reductions in their sovereign spreads. The rising course of commodity prices initiated the previous quarter continued, or even stepped up, meaning that the year-on-year growth rates of food and metal prices stood in January at around 40% and 25%, respectively. The price of a barrel of Brent oil moved above $100, entailing a rise of 29% since the start of 2010. These increases are mainly in response to the rise in demand by the emerging economies.

In the *United States*, the flash estimate for GDP in Q4 shows annualised quarterly growth of 3.2% (0.8% quarter-on-quarter, 2.8% year-on-year), compared with 2.6% in Q3, the results of the positive contributions of private consumption and external demand (due mainly to the contraction in imports), which more than offset the strong negative contribution of stockbuilding. The latest indicators have offered some positive signs, although the doubts over the strength of the recovery in the medium run have not yet been dispelled. On the supply side, despite the slowdown in industrial production, business confidence – measured by the ISM indices – and

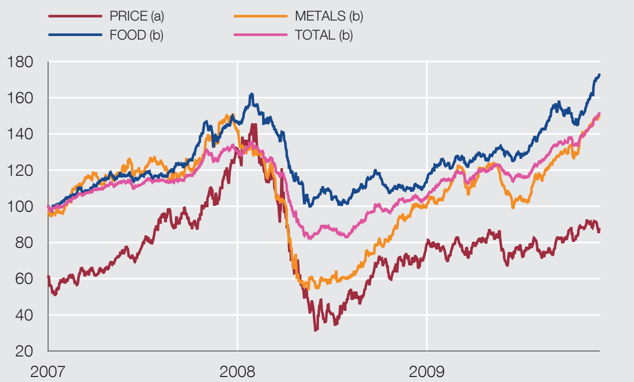
Over the course of the past quarter there has been a strong rise in commodity prices, driven essentially by the growth in demand by the main emerging economies. This increase has been across the board, although the intensity differs from product to product, and it has prompted a rise in inflation in many countries, especially in the emerging economies themselves. Set against the current sizable capital inflows in these countries, this development contributes to accentuating the monetary policy dilemmas present in many of them. This box reviews commodity price developments in 2010 and their influence on inflation in the emerging economies.

Over the course of 2010 commodity prices rose most markedly. The prices of food, industrial metals and crude oil grew, in year-on-year terms, by around 30%, 20% and 25%, respectively (see Panel 1).[1] Behind the rises is a substantial upward revision of demand projections, especially for the emerging countries, in the second half of the year. Thus, in the case of oil, at the end of 2009 the International Energy Agency expected an increase in global demand in 2010 of 1.4 million barrels per day (mbd); the actual increase was finally 2.7 mbd (of which China accounted for one-third). This rise in total demand was greater than that in the supply of non-OPEC producers (1.1 mbd), whereby OPEC's market share has increased.[2] In the case of food, demand factors have been complemented by supply factors (which have affected specific products), such as poor harvests, due above all to bad weather, or grain export restrictions in certain countries. As a result, corn prices doubled from June to December 2010, while wheat prices rose by more than 60% over the same period.[3] In

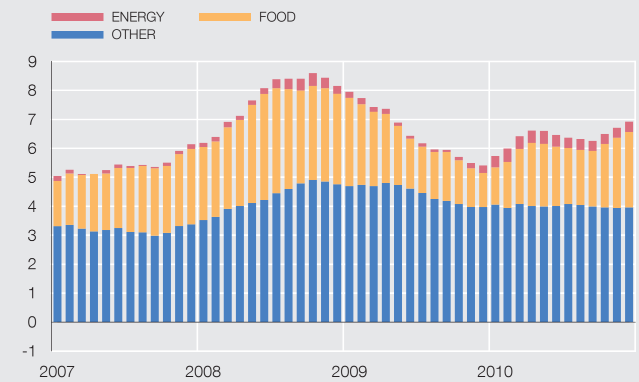
1. For the aggregate prices of metals, food and commodities, the CRB commodity index has been considered. For crude oil prices, the barrel of Brent is used. The US dollar is used as the currency for calculation.

2. This situation – increases in prices and amounts in parallel with a rise in the cartel's share – corresponds to what economic theory predicts in the case of an upward surprise in expected demand. See Anton Nakov and Galo Nuno (2009), *Oligopoly: A General Equilibrium Model of the Oil-Macroeconomy Nexus*, Documentos de Trabajo, no. 0932, Banco de España. **3.** See the World Bank report *Global Economic Prospects,* January 2011, p. 61.

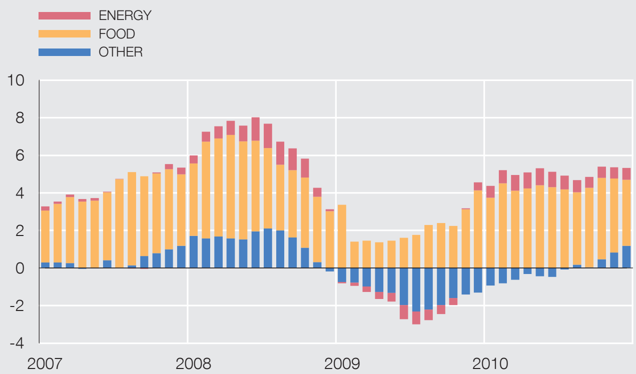
1 PRICE OF OIL AND OTHER COMMODITIES



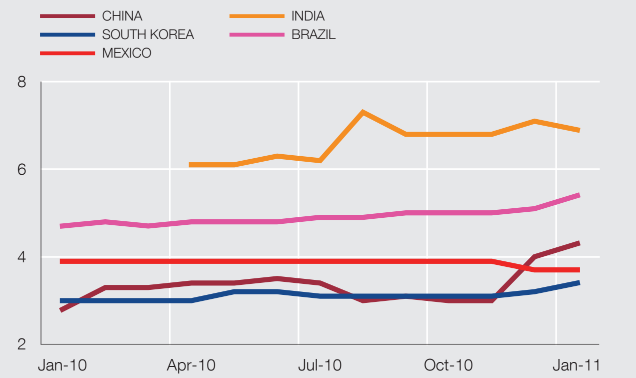
2 CONTRIBUTION TO INFLATION IN LATIN AMERICA (c) (d) (e)



3 CONTRIBUTION TO INFLATION IN EMERGING ASIA (c) (d) (e)



4 INFLATION FORECASTS FOR 2011 (f)



SOURCES: Datastream and Banco de España.

a. Price/barrel in dollars.
b. January 2007 = 100.
c. As a percentage.
d. Authors' estimate stripping out the food and energy indices from the overall index.
e. LATIN AMERICA: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. EMERGING ASIA: China, India, Thailand, Philippines, South Korea and Singapore.
f. % y-o-y.

addition, it cannot be ruled out that the upward trend in prices has been amplified by an increase in the financial flows routed towards the commodity markets, against a backdrop of abundant global liquidity and international investors' interest in this type of asset.

The rise in international energy and food prices is passing through in differing degrees to domestic prices, depending on the oscillations in the various exchange rates against the dollar (the currency to which most commodity prices are referenced), on existing tariffs and taxes, and on national transport and distribution costs.[4] The changes in domestic commodity prices may affect aggregate inflation through various channels. Firstly, there are the direct effects of the increase in commodity prices on the overall price index, which will be all the greater the higher the weight of energy and food in the country's representative consumption basket. In the emerging economies, food and energy account for between 30% and 40% of the consumption basket, while in the developed countries they represent less than 25%. Secondly, there are indirect effects in the form of the increase in production and distribution costs, which are more significant in the case of energy. Finally, there are the so-called "second-round effects", which reflect the incorporation of the initial rise in prices into price- and wage-setting processes whereby the initial shock ultimately passes through to core inflation and to inflation expectations. This is why these effects are of particular relevance for monetary policy.

The rise in overall inflation since mid-2010 in the emerging Latin American economies has mainly been driven by the increase in the food component (see Panel 2). Core inflation has held fairly stable today, unlike the case in early 2008, when the marked rise in food prices was accompanied by a strong hike in core inflation. This appears to indicate that, so far, the impact via second-round effects has been limited. Nonetheless, in the case of the emerging Asian economies, the rise in inflation rate is not attributable solely to the contribution of food, but to the progressive increase in core inflation over the course of 2010, which may be reflecting second-round effects and a narrowing of the output gap in these economies (see Panel 3). Mention should also be made of the lesser impact, compared with food, of the rise in the price of energy commodities in the rate of inflation, especially in Latin America. This is not only due to their lower weight in the consumption basket, but also because this is probably in response to the extended presence of subsidies and administered prices in this sector.

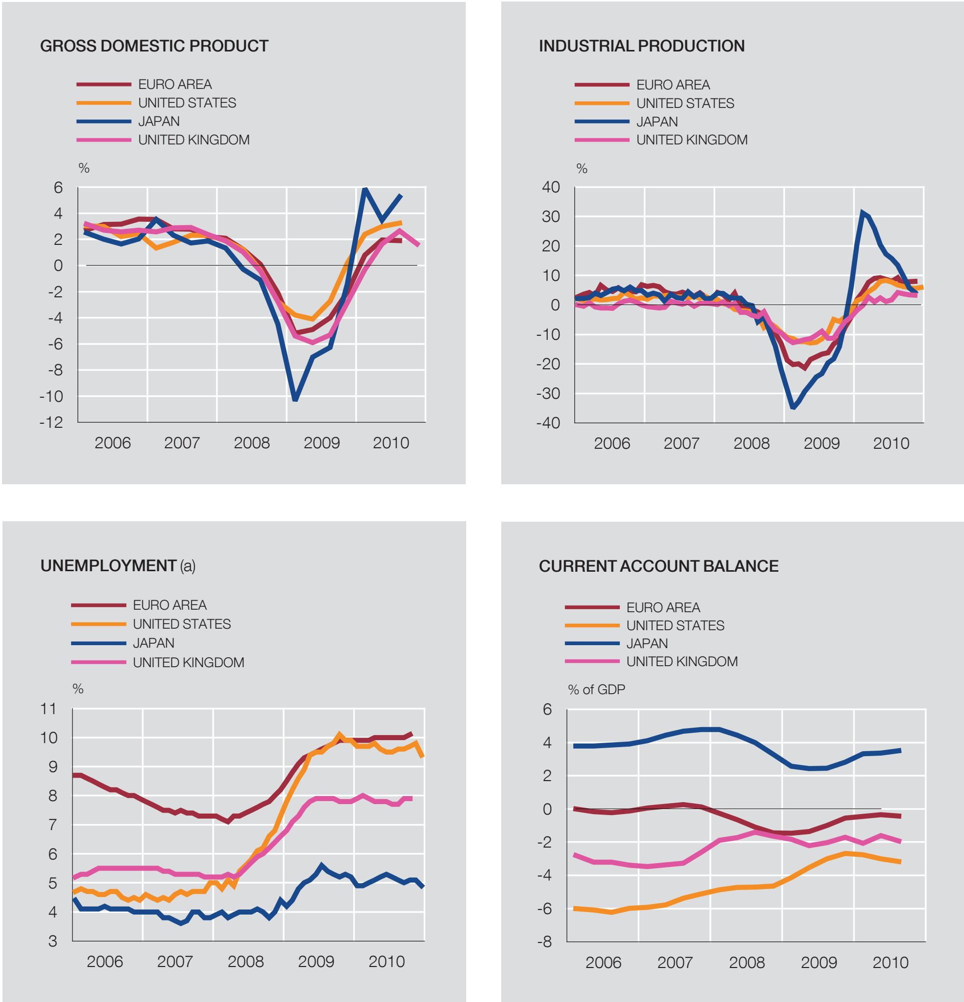
Central banks' monetary policy response to the rise in commodity prices will depend on the extent to which it can be passed through to agents' inflation expectations and to their price- and wage-setting decisions (second-round effects). If there are risks that inflation expectations may become disanchored or that second-round effects may occur, the central bank should tighten the monetary policy stance. Currently, with the odd exception (such as Mexico), inflation prospects are on the rise in several emerging countries (see Panel 4), due not only to the increase in commodity prices, but also to their growth dynamics, which pose a significant risk to these economies of inflation expectations becoming disanchored. Moreover, many of them face an additional monetary policy dilemma arising from the strong capital inflows they are currently experiencing, which might increase with a rise in interest rates. Faced with this dilemma, the emerging economies have opted for pragmatic solutions based on a broad range of measures: the raising of official interest rates when circumstances allow; progressive though controlled exchange rate appreciations via intervention and the build-up of reserves; and, in other cases or as a complement, the adoption of macroprudential measures or, indeed, the introduction of capital controls.

4. The commodity component in inflation also groups together unprocessed foods such as energy.

capacity utilisation advanced slightly. On the demand side, both retail sales and consumer sentiment proved supportive of an increase in consumption. The housing market evidences signs of stabilising, although its recovery remains very uncertain, given the weakness of the labour market. In particular, net job creation in the private sector remains very modest, while the 0.4 pp decline in the unemployment rate to 9.4% masks exits from the labour force due to the discouragement effect in job search. The strong increase in energy prices pushed the CPI up 0.4 pp to 1.5% year-on-year in December, although core inflation stabilised at 0.8%. Against this background, the Federal Reserve held its official interest rate in the 0%-0.25% range, reiterating that it would remain at a low level for some time. At its November meeting, it also announced staggered Treasury bond purchases to June 2011 for an amount totalling $600 billion, and it retained its commitment to plough the funds redeemed from its MBS holdings back into government bonds. In the fiscal arena, a series of measures was approved in December, including the extension of certain tax exemptions. These measures will increase the budget deficit by $858 billion to 2020 and entail a strong stimulus to activity in the short run, estimated at between 0.6 and 2 pp in 2011, and between 0.5 and 1.9 pp in 2012.

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



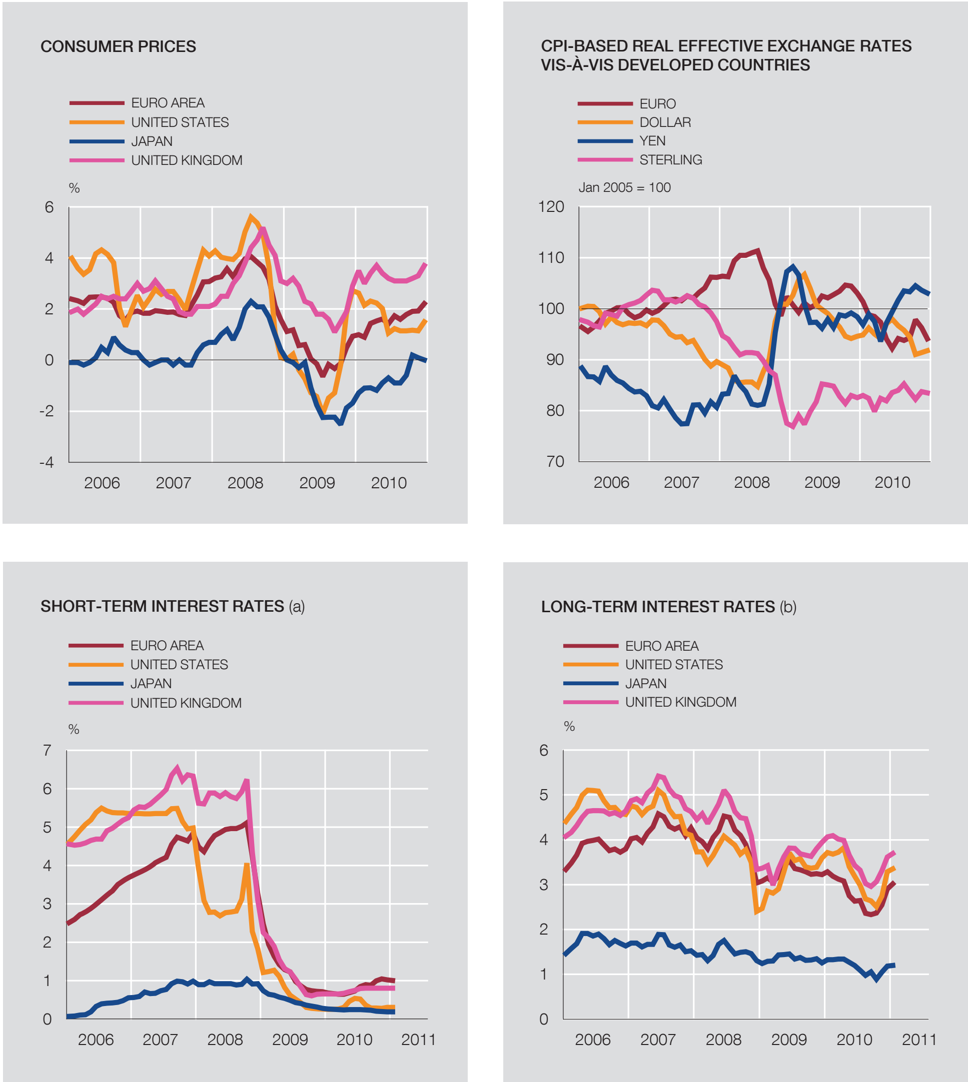
SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

GDP in *Japan* grew at a quarterly rate of 1.1% in Q3, far exceeding the figure of 0.4% posted the previous quarter. This raised year-on-year growth to 5.3%. Underpinning this acceleration was the bringing forward of car purchases prior to the related public stimulus programme expiring and, to a lesser extent, the bigger contribution of inventories and private investment. However, the latest indicators point to a contraction in activity in Q4 (more marked in the manufacturing sector), owing to the deterioration in exports and the progressive phasing out of the fiscal stimuli, although a progressive recovery is expected during 2011. Turning to the external sector, the current account surplus narrowed in November as a result of the momentum of imports and the sluggishness of exports, against a background of lower global demand. The unemployment rate fell by 0.1 pp during the quarter to 4.9%, and other labour indicators have offered positive signs. CPI inflation posted zero growth in December, owing to the rise in food prices and the higher taxes on tobacco, while core inflation remains in deflationary territory. Against this backdrop, the Bank of Japan has not altered the range of its official interest rate, from 0-0.1%. Lastly, the government approved a new fiscal stimulus package (of the order of 0.9% of GDP), aimed at promoting employment and supporting SMEs, and published the draft budget for fiscal year 2011, with a 5 pp cut in the corporate tax rate, to 35%, so as to raise the international competitiveness of Japanese companies.

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



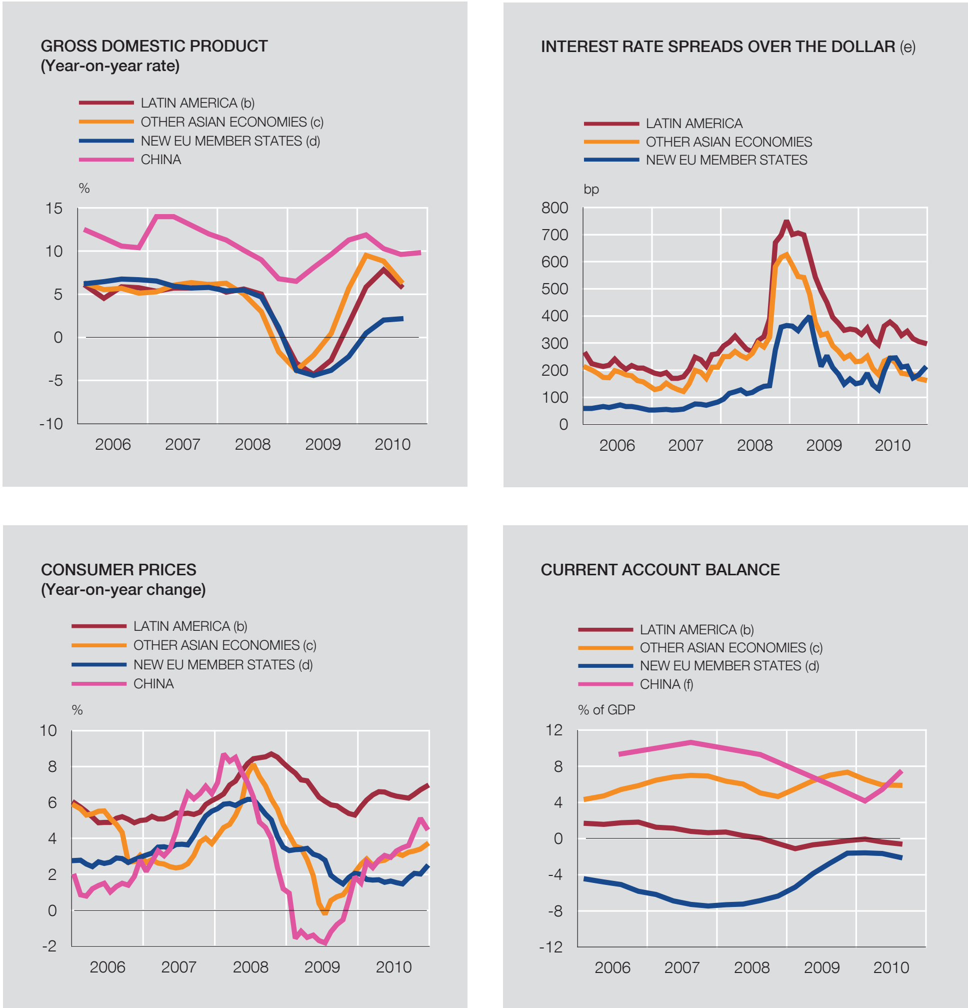
SOURCE: Banco de España.

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

In the *United Kingdom*, the preliminary estimate of GDP for Q4 indicates a quarter-on-quarter decline of 0.5% (+1.7% year-on-year), compared with growth of 0.7% the previous quarter. This contraction was largely caused by the effect of the bad weather in December on activity in the construction and services sectors. Recent coincident indicators already suggested an easing of growth during the quarter, albeit not so sharp, with differences from sector to sector: business surveys pointed to a significant increase in manufacturing activity, spurred by external demand, set against the poor behaviour of construction and services. Retail sales were slack, amid diminished confidence. The labour market worsened slightly during the quarter – the unemployment rate rose by 0.2 pp to 7.9% in November – as private-sector job creation was incapable of making up for job losses in the public sector resulting from the fiscal adjustment. The real estate market also weakened in the closing months of the year and a further downward adjustment in house prices has begun. The CPI quickened by 0.4 pp in December to a year-on-year rate of 3.7% (the core inflation rate rose to 2.9%) and this, combined with the tax rises applied at the start of the year, will lead to a notable increase in the rate of inflation in the coming months. Nonetheless, the Bank of England considers that this rise is due to temporary factors and has kept bank rate at 0.5%, without reactivating its asset purchase programme.

EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

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

In the *new EU member states not belonging to the euro area*, GDP grew in Q3 on average at a year-on-year rate of 2.2%, compared with 1.9% in Q2, continuing on a gradual path of recovery. There are notable differences from country to country, with the recovery in Poland proving most robust set against the deepening of the recession in Romania. The favourable performance continues to be external demand-led (except in Poland, where private consumption is also proving notably dynamic) thanks to the momentum of the German economy. The Q4 indicators show continuity in the improvement in industrial production and a pick-up in private consumption in some countries, although the current instability in the euro area adds a high degree of uncertainty. During the quarter, inflation followed a rising course, linked to the increase in fuel and food prices, climbing to a year-on-year rate of 4% on average for the region. The growing concern over inflation has prompted the start of official interest rate rises in Hungary (to 6%) and in Poland (to 3.75%).

In *China*, economic activity remained very buoyant in 2010 Q4, with real GDP growing at a year-on-year rate of 9.8% (10.3% for the year as a whole). Moreover, the rate of expansion has quickened owing to the robustness of domestic demand, although external demand has also picked up. The main risk to the Chinese economy is the possibility of overheating: inflation increased by 1 pp in the final quarter to 4.6% in December. Against this background, the authorities have raised benchmark interest rates and the bank reserves ratio (two and four times, respectively, during the quarter) and have made changes to their monetary and financial strategy so as to facilitate more effective control of new credit. In the rest of Asia, activity remained notably dynamic, though somewhat less so than in the first half of the year. The exception here was India, where growth continued to quicken, led by the strength of domestic demand. Inflation increased during the quarter across the board, albeit gradually, owing to higher food prices, and the countries in the region facing the biggest inflationary pressures (South Korea, Thailand and India) have resumed official interest rate rises, which they had postponed in previous months amid fears that that would generate bigger capital inflows. In a setting of abundant global liquidity, these rises have been complemented by foreign exchange market intervention, macroprudential measures and, in Thailand and South Korea, capital controls.

In *Latin America*, year-on-year GDP growth stood at 6% in Q3, against 7.9% in Q2. The slowdown is much more evident when considering the quarter-on-quarter rate, which was 0.6%, compared with 2.1% the previous quarter. The lower growth in the region's year-on-year rate is in response to both a lesser contribution of domestic demand (which even so stood at 9.2 pp) and to an increase in the negative contribution of external demand. The economic indicators for Q4 offer mixed signals, since industrial production continues to slow, while the demand and labour market indicators remain robust. The rise in commodity prices has slackened the effect of the buoyancy of imports on trade balances, which in some cases (Chile and Peru) has seen surpluses widen. Inflation continued climbing during the quarter across the region, up from 6.3% in September to 6.9% in December, set against the upward trend of commodity prices. In some countries there was some worsening of shorter-dated inflation expectations, but long-term expectations remain anchored. In this macroeconomic setting, the Brazilian and Peruvian central banks resumed in January the cycle of official rate rises, after having interrupted it in Q3. Meantime, the Chilean central bank raised its official rates at each of its meetings in Q4, (though not at the January meeting). In both Brazil and Peru, new measures were adopted aimed at containing credit growth, and measures were introduced in Brazil and Chile to ease upward pressure on their currencies (with a cap on short positions in dollars in respect of Brazil's financial system, and a currency purchase programme in Chile's case).

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

Strains on sovereign debt markets worsened during the closing months of 2010 and at the beginning of 2011, mainly triggered by growing concern about the implications for Ireland's public finances of the extremely weak situation of its banking system. The strains rapidly spread to Portugal, in the face of uncertainty about the fulfilment of its budget consolidation commitments, to Spain and, to a lesser degree, to Italy and Belgium. The turmoil on sovereign debt markets had a mixed effect on other financial markets, in terms of sector and country, and on the euro exchange rate, which depreciated markedly. At the end of November, the European authorities decided unanimously to respond positively to the Irish government's request and to grant, in conjunction with the IMF, financial assistance tied to the extensive restructuring of its banking system and compliance with a very demanding programme of macroeconomic adjustment and structural reforms (see Box 2). As in the case of Greece, the intervention has not dispelled uncertainty and interest rates on the secondary debt market have remained at very high levels, although in recent weeks they have eased somewhat.

Despite these fresh bouts of financial instability, economic activity in the euro area as a whole continued to pick up in the closing months of 2010, albeit at a moderate and uneven pace both in terms of components and countries (see Box 3). The expansion remains export-driven, while domestic spending – and, in particular, private consumption – has not yet managed to recover. The strength of the German economy contrasts with the rest of the euro area and particularly with certain economies hit by the debt crisis whose growth is much more moderate or which are still mired in recession.

Although the outlook of analysts and international organisations for 2011 has been revised slightly upwards, it portrays a slow recovery which is highly reliant on the external sector, since in many economies, households and corporations remain immersed in a deleveraging process which is constraining their consumption and investment decisions. Furthermore, this scenario is subject to considerable uncertainty and downside risks linked to a large degree with strains on sovereign debt markets which, if they continue, could prompt a further tightening of private-sector financing conditions and a deterioration of economic agents' confidence. Under these circumstances, it would be more difficult, with a view to consolidating the recovery, for private-sector demand to take over the role played to date by economic policy stimulus. In addition to this, is the slight worsening of the short-term inflation outlook, which to a large degree is linked to the rise in energy prices on international markets, and whose impact has been increased by the depreciation of the euro exchange rate. However, these temporary factors are not projected to result in underlying inflationary pressures given the existing high economic slack and wage moderation.

The absence of inflationary pressures over the horizon relevant for monetary policy led the ECB to maintain an accommodative stance in this connection: official interest rates held at low levels and the non-conventional credit-support measures remained in place. In response to the rise in debt market tensions and their negative effects on the monetary policy transmission mechanism, the ECB stepped up purchases of public debt on secondary markets, through the Securities Market Programme.

The European Summit on 16-17 December agreed on the general principles of the future European Stability Mechanism, the permanent crisis-management instrument that will come into force from 2013. Its functioning will draw on the arrangements used for the current European

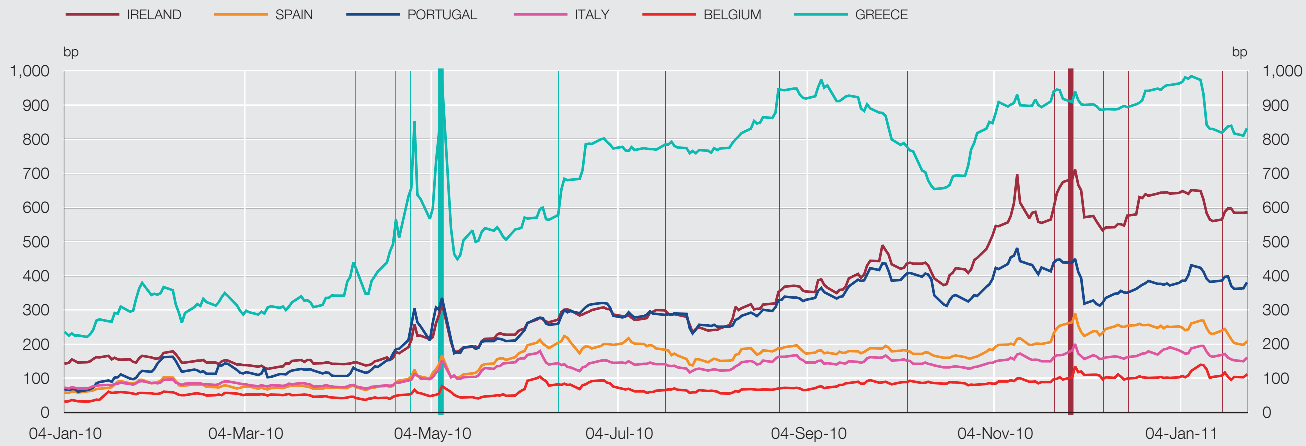
THE IRISH BAIL-OUT PROGRAMME

BOX 2

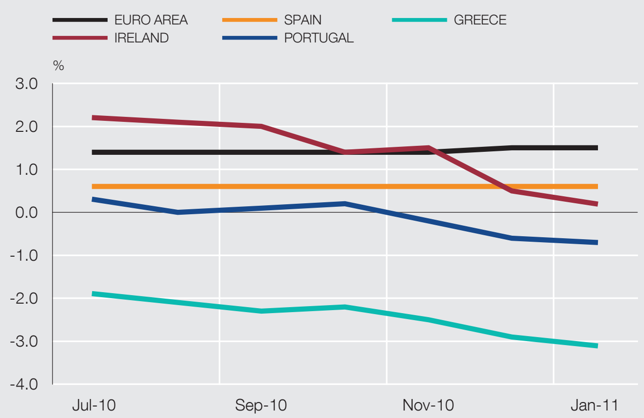
In 2010 Q4, Irish public debt tensions heightened and the instability spread to other peripheral countries in the euro area (see accompanying panel). The factors fuelling this process included primarily and most notably the critical excessive size of the Irish banking sector and the risks this entails for the public sector. Thus, despite being strongly propped up by public aid since September 2008, the massive losses incurred in the purchase of assets by the public agency NAMA, with an aggregate discount of 58% on book value, have led to the virtual nationalisation of the bailed out institutions. This has had an impact on the budget deficit of 20% of GDP in 2010, yet without dispelling the lack of confidence in the sector. The interaction between the problems of Ireland's national banks and State solvency formed a two-way feedback loop and choked off the access of both to the markets, making Irish banks absolutely dependent on Eurosystem financing and on their central bank. Early in the autumn, the Irish authorities revealed that the budget deficit would be close to 32% of GDP in 2010, owing to the combined effect of the economic crisis and the recapitalisation of the banking sector. Consequently, the debt ratio could rise to close to 100% of GDP.

Also contributing to these tensions were the difficulties the Greek and Portuguese authorities faced in meeting their fiscal adjustment commitments, the speculation over the availability of funds to withstand contagion to other bigger countries and the ongoing debate on the design of the permanent crisis-resolution mechanism intended to replace, as from mid-2013, the instruments currently in place. Further contributing to heighten this episode were investors' doubts over the future growth capacity of the economies affected, as illustrated in the second panel, and the negative warnings about sovereign credit ratings. From November to December, Ireland's sovereign rating was downgraded several notches by the three main agencies, to BBB+(Baa1) by Fitch and Moody's, two levels below the A rating assigned by S&P. In December Fitch downgraded Portugal's sovereign rating by a step to A+, and in January it assigned a speculative or junk rating to Greek sovereign issues, a measure previously applied by the other two main rating agencies. There were also warnings by Moody's of possible downgrades for Spain's Aa1 and Greece's Ba1 rating, and by S&P for Belgium's AA+. These developments increased the risk of a large-scale debt crisis in the euro area and precipitated

TEN-YEAR SOVEREIGN SPREADS. DAILY DATA (a)



GDP FORECASTS FOR 2011



IRISH ASSISTANCE PROGRAMME

FUNDS AVAILABLE	85.0
DRAWN FROM:	
Irish government	17.5
IMF	22.5
European Financial Stabilisation Mechanism (EFSM)	22.5
European Financial Stability Facility (EFSF)	17.7
Bilateral loans	
United Kingdom	3.8
Sweden	0.6
Denmark	0.4
EARMARKED FOR:	
Bank recapitalisation	10.0
Contingent funds. Banking sector	25.0
State financial needs	50.0

SOURCES: Consensus Forecast and Banco de España.

a. Greece and Ireland: the fine lines depict downgrades; the bold lines depict interventions or bail-outs.

the Irish authorities' request for financial assistance, with the dual aim of stabilising the delicate situation of its banks and that of its public finances.

On 28 November, the ECOFIN approved the extension of financial assistance to Ireland for €85 billion (52% of GDP). As can be seen in the accompanying table, Ireland will contribute to the programme with funds from its National Pension Reserve Fund (NPRF) and with other domestic sources. For the remainder, funds will be provided by the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), by the United Kingdom, Sweden and Denmark, and by the IMF. The loans will bear an annual average interest rate of 5.8%. In January, the EU and the EFSF launched issues to fund the initial outlays, for an amount of €5 billion in both cases.

The financial assistance is conditional upon compliance with a three-pronged programme of measures: the recovery of the banking sector, budgetary adjustment and structural reforms to promote economic growth. Furthermore, Ireland's participation in the loan facility extended to Greece in May has been suspended.

The aims of the measures geared to banking recovery are the redimensioning and reorganisation of the sector, to recapitalise it at the highest levels required by international standards and to improve its access to financial markets. The banking sector may receive up to €35 billion (over 20% of GDP), earmarking €10 billion to recapitalising the banks and €25 billion to a contingency fund. The Irish Central Bank raised capital requirements from 8% to 10.5%, although three ailing institutions (AIB, BOI and EBS) have immediately been required to comply with a figure of 12%. Further, it will perform liquidity tests to identify deleveraging needs and to reduce short-term funding, and it will call, before the end of April 2011, for sale or asset securitisation plans. It is also intended to finalise the restructuring plans for Anglo Irish and INBS, and to add the finishing touches to a specific bank liquidation regime and to stricter regulations for credit cooperatives.

To restore the country's budgetary sustainability, the excessive deficit must be corrected by 2015 – an extra year on the term already agreed. The Irish State will receive €50 billion from the bail-out programme to stabilise public finances and it will pursue further adjustment measures in the next four years for an amount of €15 billion (€6 billion of which are for 2011). Two-thirds of the adjustment will fall on spending cuts (€7 billion on current expenditure and €3 billion on public investment), and the remaining third on revenue-raising measures (personal income tax, VAT and local taxes, the elimination of tax expenses and changes in the taxation of pensions).

The purpose of the structural reforms approved is to promote the sustainable growth of the economy, allowing competitiveness and job creation to be developed. Sectoral policies to encourage exports and the recovery of domestic demand in order to support economic growth and reduce long-term unemployment are also envisaged.

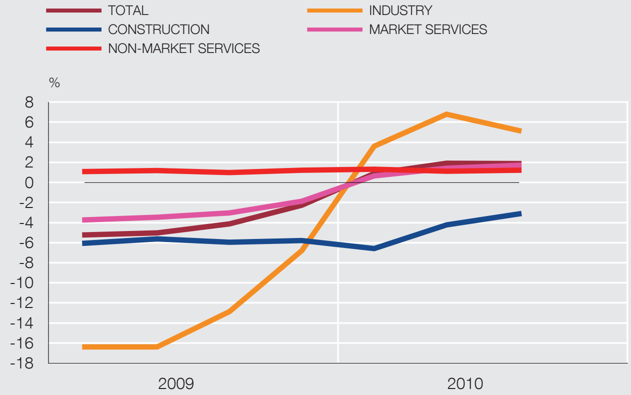
Instrumentation of the financial assistance to Ireland has had a limited impact on reducing sovereign debt spreads in the euro area. Among other reasons, because the markets appear to have adopted, as they did in the case of Greece, a wait-and-see attitude in the face of the bail-out measures, until doubts have been dispelled concerning the authorities' ability to correct imbalances and, in particular, the risks arising from the banking sector. The reaction by the markets also had to do with the discussions on the terms of the permanent mechanism that will come into force in 2013. Nonetheless, bond market tensions have recently eased significantly further to the comments on the possibility of the European authorities reaching agreement on an increase in the funds the EFSF might mobilise, and on them giving this Fund greater flexibility by means of an extension of the range of instruments through which the financial assistance can be implemented.

Financial Stability Facility, which it will replace, and its ultimate goal will be to safeguard financial stability in the euro area, granting assistance to member countries facing difficulties raising financing on the market. Such assistance will be subject to a unanimous approval procedure and strict conditionality, as stipulated in the reformed article 136 of the Treaty approved at this same Summit (see the article on the reform of governance included in the January edition of the *Boletín Económico*).

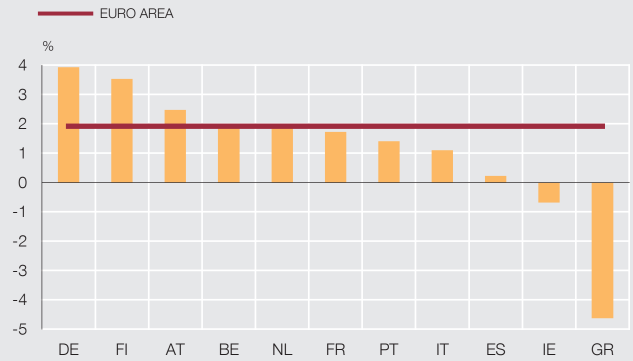
During the last three months, the euro area economies, which are perceived as the most vulnerable, have established ambitious structural reform and fiscal consolidation programmes and undertaken an extensive restructuring of their financial systems. It is necessary for these plans to be strictly complied with in order to eliminate imbalances and re-establish their competitive positions. Furthermore, in order to put the recovery of the area as a whole on a sounder and more resolute footing, labour markets must function better; the Services Directive requires full implementation to boost potential niches of activity; and the financial system needs to be restructured and normalised in order for credit to flow again. This was advocated by the Annual Growth Report recently presented by the Euro-

Over the course of 2010 the economic recovery that began the previous year in the euro area took root. Yet when the information for the area as a whole is broken down by branch of activity and by country, very heterogeneous rates of increase can be discerned, which run to the recent period. As the first panel shows, the year-on-year change in total gross value added in the euro area was 1.9%, the result of an especially high increase in GVA in industry (of over 5%) and a more moderate one in services (1.7% for market services, and 1.2% for non-market services). Meantime, construction posted a year-on-year decline, in line with the previous quarters. In quarter-on-quarter terms,

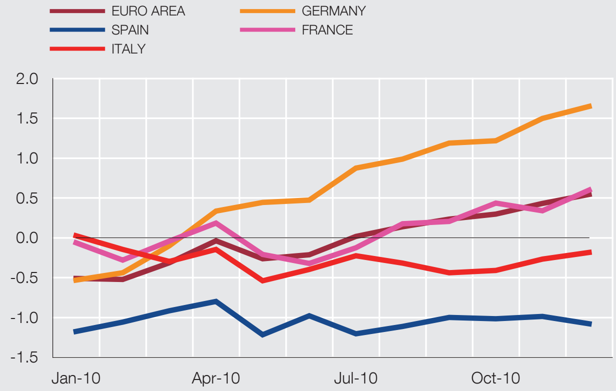
1. EURO AREA. GROSS VALUE ADDED
Year-on-year rates of change



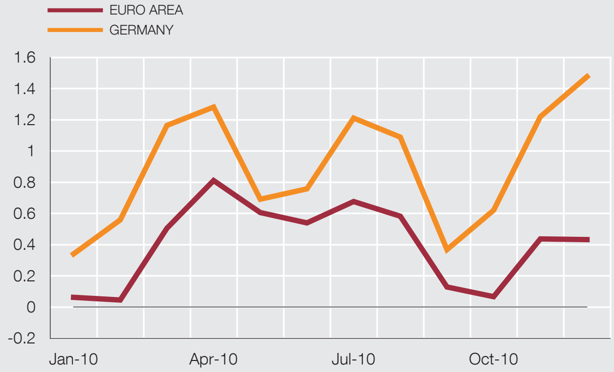
2. GROSS DOMESTIC PRODUCT
Year-on-year rates of change



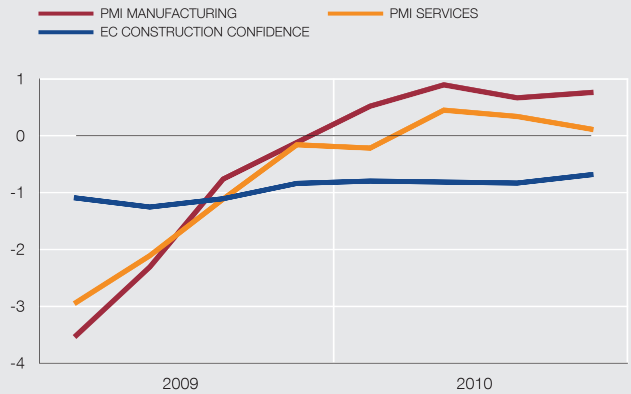
3. EC ECONOMIC SENTIMENT INDICATOR
Normalised series



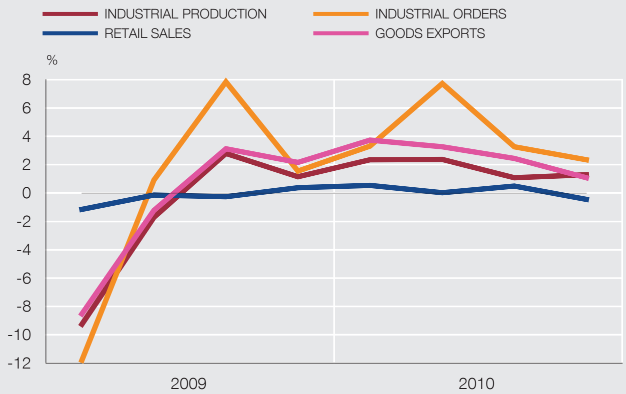
4. COMPOSITE PMI
Normalised series



5. EURO AREA. QUALITATIVE INDICATORS
Normalised series



6. EURO AREA. QUANTITATIVE INDICATORS (a)
Quarter-on-quarter rates of change



SOURCES: European Commission, CPB, Eurostat and Markit Economics.

a. The information for 2010 Q4 refers to the October-November period.

value added in construction also fell, while increases in industry and services were on a similar scale, at around 0.4%.

The change in GDP in 2010 Q3 also varied greatly from country to country. As can be seen in the second panel, the year-on-year increase in output was far greater than that in the euro area in Germany, Finland and, to a lesser extent, Austria. At the other extreme are countries such as Ireland and Greece, where GDP fell, sharply so in the latter case. In quarter-on-quarter terms, there was also marked heterogeneity, with rates of change ranging between 0.9% in Austria and -1.3% in Greece, compared with euro area growth of 0.3%.

On the conjunctural information available, some difference between the various countries' growth rates is expected to have continued in 2010 Q4. The European Commission's economic sentiment indicator in the third panel, which shows high correlation with the changes in GDP, evidenced an increase throughout the euro area in the closing months of the year. Taking the four major euro area economies, the figures were particularly high in France and Germany, whereas in Italy and Spain they were somewhat flat. Likewise, the composite PMI, depicted in the fourth panel, increased significantly in Germany in the final quarter, in contrast to the more stable performance of the euro area as a whole, which reflects the greater dynamism of the German economy compared with that of the other members.

As regards sectoral developments, information from the qualitative indicators for Q4 (see Panel 5) would suggest that growth in economic activity continues largely to be underpinned by industry, driven by the favourable performance of exports, while the services indicator points to some slowing, and the construction indicator shows a slight improvement from relatively low levels. This divergence is confirmed by the behaviour of the real indicators of activity in Q4 (see Panel 6), which shows relatively high growth in production and industrial orders, and in goods exports, along with containment of retail sales.

Consequently, according to the latest information, the differences in the growth rates of activity by country and by branch that have been manifest since the start of the recovery will foreseeably continue in the final quarter of 2010. Broadly speaking, the trend of the indicators point to the continuation of comparatively high growth in Germany and to some stabilisation in other economies in the area, as well as to a more marked expansion in industrial than in services branches.

pean Commission, which represents the starting point for economic policy coordination within the European semester.

Lastly, on 1 January 2011 Estonia became the seventeenth country to adopt the euro as its currency.

3.1 Economic developments

In 2010 Q3, euro area GDP grew by 0.3% in quarter-on-quarter terms, following an increase of 1% in Q2, due to temporary factors (see Table 1). Output rose largely as a result of the growth of exports and government consumption, while private consumption and investment in capital goods increased but moderately and expenditure on construction fell. The breakdown by sector shows that value added increased in industry and in services while it decreased in agriculture and construction. In year-on-year terms, the seasonally adjusted rate of change in GDP stood at 1.9%, similar to that of the previous quarter (2%).

By country, the growth rate of activity in Germany moderated (to 0.7%), compared with its extraordinary buoyancy of the previous quarter, but it remained higher than in other large euro area economies. In addition to the greater momentum of the external sector in Germany, there was also a firmer recovery in domestic demand, especially in investment in capital goods, while consumer spending has been boosted by the improvement in the labour market and in consumer confidence. Conversely, in France and Italy activity posted more moderate rates of increase (close to 0.3% in both cases), reflecting the smooth growth of domestic demand and the ongoing positive contribution from stockbuilding, whereas net external demand contributed negatively to GDP (see Box 3).

The process of job destruction came to a halt in 2010 Q3 on National Accounts figures. Thus, the number of jobs remained stable in Q3 at similar levels to Q2 while the year-on-year rate of change stood at -0.1%, compared with -0.6% in Q2. This performance is consistent with the

EURO AREA ECONOMIC INDICATORS (a) TABLE 1

	2009			2010				2011
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
NATIONAL ACCOUNTS (Quarter-on-quarter rates of change, unless otherwise indicated)								
GDP	-0.1	0.4	0.2	0.4	1.0	0.3		
Private consumption	0.0	-0.2	0.3	0.3	0.2	0.1		
Public consumption	0.6	0.5	-0.1	0.1	0.1	0.4		
GFCF	-2.3	-1.2	-1.2	-0.4	2.0	-0.3		
Imports	-2.7	2.1	1.2	4.2	4.3	1.5		
Exports	-1.3	2.2	2.0	2.6	4.4	1.9		
Contributions to quarter-on-quarter GDP growth (pp)								
Domestic demand (excl. stocks)	*-0.3*	*-0.2*	*-0.1*	*0.1*	*0.5*	*0.1*		
Change in stocks	*-0.4*	*0.6*	*0.0*	*0.7*	*0.4*	*0.1*		
Net foreign demand	*0.4*	*-0.1*	*0.2*	*-0.5*	*0.1*	*0.3*		
GDP (year-on-year rate of change)	-4.9	-4.0	-2.0	0.8	2.0	1.9		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	-1.7	2.8	1.1	2.4	2.4	1.1	1.4	
Economic sentiment	75.6	84.1	91.9	96.6	99.2	102.1	105.3	106.5
Composite PMI	43.2	49.5	53.6	54.4	56.6	55.7	54.9	56.3
Employment	-0.6	-0.5	-0.2	0.0	0.1	0.0		
Unemployment rate	9.4	9.7	9.9	9.9	10.0	10.0	10.1	
PRICE INDICATORS (year-on-year change in end-of-period data)								
HICP	-0.1	-0.3	0.9	1.4	1.4	1.8	2.2	
PPI	-6.6	-7.7	-2.9	0.9	3.1	4.3	4.5	
Oil price (USD value)	68.8	67.7	74.4	78.8	75.0	78.4	92.3	97.4
FINANCIAL INDICATORS (end-of-period data)								
Euro area ten-year bond yield	4.2	3.8	4.0	4.0	3.7	3.5	4.1	4.1
US-euro area ten-year bond spread	-0.63	-0.47	-0.17	-0.08	-0.72	-1.01	-0.78	-0.57
Dollar/euro exchange rate	1.413	1.464	1.441	1.348	1.227	1.365	1.336	1.369
Appreciation/ depreciation of the NEER-20 (b)	-0.7	0.3	-0.9	-4.5	-10.3	-6.3	-8.2	1.3
Dow Jones EURO STOXX 50 index (b)	-2.0	17.2	21.0	-1.2	-13.2	-7.4	-5.8	5.8

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

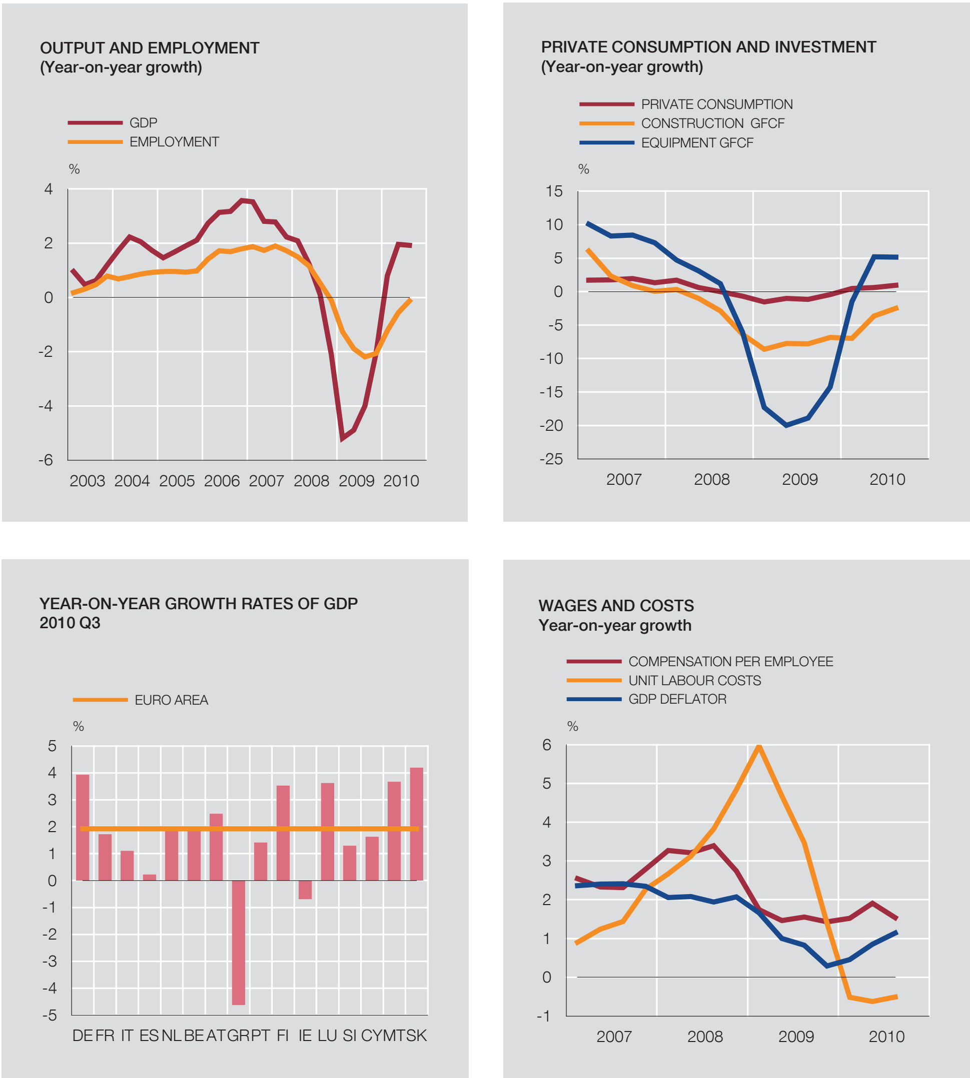
a. Information available up to 31 January 2011.
b. Percentage change over the year.

recovery of employment usually lagging activity by two or three quarters, a lag which may have been extended during the current expansion owing to the adjustment in hours worked by employees throughout the crisis. For the moment, this variable has not returned to previous levels, despite the increase observed since mid-2009. This lag between the recovery of output and employment prompted apparent labour productivity to post rates of increase of more than 2%, for the third consecutive quarter, and led to unit labour costs falling further since growth in compensation per employee remained moderate. As a result of the rise in the GDP deflator and the decline in unit labour costs, business margins grew further for the third consecutive quarter (see Chart 8).

The latest conjunctural information suggests that in Q4 GDP held at a similar or slightly higher rate than in the previous quarter, driven by external demand and the industrial sector. Thus, following its decline in September, industrial production expanded again in October and November, while the sector's confidence indicators prepared by the European Commission showed positive figures until January 2011, for the first time since the beginning of the crisis, and the PMI indicators ended the year at 57.1, considerably higher than their historical average. Conversely, indicators gave mixed signals for services in 2010 Q4, since an improvement was seen in the European Commission's confidence indicators, which continued in January,

EURO AREA NATIONAL ACCOUNTS

CHART 8



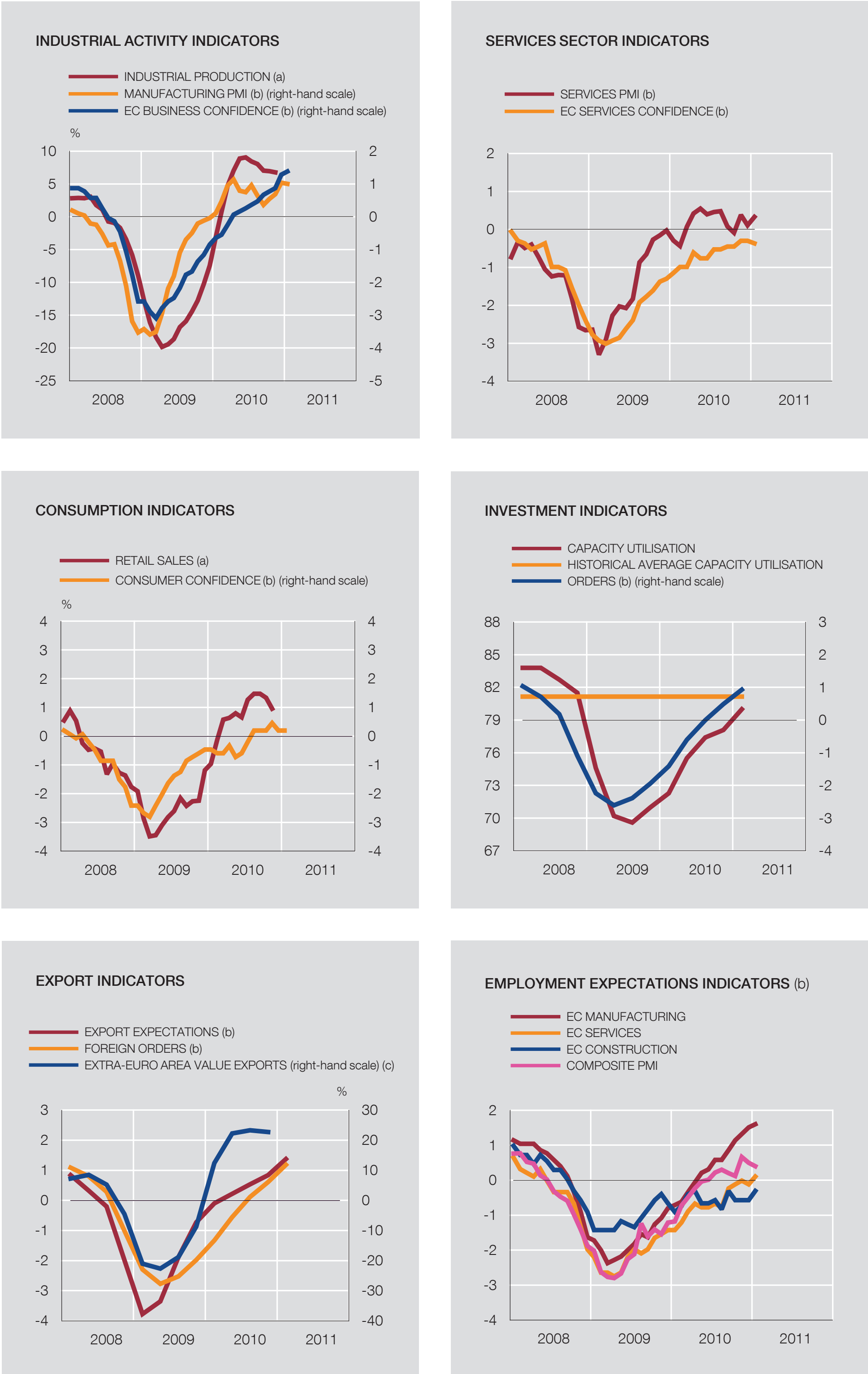
SOURCES: Eurostat and national statistics.

and a slight deterioration was observed in purchasing managers' opinions, although they held at considerably higher values than those recorded at the beginning of the year. It is estimated that the rate of contraction in construction may have decreased, although information is not yet available for analysing how its activity was affected by the adverse weather conditions in December 2010.

The recovery of industry seen in most economies (especially in Germany) is closely tied to the performance of exports which expanded again in the closing months of 2010, although without regaining their buoyancy of the first half of 2010, at the same time as the assessment of foreign order books and export expectations posted a fresh rise. The most recent domestic demand-related indicators show greater fluctuations. For instance, in 2010 Q4 retail sales decreased – on data to November – whereas new car registrations increased after the notable decline of previous quarters. The consumer confidence index held at negative values from summer 2010 until January 2011. As for investment indicators, the level of capacity utilisation for 2010 Q4 and 2011 Q1 remained on a rising trajectory (despite the fact it is still below its long-term average) and the assessment of industrial order books increased. Lastly, all the qualitative indicators point to an improvement in the labour market in Q4, even though the rate

EURO AREA. ACTIVITY, DEMAND AND EMPLOYMENT INDICATORS

CHART 9



SOURCES: European Commission, Eurostat and Markit Economics.

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

GDP AND HICP PROJECTIONS FOR THE EURO AREA (a)

TABLE 2

	2010		2011		2012	
	GDP	HICP	GDP	HICP	GDP	HICP
ECB (December 2010)	1.6-1.8	1.5-1.7	0.7-2.1	1.3-2.3	0.6-2.8	0.7-2.3
European Commission (November 2010)	1.7	1.5	1.5	1.8	1.8	1.7
IMF (January 2011 - October 2010) (b)	1.8	1.6	1.5	1.5	1.7	1.5
OECD (November 2010)	1.7	1.5	1.7	1.3	2.0	1.2
Consensus Forecast (January 2011)	1.7	1.6	1.5	1.8	1.6	1.7
Eurobarometer (January 2011)	1.6	1.5	1.5	1.7	1.6	1.7

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

a. Annual growth rates.
b. Interim estimate of January 2011 for GDP and of October 2010 for HICP.

of unemployment posted a slight rise to 10.1% in October and in November, compared with 10% in the two previous quarters.

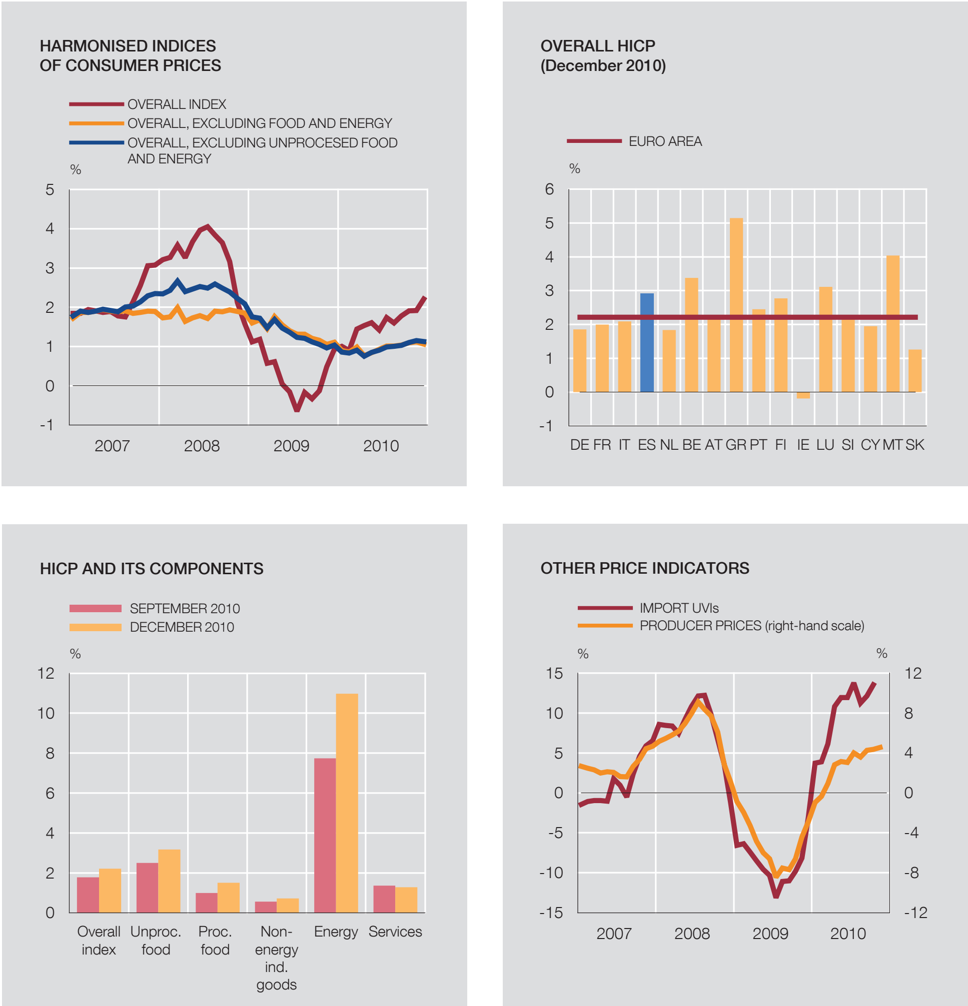
In short, the latest economic information confirms that activity in the euro area continued to expand in the final stretch of 2010 at a lower rate than that posted mid-year, due to the petering out of economic policy stimulus, the slowdown in the growth of international trade and the end of the stockbuilding process observed in the first half of the year. Growth of activity continued to be firmly underpinned by industrial production and exports, which are expected to have been boosted by the recent depreciation of the euro exchange rate. Conversely, household spending remains weak, in a setting in which high rates of unemployment, wage moderation and the gradual rise of inflation rates are curtailing real disposable income. Business investment also rose modestly, despite the recent rise in business margins and the momentum of external demand, since the ongoing low levels of capacity utilisation are hampering the need to increase plant capacity.

In the medium term, on the forecasts of international organisations there will be a moderate recovery over the coming quarters, with rates expected to be close to 1.5% on average in 2011 and 2% at end-2012, in a setting in which fiscal consolidation requirements will trigger a contraction of consumption and public investment, and private spending will gradually take over from the momentum of external demand (see Table 2). However, this scenario is subject to considerable downside risks linked to the instability of debt markets which, if they continue, could ultimately affect household and business confidence and trigger a further tightening of financing conditions.

The 12-month inflation rate ended the year at 2.2%, more than double that seen at end-2009 (0.9%) and, according to the Eurostat preliminary estimate, it increased to 2.4% in January. The deterioration of inflation in recent months is largely due to the rise in food and energy prices in line with the increase of these products' prices on international markets, the effects of which have been amplified by the deprecation of the euro exchange rate. Nevertheless, core inflation measured by the CPI excluding energy and unprocessed food prices remained practically stable in Q4 at 1.1% (compared with 1% in Q3), and worth noting is the slight slowdown of services, the prices of which ended the year 1.3% higher, very close to their all-time low. By contrast, non-energy industrial goods inflation climbed 0.2 pp in Q4 to 0.7% (see Chart 10). Industrial prices grew by 4.5% in October and November, 0.5 pp up on the figure for 2010 Q3. All components quickened in the final stretch of 2010, although the rise in energy prices was higher. The short-term inflation outlook deteriorated slightly as reflected by the forecasts of

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

CHART 10

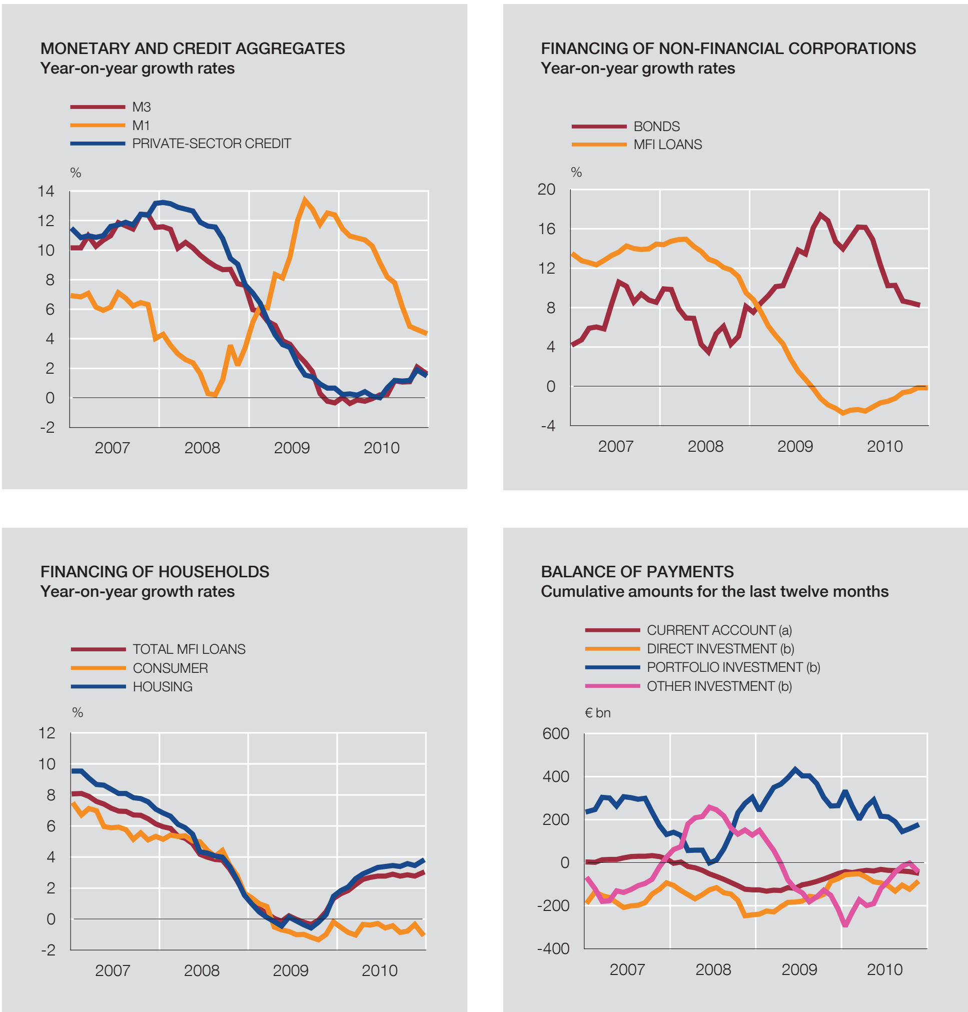


SOURCES: Eurostat and ECB.

various international organisations, although recent commodity price rises will foreseeably not trigger second-round effects on prices and wages due to the ongoing fragility of demand and the labour market (see Table 2). Against this backdrop, long-term inflation expectations remain moderate.

The euro area ran a current account deficit of €61.6 billion from January to November, practically the same as the deficit of €59 billion in the same period of 2009. By country, there has been a considerable correction of the current account imbalances of Ireland (where the sharp improvement in price and cost competitiveness notably boosted its exports) and of Spain. By contrast, the Portuguese and Greek deficits remained high, close to 10% of GDP, despite having been corrected to some degree. In terms of components, there were no major changes with respect to the previous year: goods and services recorded a surplus of above €20 billion and €30 billion, respectively, while income and current transfers posted a deficit of €10 billion and €104 billion, respectively. As for the financial account in the same period, there were more net capital outflows in the form of direct investment, which amounted to €103 billion compared with €84 billion in 2009, while net portfolio investment inflows fell from €240 billion to €147 billion. As a result, the basic balance, which is the sum of these two types of investment and the

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS CHART 11



SOURCES: ECB and Banco de España.

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

current account balance recorded a deficit of €15 billion between January and November 2010, compared with the surplus of €95 billion in the same period of 2009 (see Chart 11).

Turning to public finances, the results of the various countries were in line with the commitments undertaken within the framework of the SGP, and in certain cases they were exceeded (such as by Germany, where the correction of the deficit was favoured by its strong recovery). The countries facing more complex situations were forced to adopt further fiscal measures in the closing months of the year. Thus, the situation of the Irish banking system was ultimately reflected in the sharp deterioration of its public finances, despite the budget consolidation measures implemented since 2009, and led to its request for financial assistance from European institutions and the IMF, which was granted on 28 November (see Box 2). In Greece, the second review of the adjustment programme by the IMF, EC and ECB concluded that the fiscal adjustments and reforms implemented were on track, although, in order to guarantee that the fiscal targets for 2011 would be met, the Government introduced supplementary measures to broaden tax bases and rationalise spending. Lastly, Portugal, which came under constant pressure on debt markets, approved several measures in November to cut public-sector wages by 5% and raise VAT from 21% to 23%; and it introduced further supplementary measures in

EURO AREA GENERAL GOVERNMENT.
BUDGET BALANCES AND PUBLIC DEBT

TABLE 3

% of GDP

	BUDGET BALANCE (a)					
	2008	2009	2010		2011	
			EC (b)	IMF (c)	EC (b)	IMF (c)
Belgium	-1.4	-6.1	-4.9	-4.8	-4.7	-5.1
Germany	0.1	-3.0	-3.7	-4.5	-2.7	-3.7
Greece	-9.6	-15.4	-9.6	-7.9	-7.4	-7.3
Spain	-4.2	-11.1	-9.3	-9.3	-6.4	-6.9
France	-3.3	-7.6	-7.8	-8.0	-6.3	-6.0
Ireland	-7.3	-14.4	-32.3	-17.7	-10.3	-11.2
Italy	-2.7	-5.3	-4.9	-5.1	-4.2	-4.3
Luxembourg	3.0	-0.7	-1.8	-3.8	-1.3	-3.1
Netherlands	0.5	-5.4	-5.8	-6.0	-3.9	-5.1
Austria	-0.5	-3.5	-4.3	-4.8	-3.6	-4.1
Portugal	-3.0	-9.4	-7.3	-7.3	-4.9	-5.2
Finland	4.2	-2.7	-3.3	-3.4	-1.8	-1.8
Slovenia	-1.8	-5.8	-5.8	-5.7	-5.3	-4.3
Cyprus	0.9	-6.0	-5.9	-6.0	-5.7	-5.6
Malta	-4.8	-3.8	-4.2	-3.8	-3.0	-3.6
Slovakia	-2.1	-7.9	-8.2	-8.0	-5.4	-4.7
Estonia	-2.9	-1.8	-1.1	-1.1	-2.0	-1.7
PRO MEMORIA: Euro area						
Primary balance	1.0	-3.5	-3.5		-1.6	
Total balance	-2.0	-6.3	-6.3	-6.5	-4.6	-5.1
Public debt	69.7	79.1	84.1	84.1	86.5	87.0

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 (October 2010).

December to increase the control of general government spending and to set up a pluriannual budgetary framework.

As a result of the foregoing, the European Commission's autumn forecasts put the deficit for the euro area as a whole at 6.3% of GDP, which is below last spring's forecast (see Table 3). According to the projections and budgets approved for 2011, a further reduction (of up to 4.6%) is expected in the deficit for the area as a whole, which includes a 1.5 pp decrease in the cyclically adjusted deficit, and, consequently, it is estimated that the fiscal policy stance would become more restrictive. The public debt of the euro area in its entirety is estimated to be 84.1% of GDP for 2010 as a whole, on the Commission's estimates and could rise to 86.5% in 2011, with substantial cross-country differences.

3.2 Monetary and financial developments

Strains on sovereign debt markets in the euro area worsened again during 2010 Q4 and at the beginning of 2011. Throughout October, Greek, Irish and Portuguese sovereign spreads over the German *Bund* rose and, at the beginning of November, they breached 800 bp, 600 bp and 400 bp, respectively. In November the instability ultimately spread to other countries such as Spain, Italy and Belgium, whose spreads exceeded the highs during the turmoil of May 2010. These strains were apparent in the notable deprecation of the euro and, to differing degrees, in private risk premia and stock prices in the countries affected, particularly in the financial sector. The situation finally precipitated the Irish government's request for financial aid from the EU/IMF. As explained in detail in Box 2, the formalisation of the Irish aid programme at end-November had a very limited impact on spreads, which did not begin to correct noticeably until the second half of January at the same time as the euro and stock markets recovered.

The ECB's monetary policy stance remained accommodative since, despite short-term price rises, medium-term inflationary pressures remained moderate and inflation expectations continued to be anchored at levels compatible with the definition of price stability. Thus, the Governing Council of the ECB decided to leave official interest rates unchanged at historically low levels at its last few meetings in 2010 and at its first two meetings in 2011. The rate on the main refinancing operations remained at 1%, its level since May 2009, and the rate on credit and deposit facilities held at 1.75% and 0.25%, respectively (see Chart 12). Similarly, the ECB pursued its credit support policy and granted liquidity through tender procedures with full allotment, which it will continue at least during 2011 Q1. In December it also arranged a liquidity facility with the Bank of England, under which it could provide sterling to the banking system until September 2011, although it has not been instrumented yet, and extended the agreement with the Federal Reserve until August, whereby it will continue to provide dollars through weekly tenders. Lastly, operations under the Securities Market Programme resumed, with purchases amounting to nearly €13 billion from mid-November, which raises the total portfolio acquired by the ECB to slightly more than €76 billion.

Interbank market interest rates continued to move on a smooth rising trend and increased by approximately 15 bp from end-September for operations with a maturity of more than one month. The three-month and one-year EURIBOR stood, respectively, at average levels of slightly more than 1% and 1.5% in January. The EURIBOR yield spread over repo operations at equivalent terms held at more than 60 bp for the one-year EURIBOR, which continues to point to strains on interbank funding markets. Long-term rates in the euro area rose more than 50 bp during Q4 and January to levels of more than 4% for the ten-year EURIBOR. The yield on the ten-year German *Bund* increased by more than 90 bp from end-September, to more than 3%. As discussed above, in the second half of January sovereign spreads narrowed markedly to levels similar to those seen in early November, although volatility continued to be very high.

Risk premia rose slightly on private fixed-income markets particularly for financial sector securities and in countries hit hardest by the sovereign debt crisis. As for credit, the cost of private-sector bank loans to households held relatively unchanged during October and November, while it rose slightly in the case of corporations. For instance, the rate on new lending to non-financial corporations stood at 2.8% in November compared with the low of 2.4% in spring 2010; the increase was more pronounced for large loans of more than €1 million. The Bank Lending Survey (BLS) for Q4 indicates that the credit standards for new loans did not ease in Q4, nor are they expected to do so in coming months. The BLS confirms the smooth increase in the demand for loans by non-financial corporations, which is projected to step up in 2011 Q1.

As for private-sector financing, the total amount of debt issued by non-financial corporations grew at high rates, of more than 8% year-on-year in November, within the slightly moderating trend. Bank loans, by contrast, continued to recover smoothly in 2010 Q4, which is explained by the improvement in short-term financing, the type most closely linked to productive activity. In year-on-year terms, the decline in business loans decreased and stood at -0.2% in December. Lending to households performed stably and grew by approximately 3.7% year-on-year for home loans, whereas consumer loans continued to contract.

EURO AREA INTEREST RATES

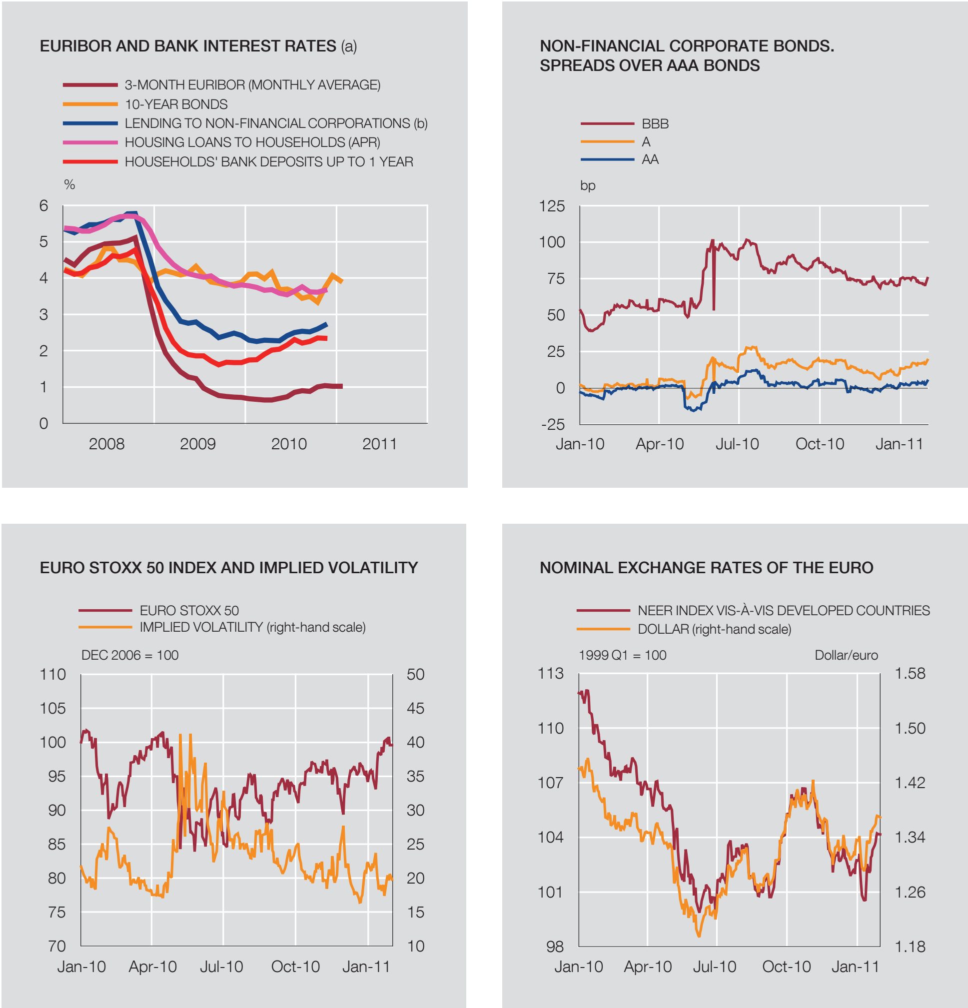
CHART 12

SOURCES: ECB and Banco de España.

a. ECB estimate using swap market data.

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX

CHART 13



SOURCES: ECB and Banco de España.

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

The performance of stock markets was very mixed by country and sector. The EUROSTOXX appreciated by more than 1.5% in 2010 Q4, placing its cumulative fall in 2010 at approximately 6% (see Chart 13). Except for Germany's DAX, which was up by more than 16% in the year, the major European stock market indices posted declines, which were sharper in the financial sector and in the countries affected by sovereign strains. The change in sentiment in January, with an easing of tensions on debt markets and the publication of some positive economic data in the United States and Europe, prompted a widespread reversal of this trend, with the EUROSTOXX rising by approximately 6%.

The euro exchange rate was not insulated from sovereign debt market instability in the area and the loss of investor confidence resulted in a depreciation of the euro by 2% in Q4 in effective terms, which represents more than 8% in 2010 as a whole. This trend was partly corrected at the beginning of 2011.

Lastly, the growth of the M3 monetary aggregate increased substantially in Q4, to 1.7% in year-on-year terms in December, which was explained by base effects relating to the rate and specific factors which raised the less liquid marketable securities component.

On Quarterly National Accounts (QNA) estimates, there was a pause in the ongoing recovery in economic activity in 2010 Q3, as the quarter-on-quarter rate of GDP posted a zero change, compared with 0.3 % growth in Q2. National demand fell by 1.4 % in quarter-on-quarter terms, reflecting the impact exerted by the reversal of some of the temporary effects that boosted it in the first half of the year. In contrast, net external demand made a positive contribution of the same amount to GDP growth, this being due to the loss of momentum of national demand feeding through into a sharp reduction in imports. In year-on-year terms, output grew by 0.2 %, 0.2 pp up on the previous quarter.

On the latest available information, the Spanish economy is estimated in Q4 to have resumed the path of slow recovery seen in the first half of the year, posting quarter-on-quarter GDP growth of 0.2 % (see Chart 14). Unable to resume its dynamism of the first half of the year, national demand fell by 0.4 % in relation to the previous quarter, while the contribution of external demand was positive (at around 0.6 pp), underpinned by the strength of exports, against the background of the improvement in Spain's foreign markets. In year-on-year terms, GDP is estimated to have grown by 0.6 %, 0.4 pp up on the previous quarter.

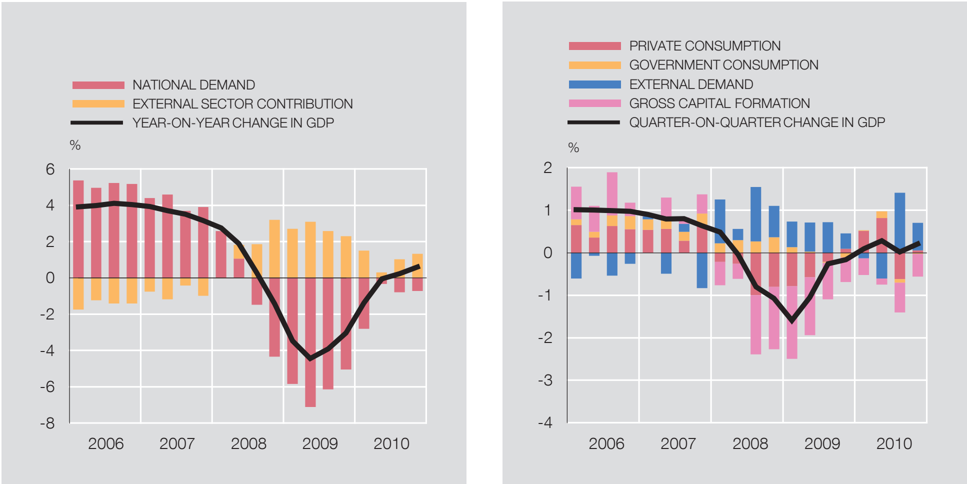
In line with these developments in activity, the fall in employment slowed in Q4 to an estimated rate of decline of 1.3 % year-on-year, 0.4 pp less marked than in the previous quarter. Given the estimated trend of output and employment, apparent labour productivity growth is expected to have remained sharp. Compensation per employee slowed again with the added impact of the cut in public-sector wages. As a result, the rate of decline of economy-wide unit labour costs, which had been falling since 2009 Q3, steepened slightly. Finally, the growth rate of the CPI rose notably during the last quarter of the year, placing year-on-year inflation at 3 % in December, 0.9 pp up on September. Chiefly behind this was the energy component. However, the CPI excluding energy and unprocessed food prices also quickened during the quarter (to 1.5 %, 0.4 pp more than at the start of Q4).

4.1 Demand

In 2010 Q4, private consumption is expected to have posted practically zero quarter-on-quarter growth following its sharp decline in the previous quarter, meaning its year-on-year rate will have held stable (see Chart 15). As previously indicated, there was a sharp slowdown in consumption in Q3 as a result of the reversal of the effects of a series of factors that had boosted this variable in the first half of the year. In part, the weakness of household consumer spending in the last three months of the year suggests a continuation of the adverse influence of these temporary factors. But it is also due to the fact that the prevailing circumstances, characterised as they are by the poorly performing labour market, the reduction in the value of real estate wealth, still-tight credit conditions and tax increases, are not very propitious for such spending decisions. Among the quantitative indicators, the quarter-on-quarter decline in new car registrations eased to 2.8 % (after having fallen 22 % in Q3). The retail trade index posted a quarter-on-quarter decline of 1.2 %, similar to that in Q3. Conversely, the year-on-year rate of decline of large corporations' sales eased in October and November. Among the qualitative indicators, the European Commission's consumer confidence index improved slightly on average in Q4, albeit moving on a deteriorating path, while retail traders' confidence worsened in the final quarter of the year. Into January 2011, the consumer indicator improved somewhat, while that for retailers held stable.

MAIN DEMAND AGGREGATES. CONTRIBUTIONS TO GDP GROWTH (a)

CHART 14

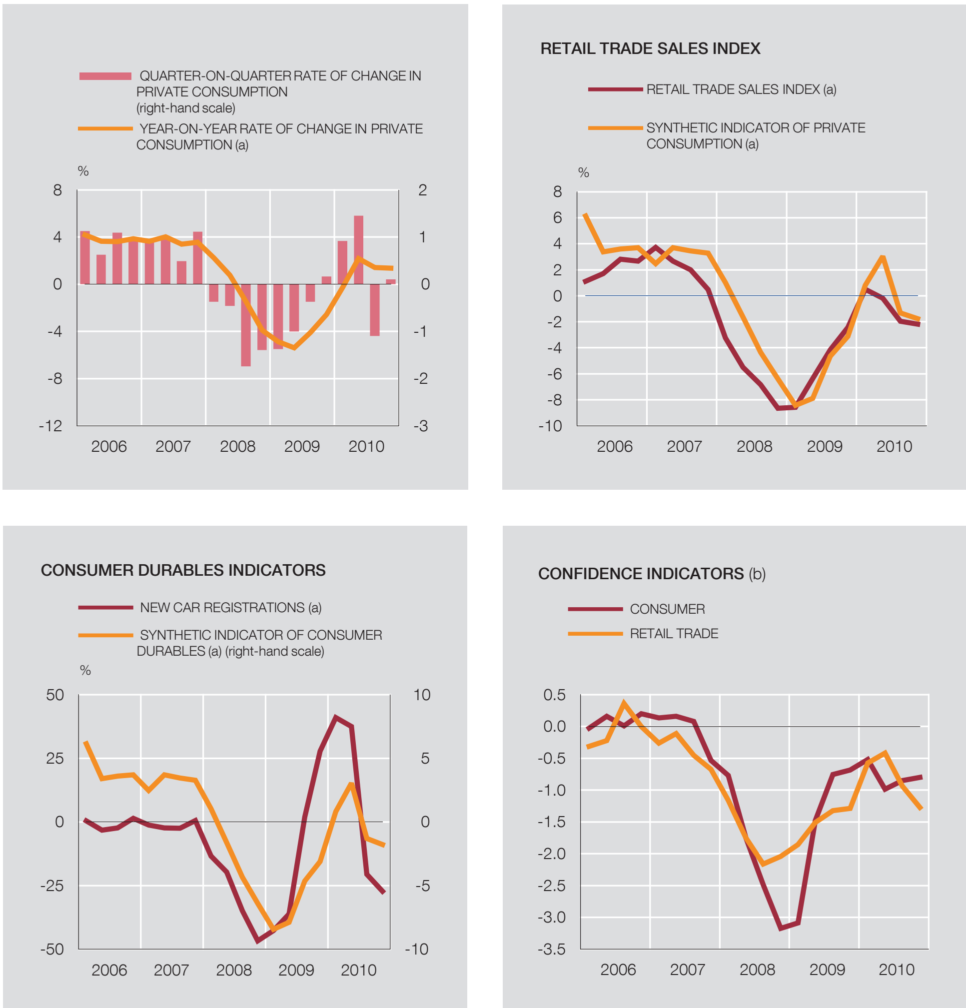


SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION

CHART 15



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

a. Year-on-year percentage change based on the seasonally adjusted series.
b. Normalised indicators (difference between the indicator and its mean value, divided by the standard deviation).

On the information available on the non-financial accounts of the institutional sectors (running to 2010 Q3), the rate of decline in four-quarter cumulated figures of household income steepened slightly. On one hand, this was the result of the decline in the contribution of property income, which turned negative, mainly as a consequence of the unfavourable trend of interest. On the other, there was a further reduction in the positive contribution of general government to upholding household income, owing to the behaviour of direct taxes and of social benefits. The trend of these two components was not offset by that of primary income (employee compensation and surplus), the rate of decline of which slackened. The course of disposable income, in step with an increase in the inflation rate, is expected to have constrained household purchasing power in the closing months and, thereby, the possibility of the pick-up in private consumption gaining momentum. Indeed, the trajectory of income and consumption to Q3 gave rise, once again, to a fall in the savings ratio, of the order on this occasion of 1.2 pp, down to 14.4 %, 3.6 pp less than at end-2009.

General government final consumption is expected once again to have posted a quarter-on-quarter decline in Q4, judging by the information available from the State budget outturn.

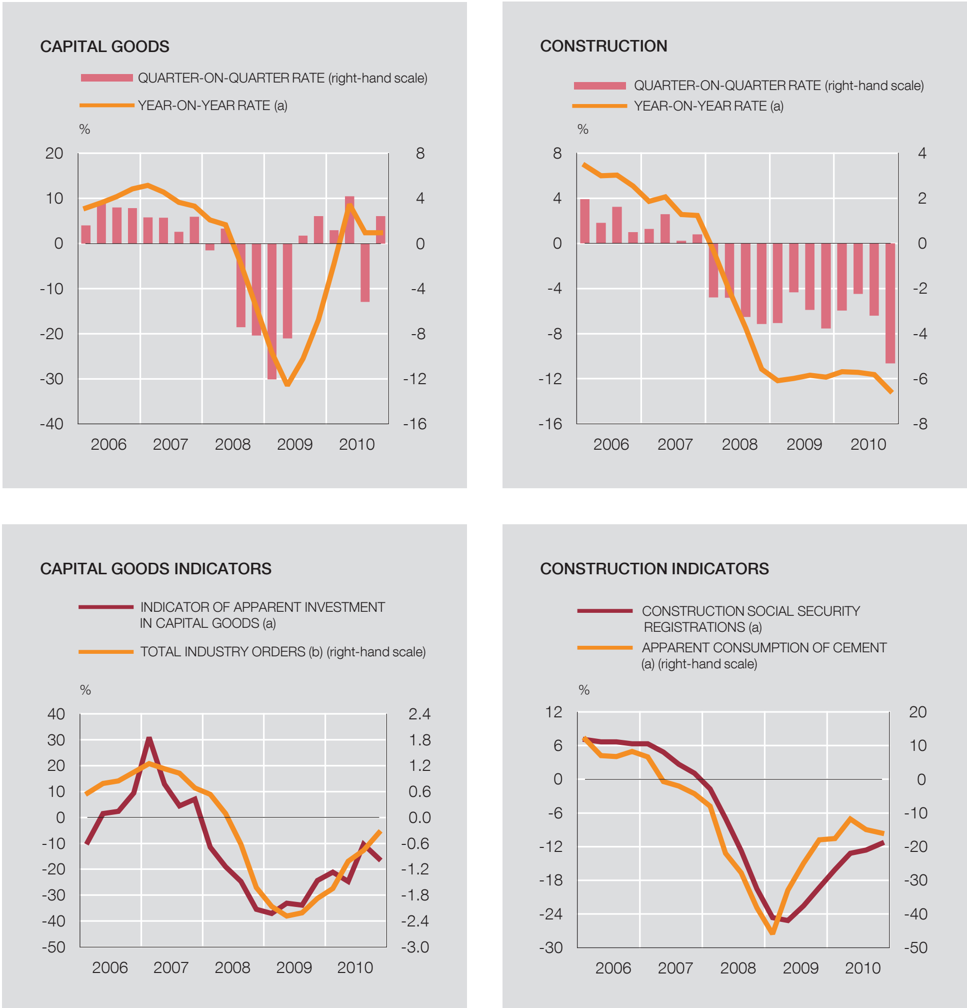
Investment in capital goods is estimated to have recorded positive quarter-on-quarter growth in Q4, while its year-on-year rate of change will have held stable. Among the quantitative indicators, new commercial vehicle registrations ended Q4 showing a quarter-on-quarter increase of 7.8 %, in contrast to the 13.3 % decline in Q3, while the year-on-year rate of decline of sales by large corporations (on information to November) is expected to have slowed by somewhat more than 2 pp. Figures on the domestic production of capital goods for October and November also reflect a slackening in their year-on-year contraction in the final stretch of the year, while imports remained very buoyant over these same months. Among the qualitative indicators, capacity utilisation is estimated to have increased by 1.1 pp at the start of the year. Further, business confidence in the industrial sector improved in Q4, both across the manufacturing branches as a whole and at capital goods producers. Conversely, services confidence worsened over the same period. In January, the trend of these indicators was in the opposite direction, although the changes were, in any event, small.

The information available on the non-financial accounts of non-financial corporations for 2010 Q3 is also conducive to a recovery in investment in capital goods. The figures suggest that these agents are rebuilding their financial positions, lowering their debt ratios and improving their profitability. On four-quarter cumulated figures, net borrowing was notably corrected, turning into what was marginally net lending, an unprecedented development in the time series. This was due to the increase in business saving, driven by the rise in the surplus, the reduction in the interest burden and fall in taxes paid, while investment by these agents continued to decline, albeit less sharply than in the preceding quarters.

The behaviour of investment in construction is, on the latest information (see Chart 16), estimated to have become more contractionary in Q4. 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, showed a steepening of year-on-year rates of decline, while, in contrast, the employment indicators evidenced slightly more moderate year-on-year falls than those for the previous quarter. This divergence is compatible with the stepping up of the fiscal consolidation process in the public works arena, which is less labour-intensive than other construction segments. In addition, 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, a trend which was repeated in January.

GROSS FIXED CAPITAL FORMATION

CHART 16



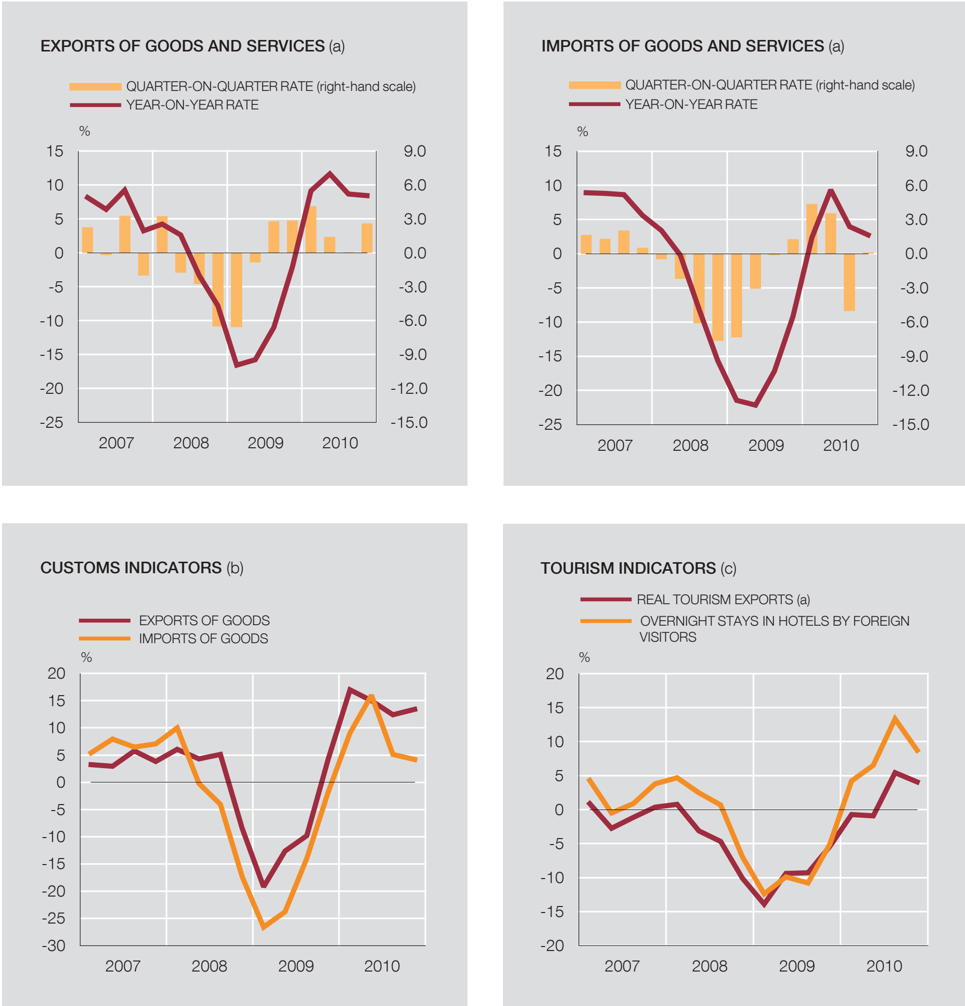
SOURCES: INE, European Commission, Eurostat, OFICEMEN and Banco de España.

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

Across the different types of works, the quarter-on-quarter decline in investment in residential building is estimated to have eased in relation to the previous quarter, as a result of the narrowing of the negative gap between the number of housing starts and completions. Moreover, the current trends for housing starts and completions will see an extension of the path of less pronounced reductions in investment in housing in the coming quarters. On the demand side of residential assets, a significant fall in housing market transactions was discernible in the second half of the year, probably attributable to the effect of the bringing forward of some purchasing decisions to the months prior to the VAT rise in July. The latest information in this respect, for November, appears to substantiate the somewhat more dynamic behaviour of transactions in the closing months of last year. Such behaviour might intensify in December in light of the improvement in the affordability indicators arising from the fall in house prices and, above all, from the temporary impulse associated with the partial elimination of house-purchase tax relief for individuals as from 1 January. Non-residential building permits underwent a severe loss of momentum in Q4. Finally, investment in public works trended unfavourably during the final quarter of the year, the result of the intensification of the budgetary consolidation process across the different tiers of government.

FOREIGN TRADE
Year-on-year rate of change

CHART 17



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.

The latest information available on net external demand points to a further positive contribution to GDP growth in 2010 Q4. Specifically, this contribution is estimated to be 0.6 pp in quarter-on-quarter terms and around 1.3 pp in year-on-year terms, 0.3 pp up on Q3. This improvement was the outcome of exports proving more buoyant than imports (see Chart 17). The mild slowdown in the year-on-year increase in imports is in keeping with the sluggishness of national demand, and especially of household consumption. The estimated year-on-year trend is consistent with a flattening out of the demand for imports in quarter-on-quarter terms. Exports remained notably robust in 2010 Q4, as evident in year-on-year growth that was analogous to that in Q3, against an international backdrop marked by the forceful momentum of the emerging economies – especially Asia and Latin America – and by the firming of the recovery in the developed economies, as can be inferred from the global merchandise trade data, which are holding at a high rate of growth. Turning to the competitiveness indicators, the information to November indicates that the depreciation of the nominal effective exchange rate enabled the slight increase in relative prices to be offset, which made for an improvement in the price-competitiveness indices vis-à-vis the developed countries.

According to Customs data, real goods exports increased by 15 % year-on-year on average in the October-November period, quickening in relation to Q3, in which they grew by 11.7 %. In the two months spanning October and November, the goods categories that performed most dynamically were, according to Customs, intermediate and capital goods, with rates of increase of 31.4 % and 25.8 %. By geographical area, the improvement was extensive both to real sales to the EU and, to a greater extent, to those intended for third markets (with respective increases of 13 % and 19.2 %). Notable on the Community front were the firmness of exports to Spain's main markets – France and Germany, with growth rates of around 13 % – and the even more marked buoyancy of exports to Italy and to the United Kingdom. Outside the Community there were sizeable increases in exports to the south-east Asian countries, China, Russia and Latin America, running at a year-on-year rate of around 30 % in all cases.

As to real exports of tourist services, information from the Balance of Payments to November points to a favourable performance in Q4, albeit with a less sharp increase than in Q3. The indicators of inbound tourism tended to ease off in year-on-year terms in Q4, this being related, at least in part, to the difficulties faced when travelling by air as a result of the dispute with the Spanish air traffic controllers and the bad weather in central and northern Europe. The indicator of overnight hotel stays by foreign visitors, drawn from the Hotel Occupancy Survey, grew by 8.9 % in Q4, entailing a slowdown of more than 3 pp on the previous quarter. The growth of incoming foreign tourists slowed by a similar amount, to 1.4 %, owing to the fall-off in British and German tourists, whereas the high rate of expansion shown by Nordic and Italian visitors in Q3 accelerated. According to EGATUR (the tourism expenditure survey), nominal spending by foreign visitors posted a year-on-year growth rate of 4.4 % over the October-November period (4.3 % in Q3), accompanied by a slight increase in spending per tourist (0.8 %). In the case of non-tourist services exports, the Balance of Payments indicators presage favourable figures in Q4, in step with the course of merchandise trade.

Turning to imports, goods purchases abroad, according to Customs figures, grew by 2.8 % year-on-year in the October-November period, entailing a 2 pp slowdown from the rate observed in Q3. For the first 11 months of the year, real imports increased by 8.6 %, in clear contrast to their collapse over the course of 2009 (-17.4 %). By product group, non-energy intermediate goods (13.9 %) and capital goods (9.1 %) proved to be the most buoyant in the October-November period. Conversely, the decline in consumer goods imports steepened to -17.3 % as a result of the fall-off in non-durable goods, since the year-on-year decline in durables eased following the heavy falls in Q3.

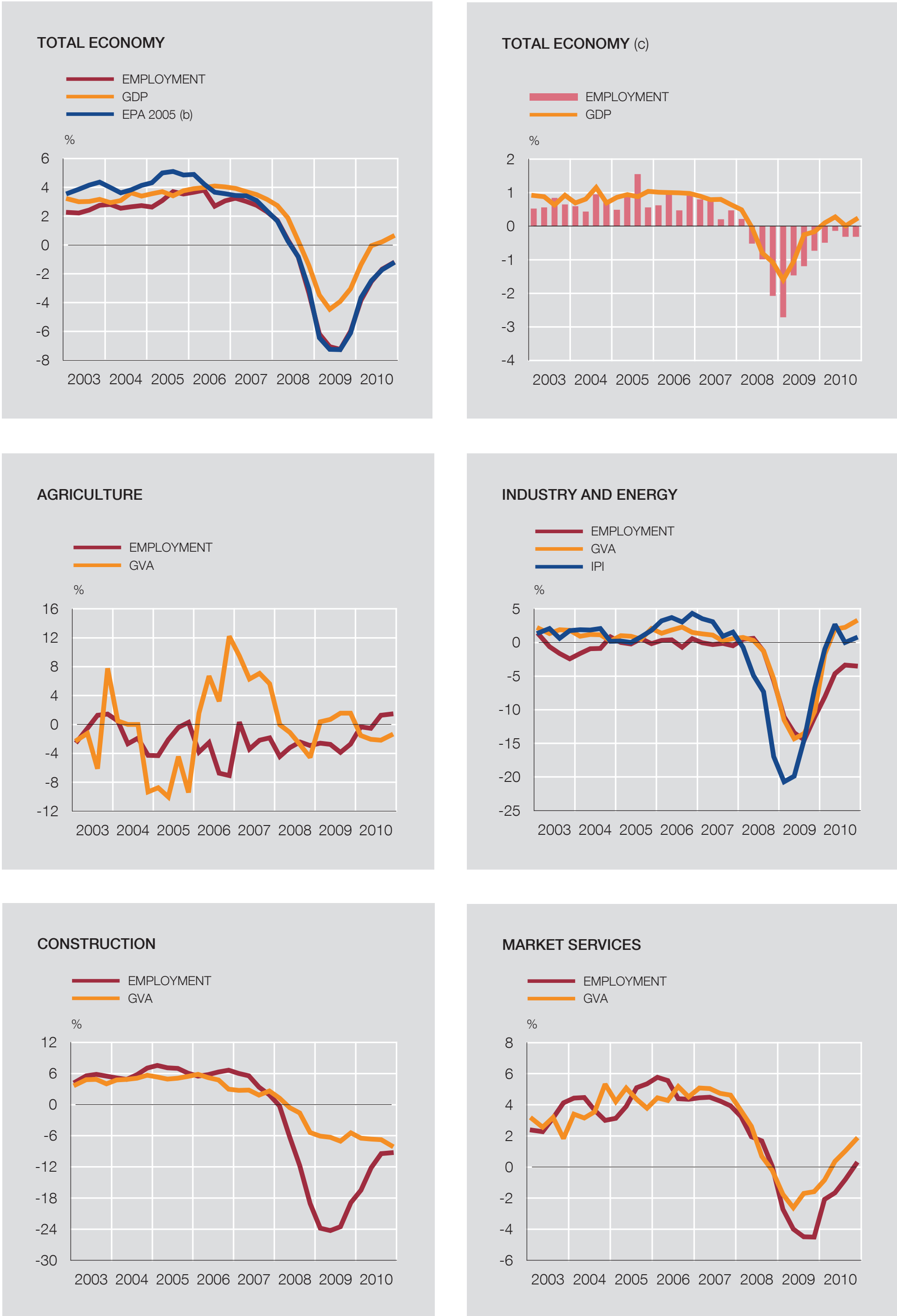
Regarding real services imports, the available indicators point to some worsening in 2010 Q4 owing to the weakening of the non-tourist services component. Tourist imports, in contrast, remain dynamic.

4.2 Output and employment

During Q4, gross value added in the market economy increased modestly in quarter-on-quarter terms, on a par with the previous quarter. Nonetheless, this would be the result of divergent branch-by-branch patterns, there having been an estimated strengthening of activity in the industrial and energy branches compared with the previous quarter, while in construction and market services, on the other hand, the performance was more unfavourable (see Chart 18).

Specifically, the information available on the indicators for industry points to a resumption of positive quarter-on-quarter growth rates in value added, following the slippage recorded in this branch in Q3. Indeed, the industrial production index regained some momentum in the final months of the year enabling it, pending the December figure, to close 2010 with positive rates of change for the year as a whole, after the contraction of almost 16 pp in 2009. The rate of

GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 18



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

a. Year-on-year percentage rates based on seasonally adjusted series, except in the case of EPA gross series. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b. Series linked by the DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.
c. Quarter-on-quarter rates based on seasonally adjusted series.

decline of the employment indicators continued to slacken in Q4 and the survey-based indicators also trended more favourably in this period. The pace of decline of value added in the construction sector stepped up, as a result – as mentioned – of the strong contraction in civil engineering works associated with the fiscal consolidation process under way across the different tiers of government.

The indicators available in relation to market services showed less momentum than in the previous quarter. Among the qualitative indicators, the services PMI was once again clearly below the benchmark level of 50 in Q4, contrasting with the more favourable picture portrayed for the euro area as a whole. The European Commission's opinion-based survey for the services sector also fell back in Q4 (although the figure for January partially corrected this decline). Information on the quantitative indicators for Q4 corroborates the relative weakness of the sector. Specifically, the number of Social Security registrations, which held unchanged in quarter-on-quarter terms, posted modest year-on-year growth of 0.4 %. Lastly, figures drawn from the index of services sector activity and large corporations' sales, with information to November, continued to show year-on-year declines, although these are less pronounced than in Q3.

In the labour market, the monthly indicators showed a slight easing in the pace of the year-on-year decline in employment during Q4. Average Social Security registrations moved on a progressively – albeit mildly – improving path during the quarter, declining by a rate of 1.3 %, 0.3 pp less pronounced than in Q3. However, in quarter-on-quarter terms, the seasonally adjusted series is stable in terms of the pace of decline, with a similar fall to that in previous quarters (-0.3 %). New hires registered at the National Public Employment Service (SPEE by its Spanish abbreviation) trended similarly in Q4 as they did in Q3 (year-on-year growth of 2.5 %), and permanent contracts were seen to accelerate, thanks mainly to the favourable pattern involving conversions of temporary contracts into permanent ones (15.5 %), since initial permanent contracts continued to post declines, albeit at a lower pace.

The EPA figures for Q4 show a year-on-year decline in employment of -1.3 %, 0.4 pp down on Q3. Construction and non-market services are the only branches to have performed worse than in the previous quarter. The remaining branches fared better, with positive year-on-year rates in agriculture and services. The slowdown in the rate of decline of employment affected solely the self-employed, whose numbers declined by 1.9 %, compared with 4.0 % the previous quarter, whereas wage-earners continued to show a decline of 1.2 %, as in Q3. In terms of nationality, the intensity of job destruction slowed both among foreign workers, with a fall in employment of 1.5 %, and among Spanish nationals (-1.2 %). As regards contract duration, the year-on-year rate of decline among temporary wage-earners eased once again (-2.2 %), although the adjustment to the latter group is greater than that observed for permanent employees, where the related rate fell by 0.8 %. As a result, the proportion of temporary to permanent employees fell slightly to 24.8 %, 0.8 pp down on the previous quarter and 0.3 pp below the level a year earlier (25.1 %). Finally, part-time hires practically held at the growth rate they have posted since the start of the year, with an increase of 0.2 %, while the rate for full-time employees declined by 1.5 %. These developments placed the ratio of part-time to total employees at 13.4 %, against 13.3 % one year earlier.

The labour force increased at the same pace as the previous quarter (0.6 %), against the background of the stability of the working population aged over 16 (0.2 %) and a slight year-on-year increase in the participation rate, which stood at 60 %, compared with 59.8 % in 2009 Q4. In terms of the breakdown by sex, the female labour force increased by 2.1 % in Q4, while the declining path of the male labour force steepened slightly (from -0.4 % in Q3 to -0.6 % in Q4). By nationality, foreign workers fell by 0.6 %, in line with the ongoing reduction in the foreign labour force (-0.6 % year-on-year). As a result, the participation rate of this latter group stood at 76.2 %, virtually unchanged on a year earlier. Spanish nationals, for their part, increased by 0.8 % and their participation rate held at 57.7 %.

Finally, the numbers of unemployed increased by 121,900 compared with Q3, placing the total number of jobless at 4.7 million. In year-on-year terms, the rise in unemployment eased to a rate of 8.6 %, below the figure of 10.9 % for the previous quarter. The unemployment rate increased by 0.5 pp during the quarter to 20.3 % of the labour force. Similarly, the SPEE registered unemployment figures confirmed the progressive easing in the deteriorating labour market path, with a 6 % increase in the number of unemployed in 2010 Q4, compared with 9.3 % in Q3.

4.3 Costs and prices

Wage settlements in 2010 stood at 1.3 % (see Chart 19). The figure marks a notable easing in relation to 2009, more in keeping with the unfavourable labour market situation. Contributing to these smaller wage increases was the agreement entered into by the social partners in February last year, which set a ceiling of 1 % on the increase in wage rates in 2010. However, the rise set in newly signed collective bargaining agreements exceeded this rate slightly. Elsewhere, the unfavourable course of the CPI in recent months might already be affecting wage increases, as apparently signalled by the fact that the agreements signed in the closing months of 2010 should on the whole have included wage rises somewhat higher than those agreed in previous months. This slight rise in wage rates comes about, moreover, in a setting in which a significant proportion of agreements has yet to be signed. Specifically, the agreements registered to December affect 7.1 million workers, one-third down on the number recorded in 2009. Finally, the current inflationary surge might adversely affect wage moderation through the indexation clauses, whose presence, albeit less than in previous years, is still significant as it affects 45.8 % of workers, compared with 70.5 % in December 2009. Given the temporary nature of the current inflationary rebound, it would be desirable that margins and wages should not react to it by seeking to maintain their level in real terms (see the analysis on this point in the article "La evolución reciente de la inflación española y perspectivas a corto plazo" in the January edition of the *Boletín Económico*).

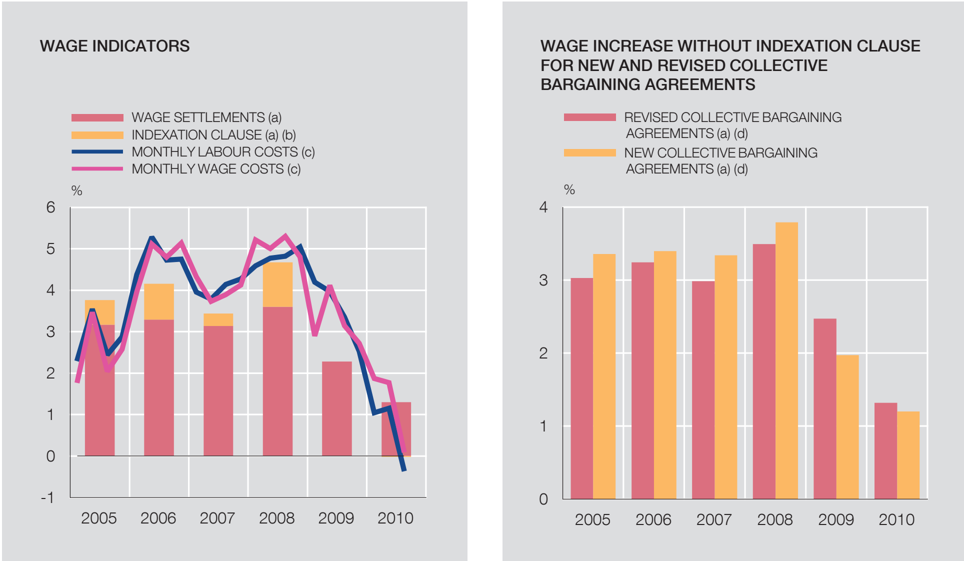
In terms of the QNA for 2010 Q4, the growth rate of compensation per employee economy-wide is expected to have eased further compared with the INE estimate for Q3, when this variable grew at a year-on-year rate of 0.5 %, 1 pp down on Q2 (see Chart 20). This slowing in the last quarter is due virtually in its entirety to the course of non-market services. Overall, the increase in compensation in the market economy in 2010 is higher than the wage increases agreed under collective bargaining. That reflects the phenomenon of positive drift habitually seen in periods of job destruction, owing to a composition effect whereby the loss in employment has a more than proportionate influence on jobs with less-than-average compensation. In Q4, and on National Accounts figures, the somewhat lower growth of wages, along with the continuing buoyancy of the rate of increase in productivity, is expected to have led to a decline in unit labour costs in the market economy, on a similar scale to that of the previous quarter.

The deflators of most demand components held, in Q4, at similar year-on-year growth rates to those in the previous quarter. Of most note was the slowdown in the government consumption deflator, attributable to the cut in public-sector wages. Both the rate of change of the domestic component of inflation and that of the external component (measured, respectively, by the GDP and imports deflators) are expected to have stabilised, albeit at higher levels than those at the start of the year.

The various consumer price indicators continued to quicken during Q4. The year-on-year rate of the CPI grew to 3 % in December, 0.9 pp up on the end of Q3. While the rising behaviour of infla-

WAGE INDICATORS AND LABOUR COSTS

CHART 19

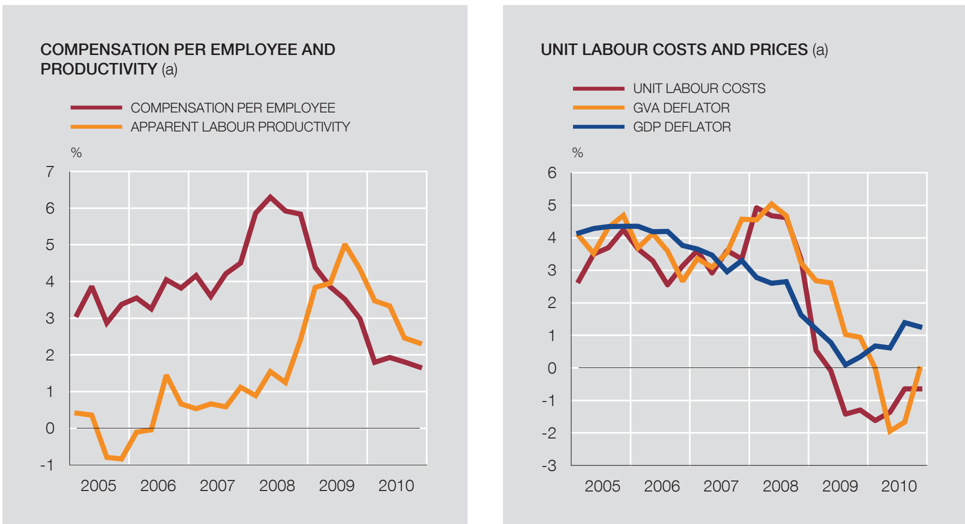


SOURCES: INE and Ministerio de Trabajo e Inmigración.

a. The last year, with information from collective bargaining agreements to December 2010.
b. Previous year's indexation clause.
c. ETCL (quarterly labour costs survey). Year-on-year rates of change.
d. Revised: collective bargaining agreements with economic effects in the year but which were signed in previous years and are in force for more than one year. New: collective bargaining agreements signed and with economic effects in the year, this being the first or only year they are in force.

PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

CHART 20



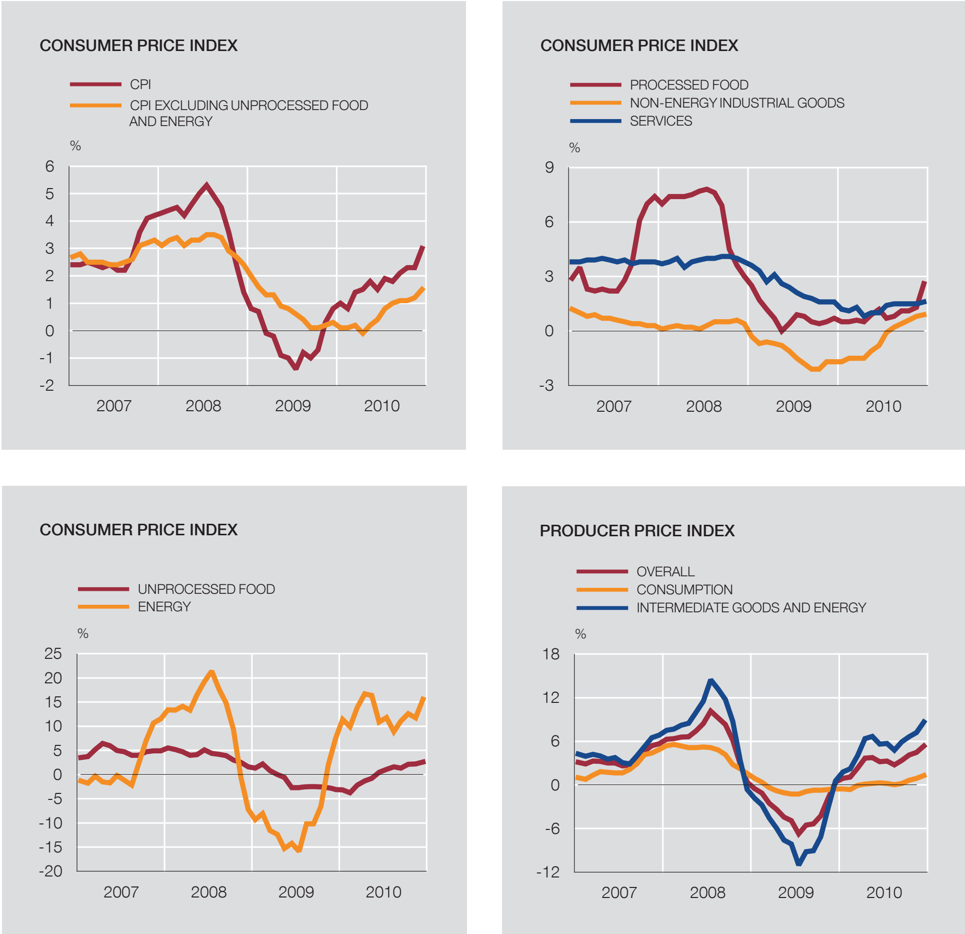
SOURCES: INE and Banco de España.

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

tion was, in terms of its components, across the board (see Chart 21), the essential determinant was energy, whose prices rose by 4.5 pp from September to December to 15.6 %, reflecting the rise in fuels, but also in other sub-components such as electricity and gas. The acceleration in food prices was also notable (by 1.4 pp to 2.6 %). Conversely, the increase was more moderate in the case of non-energy industrial goods and, above all, in that of services. As a result of the performance of the different components, the rate of change of core inflation – which excludes energy and unprocessed food prices – climbed to a lesser extent than the CPI (specifically, it was

PRICE INDICATORS (a)
Spain

CHART 21



SOURCE: INE.

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

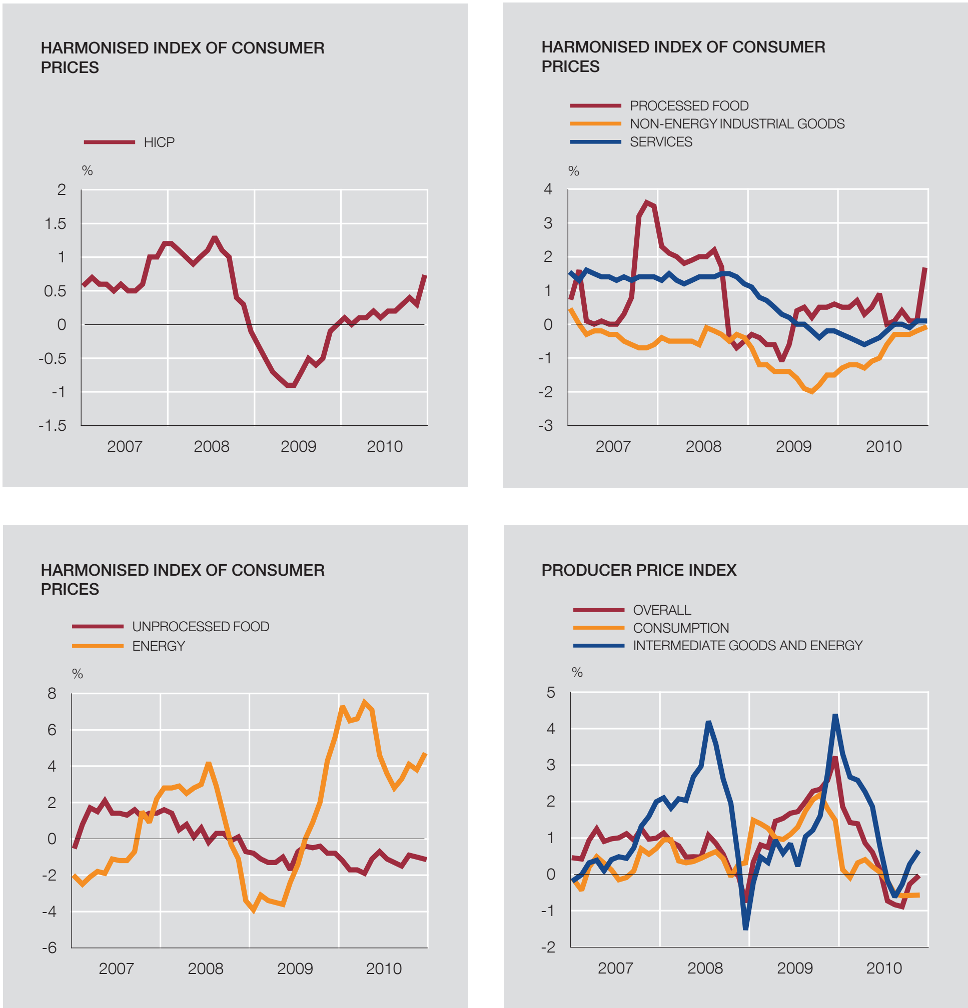
up by only 0.4 pp, to 1.5 %). INE has begun to publish a leading indicator of the CPI, and according to this the increase in consumer prices is estimated to have stood in January at 3.3 %.

The rebound in inflation, measured by the harmonised index of consumer prices (HICP), was sharper in Spain than in the euro area, whereupon the spread widened from September to December by 0.4 pp to 0.7 pp (see Chart 22). The growth rates of the prices of unprocessed food and non-energy industrial goods remained lower in Spain, albeit to a somewhat lesser extent. There was a visible widening of the positive differentials for energy components and processed food, while the spread for services remained close to zero. As a result, the difference in core inflation widened to 0.3 pp, after having stood at zero in September. With regard to the leading indicator of the HICP for January, this difference is expected to have narrowed by 0.1 pp, after posting a year-on-year rate of change of 3 % in Spain, compared with 2.9 % the previous month, while in the euro area as a whole the inflation rate is estimated to be 2.4 %, 0.2 pp up on December.

The producer price index also moved on a rising course during Q4, climbing from 3.4 % in September to 5.3 % in December. As in the case of the CPI, this acceleration was due to developments in all the components, although it was comparatively more pronounced in the case of energy. Relative to the euro area, the differences remained negative in all cases, except for energy and consumer durables. Finally, the year-on-year rates of increase in the import and export price

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

CHART 22



SOURCES: Eurostat and Banco de España.

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

indices for industrial products steepened, rising to 9.2 % and 5.6 %, respectively, in November. In both cases, the growth rates of energy prices dipped, although these remained high.

4.4 The State budget

On the latest information drawn from the Quarterly National Accounts for general government, in Q3 last year this sector posted a deficit of 10.2 % of GDP in cumulated four-quarter terms, down from the peak of 11.6 % of GDP in 2010 Q1. This improvement, which confirms the change in budgetary policy stance, was due above all to the considerable acceleration in revenue, to a year-on-year rate of 4.7 %, although a further contributing factor was the containment of expenditure, whose growth rate fell to 1.3 %.

In terms of agents, and according to a provisional estimate released by the Spanish Ministry of Economy and Finance, central government, which includes the State and the autonomous agencies reporting to it, is expected to have ended 2010 with a National Accounts-terms deficit of €53.44 billion, equivalent to 5.1 % of GDP. This provisional figure is consistent with comfortable compliance by central government with its deficit target for last year, set at 5.9 % of GDP. The latest full figures released are for November, to which month the State posted a deficit of €38.8 billion (3.7 % of GDP) in National Accounts terms, far below the €71.5 billion

STATE BUDGET OUTTURN

TABLE 4

€m and %

	Outturn 2009	Percentage change 2009/2008	Budget outturn projection	Percentage change 2010/2009	Outturn Jan-Sep. Percentage Change 2010/2009	Outturn		
						2009 Jan-Sep	2010 Jan-Sep	Percentage change
	1	2	3	4 = 3 / 1	5	6	7	8 = 7 / 6
1 REVENUE	102,038	-21.1	121,551	19.1	31.1	95,092	119,210	25.4
Direct taxes	54,096	-27.0	58,270	7.7	11.9	51,955	57,057	9.8
Personal income tax	*30,432*	*-29.9*	*39,950*	*31.3*	*35.4*	*28,826*	*37,055*	*28.5*
Corporate income tax	*20,188*	*-26.1*	*14,648*	*-27.4*	*-21.3*	*19,947*	*16,489*	*-17.3*
Other (a)	*3,476*	*2.8*	*3,672*	*5.7*	*7.6*	*3,182*	*3,512*	*10.4*
Indirect taxes	28,664	-26.9	48,769	70.1	99.1	27,900	49,735	78.3
VAT	*15,784*	*-36.7*	*35,032*	*121.9*	*180.1*	*16,081*	*37,445*	*132.8*
Excise duties	*10,141*	*-9.6*	*10,884*	*7.3*	*6.4*	*9,297*	*9,515*	*2.4*
Other (b)	*2,739*	*-11.2*	*2,853*	*4.1*	*7.5*	*2,522*	*2,775*	*10.0*
Other net revenue	19,277	20.4	14,511	-24.7	-19.5	15,237	12,419	-18.5
2 EXPENDITURE	189,319	27.8	183,654	-3.0	-2.2	163,601	162,257	-0.8
Wages and salaries	26,570	5.3	26,973	1.5	2.7	22,952	23,181	1.0
Goods and services	4,860	7.2	4,409	-9.3	-2.3	4,007	3,542	-11.6
Interest payments	17,650	10.8	22,237	26.0	9.1	17,342	19,516	12.5
Current transfers	112,412	35.8	105,297	-6.3	-2.9	95,659	95,404	-0.3
Investment	10,468	-1.6	8,458	-19.2	-11.0	8,900	7,352	-17.4
Capital transfers	17,360	94.1	16,280	-6.2	-14.1	14,741	13,263	-10.0
3 CASH-BASIS BALANCE (3 = 1-2)	-87,281	—	-62,103	—	—	-68,508	-43,047	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)								
TOTAL	116,779	-15.9	133,578	14.4	19.8	109,866	127,752	16.3
Personal income tax	63,857	-10.5	67,601	5.9	5.6	59,809	62,610	4.7
VAT	33,573	-30.1	45,625	35.9	57.1	32,299	46,947	45.4
Excise duties	19,349	-1.1	20,352	5.2	4.2	17,758	18,195	2.5

SOURCE: Ministerio de Economía y Hacienda.

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

(6.8 % of GDP) for the same period a year earlier. Under this accounting convention, State revenue increased by 25.4 % to November, while expenditure contracted slightly, with a rate of change of -0.8 %. Both rates are higher than those forecast in the budget outturn projection included in the State budget for 2011, in particular in the case of revenue (see Table 4).

In describing developments in government revenue, use is made of the figures on takings for the main taxes, having regard to the portion assigned to the State and to that corresponding to the ordinary-regime territorial governments. According to these figures, the buoyancy of revenue eased slightly in the closing months of 2010. In the case of personal income tax, the effect of the elimination of the tax credit of up to €400 was partly offset by the influence of the 5 % cut in public-sector wages on tax withholdings. As to corporate income tax, its growth rate has improved recently owing to the second partial tax payment for the year. Despite this, tax takings between January and November were 17.3 % down on the related figure in the same period of 2009.

Turning to indirect taxes, VAT continued posting the sharpest rises (45.4 % on figures to November). This was due, above all, to the return to a level of takings more in keeping with that

REGIONAL GOVERNMENT BUDGET OUTTURN

TABLE 5

€m and %	Initial budget 2009	Percentage change 2009/2008	Initial budget 2010	Percentage change 2010/2009	Outturn Jan - Sep 2009	Outturn Jan - Sep 2010	Outturn Jan - Sep 2010
	1	2	3	4 = 3 / 1	5	6	7 = 6 / 5
1 REVENUE	164,585	-2.0	150,887	-8.3	—	95,045	-13.5
Direct taxes	36,516	18.8	29,955	-18.0	—	22,158	-23.0
Indirect taxes	44,663	-20.3	36,114	-19.1	—	25,059	-12.7
Charges, prices and other revenue	4,819	4.5	4,882	1.3	—	3,763	3.9
Current transfers	68,502	1.5	71,088	3.8	—	41,167	-9.7
Interest and dividends	592	6.4	551	-6.9	—	222	-37.0
Disposal of investments	633	0.4	518	-18.1	—	131	-22.7
Capital transfers	8,861	8.4	7,778	-12.2	—	2,544	-3.7
2 EXPENDITURE	174,801	3.8	175,336	0.3	—	108,106	-2.5
Wages and salaries	55,335	5.7	56,506	2.1	—	43,106	-0.2
Goods and services	28,924	3.2	29,469	1.9	—	18,721	-4.7
Interest payments	2,741	10.1	3,714	35.5	—	1,887	12.4
Current transfers	55,752	4.9	55,722	-0.1	—	32,308	-2.4
Contingency fund	209	19.2	237	13.6	—	—	—
Investment	15,975	-2.5	13,280	-16.9	—	5,572	-10.8
Capital transfers	15,865	0.5	16,408	3.4	—	6,512	-6.6
3 BALANCE (3 = 1 - 2)	-10,215		-24,450	—	—	-13,061	—

SOURCE: Ministerio de Economía y Hacienda.

of the tax bases, after the decision to generalise the monthly refund regime in 2009 gave rise that year to a temporary increase in such refunds, which exceptionally reduced net revenue for that year. Combining with this effect, moreover, was a very marked reduction in applications for refunds in 2010. Excise duties, for their part, slowed in Q3, following the stripping out of the positive effect on revenue in the first half of the year exerted by the rises in rates on taxes on hydrocarbons and tobacco approved in 2009.

The slight reduction in State cash-basis expenditure in cumulative terms to November entails a mild acceleration on the previous months, which was due, above all, to transfers, especially those to other general government sectors. In the same respect, interest payments stepped up (to 12.5 %). Conversely, there has been notable containment in personnel costs (which grew at a rate of 1 %), following the wage cuts applied mid-year, and the strong reduction in investment spending, which fell by 17.4 %.

With regard to the regional governments, in December 2010 they published data for the first time on their respective budget outturns to September 2010 (in terms of recognised entitlements and obligations), along with the related year-on-year rates compared with the same period in 2009 (see Table 5). According to this information, the regional governments' deficit is estimated to have reached €13.1 billion in 2010 Q3 (1.2 % of GDP). This is the result of a decline both in revenue (-13.5 %) and in expenditure (-2.5 %). The fall in regional governments' tax revenue is due to the functioning of their financing system since, at the overall level of the State and regional governments, tax revenue increases most notably in 2010. As to expenditure, the interest payment item is the only one to have increased during the period. In respect of declines, mention should be made of the slight reduction in personnel costs and the 10.8 % fall in real investment, which is somewhat lower than that in the case of the State. Box 4 analyses the regional government budgets for 2011.

The regional (autonomous) governments have reached a very significant weight in general government. On the latest available figures, for 2009, the regional governments received 38.7 % of current taxes raised and managed 35.7 % of total expenditure. Notable regarding this expenditure was that the regional governments were responsible for more than 90 % of public spending on health and education. These figures highlight the need to pay attention to the budgetary conduct of the regional governments, in particular in relation to their necessary contribution to budgetary stability. The new ordinary-regime regional government financing system, which came fully into force on 1 January 2010, furthermore, significantly increased the percentages assigned to regional governments of personal income tax (from 33 % to 50 %), of VAT (from 35 % to 50 %) and excise duties on manufactured products (from 40 % to 58 %).

On the latest available information, the regional government deficit, in terms of National Accounts, amounted to -2.0 % of GDP at end-2009, and should stand on official projections at -3.1 % and at -3.3 % of GDP at end-2010 and end-2011, respectively. Stripping out the effect of regional government payment deferrals to the central government as a result of the final settlement of revenue for 2008 and 2009[1] would give deficits of -2.4 % and -1.3 % of GDP in 2010 and 2011. The regional government budget outturn data to 2010 Q3 (published at end-2010) were, overall, in line with that target (see Section 4.4 of this report).

1. Nevertheless, it should be noted that in 2010 and 2011 there will be notable discrepancies between the estimated budget balance and the National Accounts balance for the regional governments. In fact, under the financing system of regional governments, the latter receive annually the funds from the taxes transferred to them based on forecasts of tax receipts included in the State Budget. Subsequently, with a two-year lag, this revenue is settled definitively on the basis of final receipts. As a result of optimistic revenue forecasts made in 2008 and 2009, in 2010 and 2011 the definitive revenue settlement is expected to mean that the regional governments should return the surplus funds received to the State. The State, however, has allowed the regional governments to delay these refunds until 2012 (and by up to 60 months), consequently, the regional governments' payments to the State are not reflected in their budgets for 2010 and 2011 and, consequently, are not reflected in their budget deficits for those years. The National Accounts' criterion, however, includes these payments in the years when they should be made, namely in 2010 and 2011; therefore, the above-mentioned deficits (-3.1 % of GDP and -3.3 % of GDP), net of those payments, would amount to -2.4 % of GDP in 2010 and to -1.3 % of GDP in 2011, ratios which are readily comparable with the budgeted figures of the regional governments, since they are also net of those payments.

€m and %

	2009	2010	2011	Rates of change			State
				2009/2008	2010/2009	2011/2010	2011/2010
1 REVENUE	135,716	124,559	123,241	-2.1	-8.2	-1.1	-12.5
Current revenue	126,539	116,628	114,472	-2.7	-7.8	-1.8	-11.5
— Direct taxes	28,553	22,834	31,083	17.4	-20.0	36.1	-16.8
— Indirect taxes	34,671	28,459	40,671	-20.0	-17.9	42.9	-11.3
— Charges, prices and other revenue	3,751	3,971	3,987	4.1	5.9	0.4	7.5
— Current transfers	59,040	60,878	38,257	1.2	3.1	-37.2	-14.1
— Interest and dividends	523	486	474	6.3	-7.1	-2.5	76.0
Capital	9,177	7,931	8,769	7.7	-13.6	10.6	-76.1
— Disposal of investments	633	518	1,760	2.0	-18.1	—	-2.5
— Capital transfers	8,544	7,413	7,009	8.2	-13.2	-5.5	-80.3
2 EXPENDITURE	143,338	142,248	132,536	3.8	-0.8	-6.8	-18.9
Current expenditure	114,592	115,658	111,189	4.8	0.9	-3.9	-16.2
— Wages and salaires	46,759	47,542	44,951	5.6	1.7	-5.4	-2.1
— Goods and services	21,095	21,120	20,231	3.3	0.1	-4.2	-3.7
— Interest payments	1,808	2,470	2,955	5.0	36.6	19.6	18.1
— Current transfers	44,831	44,438	42,975	4.6	-0.9	-3.3	-27.7
— Contingency fund	99	87	78	51.8	-11.7	-10.8	-28.7
Capital	28,746	26,590	21,347	-0.2	-7.5	-19.7	-37.1
— Investment	14,260	11,658	8,807	-1.7	-18.2	-24.5	-38.3
— Capital transfers	14,486	14,932	12,540	1.2	3.1	-16.0	-36.3
BALANCE	-7,622	-17,689	-9,295	—	—	—	—
% of GDP	-0.7	-1.7	-0.9	—	—	—	—
MEMORANDUM ITEMS (% of GDP):							
BALANCE (all regional governments)	-0.1	—	—	—	—	—	—
NAT. ACCOUNTS BALANCE	2.0	-3.1	-3.3	—	—	—	—
NAT. ACCOUNTS BALANCE with deferrals (% of GDP)	2.0	-2.4	-1.3	—	—	—	—

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

a. In 2011 the regional governments of Cataluña and the Balearic Islands extended the 2010 budget to 2011.

In this setting, the regional governments have submitted their draft budgets for 2011, the main headings of which are in the accompanying table,[2] with the exception of Catalonia and the Balearic Islands, which have extended the 2010 budget to 2011. The budgets indicate a notable improvement in the balance, to -0.9 % of GDP in 2011, in comparison with the initial budget for 2010 (-1.7 % of GDP). Should the Catalan and Balearic Islands' deficit perform similarly to the average of the other regional governments, the balance would stand at approximately -1.1 % of GDP in 2011, compared with -2.3 % of GDP for all regional government budgets for 2010 and would, in principle, be compatible with the public deficit target for that year. The improvement in the deficit budgeted for 2011 seems to suggest that there will be a slight fall in revenue, while expenditure will contract notably by -6.8 % with respect to the amount budgeted for 2010.

Notable on the current revenue side are the sharp increases expected in direct and indirect taxes and the projected fall in transfers, as a result of which these budgets are the first to fully reflect the new ordinary-regime regional government financing system.[3] Thus, the budgets include the higher tax assignment percentages. It is estimated that this higher tax revenue[4] would be offset by lower current transfers.[5] Also noteworthy is the expected fall in capital transfers, but in this case it is due, in particular, to fewer EU funds.

A greater fall has been budgeted in expenditure than in 2010. This affects all headings, except for interest payments. In the case of wages and salaries, the regional government budgets for 2011 envisage a decline in personnel costs, partly due to the wage cut applied mid-2010 and the freeze projected for 2011, and partly due to possible limitations on replacing retiring employees (compulsorily capped at 10%, as at State level). Declines are also projected for expenditure on purchases and current transfers, which are very closely linked to the functions of healthcare and education. The interest burden is expected to grow strongly in 2011, as a result of the increase in debt issued and the downward path of interest rates having run its course. Lastly, in line with the previous year, capital expenditure was subject to the highest cuts in the regional government budgets and real investment slowed (to a rate of -24.5 %) as did capital transfers (to a rate of -16 %).

2. The table presents the aggregate figures of the initial budget of the regional governments and, in the last column, that of the State. They do not include, however, the budgets for Catalonia or the Balearic Islands, which have extended the 2010 budget to 2011. **3.** The attendant legislation is published in the Official State Gazette of 19 December 2009.

4. From 2011 onwards all regional governments must approve their specific rate for personal income tax. When doing this, some regional governments such as Andalusia and Extremadura raised the marginal personal income tax rates. In the case of these two regional governments, the top rate was increased by 3 pp (to 24.5 %) from €120,000. **5.** Not only due to the reduction of transfers from the State but also because the new system entails contributions from certain regional governments involving budgeting a negative figure for current transfers as in the case of Madrid which budgeted a negative figure of €1,536 million for the whole of this revenue item.

Finally, the Social Security system posted a surplus of €2.4 billion to December 2010, accounting for 0.22 % of GDP, compared with the forecast of 0.27 %. Compared with 2009, recognised entitlements fell by 1 %, while recognised obligations increased by 4.6 %. By component, revenues relating to contributions shrank by 0.8 %, reflecting the trend of Social Security registrations. Contributory pensions spending rose by 6.4 %, which includes the payment relating to the CPI inflation deviation from its forecast. Sickness benefit spending continued to decline, at a rate of 4.7 %. In the case of the SPPE (State Public Employment Service), revenue from contributions to September show a decline of 0.2 %. Regarding expenditure, unemployment benefits continued to slow to a rate of 4.8 % in December, in line with the observed trend of unemployment and with the changes in the characteristics of recipients, the reflection of which is lower average spending per beneficiary. According to a provisional estimate from the Ministry of Economy and Finance, the SPPE is expected to post a deficit of 0.3 % of GDP in 2010, compared with the balanced budget initially foreseen.

Overall, the information available on the general government budget outturn is estimated to be compatible with compliance with the government-set budget deficit targets for 2010 (9.3 % of GDP), with the better performance of the central government deficit enabling the deviations in other government levels to be offset.

4.5 Balance of payments

In the first 11 months of 2010, the overall current and capital account balance showed a deficit of €39 billion, 23 % down on the same period in the previous year (see Table 6). Taken indi-

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 6

€m

		January-November		RATE OF CHANGE
		2009	2010	2010/2009 (b)
CREDITS	Current account	277,884	304,770	9.7
	Goods	*146,698*	*172,106*	*17.3*
	Services	*81,280*	*85,194*	*4.8*
	— Tourism	36,084	37,532	4.0
	— Other services	45,197	47,662	5.5
	Income	*34,981*	*33,001*	*-5.7*
	Current transfers	*14,924*	*14,469*	*-3.1*
	Capital account	5,157	6,899	33.8
	Current + capital accounts	283,040	311,669	10.1
DEBITS	Current account	332,119	349,374	5.2
	Goods	*188,100*	*213,518*	*13.5*
	Services	*57,331*	*58,720*	*2.4*
	— Tourism	11,136	11,692	5.0
	— Other services	46,196	47,027	1.8
	Income	*63,399*	*54,301*	*-14.4*
	Current transfers	*23,289*	*22,836*	*-1.9*
	Capital account	1,888	1,447	-23.4
	Current + capital accounts	334,008	350,820	5.0
BALANCES	Current account	-54,236	-44,604	9,631
	Goods	*-41,402*	*-41,411*	*-10*
	Services	*23,949*	*26,474*	*2,525*
	— Tourism	24,948	25,839	891
	— Other services	-999	635	1,634
	Income	*-28,419*	*-21,300*	*7,119*
	Current transfers	*-8,365*	*-8,367*	*-3*
	Capital account	3,268	5,453	2,184
	Current + capital accounts	-50,967	-39,151	11,816

SOURCE: Banco de España.

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

vidually, both balances improved. The narrowing of the current account deficits is essentially due to the reduction in the income deficit and, to a lesser extent, to the widening of the services surplus, insofar as the balances on trade and current transfers remained virtually stable. The surplus on capital transactions increased substantially.

As regards the current account, the €41 billion deficit on the trade balance from January to November was practically identical to that in the same period in 2009, against a background of strong growth both in goods imports (14 %) and exports (17 %). The course of the trade deficit was the result of the opposite-running trajectories of the energy balance, which worsened further to the rise in oil prices, and of the non-energy balance, which was significantly corrected. The rise in crude oil prices in euro gave rise to a worsening in the terms of trade, while the trade balance in real terms improved over the first 11 months as a whole. The services balance posted a surplus of €26.5 billion, 11 % more than in the same period in 2009. This was chiefly due to the improvement in the balance of non-tourism services, although the tourism surplus also rose. In the income balance there was a much sharper decline in payments than in income, which made for a 25 % decline in the deficit on year-on-year terms, to €21.3 billion. The deficit on current transfers also practically matched that of the same period the previous year, standing at €8.4 billion, in a setting of moderately declining income and payments. Finally, the capital account surplus rose in the first 11 months of 2010 to €5.5 billion, principally as a result of the climb in income received by general government from the various Community funds included in the capital balance.

5.1 Highlights

During 2010 Q4 there were further financial strains in the euro area. The trigger on this occasion was the problems of Ireland's financial system and public finances which led, at the end of November, to the approval of an aid programme by other European countries and the IMF. Spain was once again among the countries hardest hit by this bout, as reflected in the fall in share prices, which proved sharper in the financial sector, and the rise in risk premia on fixed-income securities issued by the public and private sectors.

In this setting, in 2010 Q4 the IBEX 35 posted a fall of 6.2% (which raised its cumulative loss for 2010, as a whole, to 17.4%), compared with increases of 1.6% in the EUROSTOXX 50 (but a decline of 5.8% for the whole year) and of 10.2% in the S&P 500 (12.8% in year-on-year terms) (see Chart 23). The yield on Spanish 10-year government bonds increased by 136 basis points (bp), at the same time as the spread over the 10-year German *Bund* rose by 63 bp to 250 bp, although it reached 290 bp at end-November. The risk premia on private-sector fixed-income securities also moved higher, especially those of financial corporations. By contrast, on the interbank market the twelve-month EURIBOR rose a meagre 8 bp to 1.51%.

In 2011 to date there has been some easing of the strains on financial markets. For instance, in January the Ibex 35 appreciated by 9.6%, while the spread over German ten-year bonds, which edged upwards again early in 2011, fell back at end-January to approximately 225 bp, 25 bp lower than the figure for end-2010. However, uncertainty and volatility remain high.

The financial strains were also apparent in the fall in activity on primary markets for credit institutions' debt during the last two months of 2010. As a result, and on available provisional figures, it is estimated that gross issuance was not sufficient to cover redemptions in December. However, unlike the events of spring 2010, this time there was no decline in interbank funding owing to certain banks having the possibility of obtaining funds through clearing houses, once they had registered with these systems.

In the real estate market, the latest data published by the Ministry of Infrastructure and Transport for end-2010 indicate that, in 2010 Q4, open-market house prices continued to fall at a year-on-year rate similar to that for Q3 (3.5%) (see Chart 23). The correction of this variable from its peak in March 2008 is 13% in nominal terms and 18% in real terms.

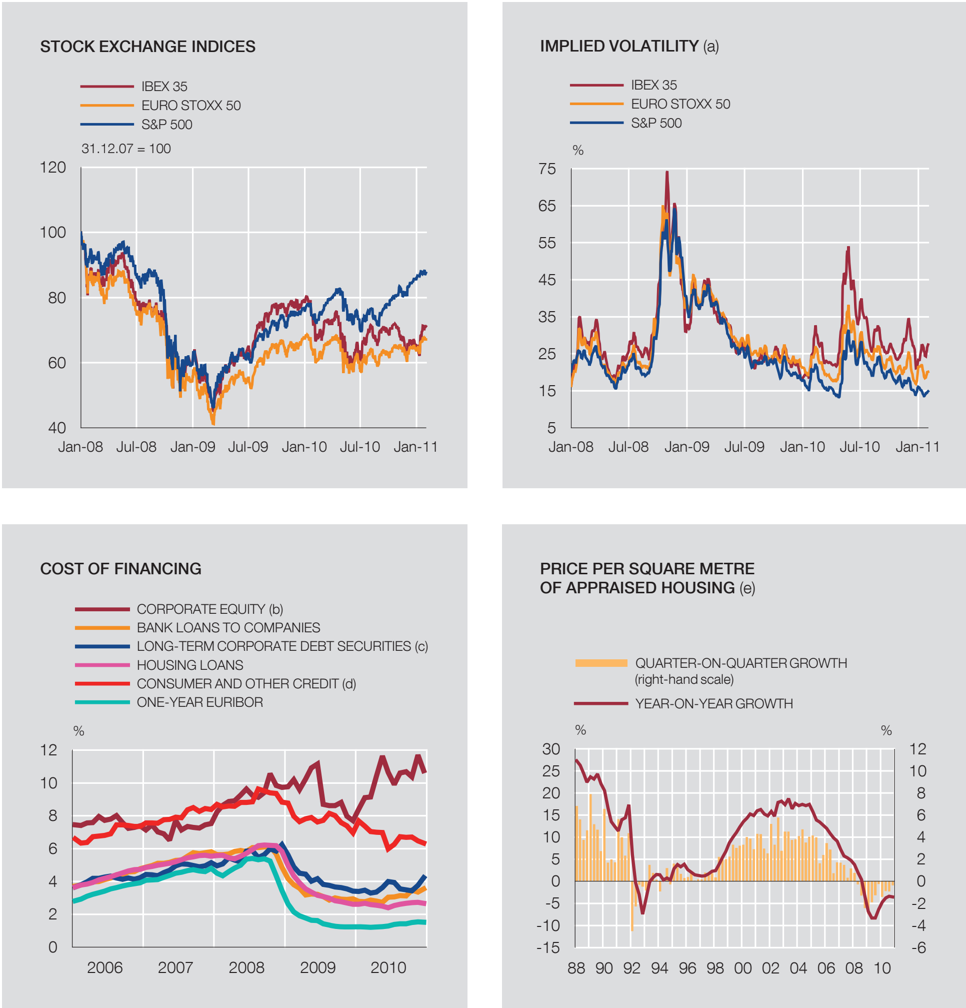
On available information the strains in financial markets do not seem to have been reflected to date in a tightening of private-sector financing conditions. Thus, according to the Bank Lending Survey (BLS) for January 2011, it is estimated that credit standards remained unchanged in all segments during 2010 Q4, while credit institutions did not envisage any changes for the early months of 2011.[1] Similarly, in general the margins applied increased very slightly, although the cost of business loans moved moderately upwards, partly as a result of interbank interest rate rises (see Chart 23). The cost of market-based financing through debt climbed sharply but hardly changed in the case of equity.

In Q4 household and corporate debt continued to rise weakly. The year-on-year growth rate of household liabilities fell back slightly (-0.1% in November, compared with 0.3% in September),

1. For more details see the article entitled "Encuesta sobre Préstamos Bancarios en España: enero de 2011", by Maristela Mulino, in the Banco de España's *Boletín Económico* January 2011.

FINANCING CONDITIONS AND ASSET PRICES

CHART 23



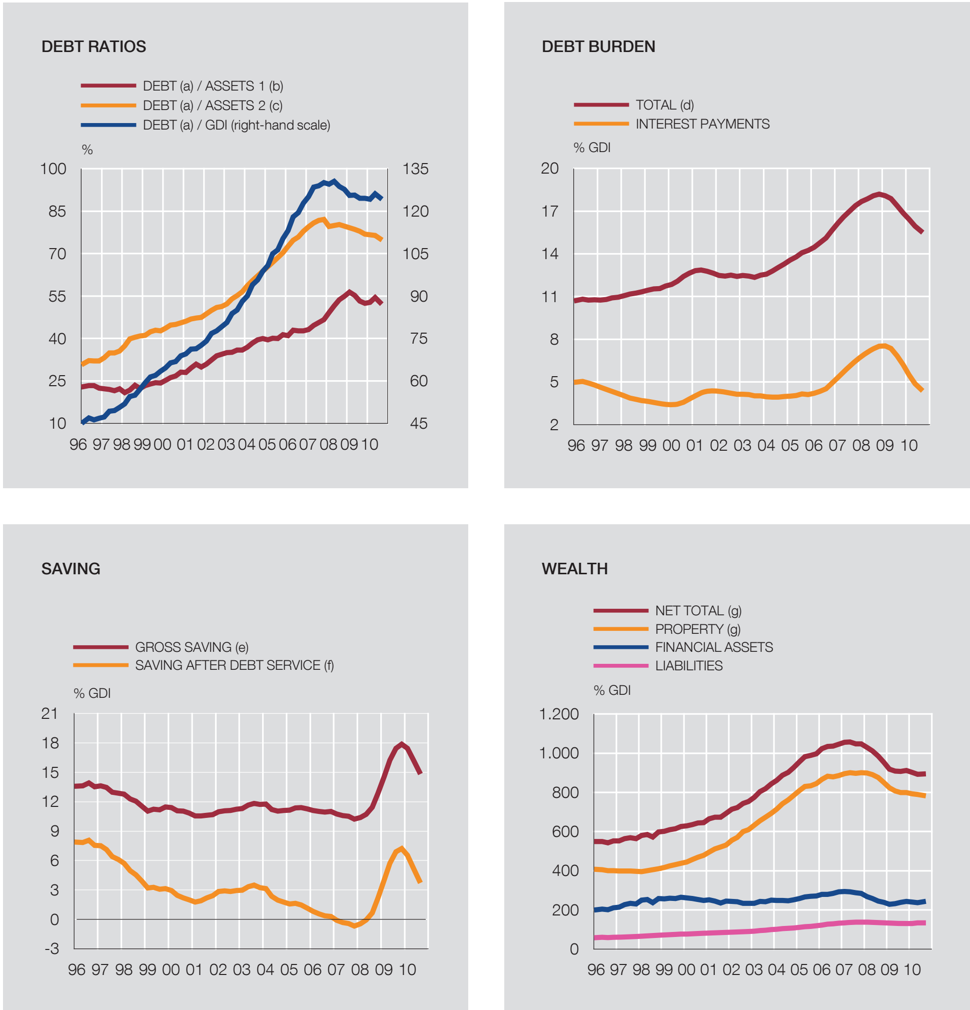
SOURCES: Bloomberg, Credit Trade, Datastream, MSCI Blue Book, Ministerio de Vivienda and Banco de España.

a. Five-day moving averages.
b. The cost of equity is based on the three-stage Gordon dividend discount model.
c. The cost of market-based long-term debt is calculated as the sum of the average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.
d. In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to customers were changed, which may cause breaks in the time series. Particularly, significant was the change in the interest rate on consumer credit and other lending, as a result of which from that month onwards it does not include credit card transactions.
e. The base year is 2001 until December 2004, after which it is 2005.

due to the loss of momentum in loans for house purchase. Conversely, the buoyancy of funds raised by corporations increased from a year-on-year growth rate of zero at the end of Q3 to 0.7% on the latest available data. The breakdown by instrument shows that the rate of contraction of resident corporations' loans continued to moderate (down 0.5% on the previous year's level), while other lending resumed a slightly more expansive course. The provisional information for December points to a recovery in house purchase loans, which is possibly linked, at least in part, to the end of tax relief on house purchase for medium- and high-income earners, while there were no significant changes in the growth of corporate loans.

The latest information on lending by purpose for 2010 Q3 shows that the fall in total bank financing stepped up in construction and real estate services, while it moderated in industry and agriculture and posted positive growth in non-real estate services. This more buoyant profile of loans to sectors not linked to the real estate market also seemingly spread, within these

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART 24



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

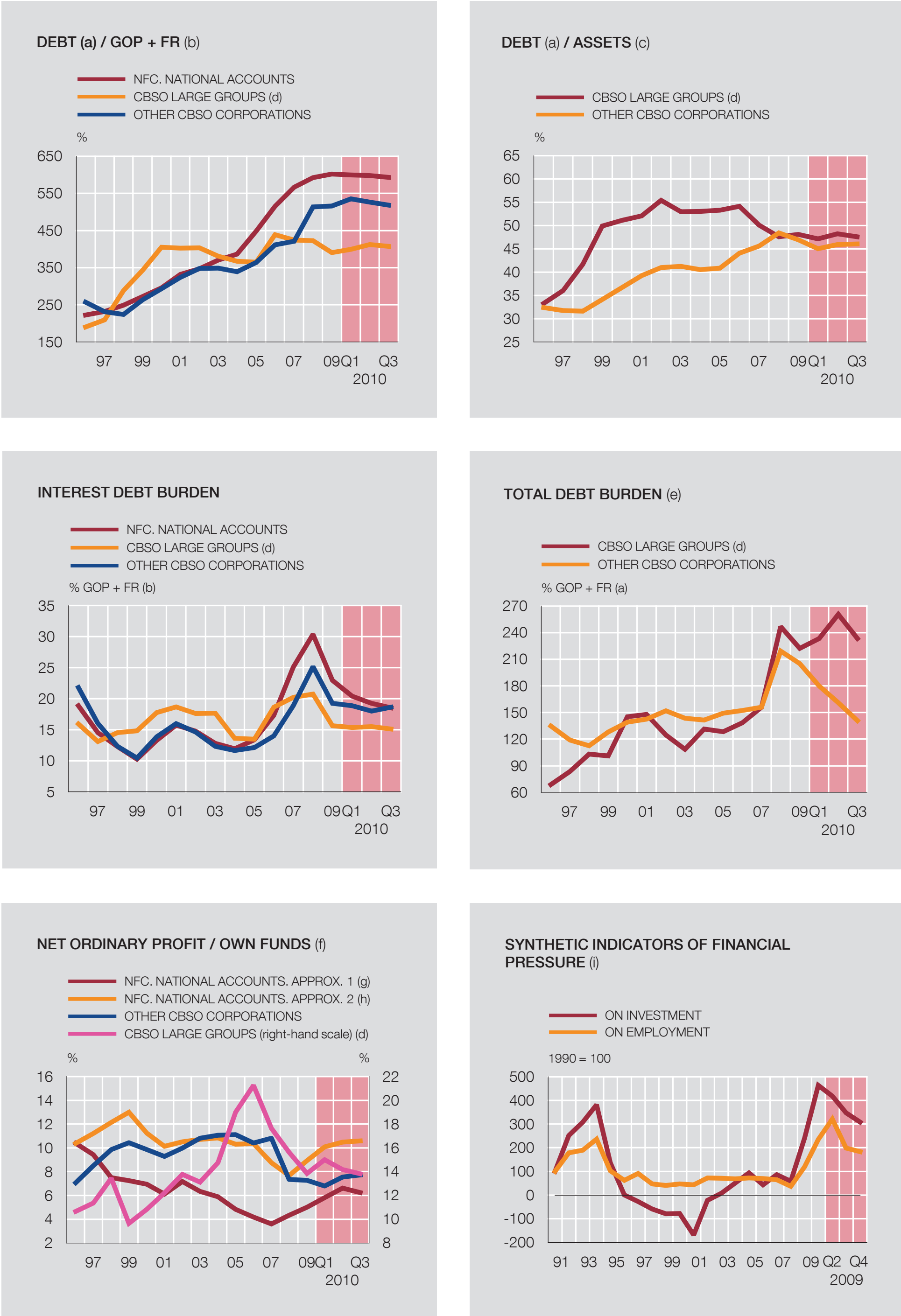
a. Includes bank credit and off-balance-sheet securitised loans.
b. Assets 1 = total financial assets - "other".
c. Assets 2 = assets 1 - shares (excluding mutual fund shares) - shares in FIM.
d. Estimated interest payments plus debt repayments.
e. Balance of households' use of disposable income account.
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.

sectors, to smaller companies, a segment in which bank lending contracted particularly sharply at the height of the crisis.

The changes in household liabilities and income in 2010 Q4 prompted a slight decrease in the ratio of debt to gross disposable income (GDI) (see Chart 24). This, together with the declining profile of the average cost of on-balance-sheet liabilities during the last twelve months, led to a further decrease in the indicator of the debt burden as a percentage of GDI (which is calculated by aggregating the flows of the last twelve months). This sector's gross saving ratio and saving after debt service also declined (although the former remains at historically high levels), as did its net lending (on Financial Accounts data). Household net wealth continued to decrease moderately as a result of the decline in the value of real estate, which was partially cushioned by less buoyant liabilities and the recovery of financial asset prices during this period. The continuing pattern in indebtedness and developments in financial asset and real prices indicate that the aforementioned trends held during the closing months of 2010.

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 25

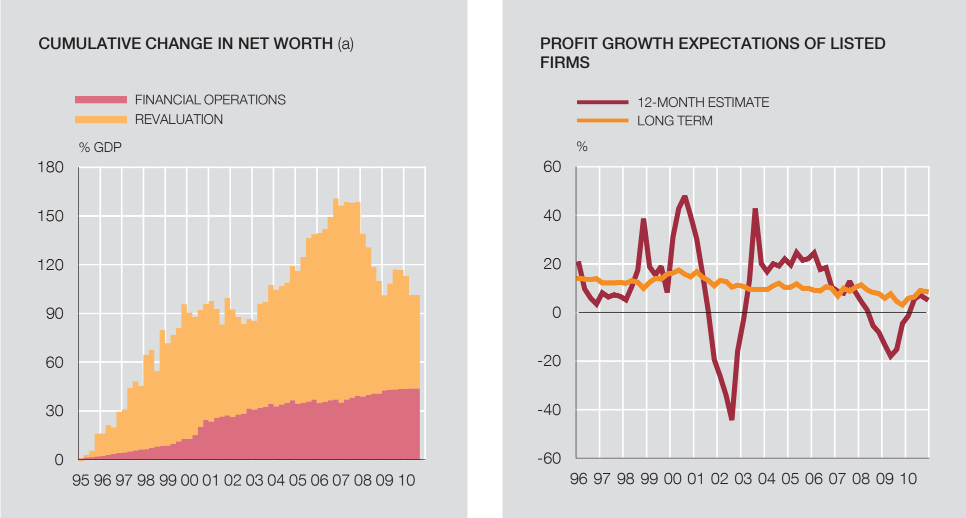


SOURCES: INE and Banco de España.

a. Interest-bearing borrowed funds.
b. Gross operating profit plus financial revenue.
c. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
d. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefónica 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.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26



SOURCES: I/B/E/S and Banco de España.

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

The corporate debt ratio and, to a greater degree, the corporate debt burden ratio dropped during 2010 Q3 (see Chart 25), a pattern that also seems to have continued during the closing months of the year. For the sample of corporations reporting to the CBQ, among which the biggest have a notable weight, a recovery was seen in corporate income. As a result, and in conjunction with unchanged debt levels, the debt ratio and the debt burden decreased slightly. The combined outcome of this was that the indicators of financial pressure on investment and on employment once again fell back. Nevertheless, in Q4 analysts revised downwards their expectations for listed companies' profits, especially in the short term (see Chart 26).

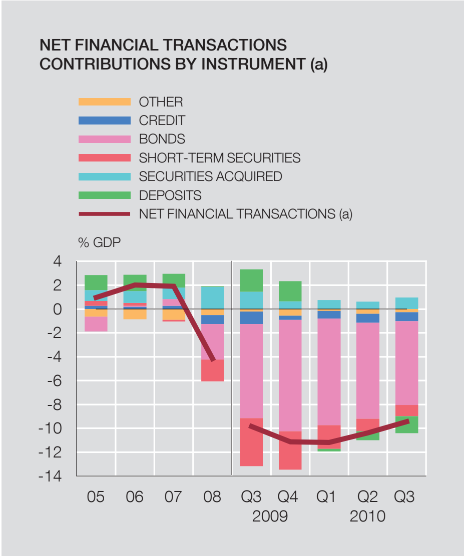
The volume of doubtful loans continued to increase which, together with the stability of the debt extended to the other resident sectors as a whole, placed the corporate sector's doubtful loans ratio at 5.68% in November (latest available figure), up 0.18 pp on September.

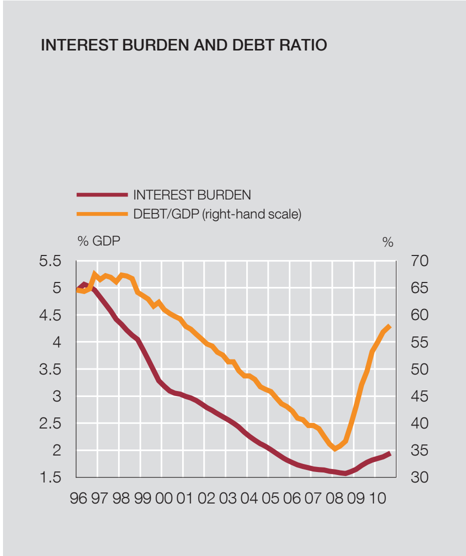
General government debt continued to increase at a high rate (14% year-on-year in November), albeit within a slowing profile (2 pp lower than in September). By instrument, the weight of funding with long-term securities has grown to the detriment of funding from short-term issues, while loans and other items were also notably buoyant. The rapid expansion of general government liabilities together with weak economic growth resulted in fresh increases in the debt ratio (approximately 58% of GDP in September) and the debt burden ratio (1.9% of GDP) (see Chart 27).

On the latest Financial Accounts data, the declining path of the nation's net borrowing, which had been interrupted in the previous quarter, resumed between July and September 2010. As a result, net borrowing stood at 4.2% of GDP, in cumulative 12-month terms, 0.3 pp less than in June (see Table 7). These developments were due to the decrease in the debit position of general government (to 9.4% of GDP, 1 pp less than at mid-year), which amply offset the reduction in the net saving of other sectors. Unlike Q2, when external funding was mainly through the reduction of the Banco de España's net assets and, to a lesser degree, through the raising of funds by general government in the rest of the world and divestment by households and institutional investments, between July and September, credit institutions were the main chan-

GENERAL GOVERNMENT
Four-quarter data

CHART 27





SOURCE: Banco de España.

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

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 7

% GDP	2005	2006	2007	2008	2009		2010		
					Q3	Q4	Q1	Q2	Q3
National economy	-6.5	-8.4	-9.6	-9.2	-6.0	-5.1	-4.4	-4.5	-4.2
Non-financial corporations and households and NPISHs	-8.4	-11.1	-13.4	-6.8	2.4	4.6	5.6	4.8	4.2
Non-financial corporations	*-7.1*	*-9.5*	*-11.5*	*-7.1*	*-2.6*	*-1.2*	*0.8*	*1.1*	*0.9*
Households and NPISHs	*-1.3*	*-1.7*	*-1.9*	*0.2*	*5.0*	*5.8*	*4.8*	*3.6*	*3.4*
Financial institutions	0.9	0.7	1.9	1.8	1.5	1.4	1.2	1.1	1.0
General government	1.0	2.0	1.9	-4.2	-9.8	-11.1	-11.2	-10.4	-9.4
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-11.4	-17.8	-15.9	-12.0	-3.8	-1.3	1.0	1.4	-0.5

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.

nel for the nation's borrowing (3.8% of GDP), while the Banco de España's net external assets increased by an amount equivalent to 4.5% of GDP (-6.2% in Q2). The still-incomplete balance of payments information available for Q4 (to November) points to this pattern continuing in the final stretch of 2010.

In short, in 2010 Q4 the Spanish economy was once again affected by a fresh bout of financial strains which resulted in tighter funding conditions on wholesale markets, but which have not fed through to banks and savings banks' lending to Spanish corporations and households. Although these tensions have eased in recent weeks, the risk premia remain at very high levels, meaning the continuation of this situation could ultimately affect the cost of and access to non-financial private sector credit. These developments have occurred in a setting in which these agents' debt has continued to rise weakly, although in the case of corporations signs of greater buoyancy can be seen, especially in the segments not linked to the real estate sector.

5.2 Households

In December, the cost of bank borrowing for households in the home loans segment stood at the same level as in September, while the interest rate on consumer and other loans, which are more variable, partly due to seasonal factors, was 34 bp lower than three months earlier. According to the BLS for January 2011, credit standards remained stable in 2010 Q4, although the margins applied widened slightly. Banks envisage that current supply conditions will hold in the early months of 2011.

In this setting, the outstanding balance of household debt was virtually unchanged (-0.1% in November with respect to 12 months earlier). The breakdown by type continues to show negative growth rates in outstanding consumer and other loans (-0.8%), although they are decreasing at a more contained pace than at the end of Q3 (-1.9%), and a slight decline in the rate of increase of funds for house purchase, which in year-on-year terms decreased from 0.7% to 0.1%. However, the provisional information for December points to a rise in this rate which is surely linked, at least partly, to the removal of tax relief for house purchases for medium- and high-income earners.

The course of income and liabilities during 2010 Q3 pushed the household debt ratio slightly lower to just less than 125% of GDI (see Chart 24). Together with lower interest payments in the last twelve months, this enabled the debt burden ratio to continue to fall to less than 16% of GDI. In any event, these aggregate indicators conceal the high heterogeneity in the sector. Accordingly, the latest information at microeconomic level points to a slight widening of the dispersion of these ratios (see Box 5). Gross saving and saving after debt service fell back again, as did net lending (see Table 7). At the same time, household net wealth continued to fall, albeit slightly, since the reduction of the real estate component (associated with the drop in house prices) was partially offset by the concurrent appreciation of financial assets.

According to the Financial Accounts, for which information is available to 2010 Q3, household investment in financial assets held, in cumulated 12-month terms, at 4.1% of GDP (unchanged on June) (see Table 8). The analysis of assets shows that households further reduced their positions in mutual funds (-1.2% of GDP), while they increased deposits. Within deposits there was a shift towards term deposits (for an amount of 2.1% of GDP, 1.6 pp higher than the figure for the first half of the year), while flows to the shares and other equity and to insurance and pension plans held up (1.4% and 0.6% of GDP, respectively).

Lastly, there were no major changes in Q3 in household liabilities classified as doubtful by credit institutions, whereby doubtful assets ratios remained virtually unchanged at 2.62% in the case of home loans and at 6.89% for consumer and other loans.

5.3 Non-financial corporations

During 2010 Q4, interest rates on bank lending to corporations increased by 18 bp for loans below €1 million and by 60 bp for loans exceeding this amount. In line with these developments, financial institutions indicated in the latest BLS (January 2011) that they had slightly increased the margins applied to new loans in 2010 Q4, although lending standards remained stable. The costs of fixed-income security issuance rose during the same period by between 35 bp and 75 bp depending on the maturity, while the changes were lower for equities in Q4 as a whole, but varied notably in keeping with the volatility shown by share prices.

CHANGES IN THE FINANCIAL POSITION OF SPANISH HOUSEHOLDS BETWEEN 2005 AND THE BEGINNING OF 2009

The Spanish Survey of Household Finances (EFF) is prepared by the Banco de España and contains information on the income, assets and debts of each household unit. The availability of the provisional results for the third edition of this survey means that an initial disaggregated analysis can be undertaken at micro level of the changes in the financial position of Spanish households during the period from the end of 2005 to the end of 2009 Q1, which is the time frame covered by the latest edition of the EFF (EFF 2008).[1] It should nevertheless be noted that, as it is constructed, the EFF 2008 does not fully include the impact of the crisis on household disposable income since households were asked about income for 2007.[2] Given the downturn in the labour market between end-2007 and 2009, it is highly likely that the indicators of financial position constructed from the revenue data of the EFF 2008 underestimate the level of financial pressure borne by certain households in that period.

The first two columns of the accompanying table show the percentage of households with debts in late 2005 and early 2009, respectively. This percentage did not vary significantly during the period analysed (it increased from 49.5% to 50.1%), indicating, therefore, the end of the rising path followed by this variable since mid-1990. This stability is the result of mixed developments in the sector. For instance, the proportion of lower-income households with outstanding debts has declined, while the opposite has been the case for the intermediate-income group. There was a significant increase of more than 6 pp in the proportion of indebted households in which no member works, which is linked to the rise in unemployment since the beginning of the crisis.

The central columns of the table show information about the debt ratio (liabilities incurred as a percentage of income) of indebted

1. For a detailed description of the results of the EFF 2008, see the article «Encuesta Financiera de las Familias (EFF) 2008: métodos, resultados y cambios desde 2005», *Boletín Económico*, December 2010, Banco de España. **2.** This is because in the EFF questions are asked about the income for the full year prior to the date on which the survey was conducted. Questions affecting other variables which are analysed in this box (labour market situation of household members, wealth, debts and debt-related payments) do refer, on the contrary, to the situation actually observed at the beginning of 2009.

PERCENTAGE OF INDEBTED HOUSEHOLDS AND MEASURES OF ASSOCIATED BURDEN FOR HOUSEHOLDS WITH LIABILITIES
By household characteristics

%	Percentage of indebted households		Household debt/income ratio				Household debt service ratio			
			2005		2009 Q1		2005		2009 Q1	
Household characteristics	2005	2009 Q1	50	75	50	75	50	75	50	75
ALL INDEBTED HOUSEHOLDS	49.5	50.1	100.0	235.4	104.7	280.5	17.2	28.3	19.0	32.5
INCOME PERCENTILE										
Less than 20	18.7	16.5	137.0	732.1	147.7	517.2	37.7	82.5	39.3	66.5
Between 20 and 40	42.3	42.3	109.4	343.8	137.0	374.9	24.6	38.2	26.3	43.3
Between 40 and 60	57.5	63.6	113.4	277.6	148.0	339.8	20.6	30.2	23.9	33.8
Between 60 and 80	63.0	61.2	114.3	218.5	95.8	271.8	15.6	24.3	17.0	26.5
Between 80 and 90	66.5	68.5	93.1	186.6	84.6	207.1	11.8	18.1	14.4	22.1
Between 90 and 100	65.4	64.7	59.9	123.8	62.0	158.7	8.1	14.7	10.0	17.8
AGE OF HOUSEHOLD HEAD										
Under 35	65.2	68.6	192.6	414.1	217.4	450.0	21.7	32.8	25.6	39.8
35-44	70.4	72.3	114.4	230.7	142.7	319.7	18.5	28.4	21.5	35.0
45-54	63.1	60.0	81.2	192.6	89.9	234.6	15.2	25.7	17.7	29.7
55-64	48.5	48.5	53.2	140.1	41.0	128.2	13.6	25.2	12.1	22.5
65-74	19.8	22.9	46.0	125.8	55.3	187.3	12.5	26.0	15.9	28.8
75 and over	5.6	9.9	32.8	147.8	18.5	85.4	11.6	17.8	12.5	21.8
NUMBER OF HOUSEHOLD MEMBERS WORKING										
None	15.2	21.3	57.1	269.2	81.2	269.0	17.6	34.4	21.0	38.7
One	56.1	56.6	104.3	306.4	100.5	300.6	19.6	32.1	20.4	31.4
Two	70.2	69.9	113.4	211.9	137.4	165.9	16.3	25.4	19.0	32.9
Three or more	69.2	69.7	54.9	163.3	48.1	305.0	12.1	22.2	11.0	24.3
NET WEALTH PERCENTILE										
Less than 25	43.9	50.1	65.5	293.3	139.4	373.8	17.7	30.4	23.8	40.5
Between 25 and 50	56.8	53.5	144.1	296.1	151.7	319.0	20.5	30.6	22.5	32.9
Between 50 and 75	49.3	47.5	93.8	187.9	87.0	215.0	16.3	25.2	16.8	29.1
Between 75 and 90	48.0	51.3	82.5	177.7	61.8	167.0	14.4	23.4	13.6	23.7
Between 90 and 100	48.2	46.3	91.0	210.5	98.6	306.4	14.0	26.4	16.8	32.3

SOURCE: Banco de España.

CHANGES IN THE FINANCIAL POSITION OF SPANISH HOUSEHOLDS BETWEEN 2005 AND THE BEGINNING OF 2009 (cont'd) BOX 5

households in the two periods analysed. Specifically, the table presents the 50th percentile of the distribution, or the median, which approximates the representative household, and the 75th percentile, which covers the position of greater relative fragility according to this indicator. As can be seen, the highest levels for this indicator are recorded in the lower-income and youngest households. The comparison between 2005 and the beginning of 2009 shows quite a widespread increase in leverage. Based on the age of the household head, this rise was more pronounced in the group aged 65 to 74, which is linked in part to changes in household composition (children who return to the parental home or who leave it later). By income level, there was a significant decline in the top quartile of the distribution of the debt ratio at lower-income households.

The last four columns in the table include information about the course of the household debt service ratio (payments associated with liabilities as a percentage of household income) for different household groups. Between the end of 2005 and the beginning of 2009 the increases in this ratio were, in general, proportionally higher than those in the indebtedness indicator, which reflects some rise in the cost of borrowing. This was accompanied by a rise in dispersion (which is also seen for indebtedness). The median increased 1.7 pp during this period to 19%, while the household debt service ratio corresponding to the 75th percentile climbed by 4.1 pp to 32.5%. Nevertheless, in the lower income segment there was a reduction of 16 pp, to 66.5%, among households subject to greater strains.

By age group, the largest rises in the debt burden ratio were recorded by the youngest indebted households, which had the highest values for this indicator. Furthermore, it is among these households that there has been a higher rise in the proportion of those whose regular debt service payments exceed 40% of their income. Specifically, in the group in which the household head is under 35, this proportion increased by 9.2 pp, to close to 25%. The analysis, based on the number of household members in employment, shows that, unlike in 2005, at the beginning of 2009 the ratio corresponding to households with no member in employment was the highest.

In short, the latest edition of the EFF shows that from late 2005 to early 2009 the degree of financial pressure borne by indebted households increased. This was a result of the amount of outstanding debt outgrowing income and of the slight rise in the cost of borrowing. Furthermore, these developments tended to be more pronounced in certain groups in a comparatively more vulnerable position, though not in the case of households in the lower income percentiles. In any event, as discussed above, since the income included in this survey refers to 2007 (before the rise in unemployment), it is possible that the financial position of these agents was less favourable at the beginning of 2009 than may be inferred from these results.

Despite the increase in costs, during 2010 Q4 the growth of corporate debt continued (in quarter-on-quarter seasonally adjusted terms), having initially resumed in the first half of the year. The result is that, on November figures, there is a positive year-on-year rate of change (0.7%, compared with 0% in September) for the first time since summer 2009. By instrument, rates of increase rose for lending from abroad (1.3%, 0.9 pp higher than at the end of Q3) and for lending by resident banks (-0.6%, compared with -1.3% posted two months earlier), while the buoyancy of funds raised through the issuance of securities other than shares moderated (17.9%, down 8.6 pp).

Credit extended to resident corporations shows two well-defined patterns according to the purpose for which it is used. Thus, in Q3 there was an acceleration in the contraction of the liabilities of firms operating in construction (9.3%, 1.5 pp more than in June) and real estate services (1.5%, 0.5 pp more than in mid-2010). By contrast, in other activities a recovery was seen, markedly so in non-real estate services (growth of 3.5%, 1.6 pp higher than in the previous period) and in industry, whose attendant rate, while still negative (-0.7%), was lower than the figure of -4% posted in Q2. It is estimated that this pattern of higher buoyancy spread within non-real estate services and industry to SMEs, whose bank borrowing fell sharply at the height of the crisis. These developments are consistent with the information provided by the ECB survey on SMEs' access to financing, which indicates that between March and September the percentage of corporations refused new loans fell.

Noteworthy among corporations' other liabilities is the increased buoyancy of trade and intercompany credit which, given its nature, was also reflected under the assets of the sec-

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

TABLE 8

% GDP	2007	2008	2009	2010		
				Q1	Q2	Q3
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	7.3	2.6	4.5	3.7	4.1	4.1
Cash and cash equivalents	-1.0	-0.4	4.1	3.3	1.9	0.7
Other deposits and fixed-income securities (a)	7.5	6.8	-1.2	-0.8	0.5	2.1
Shares and other equity (b)	0.5	-0.2	1.2	1.0	1.4	1.4
Mutual funds	-1.1	-3.4	0.0	0.0	-0.4	-1.2
Insurance technical reserves	0.9	0.2	0.9	0.7	0.6	0.6
Of which:						
Life assurance	*0.2*	*-0.2*	*0.6*	*0.4*	*0.3*	*0.2*
Retirement	*0.4*	*0.3*	*0.3*	*0.3*	*0.3*	*0.4*
Other	0.4	-0.3	-0.5	-0.5	0.1	0.5
Financial transactions (liabilities)	9.2	2.4	-1.3	-1.1	0.5	0.7
Credit from resident financial institutions (c)	9.4	3.4	-0.5	-0.1	0.6	0.0
House purchase credit (c)	*7.1*	*2.7*	*0.1*	*0.3*	*0.7*	*0.5*
Consumer and other credit (c)	*2.1*	*0.8*	*-0.4*	*-0.2*	*0.1*	*-0.4*
Other	-0.2	-1.0	-0.8	-0.9	-0.1	0.8
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	14.3	5.2	-8.9	-8.3	0.8	6.9
Cash and cash equivalents	-0.4	-1.1	-0.3	0.0	0.9	0.1
Other deposits and fixed-income securities (a)	2.0	2.3	-0.6	-0.7	-0.6	-0.1
Shares and other equity	7.8	3.2	-0.6	-0.5	0.2	1.7
Of which:						
Vis-à-vis the rest of the world	*6.6*	*3.1*	*0.1*	*0.2*	*0.6*	*1.8*
Trade and intercompany credit	3.4	0.1	-7.6	-6.7	0.8	4.9
Other	1.5	0.7	0.2	-0.4	-0.4	0.4
Financial transactions (liabilities)	25.8	12.3	-7.6	-9.1	-0.3	6.1
Credit from resident financial institutions (c)	13.8	5.5	-3.0	-3.7	-2.6	-1.3
Foreign loans	2.8	2.8	-0.1	-0.9	-1.6	-0.5
Fixed-income securities (d)	0.5	0.3	1.3	1.3	1.7	1.3
Shares and other equity	4.8	2.6	1.3	1.0	1.1	1.1
Trade and intercompany credit	4.3	-0.1	-7.7	-6.7	0.8	5.0
Other	-0.5	1.2	0.5	-0.1	0.3	0.5
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.5	6.4	-1.0	-1.4	-0.5	0.1
Households and NPISHs	12.5	4.4	-0.3	0.1	0.9	0.1
Non-financial corporations	17.7	7.9	-1.5	-2.4	-1.5	0.0

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.

tor's balance sheets. Thus, according to the Financial Accounts, the flow associated with these instruments accounted, between July and September 2010, for around 5% of GDP, in cumulated four-quarter terms, whereas hardly six months ago it showed negative amounts.

The Financial Accounts figures also show that the business sector's net financial transactions once again posted a credit balance in 2010 Q3, in cumulated four-quarter terms, amounting to the equivalent of 0.9% of GDP (0.2 pp less than in June). However, the financing gap, an indicator that approximates the funds needed to cover the difference between firms' gross saving and gross capital formation plus foreign investment of a permanent nature, recorded a negative balance as a result of the increase in Spanish firms' investment in equities abroad.

As a result of the containment of corporate debt, together with the improvement in business surpluses reflected in the National Accounts in 2010 Q3, the sector's debt ratio continued to slowly decrease for a further quarter from its peak in June 2009. Revenue growth and the decline in interest payments, in cumulated 12-month terms, also prompted a fall in the debt burden (see Chart 25). However, the market improvement in this period triggered a rise in equity values and, consequently, ROE decreased.

The corporate income of the sample of corporations reporting to the CBQ, among which the biggest have a notable weight, also recovered in 2010 Q3, with the result that the ordinary net profit of these corporations in the first nine months of the year was 6.9% higher than in the same period of 2009. Thanks to that, ROE also increased to 5.5%, 0.2 pp higher than in September 2009. These developments, combined with debt levels holding unchanged, enabled the debt ratio and debt burden to fall slightly. The overall outcome was that the indicators of financial pressure on investment and employment decreased again. Nevertheless, during the final stretch of 2010, analysts revised downwards their expectations for the profits of listed companies, especially in the short term and by slightly less for the longer term (see Chart 26).

The doubtful assets ratio of non-financial corporations continued to grow in 2010 Q3, and was stronger in the case of lending to construction and real estate services companies, rising by 54 bp for the latter, while for other companies it climbed by 20 bp. This gave rise to a widening in the difference between the indicators for the two sectors, which stood in September at 11.4% and 4%, respectively.

5.4 General government

In 2010 Q3, according to the Financial Accounts, general government net borrowing decreased by the equivalent of 1% of GDP in cumulative annual terms, although it remains high at 9.4% of GDP (see Table 7).

Once again, the main means of financing used by general government was the issuance of fixed-income securities, whereby funds equivalent to 8% of GDP were obtained (7% at long term and 1% at short term), entailing 1 pp less than in June (see Chart 27). Loans contributed a further 0.7% of GDP, while on the assets side net purchases of securities grew (1% of GDP, 0.4 pp up on mid-2010) and deposits decreased (-1.4% of GDP, a further decline of 0.7 pp with respect to Q2).

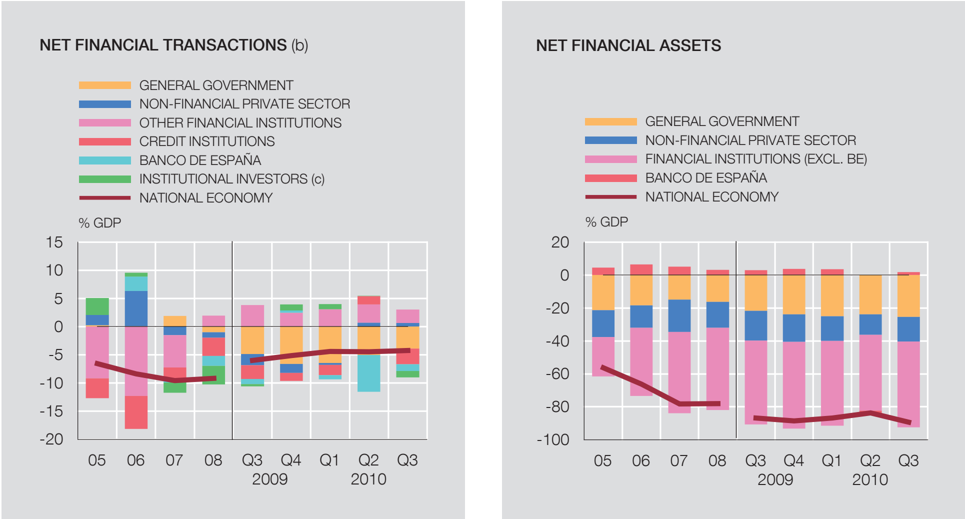
As a result of the foregoing, the growth rate of general government indebtedness remains high (14.2% in November), although it has moderated considerably with respect to its end-2009 peak. The increase in liabilities led the debt/GDP ratio to stand, in September 2010, at close to 58% of GDP, almost 1 pp higher than in June. The debt burden associated with these liabilities also increased, although it is at relatively low levels (1.9% of GDP).

5.5 The rest of the world

The nation's net borrowing once again decreased in 2010 Q3 to 4.2% of GDP, in cumulated 12-month terms, 0.3 pp lower than the June figure according to the Financial Accounts. This decline was due to a decrease in the general government debit balance, which was partially offset by the reduction in households' and corporations' net financial saving, while that of financial institutions hardly changed.

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

CHART 28



SOURCE: Banco de España.

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

The sectoral breakdown of financial transactions vis-à-vis the rest of the world shows that, between July and September 2010, credit institutions were the main vehicle for the economy's borrowing; in only three months they raised abroad the equivalent of 3.8% of GDP (in net terms), in contrast to 2010 Q2 when a net outflow of funds was routed through them. Other sectors also improved their ability to borrow from abroad with respect to the spring figures; general government managed, in cumulated four-quarter terms, to borrow the largest sum of funds from the rest of the world (3.9% of GDP) (see Chart 28). As a result of this normalisation the net assets of the Banco de España vis-à-vis the rest of the world increased, following the previous months' decline by an amount equivalent to 4.5% of GDP. In Q4, and based on the incomplete balance of payments information (which only covers up to November), the net external assets of the Banco de España continued to recover.

The breakdown by instrument shows that the bulk of capital inflows was channelled through the interbank market which, in net terms, enabled credit institutions to raise funds equivalent to 2.2% of GDP. Concurrently, purchases by the rest of the world of securities other than shares, irrespective of issuer, also increased, when hardly three months earlier non-residents had unwound positions in these assets. Foreign direct investment in Spain also grew, returning, in cumulated four-quarter terms, to positive territory (0.3% of GDP, 0.5 pp higher than in June) (see Table 9).

Capital outflows were slightly negative (-0.3% of GDP in Q3), but by a lower amount than in Q2, when they stood at -1.6% of GDP. By instrument, securities other than shares evidenced negative flows of 1.8% of GDP (-5.8% of GDP in cumulated 12-month terms) (see Table 9). Conversely, purchases of shares and other equity continued to increase and between July and September stood at the equivalent of 1.6% of GDP. In line with this, Spanish foreign direct investment recovered with respect to three months earlier (1% of GDP, in cumulated four-quarter terms).

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 9

% GDP

	2007	2008	2009	2010 Q1	2010 Q2	2010 Q3
NET FINANCIAL TRANSACTIONS	-9.6	-9.2	-5.1	-4.4	-4.5	-4.2
FINANCIAL TRANSACTIONS (ASSETS)	14.2	1.3	-1.5	-0.7	-2.6	-3.3
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	1.5	-1.3	-3.2	-2.1	-1.4	-2.3
Of which:						
Interbank (a)	*4.2*	*-0.5*	*-1.7*	*-1.6*	*-1.1*	*-1.8*
Securities other than shares	1.6	1.3	0.0	-0.3	-3.9	-5.8
Of which:						
Credit institutions	*1.8*	*1.6*	*1.2*	*0.7*	*-2.0*	*-2.7*
Institutional investors (b)	*0.0*	*-1.3*	*-0.5*	*-0.2*	*-1.4*	*-2.3*
Shares and other equity	8.8	1.9	1.5	1.3	1.7	2.7
Of which:						
Non-financial corporations	*6.6*	*3.1*	*0.1*	*0.2*	*0.6*	*1.8*
Institutional investors (b)	*-1.1*	*-1.6*	*0.3*	*0.7*	*1.0*	*1.0*
Loans	1.2	0.8	0.2	0.0	-0.7	-0.1
FINANCIAL TRANSACTIONS (LIABILITIES)	23.8	10.5	3.6	3.8	1.8	0.9
Deposits	6.7	8.0	-0.5	0.1	1.6	-0.2
Of which:						
Interbank (a)	*6.7*	*6.2*	*0.7*	*-0.6*	*-4.7*	*-2.9*
Securities other than shares	8.1	-2.7	3.8	3.4	0.6	0.6
Of which:						
General government	*-1.3*	*1.1*	*5.4*	*5.7*	*4.2*	*3.4*
Credit institutions	*3.6*	*-1.9*	*1.1*	*0.9*	*-0.4*	*-0.6*
Other non-monetary financial institutions	*5.8*	*-1.9*	*-2.6*	*-3.1*	*-3.2*	*-2.2*
Shares and other equity	4.6	3.2	0.8	1.3	0.8	0.3
Of which:						
Non-financial corporations	*4.7*	*2.4*	*0.1*	*0.4*	*0.4*	*0.5*
Loans	3.1	2.7	0.3	-0.5	-1.1	-0.1
Other, net (c)	0.3	0.6	-0.8	-1.1	-1.7	-1.8
MEMORAMDUM ITEMS						
Spanish direct investment abroad	9.5	4.7	0.6	-0.9	-0.7	1.0
Foreign direct investment in Spain	4.5	4.6	0.5	0.7	-0.2	0.3

SOURCE: Banco de España.

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

As a result of financial flows with the rest of the world, and of changes in asset prices and in the exchange rate, the value of the net liabilities built up by the Spanish economy vis-à-vis the rest of the world were equal, according to the Financial accounts, to 89% of GDP in 2010 Q3, almost 6 pp higher than in June (see Chart 28). This increase was due to the rise (of 5.8% of GDP) in the debit balance of financial institutions (excluding the Banco de España) vis-à-vis non-residents and, to a lesser degree, of the non-financial private sector and general government, while the Banco de España restored its credit position vis-à-vis the rest of the world.