QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

In 2011 Q1 the Spanish economy continued along the path of moderate recovery embarked upon a year earlier, with quarter-on-quarter GDP growth of 0.3 %, which took the year-on-year rate to 0.8 %. This trajectory was once again underpinned by the strength of net external demand, which contributed 1.4 pp to year-on-year GDP growth, while domestic demand continued to display considerable slackness, interrupted only by a rise in government consumption.

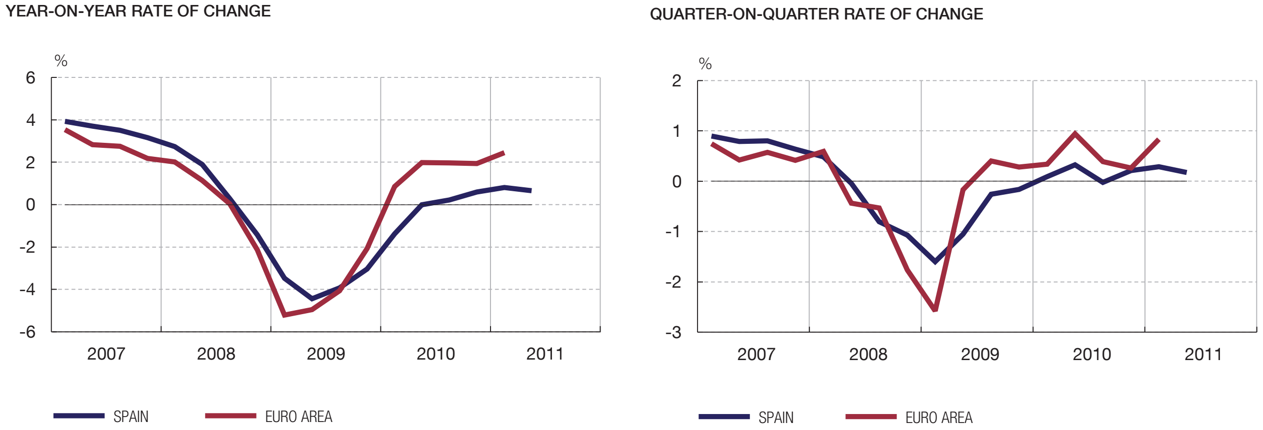
The data available for Q2 suggest that activity weakened, against a background marked by the worsening of the sovereign debt crisis in the euro area. Estimates based on the conjunctural information available indicate that GDP posted a quarter-on-quarter growth rate of 0.2 %, with the year-on-year rate standing at 0.7 %. On the expenditure side, the slowdown in activity would have been a consequence of the decline in national demand (-1.9 % year-on-year), which was more pronounced than in Q1, while the positive contribution of net external demand rose to 2.6 pp. It should be noted that the year-on-year rates for this quarter are affected by the exceptional volume of spending in the same period of last year, in anticipation of the rise in VAT on 1 July and the imminent ending of various government programmes to support spending (including Plan 2000E, which provided direct support for car purchases).

On the supply side, the weakening of industrial activity was notable, partly due to the discontinuity in productive processes prompted by the scarcity of certain inputs following the earthquake in Japan in March and the disruption of agricultural production caused by the EU food crisis. Market services, for their part, continued to display a moderate recovery, while the value added in construction fell again, although at a lower rate than in the preceding months. In these circumstances, employment declined in year-on-year terms (by -0.9 %, according to the EPA) although it stabilised in quarter-on-quarter terms, owing to the more favourable behaviour of employment in services, and the rate of unemployment posted a small decline (to 20.9 % of the labour force). Inflation turned downward in Q2, confirming the temporary nature of some of the price rises in the middle months of 2010. After rising in April and May, the CPI excluding energy and unprocessed food prices decelerated in June to stand at 1.7 %, a trend that will most probably be extended over the coming months, once the effect of the increase in VAT in July last year on prices is absorbed. In this respect, the leading indicator of the CPI showed a further reduction in July, to 3 %.

At the international level, economic and financial developments in recent months have been dominated by heightened tensions in the euro area sovereign debt markets and by a certain loss of momentum in the economic recoveries in some of the main developed economies, a further factor of uncertainty adding to the doubts over whether or not the deceleration is temporary. These developments contrasted with the sustained buoyancy of the emerging economies. The prices of oil and other commodities retreated from their April peaks, albeit remaining at high levels, and inflation continued to behave differently from one geographical region to another, with higher inflationary pressures discernible in the emerging countries, which are further ahead in the business cycle. Finally, the risks in the fiscal sphere extended beyond the euro area, with tense negotiations taking place in the United States over the increase in the debt ceiling.

In Europe, the uncertainty over the possibility of some form of Greek debt restructuring and the delay in the approval of the second Greek financial aid package meant that the

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

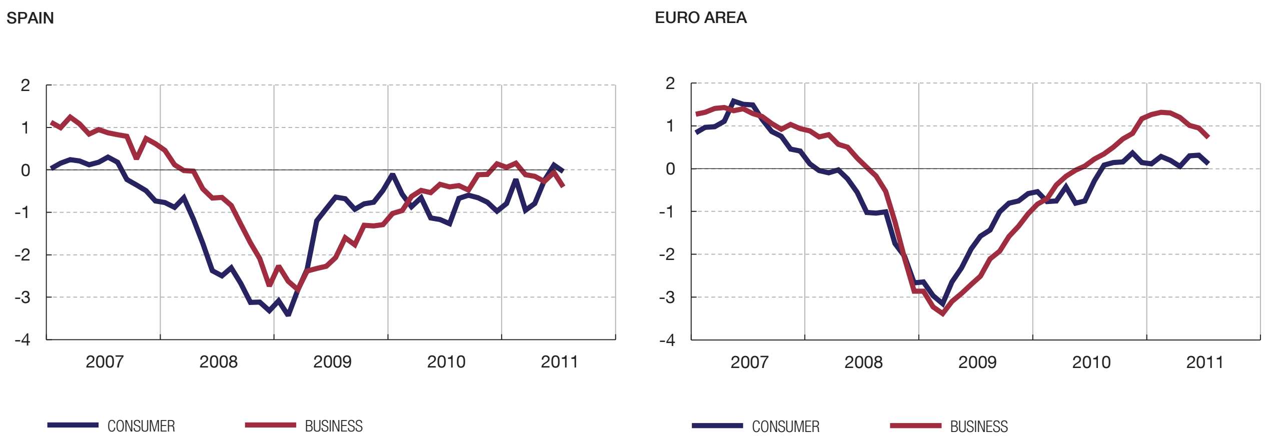
turbulence on the financial markets (which in the first stretch of the quarter affected the countries subject to assistance programmes) spread from July to the public debt markets in other euro area countries, and with particular intensity to Italy and Spain. Tensions also spread to the stock market, the foreign exchange markets - where the euro exchange rate fluctuated significantly - and the interbank market. This strong instability clouded the publication on 15 July of the positive results of the stress tests on European banks by the European Banking Authority (EBA).

Given the seriousness of the situation, an extraordinary meeting of the euro area Heads of State and Government was called on 21 July. They agreed to launch a new programme for Greece along with a broader batch of measures to improve the sustainability of Greek public debt, to halt the risk of contagion to other economies and to reinforce the available euro area crisis-management mechanisms (see Box 2). The results of the summit led to some initial easing of tensions, which was nevertheless reversed in the following days, although it is still premature to assess how investors may ultimately react.

Following a first quarter of stronger-than-expected euro area GDP growth, the conjunctural information available points to some slowing in activity in Q2, in line with expectations, as a result of the reversal of some of the temporary factors that boosted output growth in the opening months of the year. Following this pause, available estimates suggest the continuation of the recovery in activity over the rest of the year, albeit with a divergent pattern across the different countries. As regards prices, inflation held at a high level of 2.7 % in June (2.5 % in July, according to the leading indicator of the HICP), owing to the still-high rise in energy and commodity prices. Risks in the medium term remain on the upside and are related to potential and higher-than-expected increases in energy prices and indirect taxes. At its July meeting, then, the ECB duly decided to raise its MRO rate by 25 bp to 1.5 %. In August, the ECB Governing Council decided to hold its official rates unchanged and reaffirmed its commitment to financial stability by extending for as long as needed and at least until January 2012 its fixed-rate tender procedures with full allotment in its various liquidity provision operations. These would include a new six-month operation, thereby ensuring that all institutions are provided with an adequate volume of liquidity. These decisions came on top of the previous move to suspend the minimum credit rating

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).

threshold for fixed-income debt instruments issued or guaranteed by the Portuguese government, following Moody's downgrading of its sovereign debt. Finally, the Council recalled that its Securities Market Programme remained open.

The worsening of the euro area sovereign debt crisis affected the Spanish financial markets particularly sharply, prompting a rise in the risk premia on fixed-income securities issued both by general government and by the private sector, and declines in stock market indices. These trends were accentuated in July, when the yield spread between 10-year public debt and the benchmark German *Bund* widened to around 370 bp. As of the cut-off date of this report, the risk premium on Spanish bonds stood close to 400 bp. Equity market prices also fluctuated notably, placing the IBEX 35 8.3 % below its value at the start of the year.

On the real estate market, house prices continued to fall, posting a year-on-year rate of 5.2 % in Q2. This was sharper than in the previous quarter, meaning that they have fallen by close to 17 % in cumulative terms since end-2007, which represents a 22 % decline in real terms.

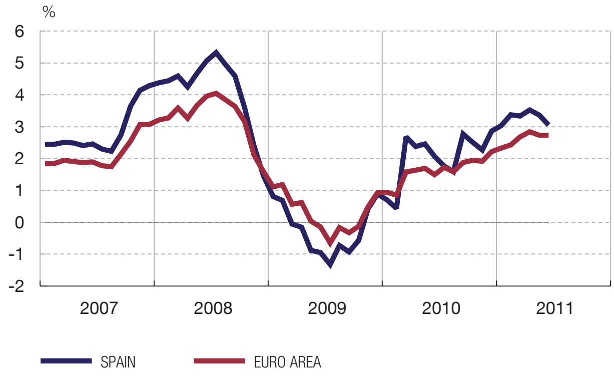
In these circumstances, resident private-sector accessibility to financing tightened further, since the tensions on financial markets led to an increase in bank funding costs which fed through, at least in part, to the interest rates on loans granted to households and firms, prolonging the rising course of such rates that had begun in early 2011. Lending standards, as opposed to interest rates, did not change significantly following the slight tightening in the opening months of 2011.

The prevailing instability described, the scant improvement in households' economic situation and tighter lending standards did not help boost household spending, which showed signs of a sluggish recovery over the quarter as a whole. Household consumption is estimated to have risen only slightly in Q2 against a background in which the value of household wealth fell once more, as did their disposable income, although the information drawn from the non-financial accounts of the institutional sectors for Q1 indicates a slight slowing in the rate of decline of this variable in nominal terms (for the first time since the start of the crisis). The saving rate continued to exert a spending-stabilising effect and fell once more in Q1 to 12.2 % of disposable income in four-quarter cumulated terms, a level close to pre-crisis values.

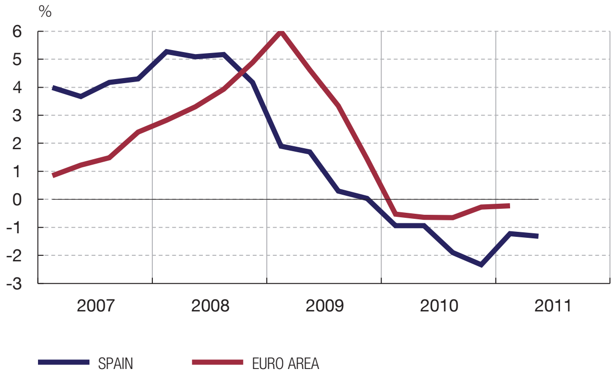
PRICES AND COSTS

CHART 3

HARMONISED INDICES OF CONSUMER PRICES (a)



UNIT LABOUR COSTS (b)



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.

Residential investment shrank in Q2 in line with the projected path, which plots diminishing declines in this domestic demand component over the rest of the year. Turning to the demand for residential assets, registered transactions fell significantly in April and May compared with the same period a year earlier. This year-on-year decline may be related to the changes in the treatment of house purchases under personal income tax as from 1 January this year, which encouraged buyers to bring forward their purchases to 2010 and altered the path of this variable. Nonetheless, the doubts that have arisen about possible changes in the tax treatment of owner-occupied property, and the prospect of the increase in the financial effort that the tightening of lending conditions will entail, might prolong this declining trajectory.

Overall, the adjustment of household consumption and investment is allowing the sector's net lending to hold at a relatively high level of 3.4 % of GDP in Q1 in four-quarter cumulated terms. Household debt can also be seen to have shrunk; its level fell by 1.1 % in year-on-year terms owing to a bigger decline than that in the preceding months in funds borrowed for consumption and other purposes, and to the slight fall in funds intended for house purchases.

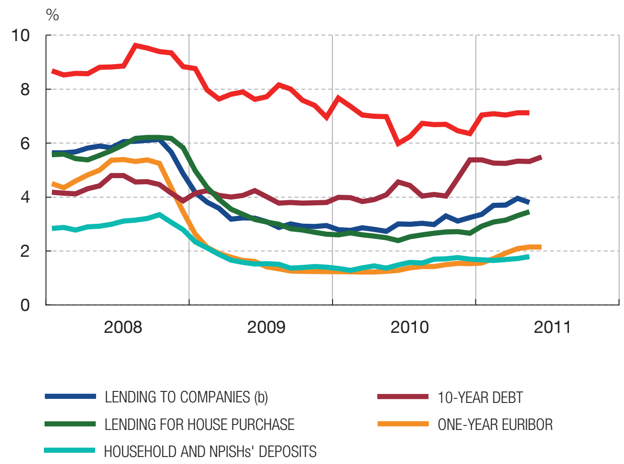
Business investment felt the impact of the uncertainty and financial instability that prevailed in the period under study. The sluggishness of this variable continued and indeed intensified owing to the lesser momentum of world trade. In terms of products, the most contractionary components of investment was that of other construction, which was affected by the adjustment in civil engineering projects brought about by the budgetary austerity plans under way. Firms also increased their net lending in the opening months of the year, to an amount equivalent to 0.9 % of GDP in four-quarter cumulated terms, perhaps in response to their efforts to clean up their balance sheets and strengthen their self-financing capacity. Also, the rate of change of firms' debt turned moderately negative (-0.3 % year-on-year in May). On the information available to March, financing by productive branch declined practically across the board, with only the non-financial and non-real estate services component posting a small increase, although as has habitually been the case, the fall in construction was sharper.

General government conduct continued to be marked by the roll-out of the fiscal consolidation plans. On the public spending side, there have been significant declines in public-

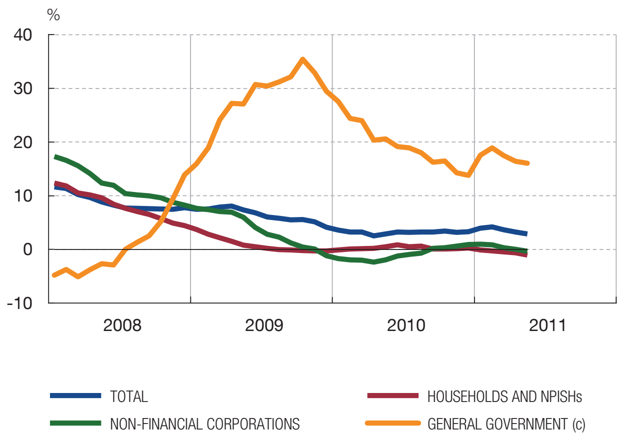
FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4

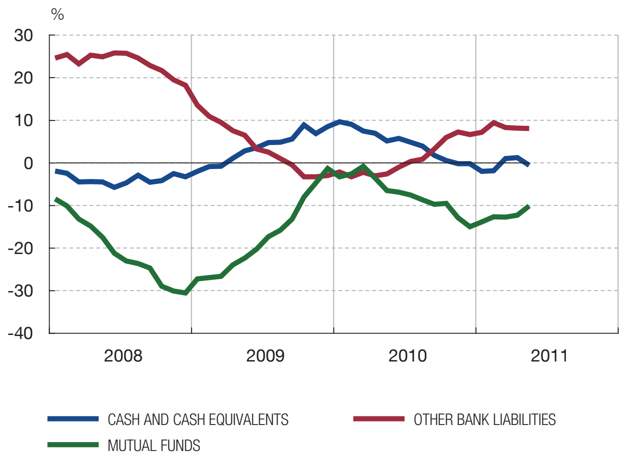
INTEREST RATES (a)



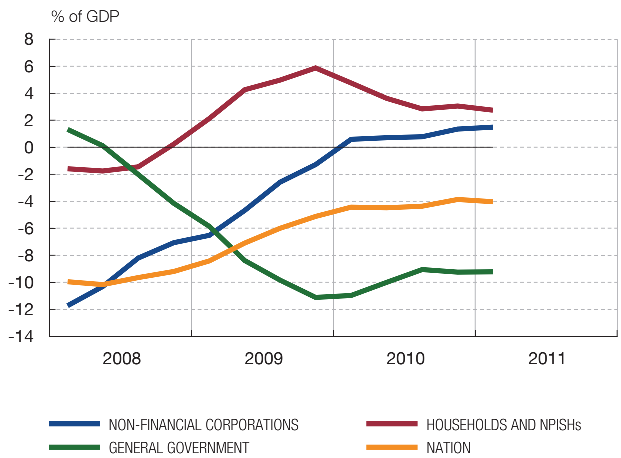
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



FINANCIAL ASSETS OF NON-FINANCIAL CORPORATIONS AND OF HOUSEHOLDS AND NPISHs (year-on-year growth)



NET FINANCIAL TRANSACTIONS (d)



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 signifcance 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 commission 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.

sector employee compensation and in investment in the year to date, along with a slowdown in spending on welfare benefits. By contrast, there was some upward deviation in non-wage final consumption spending and an increase in interest payments. On the revenue side, VAT and personal income tax trended as was to be expected given the measures adopted in 2010, while revenue from other taxes was more sluggish. Overall, fiscal consolidation is progressing towards the targets set, albeit at different rates depending on the agents involved. While the State and Social Security budget outturn broadly trended to June as projected, the regional government deficit was higher than forecast in Q1 (0.5 % of GDP). That means a sharper adjustment is needed over the rest of the year to meet the programmed deficit-reduction target in 2011 (by 1.5 pp of GDP to a deficit of 1.3 % of GDP). Against this background, the Fiscal and Financial Policy Council (CPFF by its Spanish abbreviation) endorsed at its meeting on 27 July the re-balancing plans for four of the six regional governments in which approval had remained pending. Plans for the remaining two will remain pending until the next CPFF meeting. The rigorous application of the conditionality of authorisation for indebtedness on strict compliance with these plans is a key instrument for preventing budgetary deviations from arising at the end of the year.

Measures were approved in July to reinforce the general government budgetary framework and to ensure the sustainability of public finances in the medium term, in line with the objectives set out in the Euro-Plus Pact. In this respect, Parliament approved on 14 July a decree law establishing a public spending growth rule, whereby the rate of increase of this variable may not annually exceed the economy's nominal medium-term growth rate. The rule shall be directly applicable to central government and to local governments to which State taxes are transferred. Such a rule, conceived as a complement to the legislation on budgetary stability, may prove a most useful instrument for strengthening fiscal discipline. However, for it to be fully effective it must also be applied to the regional government budgets (on the proposal of the government, the CPFF approved at its last meeting the adoption of similar rules by the regional governments). On 21 July, the Law on Social Security Reform was finally approved. It enshrines the essential elements of the related draft bill: the raising of the retirement age, the extension of the number of years taken into account for calculating the pension and the inclusion of a sustainability factor that will enable the parameters of the system to be progressively adapted to future demographic developments. On the whole, the reform is a major step forward for ensuring the sustainability of the pensions system (for a more detailed assessment of the reform, see Box 2.3 of the Banco de España 2010 *Annual Report*).

As for foreign trade, both the rate of increase of exports and, to a greater degree, that of imports decelerated in Q2. However, exports remained very buoyant, which resulted in a slight increase in the Spanish export share in real terms in the first half of the year. Tourism exports stepped up their strong recovery in the April-June period, owing to the favourable economic situation of Spain's main tourism-generating markets and to the effects of geopolitical instability in North Africa and the Middle East. These developments were accompanied by a fresh loss of momentum in goods imports, which hardly increased, and by a decline in service imports, both of which are linked to sluggish domestic demand.

The correction of the nation's net borrowing slowed in the early months of 2011. According to the non-financial accounts of the institutional sectors, the nation's net borrowing stood in Q1 at 4 % of GDP in four-quarter cumulated terms (3.9 % in 2010). The latest balance of payments information indicates that behind this lies the deterioration of the energy trade balance, reflecting the impact of high oil prices on the energy bill and the rise in the deficit on the incomes balance; the outlook for both factors is not favourable for the remainder of the year.

On the supply side, the key development was the discontinuation of the path of recovery on which industrial production had embarked at end-2010 and the beginning of this year. Since this was due, at least partly, to the above-mentioned temporary factors, the adjustments made in the sector and the productivity gains achieved should enable industrial production to resume this path of recovery in future quarters, particularly if exports pick up as they did in 2011 Q1. For their part, the market services branches showed fresh moderate growth, conditioned by sluggish consumption. Lastly, value added in construction decreased again, weighed down by the decline in the non-residential construction segment. On EPA data for Q2, it recovered in market and non-market services, while the pace of job destruction eased in the other branches, except in construction where its pace of decline stepped up. These developments in employment were accompanied by an increase in the proportion of temporary to permanent employees to 25.5 %.

Despite the weakness of the labour market, labour costs in the market economy rose in Q1, largely owing to the still-close relationship between collective bargaining and inflation. For the April-June period, employee compensation is estimated to stand at approximately 2 %, which would be consistent with the slight easing beginning to be seen in the average rates negotiated in collective bargaining agreements (2.7 % in June compared with 3.1 % in cumulated terms to March). This deceleration will foreseeably continue for the remainder of the year, as collective bargaining agreements are negotiated and, with it, the number of newly-signed agreements under which wage settlements are less closely tied to past inflation, which was exceptionally high in December 2010. Adding to this would be the potential effect on wage increases of employers and employees making intensive use of the possibilities for collective bargaining offered by Royal Decree-Law 7/2011 on urgent collective bargaining reform measures, enacted on 10 June. This reform promotes signing collective bargaining agreements at firm-level, which are more closely linked to the firm's position in the cycle. It further provides for the possibility of wage opt-out clauses (see Box 4). For the economy as a whole, it is estimated that the growth rate of compensation per employee slowed slightly more, influenced by the cut in public-sector wages; as a result, unit labour costs continued to decrease.

In short, economic developments in recent months portray a cyclical position of weak recovery, underpinned by buoyant net external demand. This pattern of exit from the crisis shows the correction of the macroeconomic imbalances which have built up, and completing this adjustment is essential for returning to a path of sustained growth, even if this restricts short-term growth capacity. However, the increase in uncertainty in recent months has accentuated the downside risks to growth. The possible repercussions of sovereign debt market tensions on the real economy are the main source of risks. Emerging successfully from this adverse climate hinges on the decisive and clear implementation at European level of the commitments agreed at the summit of Heads of State and Government on 21 July, although containing contagion also requires forceful national economic policy responses. In Spain, major reforms have been adopted over the last year in the fiscal area and in that of pensions, the labour market and financial system. Completing these reforms swiftly and ambitiously would contribute to reducing uncertainty and resuming sound growth.

2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

During Q2 the heightening of the euro area sovereign debt crisis ultimately had a severe effect on global financial markets, unlike in the previous quarter. Furthermore, the economic recovery lost momentum in some of the major developed economies, particularly the United States, adding further uncertainty which contributed to gradually increasing doubts over the temporary nature of the slowdown. Although inflationary pressures have eased in the advanced economies, in emerging economies they remain strong, against a backdrop of still-high commodity prices, which augurs a gradual tightening of monetary conditions in some of these economies in coming months. This situation is in contrast to a fresh delay in the beginning of the cycle of interest rate rises in certain developed economies and renewed debate about the appropriateness of new non-conventional monetary policy measures in the United States, and also in the United Kingdom, without any steps having been taken in this direction. Lastly, in Q2 fiscal risks have intensified and spread beyond the euro area and include, most notably, the tense negotiations in the United States about raising the debt ceiling which in recent months has been tied to achieving political consensus on the fiscal consolidation strategy (see Box 1).

International financial markets performed negatively and were characterised by greater risk aversion and investors' flight to quality, although the Eurogroup agreement on 21 July favoured a temporary correction of the quarter's trends. Thus, most developed and emerging stock markets posted heavy losses. On the foreign exchange markets certain currencies such as the dollar and Swiss franc acted as safe-haven assets and appreciated significantly. The negative developments in Europe coincided with the appreciation of the dollar against the euro by around 3% to $1.44 per euro. The yield on ten-year US Treasury bonds dropped to around 3% in the quarter, despite the accentuation of fiscal problems in the US, owing to the worse economic outlook and flight to quality movements. In emerging markets capital inflows in the form of debt remained buoyant and the issuance of fixed-income securities was high, close to record levels, despite which the sovereign spread for emerging economies as a whole widened slightly. Emerging currency movements against the dollar were mixed, although the Turkish lira depreciated noticeably (by more than 10%). Commodity prices decreased moderately following the robust rises of the previous quarter, due to lower expectations of growth in global demand, although they were very volatile and held at high levels. The price of Brent oil moved within a range of $105 and $120. OPEC's decision not to increase production quotas and the International Energy Agency's announcement to release part of its strategic reserves triggered significant price changes.

In the United States the annualised quarterly GDP growth rate stood at 1.3% in Q2 (0.3% quarter-on-quarter and 1.6% year-on-year), representing a quickening with respect to the figure of 0.4% recorded in Q1, which was revised down notably. Persistently weak growth was due to sluggish private consumption. The most recent supply and demand indicators reflect a continuation of this scant buoyancy. In June industrial production increased slightly and business confidence continued to signal moderate growth, while retail sales and consumer confidence showed signs of weakening. Similarly, the residential real estate market remains very depressed and house prices have decreased again. In May and June, following a highly buoyant period, the pace of job creation slowed and the unemployment rate increased again to 9.2% of the labour force at the close of Q2. Inflation held unchanged in June at 3.6% year-on-year and core inflation climbed 0.1 pp to 1.6% year-on-year. In this setting, the Federal Reserve maintained its expansionary policy stance leaving the official interest rate in the range of 0-0.25% and ended its asset purchase programme.

Since the financial turmoil began in August 2007 and, especially, after the bankruptcy of Lehman Brothers in September 2008, the fiscal position of the US economy has deteriorated greatly, largely as a result of the operation of automatic stabilisers and of discretionary measures adopted to soften the impact of the crisis. Specifically, the federal deficit has increased in terms of 12-month accumulated data from 1.5% of GDP in August 2007 to 8.4% in June 2011, after rising above 10% at end-2009. This was due to the decline in revenues (from 18.1% to 14.3%) and the increase in spending (from 19.7% to 21.6%) and prompted, also between August 2007 and June 2011, a rise in net debt[1] – from 36% of GDP to 64.9% – and in gross debt – from 63.6% of GDP to 95.5% – (see Panel 1).

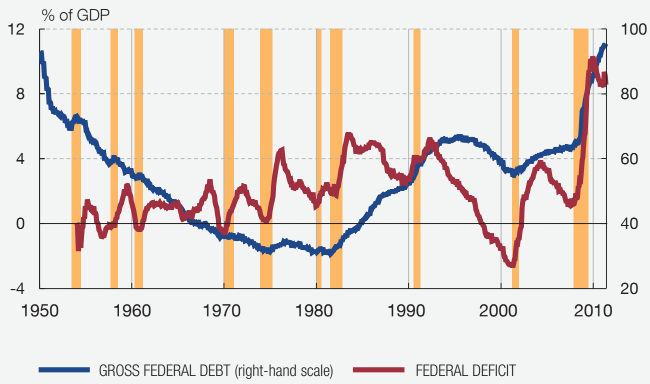
1 In this article, as is usual in statistics on US public finances, net debt is deemed the debt held by the public, which relates to marketable securities issued by the Treasury whose main holders are the external sector, the financial and non-financial private sector, the Federal Reserve and the state and local governments which purchase these debt securities in the market.

The deterioration of the fiscal situation in the United States, as a result of the crisis, has been among the deepest experienced in the developed economies. And as in the other advanced countries, this deterioration compounds the high fiscal commitments associated with population ageing, which will be manifest in growing spending on health and pensions. Consequently, the issue of the sustainability of public finances has become notably important in economic policy debates.

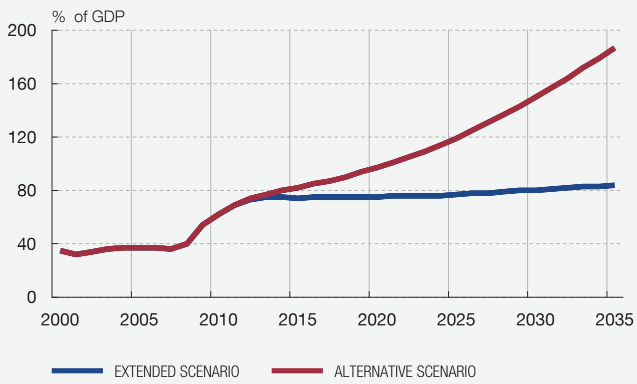
In its latest outlook report, the Congressional Budget Office (CBO – an independent agency whose mandate is to provide Congress with objective analyses for taking economic and budgetary decisions) considers two alternative scenarios for long-term public finances.[2] Under the first scenario in which it is assumed that the tax provisions will expire as scheduled and the forecast restric-

2 See the CBO's 2011 Long-Term Budget Outlook, Congressional Budget Office, June 2011.

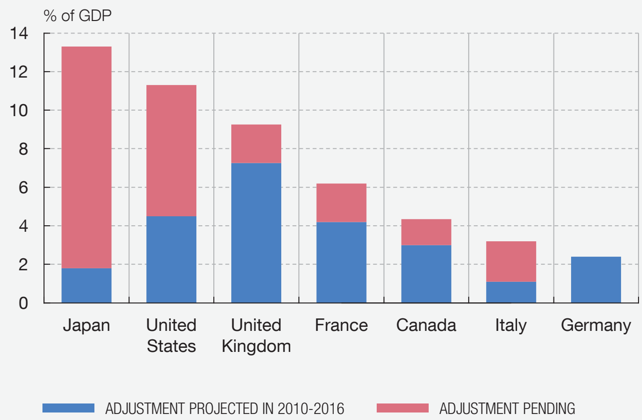
1 FEDERAL DEFICIT AND GROSS FEDERAL DEBT (a)



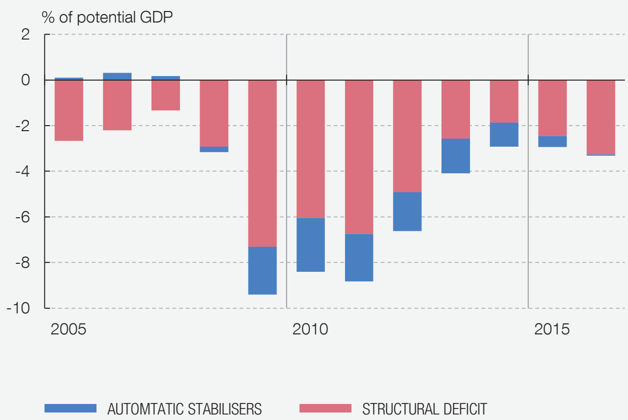
2 PROJECTIONS OF NET FEDERAL DEBT



3 ESTIMATE OF THE FISCAL ADJUSTMENT NEEDED (IMF) (b)



4 FEDERAL DEFICIT. BREAKDOWN BY COMPONENT



SOURCES: Congressional Budget Office, US Department of the Treasury, Bureau of Economic Analysis and IMF.

a The yellow bars indicate periods of recession.
b Estimate of the fiscal adjustment needed so that the debt ratio decreases to 60% of GDP by 2030 or stabilises (if it is lower than 60% of GDP).

tions on spending – especially on health – will ultimately be implemented, the deficit would decrease to 4.2% of GDP by 2035 as a result of higher revenues, which would be above the historical average (23% in 2035, compared with 18% in the last four decades), and of lower spending – excluding social security, health and interest payments – with the result that the net debt would stand at 84% of GDP. However, under the alternative scenario in which tax provisions are maintained and spending on health is not cut, the outlook is worrying: revenues would remain at historically low levels (around 18% of GDP), while spending would reach very high levels (close to 34% of GDP) – see Panel 2 –, triggering an increase in net debt to 187% of GDP.

Against this background, several estimates indicate that the fiscal adjustment required to stabilise the long-term debt level in the United States is very high and above that envisaged in most developed economies. For instance, a recent analysis of the International Monetary Fund[3] shows that the fiscal adjustment needed to stabilise debt at 60% of GDP would be 11 pp, while the adjustment forecast in the 2010-2016 horizon would hardly exceed 4 pp (see Panel 3). In fact, despite the agreement reached in June 2010 by G20 member countries to halve their fiscal deficits by 2013, which would require a reduction of around 5 pp in the United States, and, unlike the strategy adopted in other advanced countries – mainly in the United Kingdom and in several euro area countries – where ambitious fiscal consolidation plans have been approved, in the United States the choice was made to delay the fiscal adjustment needed and the role of public stimulus as a support for growth was extended. In this connection, a new fiscal stimulus programme was approved in December 2010, when most economies had already begun the contractionary fiscal cycle. At present, the design of the fiscal consolidation strategy has just been agreed, following a long and complex debate between the two main parties which were at loggerheads over this issue.

In fact, the political debate intensified and took a risky turn in February when the Republican Party tied the approval of an increase in the debt ceiling to the approval of a fiscal consolidation programme based on spending cuts, which differs radically from the Democrats' proposal of maintaining welfare benefits by raising certain taxes. The negotiations couched in these terms centre on one variable – the debt ceiling – which should not come under debate and which entails high risks. As a result of the agreement reached on 31 July, the debt can be increased by at least $2.1 trillion (although it is estimated to rise by $2.5 trillion), which is sufficient to finance the running of the Government until 2013, i.e. until after the next elections. In exchange, a spending cut of nearly $1 trillion over ten years was agreed, which would be accompanied by another deficit cut of between $1.2 trillion and $1.5 trillion to be agreed by a bipartisan committee before the end of 2011. Mechanisms have been set in place to bring pressure to bear to ensure this agreement comes to fruition. In any event, doubts still remain about the implications of this agreement for the sustainability of public debt.

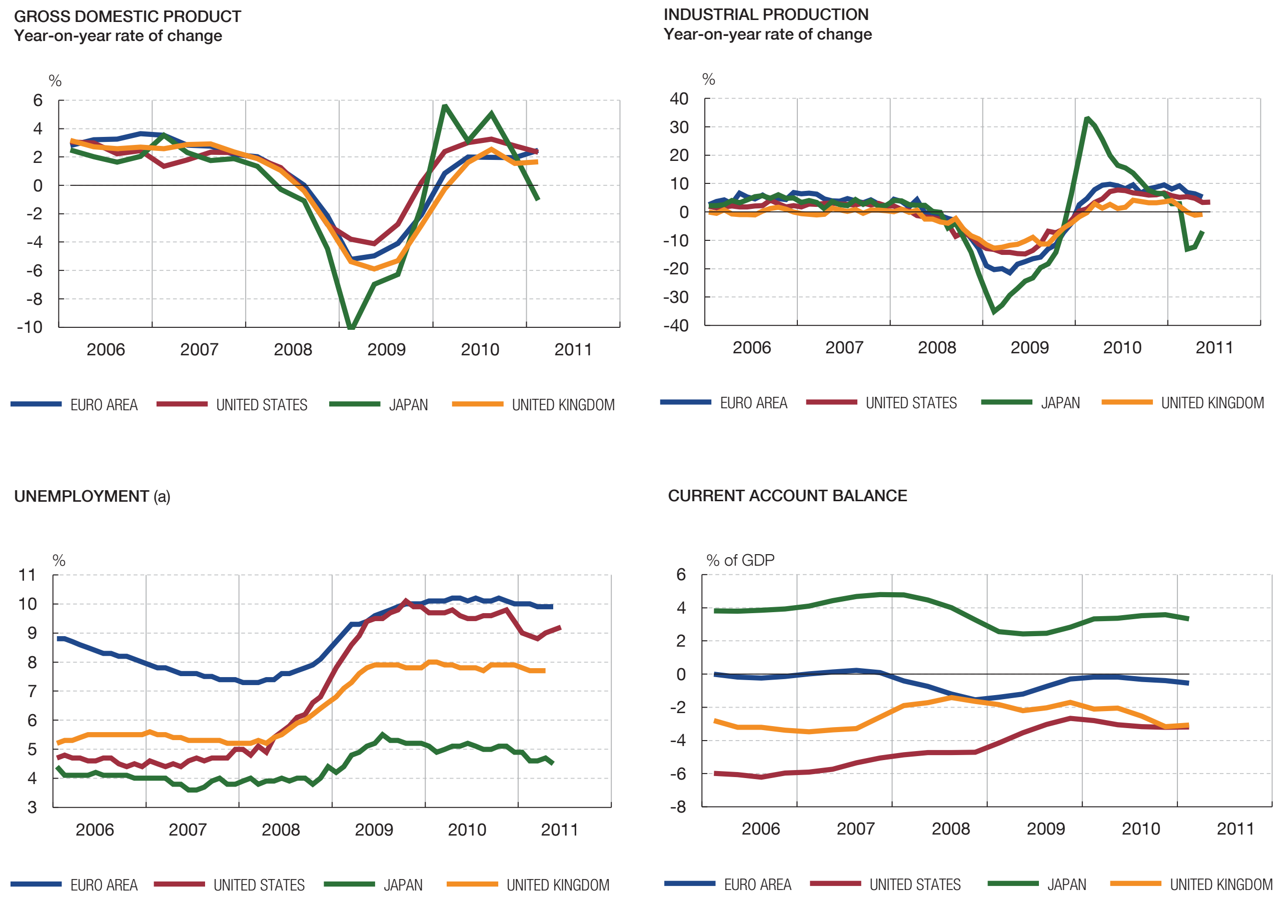
3 See Fiscal Monitor *Shifting Gears: Tackling Challenges on the Road to Fiscal Adjustment*, International Monetary Fund, April 2011. Along the same lines, Auerbach, A. (2011) points out that the increase required in the structural primary balance, over and above that currently projected, so that debt returns to a ratio of 45% in 2060 would be approximately 8 pp of GDP. See "Long Term Fiscal Sustainability in Major Economies", an article prepared for the tenth BIS Annual Conference, *Fiscal Policy and Its Implications for Monetary and Financial Stability,* in Lucerne, 2011.

In Japan, GDP in Q1 fell by 0.9% quarter-on-quarter (-1% year-on-year), due to the contraction of private demand and the rise in imports after the earthquake in March. However, the most recent indicators point to a rapid recovery and return to normal of activity from mid-Q2, due to supply gradually moving back on to a normal footing. For instance, industrial production expanded by 5.7% in May and other qualitative indicators indicate higher growth in the coming months. On the demand side the recovery remains more tenuous owing to weak consumer sentiment, although certain temporary factors are supporting consumption. As for the external sector, the trade balance recorded a deficit in May as a result of buoyant imports. Despite persisting – though increasingly weaker – deflationary pressures, inflation rose in May to 0.3%. Against this backdrop the Bank of Japan held the official interest rate within a range of 0-0.1%, and enlarged its temporary facility by ¥0.5 billion (0.1% of GDP) in order to stimulate the granting of bank credit. Finally, the government approved a second supplementary budget of ¥2 billion (0.4% of GDP).

In the United Kingdom, the GDP flash estimate for Q2 shows growth of 0.2% quarter-on-quarter (+0.7% year-on-year), compared with 0.5% recorded in Q1 and confirms that activity held up in the services sector and that the production of goods declined, which had already been indicated by the higher frequency supply indicators, such as industrial pro-

MAIN MACROECONOMIC INDICATORS

CHART 5



SOURCES: Datastream and Banco de España.

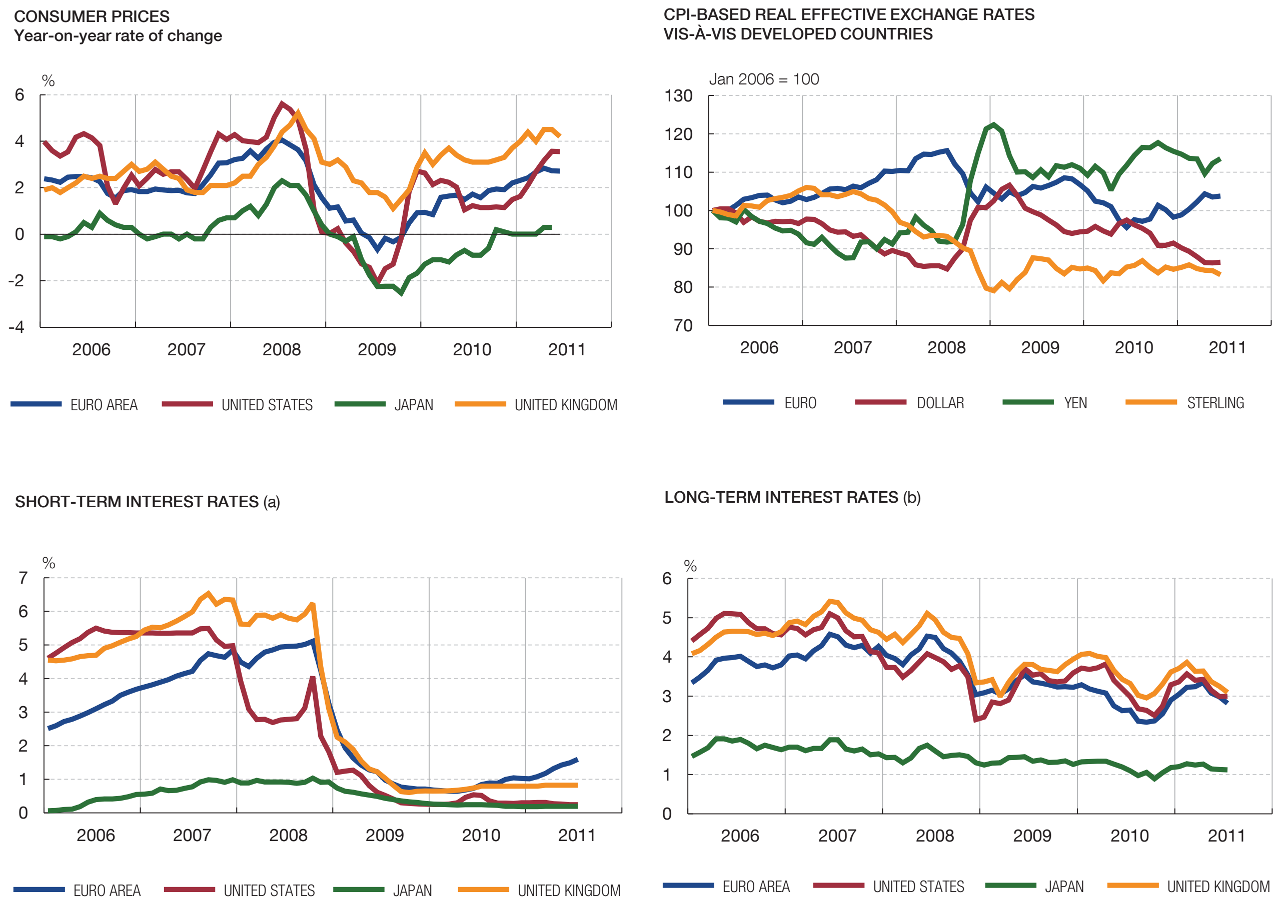
a Percentage of labour force.

duction and the Purchasing Managers' Index (PMI). Demand indicators, such as retail sales and business investment intentions, showed a slight sluggishness in line with low consumer and business confidence and the loss of household purchasing power. In the real estate market, the number of transactions recorded remained low and house prices continued to move on a slightly declining path. In the labour market job creation has lost momentum, although the unemployment rate is stable at 7.7% and wages remain contained. After a protracted rise, inflation decreased by 0.3 pp to 4.2% and the core rate declined by 0.5 pp to 2.8% in June, although notable inflationary pressures persist. The Bank of England held the official interest rate at 0.5% in July and the markets seem to rule out a tightening of its policy before the end of the year.

In the new non-euro area EU Member States as a whole, in Q1 GDP grew on average by 3.5% year-on-year. This exceeded growth of 3% in the previous quarter, showing an improvement across the board, which included most notably the emergence of Romania from recession and the solid recovery of the Polish economy. The momentum of activity continued to be tied to the expansion of exports and industrial production, due to the strength of the German economy (the region's principal trading partner), while in Poland private consumption remained notably robust. Growth is expected to continue in Q2 insofar as projections are for ongoing strong external demand, although a slight slowdown cannot be ruled out if domestic demand does not gain greater vigour. Throughout the quarter inflation behaved unevenly, moving on a rising trend until May and, subsequently,

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCES: Datastream and Banco de España.

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

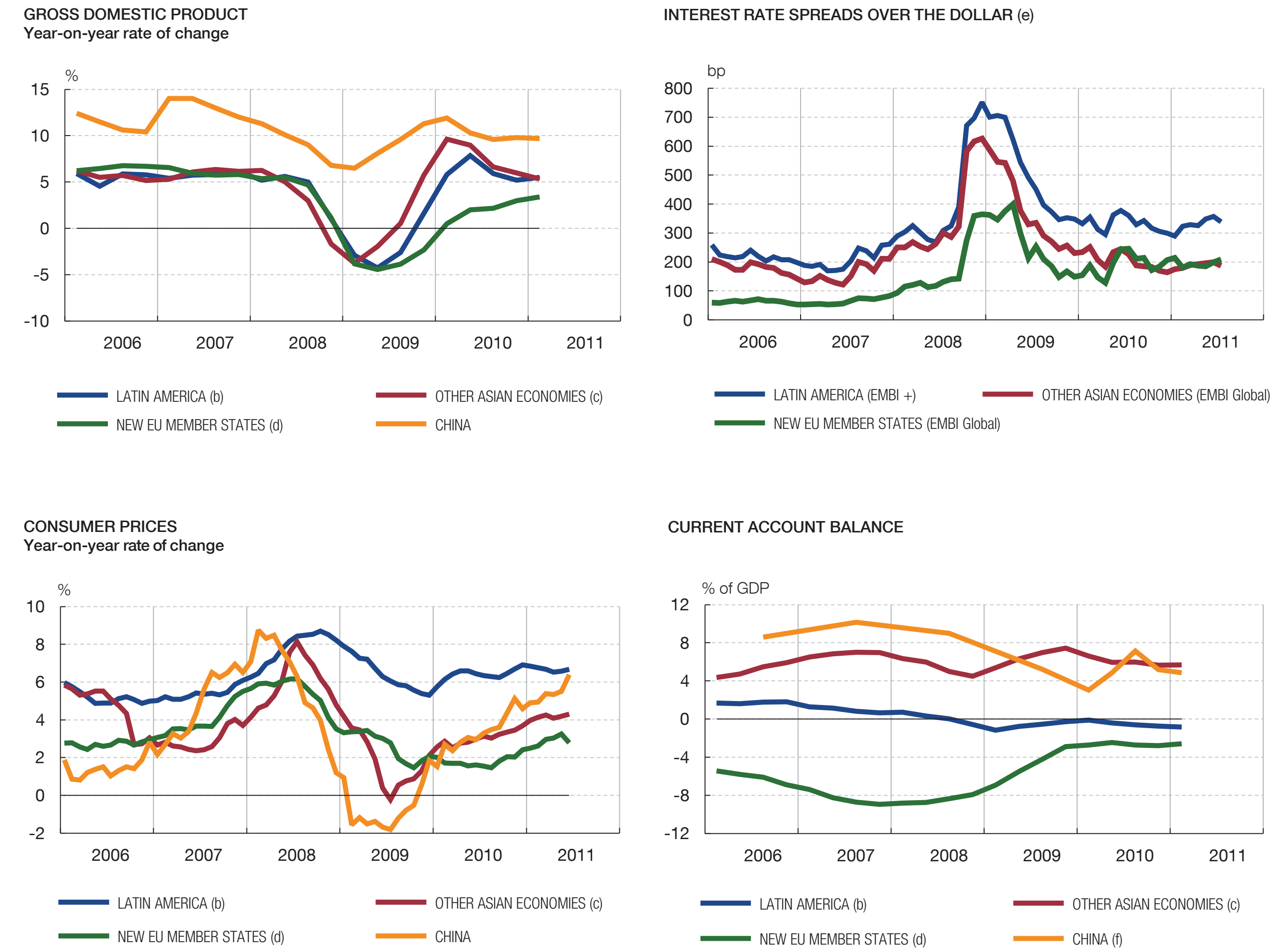
recording widespread declines in June owing to lower food prices which have contributed to putting the aggregate rate at 4.2% year-on-year. Nevertheless, greater inflationary pressures in Poland prompted a fresh increase in the official interest rate (of 50 bp to 4.5%) while in other countries it remained unchanged.

In China GDP posted growth of 2.2% quarter-on-quarter (9.5% year-on-year) in Q2. The pace of expansion is still robust, easing only slightly, despite the tightening of monetary policy and relatively weak external demand. Inflation held on an upward path, reaching 6.4% year-on-year in June (considerably higher than the target of 4%). Against this background, the authorities once again increased the reference interest rate in July (by 25 bp), leaving the rate on one-year loans at 6.56% and that on one-year deposits at 3.50%. Additionally, they raised the reserve requirement six times during 2011 to 21.5% for the major banks and 19.5% for the smaller ones. In the rest of Asia growth remained notably strong during 2011 Q1, although, in terms of year-on-year rates, the region's GDP decelerated slightly (to 6.3% compared with 7% in the previous quarter). The Q2 indicators point to a slight further moderation of activity. Inflationary pressures persisted due to the effect of food and energy prices which favoured increases in official interest rates and in reserve requirements in several of the region's economies.

In Latin America GDP growth quickened slightly in 2011 Q1 to 1.4% quarter-on-quarter, compared with 1.2% in the previous quarter (from 5.2% to 5.5% in year-on-year terms),

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: Datastream and Banco de España.

a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
b Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
d Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Bulgaria and Romania.
e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary and Poland.
f Annual data until 2009.

largely due to the lower negative contribution of external demand (given that the positive contribution of domestic demand fell). Activity indicators suggest that the buoyancy will continue in Q2. Inflation for the region as a whole stood at 6.6% in June, similar to that of preceding months and to the core inflation rate. In this context, the central banks of Brazil, Colombia, Chile and Peru increased official interest rates again (admittedly in Chile and Peru they were not altered at the last meetings of the quarter). In the sphere of fiscal policy, over the quarter there was a slight improvement in the primary balance. Furthermore, financial inflows to the region continued, which underpinned the appreciation of exchange rates. In Brazil the taxes on unhedged short positions in foreign currency became more stringent. The rating agencies increased the rating of Colombian, Brazilian and Uruguayan sovereign debt. Finally, Brazil and Colombia issued dollar-denominated debt on the external market amounting to $550 million and $2 billion, respectively.

Throughout Q2 and especially in July, financial tensions in the euro area heightened and the government bond spreads of the countries under a financial assistance programme rose to extraordinarily high levels. The turbulence spread to the debt of other countries, such as Italy and Spain, and to other financial markets, including the stock, foreign exchange and interbank markets. The trigger on this occasion was the difficulty in designing a new aid programme for Greece, a necessity once it was clear that Greece could not go back for funding to the capital market in mid-2012 as scheduled. In particular, the lack of agreement on the desirability and, where appropriate, the means of incorporating private-sector participation into the programme was seen as a major stumbling block. Finally, on 21 July, the euro area Heads of State and Government met and decided not only to set a new programme for Greece in train but also a broader package of measures to improve the sustainability of Greek debt, to halt the risk of contagion to other economies and to strengthen the crisis-management mechanisms available in Europe (see Box 2). While the results of the summit translated into some initial easing in tensions, they promptly re-emerged and, in late July and early August, Italian and Spanish debt spreads once again rose to all-time highs since the start of Monetary Union.

The background of financial instability does not appear to have significantly affected macroeconomic developments in the euro area in Q2, since the slowdown in GDP anticipated for the period is largely in response to the rise in commodities prices, to the slowdown in international trade and to the waning of the temporary factors that boosted GDP upwards in Q1. Into the medium term, the estimates available continue to point to a scenario in which the pick-up in activity advances following the pause in Q2 to attain growth that is close to potential in early 2012 and increasingly underpinned by domestic demand. In this scenario, cross-country divergences persist, with a group of euro area core economies increasingly distant from those under financial assistance programmes, which remain in a delicate situation over the course of 2011 and 2012.

Inflation in June stood at 2.7%, largely due to the notable increase in energy and commodities prices. Given the course of oil prices that the futures markets augur, inflation is expected to hold above 2% in the coming months and to return to a rate below this level in early 2012. However, medium-term risks remain on the upside and are related to potentially higher-than-expected increases in energy prices and indirect taxes. Such was the view of the ECB at its April and July meetings, when it decided to raise its official rate by 25 bp on both occasions, taking the MRO rate to 1.5% and thereby contributing to keeping euro area inflation expectations firmly anchored. It also decided to suspend the minimum credit rating threshold for fixed-income debt instruments issued or guaranteed by the Portuguese government, following Moody's downgrading of its sovereign debt by four notches to speculative bond (Ba2) status. In August, the ECB Governing Council decided to hold its official interest rates unchanged and to conduct a liquidity-providing supplementary operation with a maturity of six months, at a fixed rate and with full allotment. The ECB also decided to extend for as long as needed and at least until January 2012 its fixed-rate tender procedure with full allotment in its main refinancing operations, and to maintain this procedure too for its one-month and three-month operations until the end of 2011. Lastly, the Governing Council recalled that its Securities Market Programme remained open.

AGREEMENTS OF THE EURO AREA HEADS OF STATE AND GOVERNMENT AND THE INSTITUTIONS OF THE EUROPEAN UNION ON 21 JULY

BOX 2

Since the onset of the sovereign debt crisis, measures have been adopted to strengthen competitiveness, governance and financial stability in the euro area. But the scale of the challenges posed - once the impossibility of Greece returning to the markets for funding by mid-2012, as initially scheduled, was established - and the mounting risk of contagion of the tensions to other countries have made action on a much greater level necessary. On 21 July, the euro area Heads of State and Government reached an agreement marking a notable improvement in the terms of the loans extended to countries under financial assistance programmes, and a reform of the European Financial Stability Facility (EFSF) and the future European Stability Mechanism (ESM), providing them with greater flexibility and operational capacity. The agreement also includes a new financial support programme for Greece and, given the singular conditions of the Greek economy, it exceptionally incorporates the voluntary participation of the private sector.

Specifically, the first raft of measures is aimed at offering a solution for the Greek problem, extending assistance to cover this economy's funding needs while improving the sustainability of its public debt. In this connection, a new financial aid programme for Greece will be launched, in collaboration with the IMF and with the contribution of the private sector. Total official financing will amount to €109 billion. A key feature of the new programme is that the interest rates charged are to be lowered, in alignment with those of the balance of payments assistance mechanism (currently around 3.5%), and longer maturities considered, with a minimum of 15 and a maximum of 30 years, with a grace period of 10 years. These enhancements are also extendable to the programmes in place for Ireland and Portugal. Regarding private-sector participation, the financial sector has expressed its readiness to support Greece voluntarily through a range of options, with credit guarantees. The net private-sector contribution here is estimated to be €37 billion, to which €13 billion attained through a secondary-market repurchase programme must be added, making for total participation of €50 billion. All the Member States have firmly undertaken to confine the participation of the private sector exclusively to Greece, while the remaining countries will resolutely tackle their sovereign debt, as this is a decisive factor for ensuring financial stability in the euro area as a whole.

To boost growth and investment in Greece, the Heads of State and Government supported the Commission's decision to set up a special task force. This body will collaborate with the Greek authorities to immediately mobilise the structural funds of the EU and the European Investment Bank (EIB), earmarking them for improving competitiveness and growth, job creation and training, and providing exceptional technical assistance so as to help Greece apply its reforms. Further, the Commission and the EIB will step up the synergies between EU lending programmes and funds in all countries with IMF and EU assistance, in order to raise the capacity of these countries to absorb EU funds so as to stimulate growth and employment, also by means of a temporary increase in co-financing rates. Support will continue to be given to countries subject to programmes until they have regained access to the market, conditional upon them successfully applying their programmes.

To curb the possibility of contagion, the flexibility of the EFSF and the ESM has also been increased. This will enable them to act pre-emptively, giving them the capacity to finance the recapitalisation of banks through loans to governments, even in countries not subject to programmes. They will also be able to intervene in secondary markets further to an analysis by the ECB that acknowledges the existence of exceptional circumstances posing a risk to financial stability.

Furthermore, the Heads of State and Government called for the conclusion of the process of approval of the European governance reform proposals. These include a revision of the Stability and Growth Pact and the introduction of a surveillance mechanism for macroeconomic imbalances. In this connection it will be necessary to reach an agreement on voting rules concerning the preventive side of the Pact. It was also agreed to lessen the dependence on external credit rating agencies in the area of financial regulation, in which connection the Commission will submit proposals.

All the euro area Member States undertook at the meeting to meet in full the budgetary targets agreed upon, to improve competitiveness and to correct macroeconomic imbalances. In this respect, satisfaction was expressed at the measures taken by the Greek government to stabilise the budget deficit and reform the economy, as well as at the new batch of measures, including privatisations, recently adopted by the Greek Parliament. The set of budgetary measures recently submitted by the Italian government and the budgetary, financial and structural reforms undertaken by Spain were also very positively viewed. Favourable consideration was likewise given to Ireland's readiness to participate constructively in the discussions on the draft directive for a common corporate income tax base and in the debate on tax policy within the framework of the Euro Plus Pact.

Overall, the downside risks to growth have increased in Q2 in relation to a central scenario of moderate recovery without inflationary pressures in the medium term, against a background of still-high uncertainty. Apart from risks stemming from the international setting, which appear to have stepped up according to the latest conjunctural information for July, the biggest risk arises from the repercussions that tensions on the sovereign debt markets may have on the real economy.

On 12 July the Ecofin concluded the European Semester, the new cycle of fiscal, macroeconomic and structural policy coordination and surveillance introduced in the EU as part of a wider-ranging reform of economic governance. An assessment was also made of the reform undertakings made by governments under the Euro Plus Pact. Overall, the conclusions of this process revealed that reform policies are moving in the right direction, but that it is necessary that the measures proposed and the recommendations formulated should be more specific.

3.1 Economic developments

The economic recovery surprised on the upside in 2011 Q1, as GDP grew at a quarter-on-quarter rate of 0.8%, above forecast (see Table 1). Exports, up 1.9%, continued to be the driving force of recovery in line with the expansion of the world economy, whereby net external demand contributed 0.3 pp to euro area GDP growth. Investment in capital goods once again posted a high increase, while private consumption only rose by 0.2%, its weakness perhaps related to the sluggishness of disposable income and to the environment of high uncertainty which detracts from purchases of consumer goods, especially durables. In turn, government consumption and investment in construction rose in Q1, driven by temporary factors. Given the foregoing developments, domestic demand excluding stocks contributed 0.6 pp to growth, while the contribution of inventories was zero. Value added quickened in all branches of activity, especially in industry, construction and wholesale and retail trade, and was more lacklustre in agriculture and in intermediation and general government services.

The course of recovery in the euro area member countries is characterised by the persistence of notable differences. In some, GDP is very close to its pre-crisis level, whereas in others it is still far from that level. In the former countries, economic activity is sound, underpinned by a progressive improvement in the labour market, by the increasingly healthy financial position of households and firms, and by the restoring of business margins. All these developments are making for a substantial rise in gross fixed capital formation. Notable in this group are Germany and France, which grew by 1.5% and 0.9%, respectively, in Q1. Germany was prominent in respect of the strong expansion in its exports (far outpacing France), with relatively weak private consumption despite the resilience of its labour market. The two economies are thus distancing themselves from those countries benefiting from a financial assistance programme, which are subject to a more contractionary fiscal impulse and to tighter financial conditions. The latter group posted practically zero or, in Portugal's case, negative growth in 2011 Q1. GDP increased by only 0.1% in Italy in Q1, in line with the chronically sluggish rises in this economy.

The pick-up in employment in 2011 Q1 was once again more modest than that in GDP, growing at a muted rate of 0.1% compared with the previous quarter. That translated into a positive year-on-year rate of 0.3%, consolidating the job creation initiated at the beginning of last year. Hours worked per employee, which have still not reached pre-crisis levels, rose to a greater extent, to 0.5% year-on-year. That would suggest the tendency to restore the habitual working day duration persists. Hence the increase in labour productiv-

EURO AREA ECONOMIC INDICATORS (a) — TABLE 1

	2009	2010				2011		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
NATIONAL ACCOUNTS (quarter-on-quarter rate of change, unless otherwise indicated)								
GDP	0.3	0.3	0.9	0.4	0.3	0.8		
Private consumption	0.2	0.4	0.2	0.2	0.3	0.2		
Government consumption	0.4	-0.3	0.3	0.1	-0.1	0.5		
GFCF	-0.7	-0.7	2.2	-0.2	-0.2	1.9		
Imports	1.2	3.8	4.1	1.3	1.2	1.4		
Exports	2.3	3.4	4.3	1.7	1.6	1.9		
Contributions to quarter-on-quarter change in GDP (pp)								
Domestic demand, excl. stocks	*0.1*	*0.0*	*0.6*	*0.1*	*0.1*	*0.6*		
Stockbuilding	*-0.2*	*0.4*	*0.2*	*0.1*	*-0.1*	*0.0*		
Net foreign demand	*0.3*	*-0.1*	*0.2*	*0.2*	*0.3*	*0.3*		
GDP (year-on-year rate of change)	-2.1	0.9	2.0	2.0	2.0	2.5		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	1.0	2.6	2.5	1.0	1.8	1.1	*0.7*	
Economic sentiment	92.0	96.4	99.2	102.3	105.7	107.4	105.7	*103.2*
Composite PMI	53.6	54.4	56.6	55.7	54.9	57.6	55.6	*50.8*
Employment	-0.2	0.0	0.1	0.0	0.2	0.1		
Unemployment rate	10.0	10.1	10.2	10.2	10.1	10.0	*9.9*	
PRICE INDICATORS (year-on-year change in end-period data)								
HICP	0.9	1.6	1.5	1.9	2.2	2.7	2.7	
PPI	-2.9	0.9	3.1	4.3	5.4	6.8	*6.2*	
Oil price (USD value)	74.4	78.8	75.0	78.4	92.3	115.4	114.9	*117.3*
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	4.0	4.0	3.7	3.5	4.1	4.6	4.4	*4.6*
US-euro area ten-year bond spread	-0.17	-0.08	-0.72	-1.01	-0.78	-1.14	-1.30	*-1.56*
Dollar/euro exchange rate	1.441	1.348	1.227	1.365	1.336	1.421	1.445	*1.426*
Appreciation/ depreciation of the NEER-20 (b)	-0.9	-4.5	-10.3	-6.3	-8.2	3.5	3.9	*1.7*
Dow Jones EURO STOXX 50 index (b)	21.0	-1.2	-13.2	-7.4	-5.8	4.2	2.0	*-3.6*

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

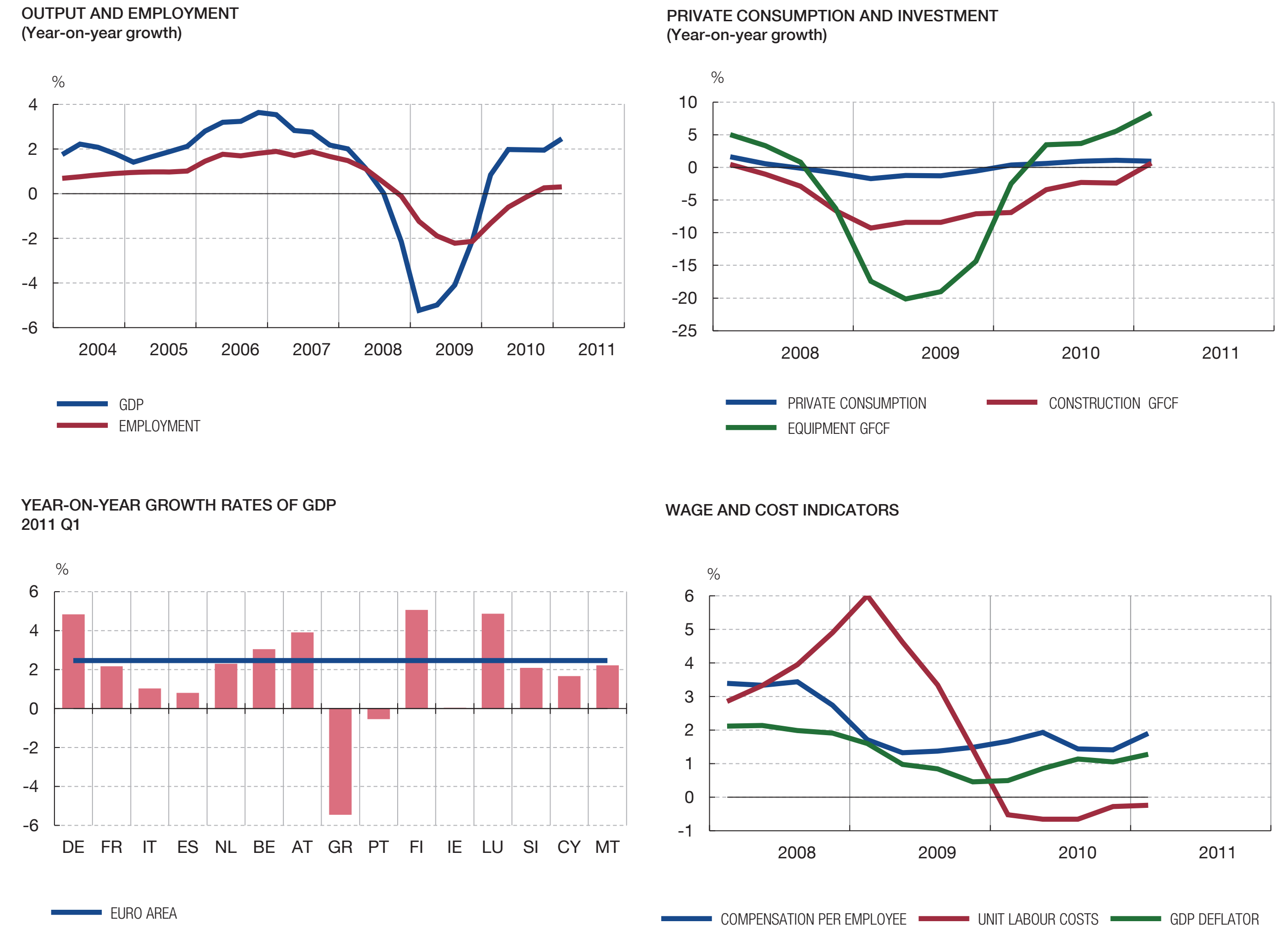
a Information to 28 July 2011.
b Percentage change in year to date.

ity exceeded that of compensation per employee, whereby unit labour costs shrank once more and, given the positive rise in the GDP deflator, business margins widened once again (see Chart 8).

The latest conjunctural information suggests that the expansion in activity continued in Q2, albeit at a slower pace. The slowdown is partly in response to the waning of some temporary factors that bore on developments in Q1 and, especially, to the loss of momentum in the industrial cycle over these past months, owing to the rise in oil prices and commodities, to the political tensions in North Africa and to the manufacturing supply chain interruptions, following the natural disaster in Japan on 11 March. Industrial production thus lost steam in April and May, posting a month-on-month growth rate of close to zero, while new industrial orders also slowed on the opening months of the year (see Chart 9). Business confidence stood at levels consistent with an increase in activity in Q2, both in the manufacturing and services sectors, despite the progressive worsening recorded in June and July. This deterioration has been sharper in those components related to expectations for the coming months than those which reflect the current situation, which adds

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

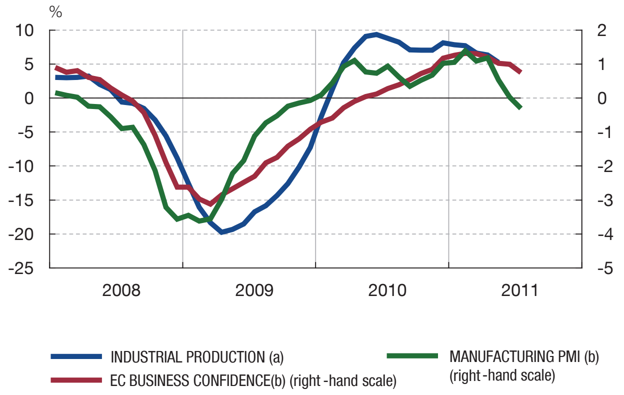
uncertainty to economic developments in the months ahead. Turning to the labour market, the unemployment rate held at 9.9% in May and the indicators of job creation expectations, which had been improving uninterruptedly since the start of the recovery, fell off slightly in May and June.

On the demand side, the consumption indicators remained somewhat weaker than in previous months as a result of the loss of purchasing power resulting from price rises and, also perhaps, of the uncertainty generated by the heightening of the sovereign debt crisis, which might have influenced the slide in consumer confidence in June and July. Retail sales, after growing forcefully in April, fell in May and new car registrations slowed, especially in April. Further, readiness to purchase durable goods, much influenced by the climate of uncertainty, remained very depressed, in line with the past year's trajectory. As to investment in capital goods, the latest indicators showed a more favourable trend, though signs of this petering out in Q3 are discernible: the degree of capacity utilisation rose up to Q2, whereafter the improvements were interrupted, and the European Commission's assessment of industrial orders is holding at high levels despite falling off slightly in May, June and July. Goods exports continued to grow at a sound pace in April and May, although export expectations lost momentum in Q2 in line with the diminished strength of world trade, and external orders worsened in May, June and July.

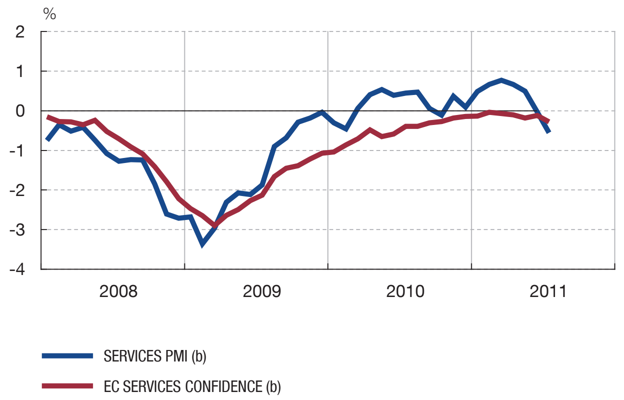
EURO AREA. REAL INDICATORS

CHART 9

INDUSTRIAL ACTIVITY INDICATORS

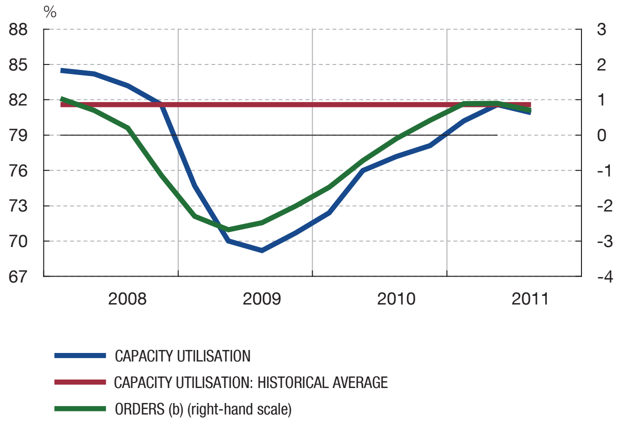


SERVICES SECTOR INDICATORS

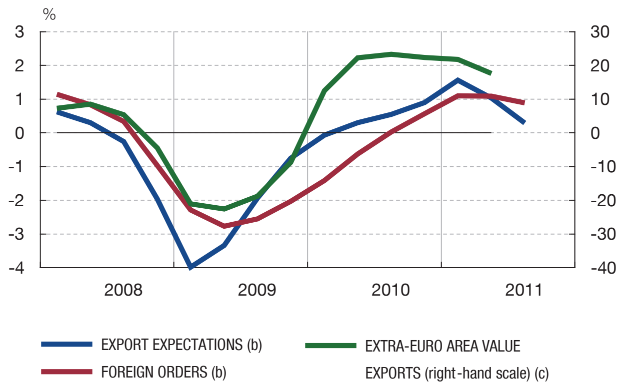


CONSUMPTION INDICATORS

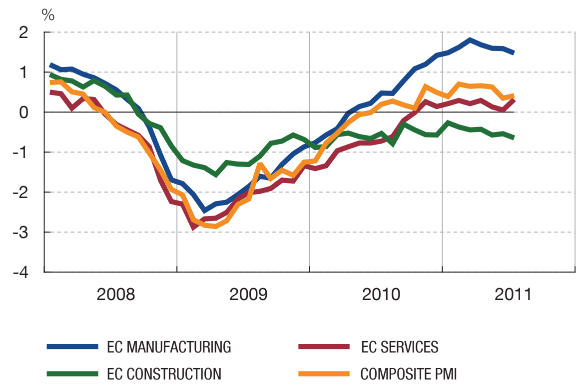
INVESTMENT INDICATORS



EXPORT INDICATORS



EMPLOYMENT EXPECTATIONS INDICATORS (a)



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 Year-on-year rates of the original series. Quarterly average.

GDP AND HICP FORECASTS FOR THE EURO AREA (a)

TABLE 2

	2011		2012	
	GDP	HICP	GDP	HICP
ECB (June 2011)	1.5-2.3	2.5-2.7	0.6-2.8	1.1-2.3
European Commission (May 2011)	1.6	2.6	1.8	1.8
Interim update (September 2008)				
IMF (June 2011)	2.0	2.3	1.7	1.7
Interim update (July 2008)				
OECD (May 2011)	2.0	2.6	2.0	1.6
Interim update (September 2008)				
Consensus Forecast (July 2011)	2.0	2.6	1.6	1.9
Eurobarometer (July 2011)	2.0	2.6	1.7	1.9

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

a Year-on-year rate of change.

Into the medium term, international agencies' forecasts coincide on a scenario for the second half of 2011 and for 2012 in which the recovery extends as domestic demand strengthens, underpinned by a monetary policy that remains accommodative, by measures to restore the functioning of the financial system and by the impact of global demand on domestic income (see Table 2). However, the downside risks to this scenario have increased, against a background of high uncertainty. Apart from those associated with a prolonged slowdown in international trade, the biggest risk stems from tensions on sovereign debt markets, insofar as the adverse effects on private-sector funding conditions and on economic agents' confidence have a bearing on their spending decisions. It is thus necessary to address more ambitiously new measures to shore up growth, in the various areas identified under the European Semester framework. Notable here are the recommendations made on 6 July by the Council to push through reforms of wage bargaining mechanisms and of tax structures, reducing the weight of taxes that have a greater bearing on employment; to finalise the full application of the Services Directive in all EU Member States; to bring pension systems more into line with the demographic outlook; and, in short, to decisively implement the commitments acquired under the Euro Plus Pact to improve growth, competitiveness and employment.

Inflation in the euro area stabilised during Q2 at 2.7%, as a result of the behaviour of oil and commodity prices. However, core inflation, measured by the CPI excluding unprocessed food and energy prices, rose by 0.3 pp to 1.8%, driven above all by the rise in services and, in particular, in tourism-related items, as well as in processed food (see Chart 10). Although inflation expectations are anchored, medium-term risks remain on the upside and are related to further rises in oil prices, or fresh increases in indirect taxes and administered prices other than those anticipated, in order to comply with budgetary stability programmes.

According to the estimates published by the ECB, the euro area current-account balance between January and May 2011 posted a deficit of €56 billion (1.4% of GDP), €38 billion up on the same period a year earlier (1% of GDP). This deterioration was largely due to the behaviour of the goods balance, which went into deficit, since the services balance improved. In the financial account, net capital outflows in the form of direct investment totalled €53 billion between January and May, compared with €68 billion in the same period

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

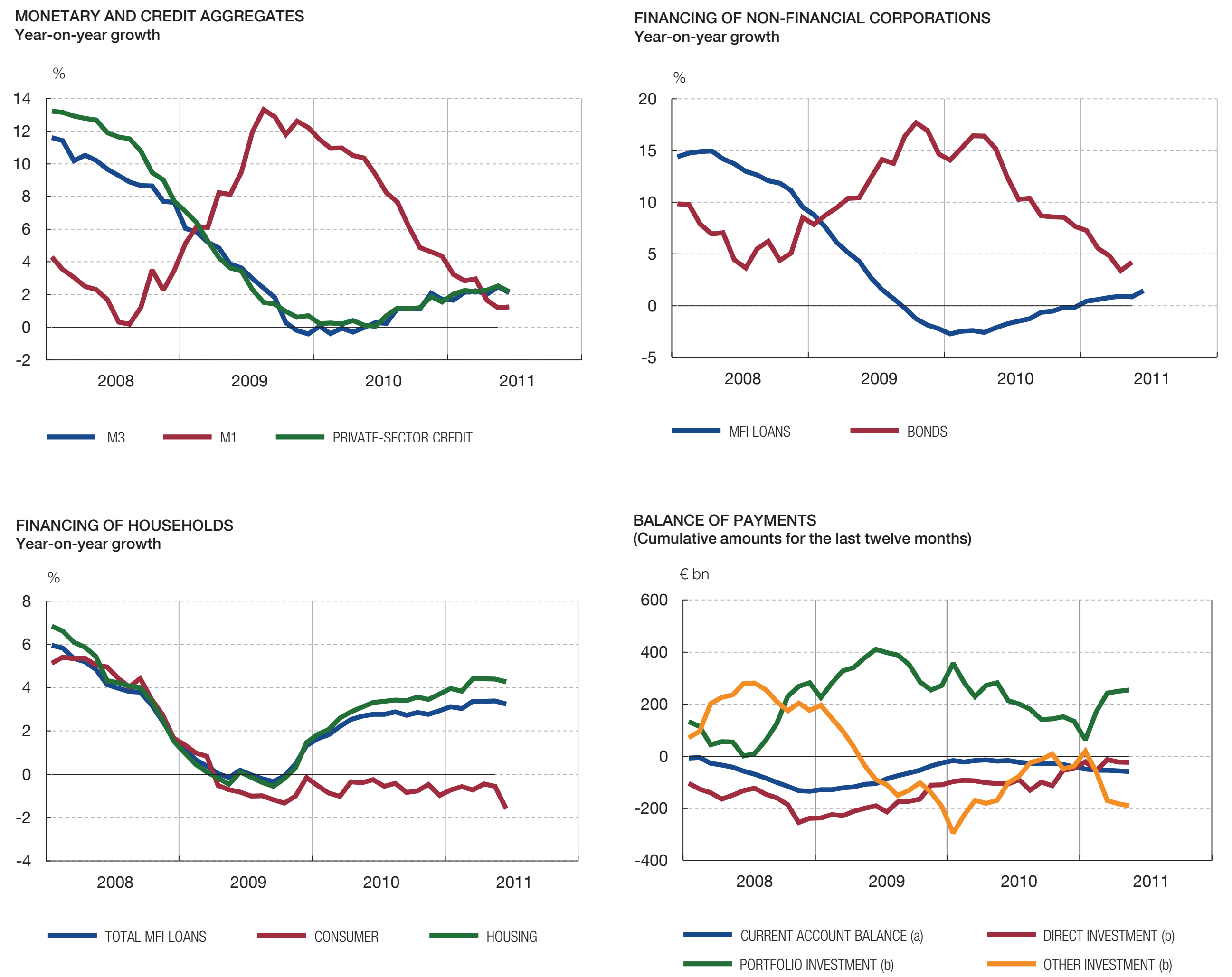
CHART 10

SOURCES: Eurostat and ECB.

in 2010, while portfolio investment gave rise to a net inflow of €254 billion, up on the €118 billion in the January-May 2010 period. The basic balance, which incorporates the current account balance into these two types of investment, posted a surplus of €145 billion from January to May 2011, compared with €13 billion observed in the same period a year earlier (see Chart 11).

EC and Stability Programme forecasts for the years 2011-2014, submitted by the euro area Member States last spring, reveal the strongly contractionary stance fiscal policy will maintain during 2011 and, to a lesser extent, in 2012 (see Box 3). On these estimates, the overall euro area general government deficit in 2011 will fall by almost 2 pp, from a starting point of 6%, and in 2012 it is expected to stand at around 3.5% (see Table 3). The correction is chiefly due to the containment of spending, associated with the easing in public-sector employee compensation, which will scarcely rise (0.2%), after running at an average growth rate of over 3% since the start of the Monetary Union. Also discernible is a fall-off in public investment and in transfers-related expenditure, as a percentage of GDP, whereas interest payments are expected to amount to 3% of euro area GDP. Public revenue also rises, albeit to a lesser extent, as a result of the increase in indirect tax and in income and wealth taxes, while social security contributions hold virtually stable.

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS — CHART 11



SOURCES: ECB and Banco de España.

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

Country by country, at the beginning of the quarter the Portuguese government was beleaguered by a far-reaching institutional crisis on top of its fiscal and structural problems, leaving it to request financial assistance from the European institutions and the IMF. The aid programme agreed in May was for an amount of €78 billion, which will be provided in equal portions by the IMF, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) over the 2011-2014 period. The granting of financial aid is conditional upon the application of a broad range of structural adjustment measures, with emphasis on improving the labour market, in addition to fiscal consolidation and the restructuring of the banking sector. In Greece, achieving the fiscal objectives agreed upon in the financial assistance programme entered into in May 2010 continues to pose major challenges, given the difficulties of tax takings attaining the levels expected against the background of a gradually deteriorating macroeconomic outlook. Consequently, the Greek government introduced the so-called Medium-Term Fiscal Strategy, which contains additional fiscal consolidation measures to those previously agreed under the assistance programme and a €50 billion (20% of Greek GDP) privatisation plan. The approval of these measures in late June was one of the prerequisites imposed by the Euro-

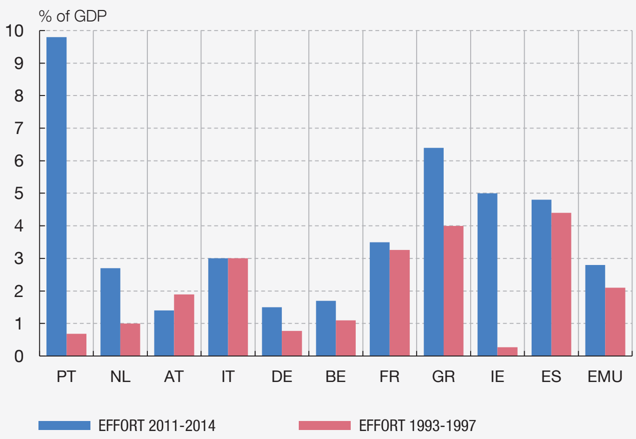
Last May the euro area countries submitted their Stability Programmes, which include the main fiscal policy measures and budgetary plans for the coming years (2011-2014). The European Commission has analysed these programmes as part of the so-called European Semester, and has formulated specific recommendations for each country that were approved by the European Council on 24 June and by the Ecofin on 12 July.

Generally, the European Commission's assessment of the programmes is relatively favourable, as most of the countries consider a fiscal consolidation underpinned by a realistic macroeconomic scenario which, if carried out, will enable the deficit and structural adjustment targets to be met within the timeframe demanded under the Excessive Deficit Procedure (EDP) (see accompanying table). Indeed, some Member States envisage meeting

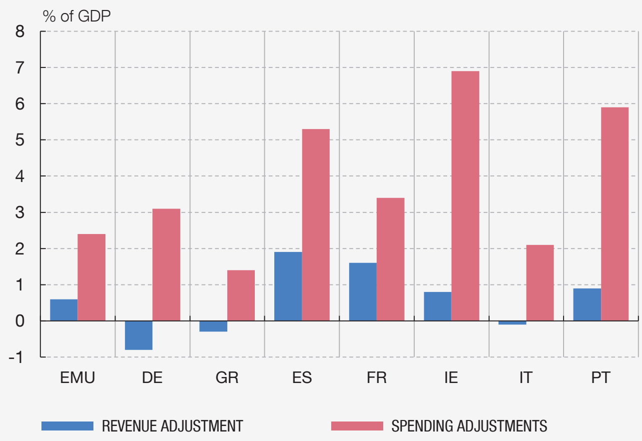
SUMMARY OF THE STABILITY PROGRAMMES

	STABILITY PROGRAMMES (a)									EXCESSIVE DEFICIT PROCEDURE	
	Budget balance					Public debt		Change in the cyclically adjusted deficit		Structural adjustment required (a)	Correction timeframe
	2010	2011	2012	2013	2014	2010	2014	2011-2010	Average 2014-2010		
BE	-4.1	-3.6	-2.8	-1.8	-0.8	96.8	92.2	0.1	0.4	0.75 in 2010-2012	2012
DE	-3.3	-2.5	-1.5	-1.0	-0.5	83.2	77½	0.3	0.4	At least 0.5 in 2011-2013	2013
EE	0.1	-0.4	-2.1	0.1	0.5	6.6	5.6	0.0	0.2	Not subject to EDP	
IE	-32.4	-10.0	-8.6	-7.2	-4.7	96.0	116.0	1.8	1.3	Assistance programme	2015
GR	-9.6	-7.6	-6.5	-4.8	-2.6	142.5	156.2	3.1	1.6	Assistance programme	2014
ES	-9.2	-6.0	-4.4	-3.0	-2.1	60.1	68.9	2.8	1.2	1.5 in 2010-2013	2013
FR	-7.0	-5.7	-4.6	-3.0	-2.0	81.7	84.1	1.2	0.9	Over 1 in 2010-2013	2013
IT	-4.6	-3.9	-2.7	-1.5	-0.2	119.0	112.8	0.5	0.8	At least 0.5 in 2011-2012	2012
CY	-5.3	-4.0	-2.6	-2.0	-1.6	60.9	60.1	1.7	0.8	1.5 in 2011-2012	2012
LU	-1.7	-1.0	-1.5	-1.2	-0.8	18.4	22.7	0.2	-0.2	Not subject to EDP	
MT	-3.6	-2.8	-2.1	-1.6	-1.0	68.0	63.7	1.6	0.8	0.75 in 2011	2011
NL	-5.4	-3.7	-2.2	-1.8	-1.4	62.7	64.1	1.1	0.7	0.75 in 2011-2013	2013
AT	-4.6	-3.9	-3.3	-2.9	-2.4	72.3	75.1	0.4	0.4	0.75 in 2011-2013	2013
PT (b)	-9.1	-5.9	-4.5	-3.0	-2.3	93.0	107.6	0.5	2.4	Assistance programme	2013
SI	-5.5	-5.5	-3.9	-2.9	-2.0	38.0	46.0	0.4	0.5	0.75 in 2010-2013	2013
SK	-7.9	-4.9	-4.1	-3.7	-3.0	41.0	45.2	2.7	1.0	1 in 2010-2013	2013
FI	-2.5	-0.9	-0.7	-0.9	-0.9	48.4	54.6	0.3	-0.3	Not subject to EDP	
Euro area	-6.0	-4.3	-3.1	-2.1	-1.3	85.4	85.1	0.9	0.7	--	--

FISCAL CONSOLIDATION EFFORT: 2011-2014 AND 1993-1997
(REDUCTION IN THE CYCLICALLY ADJUSTED BALANCE)



STABILITY PROGRAMMES: 2011-2014.
COMPOSITION OF THE DEFICIT CORRECTION



SOURCES: Stability Programmes and European Commission.

a April 2011 Stability Programmes. Percentages of GDP.
b Portugal has not submitted its Stability Programme. The data are drawn from the assistance programme.

deficit targets ahead of the terms set out in the EDP (Germany, for instance). Most of the countries envisage a notable structural adjustment, which will infuse fiscal policy over the current year – and, to a lesser extent, in subsequent years - with a strong contractionary component (see accompanying table). Indeed, as can be seen in the left-hand panel of the accompanying chart, which compares the correction of the structural balance projected for the euro area as a whole in the 2011-2014 period with that recorded in the consolidation period preceding the creation of EMU (1993-1997), the adjustment is far greater in most economies, especially in Ireland, Greece and Portugal. In the euro area as a whole, the adjustment made over the period is close to 3% of GDP, up on the figure of 2% recorded between 1993 and 1997, and likewise above the average structural adjustment observed in the consolidation episodes over recent decades in several countries, which also stands at around 2% of GDP, according to OECD and EC papers.[1]

Furthermore, these papers find that fiscal consolidations based on spending cuts have a lesser impact on economic activity in the short run [see IMF (2010)][2] and are usually more effective, as they have a more permanent effect on reducing the deficit. In this respect, the design of the plans appears to have taken these results into consideration, as the adjustment generally comes about through a containment of public spending in terms of GDP (see accompanying chart), and, hereunder, the cuts in employee compensation and in inputs, along with the reduction in social spending linked to the pick-up in employment and in economic activity, account for a high proportion.

It is noteworthy too that in most euro area economies, and especially in the countries subject to financial assistance programmes, much of the adjustment takes place or has taken place in the initial years of the consolidation period, rather than adopting other more gradual strategies, which normally entail more risks in terms of potential fatigue setting in.

However, other factors of risk remain in place since, in some countries, many of the measures needed to attain the goals proposed remain pending, while in others, the correction is based chiefly on an improvement in the economic cycle. And, more important still, the plans submitted have it that public debt across the area would post a slight correction from 2012, but would remain close to 85% of GDP in 2014. This fact confirms the need for an even greater budgetary consolidation in the coming years, to bring debt down to levels more conducive to growth and to tackle the challenges posed by population ageing.

1 OECD, Economic Outlook 2007,*Fiscal consolidation: lessons from past experience*, and European Commission, European Economy 2007 (3), Public Finances in EMU, *Lessons from successful fiscal consolidations.*

2 IMF, World Economic Outlook, 2010, Will it hurt? Macroeconomic effects of fiscal consolidation.

pean authorities and the IMF before granting the fifth aid tranche to Greece under the initial assistance programme. As earlier indicated, the euro area Heads of State and Government agreed at their meeting on 21 July to lay the foundations for a second support programme. Lastly, in Italy, on top of the consolidation measures in its stability programme, the government submitted a further range of proposals in June which were subsequently extended considerably in the Parliamentary approval process, rising to an amount of €79 billion between 2011 and 2014, the final objective being to attain a balanced budget in 2014. These measures entail a freeze on public-sector wages and employment, the extension and intensification of the so-called health care co-payment arrangements and a new programme of privatisations, although they are concentrated especially in the last two years of the adjustment period. On 12 July, Ecofin agreed to derogate the excessive deficit procedure in the case of Finland which, on the latest estimates, is expected to have maintained a budget balance below 3% of GDP in 2010. At present, of the 17 states comprising the euro area, only three (Estonia, Luxembourg and Finland) are not subject to the excessive deficit procedure.

3.2 Monetary and financial developments

Financial developments to July have been highly influenced by the tensions on euro area public debt markets. As indicated, the evident lack of consensus in the discussions on the role of private creditors in the future financial assistance plan for Greece prompted an increase in uncertainty on financial markets, and the contagion effect on economies with a weaker economic outlook intensified. The turbulence particularly affected the countries subject to a financial assistance programme (Greece, Ireland and Portugal), whose credit

EURO AREA MEMBERS' GENERAL GOVERNMENT BUDGET BALANCES AND PUBLIC DEBT (a)

TABLE 3

% of GDP

	2009	2010	2011			2012	
		EC (b)	EC (b)	IMF (c)	SCP (d)	EC (b)	SCP (d)
Belgium	-5.9	-4.1	-3.7	-3.9	-3.6	-4.1	-2.8
Germany	-3.0	-3.3	-2.0	-2.3	-2.5	-3.3	-1.5
Estonia	-1.7	0.1	-0.6	-1.0	-0.4	0.1	-2.1
Ireland	-14.3	-32.4	-10.5	-10.8	-10.0	-8.8	-8.6
Greece	-15.4	-10.5	-9.5	-7.4	-7.6	-9.3	-6.5
Spain	-11.1	-9.2	-6.3	-6.2	-6.0	-5.3	-4.4
France	-7.5	-7.0	-5.8	-6.0	-5.7	-5.3	-4.6
Italy	-5.4	-4.6	-4.0	-4.3	-3.9	-3.2	-2.7
Cyprus	-6.0	-5.3	-5.1	-4.5	-4.0	-4.9	-2.6
Luxembourg	-0.9	-1.7	-1.0	-1.1	-1.0	-1.1	-1.5
Malta	-3.7	-3.6	-3.0	-2.9	-2.8	-3.0	-2.1
Netherlands	-5.5	-5.4	-3.7	-3.8	-3.7	-2.3	-2.2
Austria	-4.1	-4.6	-3.7	-3.1	-3.9	-3.3	-3.3
Portugal	-10.1	-9.1	-5.9	-5.6	-5.9	-4.5	-4.5
Slovenia	-6.0	-5.6	-5.8	-4.8	-5.5	-5.0	-3.9
Slovakia	-8.0	-7.9	-5.1	-5.2	-4.9	-4.6	-4.1
Finland	-2.6	-2.5	-1.0	-1.2	-0.9	-0.7	-0.7
MEMORANDUM ITEM: Euro area							
Primary balance	-3.5	-3.2	-1.3	-1.7		-0.4	
Total balance	-6.3	-6.0	-4.3	-4.4	-4.3	-3.5	-3.1
Public debt	79.3	85.4	87.7	87.3	87.4	88.5	87.8

SOURCES: European Commission, Eurostat and IMF.

a Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b European Commission forecasts (autumn 2007).
c IMF forecasts (April 2011).
d Stability and Convergence Plans.

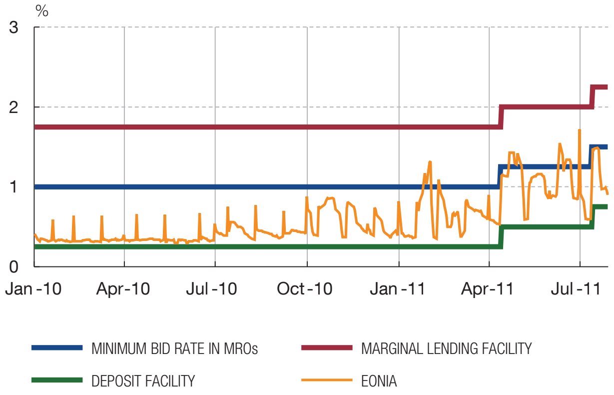
ratings were further downgraded and, to a lesser extent, it also impacted Italy and Spain. In turn, the tensions fed through to the stock market, intensely so in July, leading volatility to increase notably and prices to fall, especially in the banking sector and in those countries most clearly affected by the debt crisis. The euro exchange rate was also subject to high volatility and rises were seen in the interest rate spread between the Euribor and collateralised operations (eurepos), and in the interest rate on corporate debt. The publication of the European banking stress test results did not manage to ease the situation, even though they were fairly satisfactory. Following the agreement reached on 21 July at the meeting of the euro area Heads of State and Government (see Box 2) on the assistance programme for Greece and a broader batch of measures to reinforce crisis-management mechanisms, the tensions abated, although they mounted again in the following days.

At its meeting on 7 July, the ECB decided to increase its official rates by 25 bp in order to head off potential medium-term inflationary pressures. The MRO rate edged up to 1.5%, and the rates on the marginal lending and deposit facilities increased to 2.25% and 0.75%, respectively (see Chart 12). It further agreed not to apply the minimum credit rating threshold to tradeable bonds issued or backed by the Portuguese government. At its meeting on 4 August, against a background of uncertainty over the effects of the worsening sovereign debt crisis on the financial situation, the Governing Council decided to conduct in August a liquidity-providing supplementary longer-term refinancing operation with a maturity of

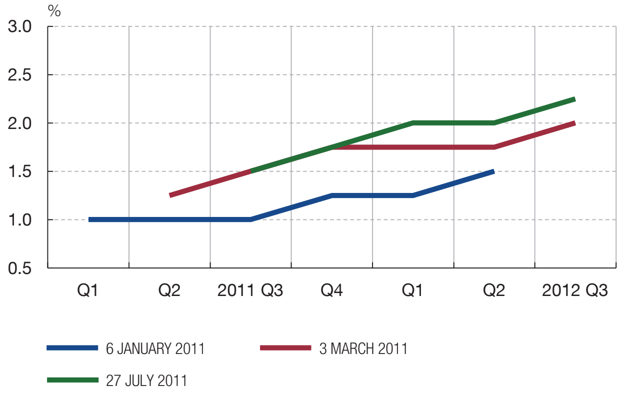
EURO AREA INTEREST RATES

CHART 12

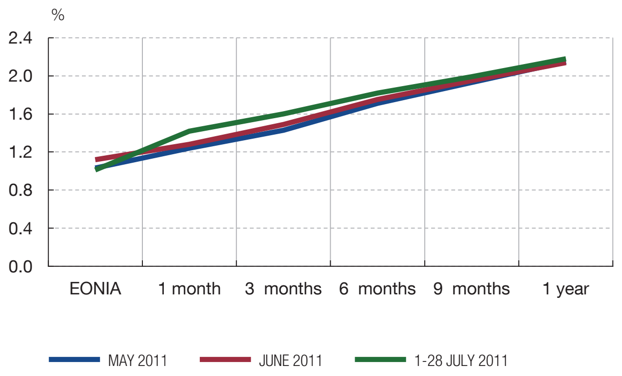
EONIA AND ECB INTEREST RATES



EXPECTED END-QUARTER ECB RATE. REUTERS SURVEYS

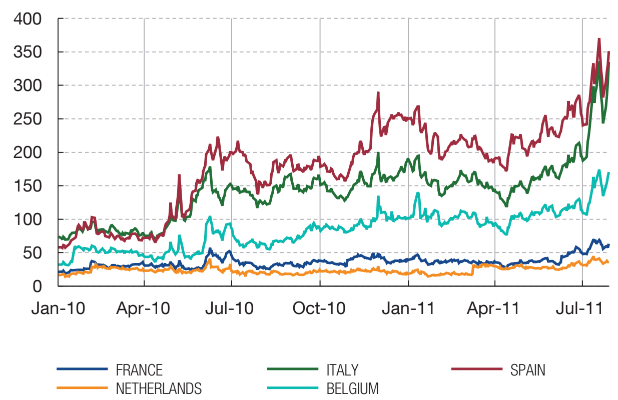


INTERBANK MARKET

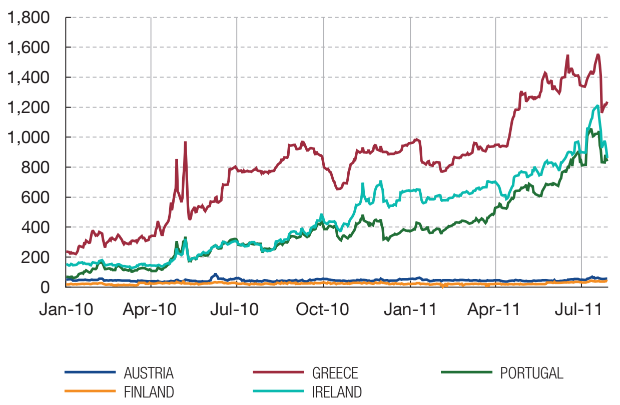


ZERO-COUPON CURVE (a)

SOVEREIGN SPREADS OVER GERMANY



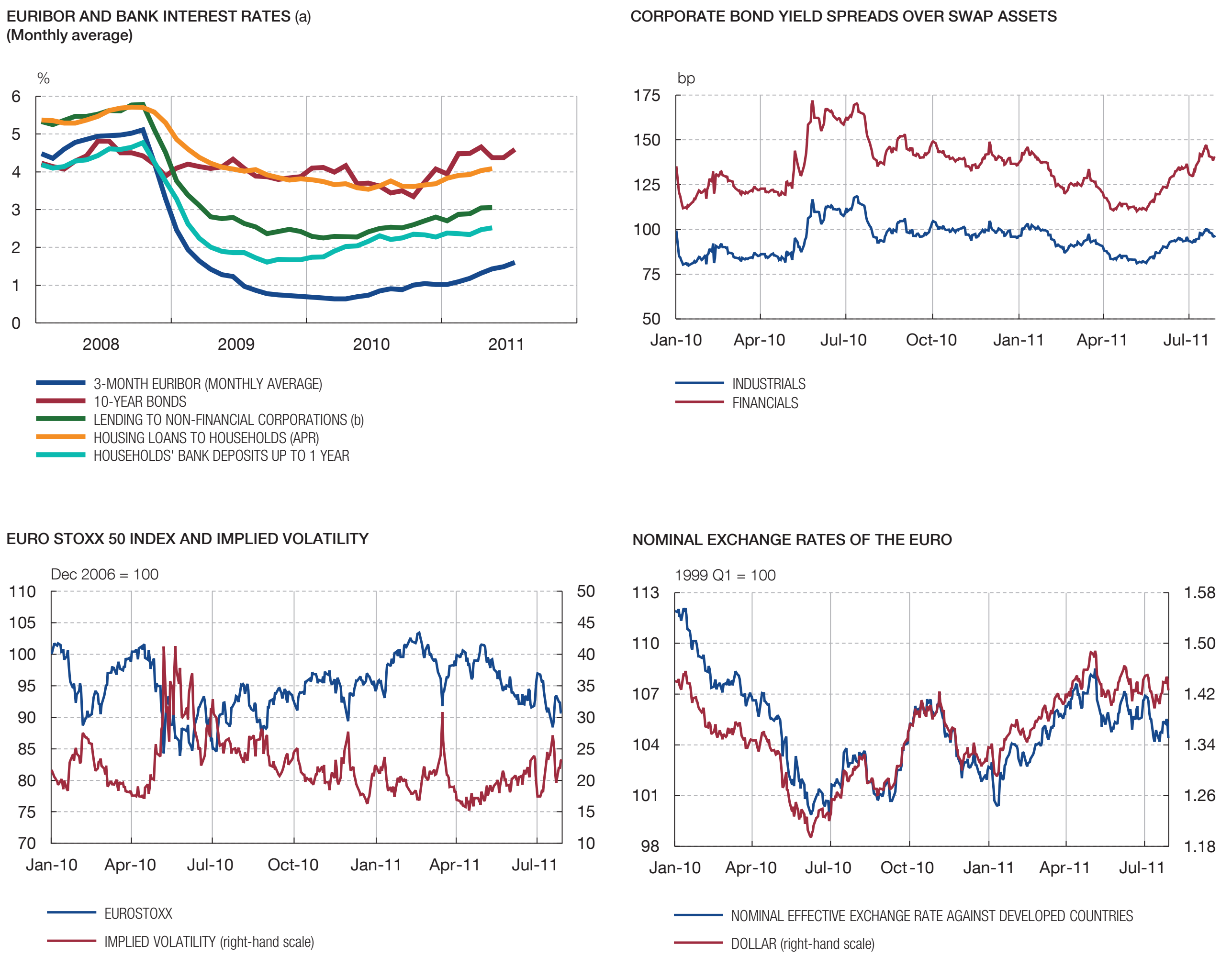
SOVEREIGN SPREADS OVER GERMANY



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

approximately six months, at a fixed rate and with full allotment. It also decided to continue conducting its MROs as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last maintenance period of 2011. Furthermore, it decided that this procedure should also be maintained for its one-month and three-month operations, at least until the end of 2011. Finally, the Governing Council recalled that its Securities Market Programme remained open.

Interbank market interest rates held on the growth path on which they embarked last year. The three-month and one-year Euribor stood, respectively, at around 1.6% and 2.2% in July, 30 bp and 15 bp above their April levels. The spread between the Euribor and the yield on repos rose sharply early in July to exceed 88 bp. It dipped afterwards to 76 bp following the agreement reached on 21 July. On the government debt market, the yield on the German Bund fell; given the high level of uncertainty, the demand for the German benchmark bond increased owing to its consideration as a haven asset (see Chart 12). The countries that saw the biggest rise in their spreads over German sovereign bonds during the quarter were those subject to a financial assistance programme. But Italy, too, and to a lesser extent Spain, also witnessed an increase in their risk premia of over 100 bp.

On the private fixed-income markets, risk premia increased. This rise accelerated in July, particularly in financial sector securities and in the countries most impacted by the sovereign crisis. Regarding credit, the cost of bank loans extended to the private sector continued on their moderate rising course. The rate on new loan transactions to non-financial corporations stood at 3.2% in May and increased less sharply in large-value transactions, rising to 2.8%. The Bank Lending Survey for Q2 indicates that lending standards for new loans did not ease either for non-financial corporations or for households, and they are not expected to do so in the coming months. Financial institutions perceived less of a fall-off in households' demand for financing, essentially in applications for house-purchase loans, while the intensity of the increase observed over recent quarters in the demand by non-financial corporations lessened.

Turning to private-sector financing, the outstanding balance of non-financial corporations' debt issues continued to slow, posting year-on-year growth of 4.2% in May (see Chart 11). There were no significant changes in the growth of bank loans to households and firms during the quarter, and the respective year-on-year rates in June stood at 1.5% and 3.2%. In contrast, consumer finance eased once more in June to stand at a year-on-year rate of 1.6%.

As mentioned, the behaviour of stock markets was unfavourable during the quarter, worsening further in July following the renewed tensions on euro area debt markets (see Chart 13). The Eurostoxx-50 posted declines of over 10% from April, with the prices of banking and construction securities being particularly punished.

The exchange rate of the euro was likewise affected by the instability of the sovereign debt markets in the area and depreciated slightly, although it fluctuated strongly during the quarter. The nominal effective exchange rate (NEER-20) of the euro fell by somewhat over 3% from April, posting a similar depreciation against the dollar.

Finally, the rate of expansion of the M3 monetary aggregate increased slightly, growing at a year-on-year rate of 2.1% in June, owing to the acceleration in other short-term deposits and in negotiable instruments.

On the latest available information, the increase in activity seems to have slowed in 2011 Q2 since GDP posted quarter-on-quarter growth of 0.2%, compared with 0.3% in the previous quarter (see Chart 14). National demand is estimated to have decreased by 0.2% in quarter-on-quarter terms, held back by weak investment in construction and, to a lesser degree, by the drop in government consumption, although information on this spending component is relatively incomplete. Conversely, net external demand once again made a positive contribution to GDP growth of 0.4 pp, 0.1 pp higher than in Q1. The strong momentum of tourism receipts and of other services together with the easing of imports, accounted for this contribution against a background of slowing goods exports in keeping with the lower vigour detected in international trade. In year-on-year terms GDP grew 0.7% in 2011 Q2, compared with 0.8% in Q1, although this slowdown is influenced by the rise in activity in 2010 Q2, which was sharper due to the effect of households bringing forward their spending on account of the rise in VAT rates in July 2010.

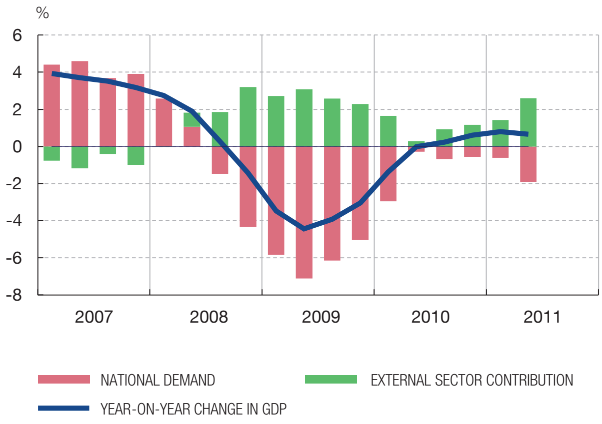
Employment continued to fall in Q2 at an estimated rate of decline of 1.2% in year-on-year terms, 0.2 pp less steeply than in the previous quarter. Given the estimated trend of output and employment, apparent labour productivity growth remained high, albeit slightly lower than in the previous quarter. The growth rate of compensation per employee slowed slightly and, as a result, economy-wide unit labour costs continued to decline at a similar pace to that of Q1, although this performance is highly influenced by the cut in public-sector wages. Finally, the upward trend in prices in previous quarters was interrupted and a gradual decline was seen in the inflation rate, since the effects of drawing comparisons with the increases in oil prices in 2010 began to disappear. Thus, the year-on-year rate of change in the CPI, which reached 3.8% in April, stood at 3.2% in June, while the CPI excluding energy and unprocessed food prices dropped from the figure of 2.1% recorded in April and May to 1.7% in June. This trend should continue over coming months, as the impact on prices of the rise in VAT in July 2010 is absorbed.

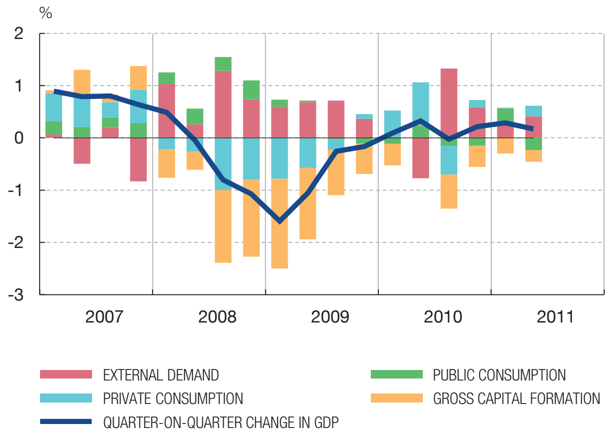
4.1 Demand

In 2011 Q2, private consumption was notably slack which resulted in modest quarter-on-quarter growth (see Chart 15). This scant buoyancy is explained by the rather unpropitious circumstances for household spending, characterised as they are by: the still-negative performance of the labour market and household income, the reduction in value of real estate wealth, relatively tight credit conditions and the loss of purchasing power due to high inflation. In year-on-year terms, consumption declined which was due to the fact that, in the same quarter of 2010, households decided to bring forward purchases of consumer goods in the face of the rise in VAT rates in July 2010. The year-on-year fall steepened particularly sharply in the case of the consumption of durable goods. In particular, new car registrations fell 35% year-on-year between April and June, 3 pp more than in Q1. Furthermore, they also declined in quarter-on-quarter terms, albeit more moderately than in Q1. Of the other quantitative indicators, the retail trade index and the indicator of large corporations' sales of consumer goods and services published by the tax authorities (in the case of the latter, with data only until May) experienced year-on-year rates of decline in Q2 which were similar to those in Q1. The European Commission's consumer and retail confidence indicators experienced a slight improvement, the scale of which is difficult to assess due to the changes in the procedure for preparing these surveys introduced in May 2011. Into July, the consumer confidence indicator fell back slightly while the retail confidence indicator remained stable.

MAIN DEMAND AGGREGATES. CONTRIBUTION TO GDP GROWTH

CHART 14



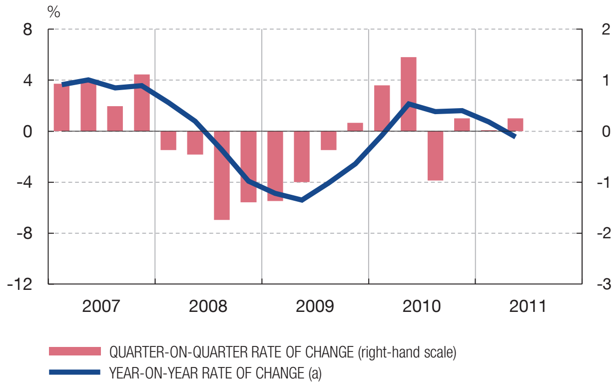


SOURCES: INE and Banco de España.

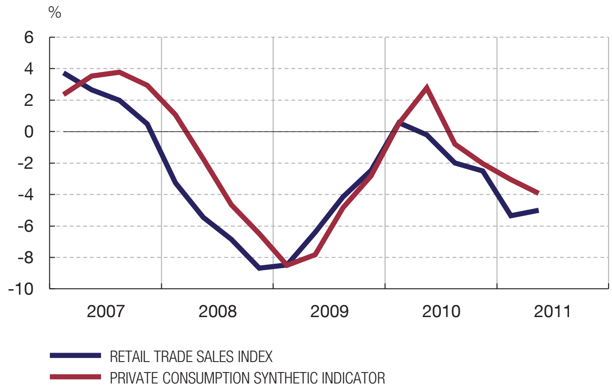
PRIVATE CONSUMPTION

CHART 15

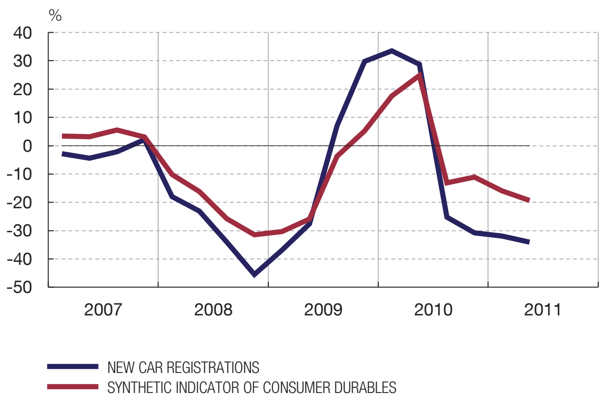
PRIVATE CONSUMPTION (QNA)



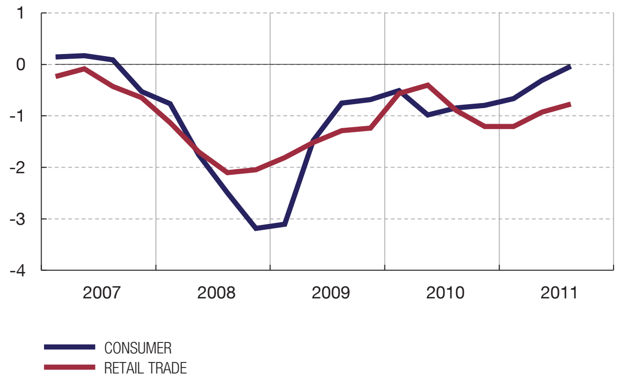
PRIVATE CONSUMPTION INDICATORS (a)



INDICATORS OF CONSUMER DURABLES (a)



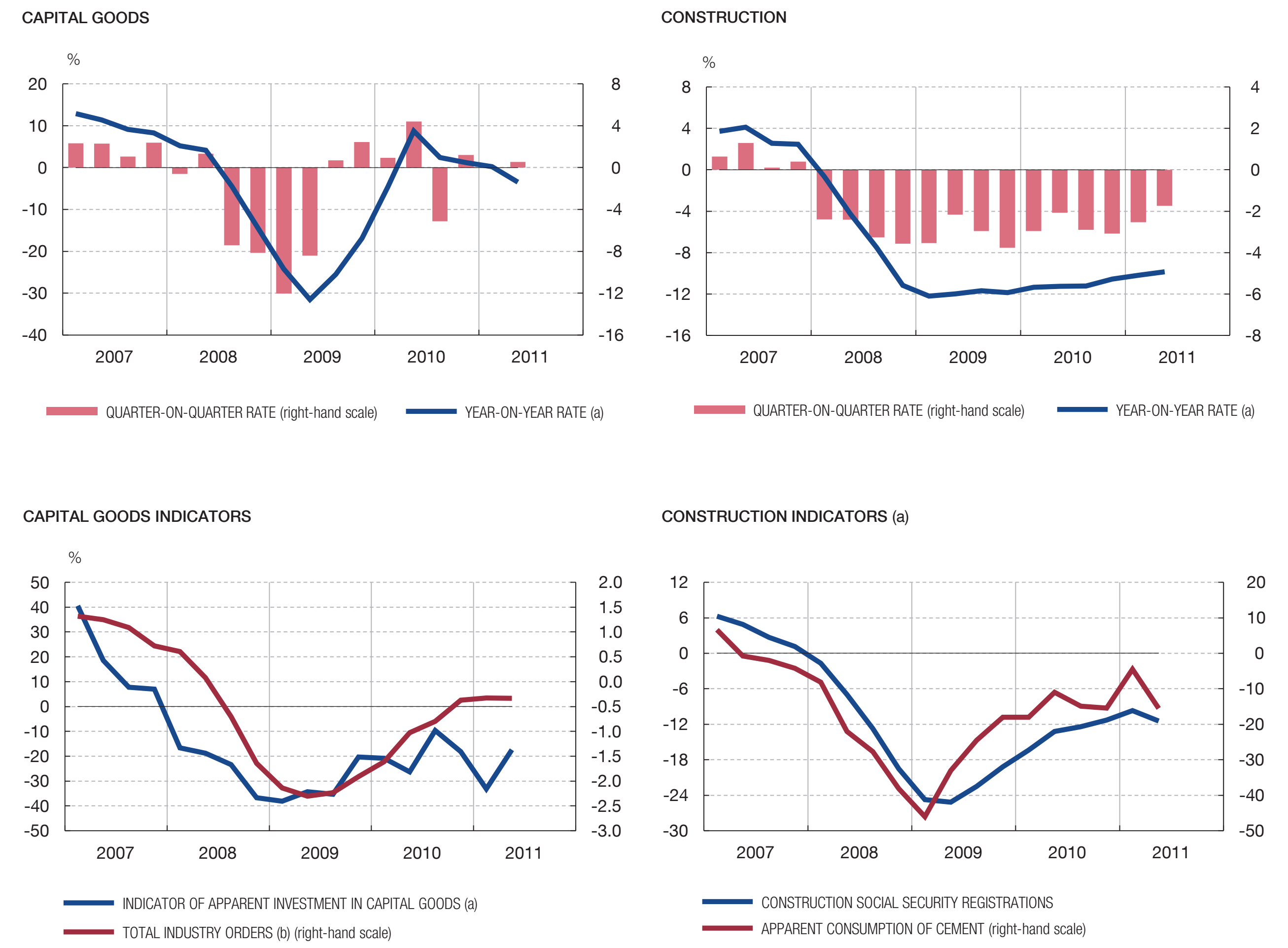
CONFIDENCE INDICATORS (b)



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

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

GROSS FIXED CAPITAL FORMATION CHART 16



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

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

The rate of decline in household income eased by 0.5 pp to -1.3% year-on-year in Q1 according to four-quarter cumulated figures from the non-financial accounts of the institutional sectors. This more moderate fall in household revenue resulted from the lower decrease in compensation of employees and an increase in the surplus in respect of the self-employed. In contrast, general government's positive contribution to sustaining household income continued to decrease and the net negative contribution from income on property continued, mainly due to changes in interest rates. However, the savings ratio continued to act as a cushion since it fell by nearly 1 pp, with respect to the figure for 2010, to 12.2% of household disposable income in four-quarter cumulated figures. After rising in Q1, general government final consumption is expected to once again show a quarter-on-quarter decline in the April-June period.

In Q2 there were also signs of weakening investment in capital goods whose year-on-year rate of change decreased noticeably. Notwithstanding this, quarter-on-quarter growth was probably slightly positive (see Chart 16). This performance, which reflected a worsening of business confidence (both industry-wide and in the capital goods segment) may partly be due to the diminished momentum of the international goods trade. Capacity utilisation in the manufacturing industry continued to increase, although it still remains below its historical average. Noteworthy among the quantitative indicators was the industrial production of these goods which held at positive year-on-year rates of change in Q2, although they were lower than those in Q1, while imports of capital goods decreased and the rate of decline of commercial vehicle registrations steepened.

On information from the non-financial accounts of the institutional sectors, the net lending capacity of non-financial corporations rose once again in 2011 Q1 to 0.9% of GDP in four-quarter cumulated figures (0.5 pp higher than in 2010). This improvement could stem from corporations' efforts to restructure their balances sheets and certain companies' desire to strengthen their self-financing ability faced with the potential difficulties of borrowing funds.

Hardly any changes were seen in the contractionary trend of investment in construction in recent quarters, against a backdrop of the ongoing adjustment process in the residential segment and of fiscal consolidation in the area of civil engineering works (see Chart 16). In recent months indicators for the sector as a whole relating to inputs, such as the apparent consumption of cement and the industrial production index for construction materials, and employment showed sharper year-on-year declines than in Q1.

Similarly, in Q2 the construction industry's perception of its situation remained negative according to the European Commission's business surveys.

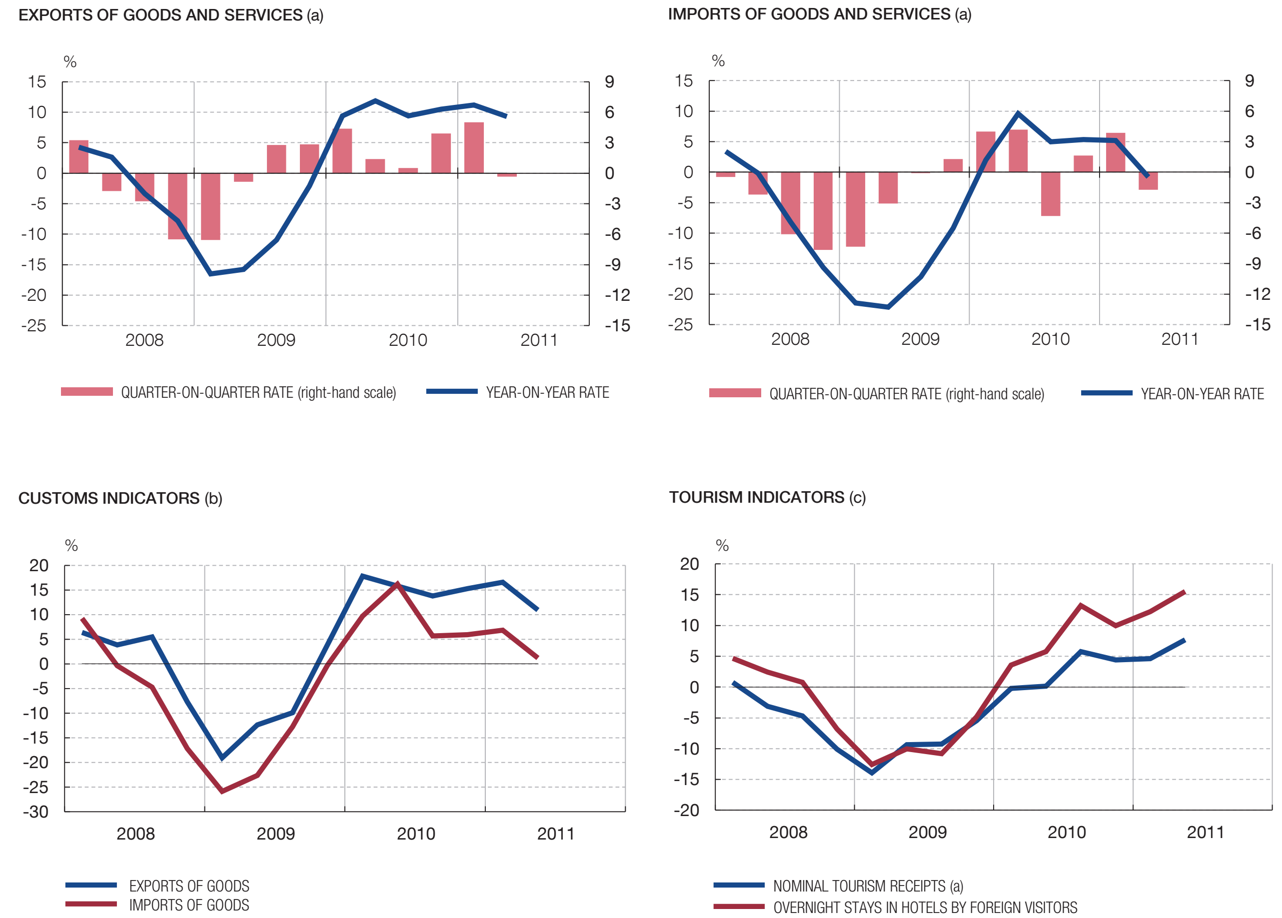
By type of work, the rate of contraction in residential investment in the April-June period is estimated to have remained strong, both in year-on-year and quarter-on-quarter terms, although it was probably slightly lower than at the beginning of the year. In coming quarters the number of houses under construction is expected to tend to stabilise. The backdrop of a trend towards contraction in the number of housing starts in recent months, would seem to be the result of a comparatively steeper decline in housing completions. On the demand side of residential assets, the latest available figures on the number of housing market transactions show a significant decrease in the April-May period in year-on-year terms, which may be related to many purchase decisions having been brought forward as a result of the change in the treatment of house purchases under personal income tax as from 1 January 2011. The surface area approved for non-residential building continued to record strong decreases to May. Lastly, government civil engineering tenders continued to fall in the April-May period at high rates, although they were lower than in Q1.

According to the latest available information on net external demand, its contribution to year-on-year GDP growth in Q2 not only remained high but probably exceeded that of the previous quarter. Specifically, its contribution was estimated to have risen approximately to 2.6 pp in year-on-year terms and to 0.4 pp in quarter-on-quarter terms. This is the result of the weakening vigour of both sides of foreign trade flows, which is sharper for imports in year-on-year terms since they were affected by the rise in purchases of imported goods in 2010 Q2 prior to the rise in VAT rates (see Chart 17). Despite the slowdown, exports remained highly buoyant, which led, furthermore to an increase in the share of Spanish exports in real terms in the first half of the year. The continuation of these positive developments in coming months is subject to certain risk, namely that the current slowdown in the world economy (which, among other factors, seems to be related with the negative impact of the earthquake in Japan on global production chains) may not turn out to be merely temporary. Turning to imports, their performance mainly reflects weak national demand.

On Customs data, real goods exports continued to grow notably in the April-May period. However, the year-on-year growth rate of 10.3% represents a slowdown in comparison with 2011 Q1 when goods exports increased by 16%. By product group, exports of capital goods decelerated

FOREIGN TRADE
Percentage change on year ago

CHART 17



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

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

considerably dragged down by the less expansionary behaviour of sales of transport equipment, while sales of machinery remained favourable. As for consumer goods exports, the growth rate of food exports eased, possibly due to the food alert in the EU, and non-food exports quickened to a certain degree, underpinned by the rise in automobile exports. Furthermore, there was an increase in exports of non-energy intermediate goods which was mainly supported by mineral and electrical products. By geographical area, noteworthy among exports to the EU was the favourable performance of exports to the United Kingdom, the newer EU Member States, France and Germany; by contrast, exports to Portugal slowed significantly. Among the rest of the world, exports to the United States, Russia and China were highly buoyant.

The available information on nominal tourism receipts points to a strengthening of their strong recovery in Q2. Specifically, the year-on-year growth rates of tourist inflows and overnight hotel stays quickened by 7.5 pp and 4.7 pp, respectively, to 10.4% and 15.7% in Q2. This highly favourable performance is explained by the boom in economic activity in Spain's main tourism generating markets and by the geopolitical instability in North Africa and the Middle East, which seems to have prompted a shift in tourist flows towards Spain. By country of origin, in Q2 there was a decrease in tourists from Germany, which was offset by the recovery of tourists from the United Kingdom and the still strong numbers of tourists from the Netherlands and the Scandinavian countries. In Q2 the year-on-year growth rate of nominal spending by tourists quickened by 10 pp to 12.6% according to EGATUR (the tourism expenditure survey) in line with tourist inflows. Non-tourist services exports seem to have returned to an expansionary path in Q2.

Imports hardly increased in the April-May period according to the Customs data. In particular, the year-on-year rate of increase stood at 0.2%, compared with 7.1% in 2011 Q1. By product group, there was a practically across-the-board decline, except for imports of non-energy intermediate goods (principally those closely related to industrial activity and exports) which, in any event, decelerated. The steepest falls were related to imports of capital goods and, especially, of consumer durables. The former experienced the slide in machinery purchases, while the latter reflected the ongoing contraction of car imports. Lastly, real services imports were estimated to have decreased in year-on-year terms in 2010 Q2, reflecting the considerable moderation of purchases of tourist and non-tourist services.

4.2 Output and employment

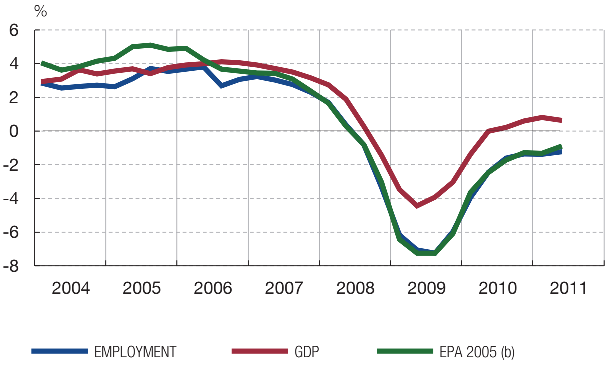
Following the modest increase in gross value added (GVA) in the market economy in the early months of 2011, its quarter-on-quarter growth is estimated to have slowed in Q2 (see Chart 18). Among the various branches, growth in industry seemed to have moderated following its buoyancy at the beginning of the year while, by contrast, market services were estimated to have posted a modest rise compared with the slight slide in Q1.

The recovery of industrial activity shown at end-2010 and at the beginning of 2011 was interrupted in 2011 Q2 on the basis of the available information. This assessment is supported by the available data from quantitative and qualitative indicators. Among the quantitative indicators, the industrial production index contracted in the first two months of the quarter. This correlates with the export activity of the industrial branches, especially that of intermediate goods which is estimated to have moderated in the same period according to the Customs data. Social security registrations in the sector continued to slide notably, albeit slightly less so than in Q1. Among the qualitative indicators, the average level of the above-mentioned European Commission's confidence indicator for Q2 was lower than in the January-March period. The same was so of the PMI which, furthermore stood below 50, a level which marks the boundary between the contraction and expansion of the sector. In July the Commission's indicator slipped further to levels similar to those of summer 2010. Conversely, according to business surveys, in these branches total orders and orders from abroad improved marginally during Q2, which could indicate a slightly less unfavourable outlook at the beginning of the third quarter.

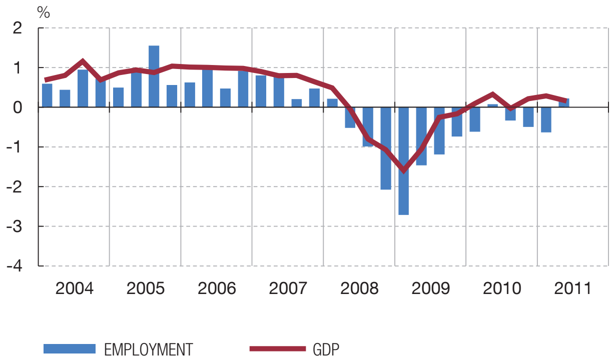
Recent changes in the market services indicators point to the continuation in the second quarter of the modest buoyancy shown by the sector's value added throughout the whole recovery phase that began approximately one year ago. However, unlike the industrial branches, the information from the indicators is consistent with a more expansive performance than at the beginning of the year. Specifically, among the qualitative indicators, the PMI improved in the period between April and June, with the result that it moved back above the 50-point mark, albeit by a narrow margin. The improvement in the indicator prepared by the European Commission was stronger, although it is possible that this result which relates to June, was influenced by the methodological change in the compilation of the index that month. In July the Commission's indicator declined slightly. Among the qualitative indicators, growth in social security registrations in the sector stepped up with respect to Q1, although rates were still low. In April and May the services sector turnover indicator continued to move on a path of gradual recovery, albeit at a slow pace. This was

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

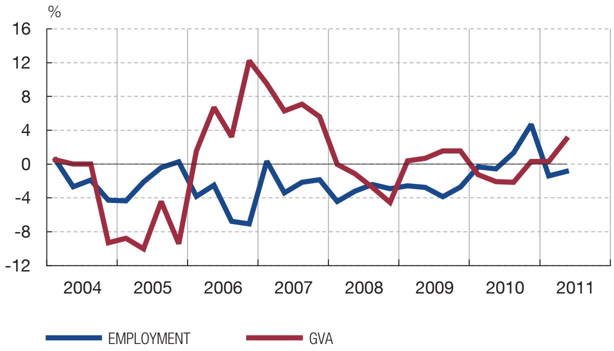
WHOLE ECONOMY



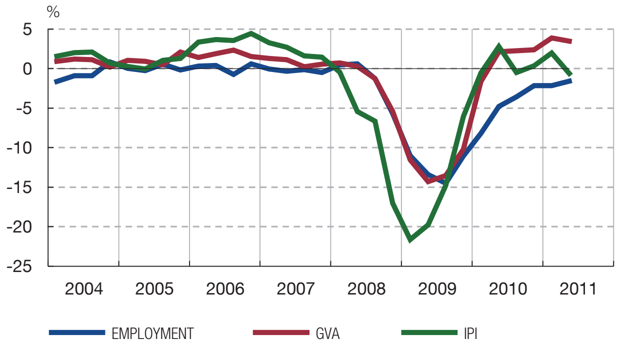
WHOLE ECONOMY (c)



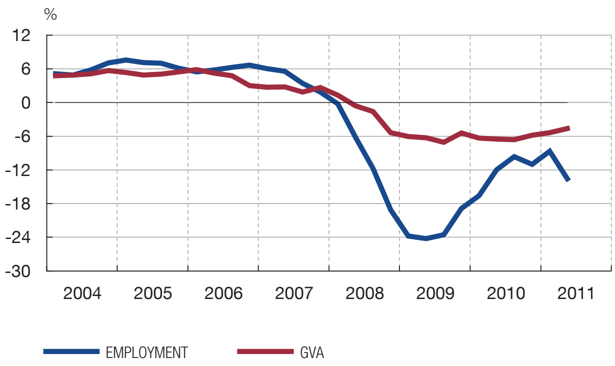
AGRICULTURE



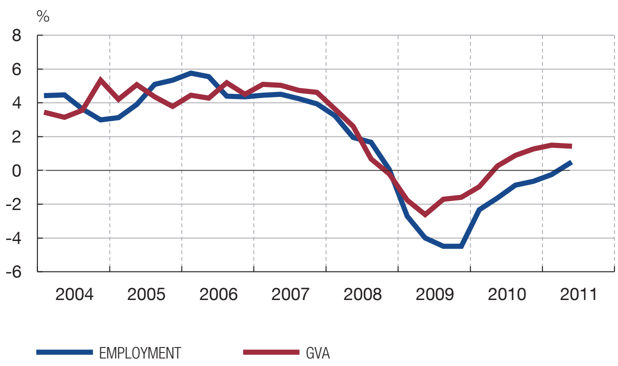
INDUSTRY AND ENERGY



CONSTRUCTION



MARKET SERVICES



SOURCES: INE and Ministerio de Trabajo e Inmigración.

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

the result of divergent behaviour by branch which included, most notably, the decline in the wholesale and retail trade, held back by weak private consumption and the pick-up in the activity of hotels and restaurants, which is linked to strong tourism. Similarly, the transport branch was more buoyant.

In the labour market as a whole job destruction continued in Q2 at only a slightly lower pace than in Q1, on the basis of information from the monthly indicators. For instance, in the April-June period average social security registrations slipped by 1% with respect to the same period in 2010, representing a slowdown of 0.2 pp in relation to the year-on-year rate of decline in Q1. In quarter-on-quarter terms, registrations contracted at a rate of 0.2% compared with 0.1% in Q1.

The growth rate of new hires registered at the National Public Employment Service (SPEE by its Spanish abbreviation) quickened in 2011 Q2, posting a year-on-year increase of 3.1%. This increased buoyancy of new hires, in line with the performance characteristically seen in the summer months, centred on temporary employment which slightly expanded its weight in total employment contracts (to 92%). The fall of permanent contracts steepened from a year-on-year rate of -1.8% to -5% for 2011 Q2, as a whole, while the conversion of temporary into permanent contracts remained on a moderating path.

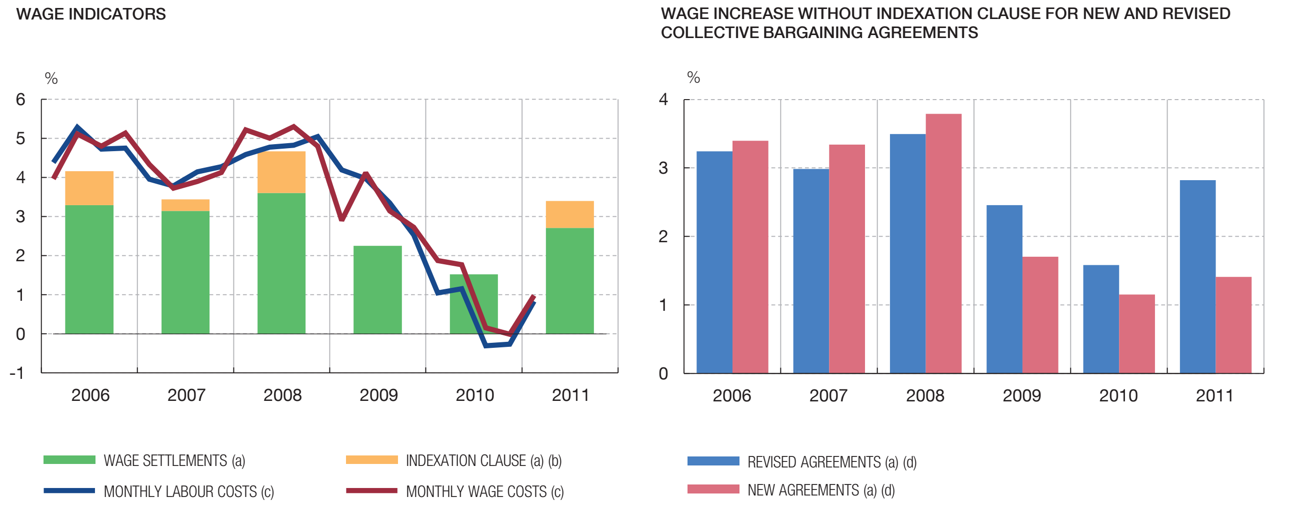
The EPA figures for Q2 show a year-on-year decline in employment of 0.9%, a rate of job destruction which is 0.4 pp lower than in Q1. All the sectors performed better than in Q1, except for construction, in which the pace of job destruction stepped up. Mention should be made, among them, of the services sector with growth of more than 1% in market and non-market services. This improvement was seen in the pace of job destruction related to wage-earners, which decreased by 0.4 pp to 0.5%, and the rate of employment destruction for the self-employed, which fell by 3.3%, 0.2 pp less than in Q1. By nationality, job destruction was concentrated among foreign workers, where there was a 4.5% reduction in employment, compared with a 0.4% decline for Spanish nationals. As regards contract duration, the year-on-year rate of change among temporary wage-earners was positive (2.1%) and higher than that in Q1, while the rate of decline for permanent employees decreased slightly to 1.3%. As a result, the proportion of temporary to permanent employees increased to 25.5%. Lastly, part-time hires continued to show strong growth (3.6%), although it was slightly less vigorous than in Q1, while full-time employees declined 1.7%, 0.5 pp less than in the previous quarter. These developments placed the ratio of part-time to total employees at 14.1%, against 13.5% a year earlier.

The labour force increased at a lesser pace than in the previous quarter (0.1% compared with 0.2% previously), against the background of zero growth in the population aged over 16 and, consequently, the participation rate rose 0.2 pp with respect to Q1 to 60.1%. In terms of the breakdown by sex, the difference between the female and male labour forces increased since female workers grew more rapidly by 0.6 pp to 2.1%, while the rate of decline of the male labour force doubled to 1.5%. By nationality, the high rate of decline in the foreign labour force (both total numbers and the population over 16) continued. The former declined by 2.2%, compared with -2.8% in Q1, and the latter fell by 2% (against -1% in Q1), putting the participation rate of foreign workers at 76.7%. Spanish nationals, for their part, increased 0.5% and their participation rate rose slightly to 57.8%.

Finally, the numbers of unemployed decreased by 76,500 compared with 2011 Q1, placing the total number of jobless at 4.8 million. In year-on-year terms, the rise in unemployment eased by slightly more than 2 pp to a year-on-year rate of change of 4.1%. The unemployment rate fell 0.4 pp in Q2 to 20.9% of the labour force. Lastly, the rate of increase in those registered as unemployed with the SPEE continued to ease to 3.2% year-on-year, compared with 4.2% in Q1. However, the decline in the growth rate of the numbers of unemployed has been increasingly lower in recent quarters, which confirms, as do the other indicators analysed, the slow improvement in the labour market.

WAGE INDICATORS AND LABOUR COSTS

CHART 19



SOURCES: INE and Ministerio de Trabajo e Inmigración.

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

4.3 Costs and prices

The average rise in wage rates agreed for 2011 in the collective bargaining agreements recorded to June stands at 2.7% (see Chart 19), representing a moderation of 0.4 pp compared with the rates agreed to March. However, the rises agreed remain high and mark a substantial increase on the average figure of 1.5% for 2010, which does not appear to be in line with the labour market situation. Foreseeably, as collective bargaining processes advance, the average settlement rate will ease further, in step with the deceleration of inflation and the possible positive effects of the recently approved collective bargaining reform (see Box 4). Accordingly, it should be taken into account that nearly all the collective bargaining agreements recorded in the January-June period are revisions of multi-year agreements entered into in previous years, in which the increases in wage rates are largely referenced to the year-on-year increase in the CPI as at December 2010, which turned out to be high. The as yet few newly signed agreements in 2011 show a more modest increase of 1.4%. The rise in inflation at end-2010 activated the indexation clauses which has an estimated impact of around 0.7 pp. The presence of these clauses which is less than in previous years, is still significant since it affects approximately 53% of workers (against 70% in December 2009). On the basis of this information, together with an estimate of the wage drift, the year-on-year rate of expansion of compensation per employee in the market economy is estimated to stand at approximately 2% in 2011 Q2, a similar rate to that in Q1 (see Chart 20). This trajectory of wages in conjunction with slightly higher year-on-year productivity growth than in Q1 will seemingly prompt a modest steepening in the decline of unit labour costs in the market economy. Compensation per employee in the non-market services branches is estimated to have declined by approximately 3%.

In 2011 Q2, the demand deflators continued to post high year-on-year growth rates, although they tended to moderate. This slight deceleration of the deflators was due to the performance of domestic producer prices – measured by the GDP deflator – but, especially, to changes in imported goods prices which slowed substantially.

The Spanish labour market experienced considerable job destruction during the last recessionary period, while other variables, such as real wages hardly reacted. The strong rise in unemployment was concentrated in certain specific sectors, in particular, the construction sector, which implies that emerging from the crisis will require a profound sectoral reallocation of employment and, likewise, a substantial increase in internal flexibility at companies to absorb these flows of unemployed workers. A key institution when determining this flexibility is the collective bargaining system which, in the case of Spain, has shown a series of shortcomings that has hindered wage flexibility and the internal reorganisation of firms. In an attempt to resolve these shortcomings, the government approved Royal Decree-Law 7/2011 of 10 June 2011 on urgent measures to reform collective bargaining, which was subsequently validated by Parliament and is currently being processed as a draft law.

Ideally, the institutional framework of collective bargaining should achieve *two* basic *objectives* [(Bentolila and Jimeno (2002)].[1] Firstly, it should favour wage growth which is compatible with a low unemployment rate in the medium term and with macroeconomic stability in general. To this end, a series of conditions must be met such as nominal wages being consistent with the objective of price stability and real wages moving in line with labour productivity and inversely to the unemployment rate. Secondly, the wage differences between sectors, regions and educational attainment levels must provide incentives for the sectoral reallocation of labour, for geographical mobility which cuts the unemployment rate differentials between regions and for investment in human capital. The foregoing would result in higher levels of productivity and, therefore, of competitiveness of the Spanish economy. However, there is broad consensus that the collective bargaining system in force in recent decades is not appropriate for achieving these aims.[2] There are three basic aspects which make it difficult for this system to work.

Firstly, due to the principle of automatic general effectiveness,[3] the Spanish system is characterised by an intermediate level of centralisation (at sectoral/provincial level) (see Table 1), at which firm-wide collective bargaining agreements are less frequent than in the majority of other developed countries for all firm sizes.

1. S. Bentolila, and J. F. Jimeno (2002), "La reforma de la negociación colectiva en España", in J. Aurioles and E. Manzanera (Eds.) *Cuestiones clave de la economía española. Perspectivas anuales,* 2001, Editorial Pirámide and Fundación CENTRA.

2. For a more in-depth analysis of these issues, see S. Bentolila, M. Izquierdo and J. F. Jimeno (2010), "Negociación colectiva: la gran reforma pendiente", *Papeles de Economía Española,* No. 124.

3. By virtue of this principle, what is agreed in higher-level collective bargaining agreements covers all firms at lower levels, irrespective of whether or not they participated in the negotiations. Although legislation envisages the existence of opt-out clauses from these collective bargaining agreements, in practice they are not used very frequently, although the latest labour reform provided greater flexibility regarding their use.

PERCENTAGE OF WORKERS COVERED BY COLLECTIVE BARGAINING LEVEL (a) TABLE 1

	FIRM	OTHER LEVEL			
		Total	Provincial	Regional	National
Average 1990-1999	13.3	86.7	54.0	6.2	26.5
2000	12.3	87.7	54.4	8.1	25.2
2001	11.7	88.3	54.4	9.3	24.6
2002	11.5	88.5	54.8	9.5	24.2
2003	11.5	88.5	54.4	10.4	23.6
2004	10.8	89.2	54.7	10.2	24.4
2005	11.6	88.4	53.0	10.0	25.3
2006	12.1	87.9	52.7	9.8	25.4
2007	12.1	87.9	53.1	9.0	25.8
2008	11.3	88.7	53.2	8.4	27.1
2009	10.9	89.1	53.4	8.9	26.8
2010	8.0	92.0	55.0	6.5	30.4
2011	7.5	92.5	63.0	5.2	24.3

SOURCE: Ministerio de Trabajo e Inmigración.

a The information for 2010 refers to collective bargaining agreements registered to May 2011 and that for 2011 to those regired to June of that year.

It is this level of centralisation which, according to the literature, produces the worst results in terms of unemployment and wage pressure. The latter is illustrated in Table 2, which shows that both the initially agreed wage rise and the impact of the indexation clause were generally lower in the company-specific arrangements than in agreements at other levels in the period 2003-2010. Secondly, there is the principle of "ultra-activity", which extends the regulatory aspects of an expired agreement if an agreement to renew the old one is not reached. This principle makes it difficult to change collective bargaining agreements and perpetuates certain clauses that had been agreed upon which are considered vested rights. This introduces considerable inertia into the process of determining working conditions, making it very difficult to modify in practice the terms agreed in the past. Thirdly, the average duration of collective bargaining agreements (approximately three years) is high. Under these agreements (which cover around 70 % of workers) wages are usually indexed to inflation. As a result of all of these characteristics, the system incorporates high rigidity into real wages and very little sensitivity to the labour market situation (approximated by the unemployment rate) and to changes in sectoral productivity as can be seen in Table 3.

In order to improve the possibilities of internal flexibility at companies and to encourage a collective bargaining structure tailored to individual firms, the government approved the collective bargaining reform in June. There are mainly two measures which are notable among those adopted. Firstly, the conditions agreed in firm-based collective bargaining agreements have priority over higher-level agreements with regard to a wide-ranging list of matters, including wages. The reform makes progress towards the desirable convergence on a more decentralised collective bargaining model, although actual progress is conditional upon agreements not being reached to the contrary by workers' and employers' representatives at a higher level than that of the firm. While this does not occur, a window of opportunity opens for those companies which need to sign firm-level agreements that are better adapted to their needs to do so. Such agreements would prevail over higher-level collective bargaining agreements. Given the costs associated with the negotiation of a collective bargaining agreement, this option may be more significant for larger corporations. However, small and medium-sized firms may resort to opting out from the higher-level agreement as regards wage setting, which merely requires the consensus of employers and workers. In this connection, under the Royal Decree the grounds for justifying wage opt-outs are made slightly more flexible since they additionally provide for a persistent decline in firms' revenues.

Secondly, the Royal Decree introduces important amendments in the duration of collective bargaining agreements in order to mitigate the problems associated with the principle of "ultra-activity". Specifically under the Royal Decree-Law the minimal content of collective bargaining agreements must include the deadlines for providing notice of termination of the agreement, and for the commencement and termination of bargaining. In the absence of an accord, the deadline for notice of termination is set at three months prior to expiry, that for commencing negotiations is one month and that for the duration of the negotiations is eight months, if the term

COLLECTIVE LABOUR AGREEMENTS (a) TABLE 2

	2003	2004	2005	2006	2007	2008	2009	2010
				AGREED WAGE INCREASE (%)				
Total	3.48	3.01	3.17	3.29	3.14	3.60	2.25	1.52
Firm-wide	2.70	2.61	2.94	2.92	2.70	3.09	2.17	1.27
Other level	3.58	3.06	3.19	3.34	3.20	3.65	2.26	1.54
				REVISED WAGE INCREASE (%)				
Total	3.68	3.60	4.04	3.59	4.21	3.60	2.24	2.21
Firm-wide	2.94	3.14	3.61	3.15	3.57	3.09	2.17	1.77
Other level	3.77	3.65	4.09	3.65	4.28	3.65	2.25	2.24
				INDEXATION CLAUSE (pp)				
Total	0.20	0.59	0.87	0.30	1.07	0.00	-0.01	0.69
Firm-wide	0.24	0.53	0.67	0.23	0.87	0.00	0.00	0.50
Other level	0.19	0.59	0.90	0.31	1.08	0.00	-0.01	0.70

SOURCE: Ministerio de Trabajo e Inmigración.

a Provisional data for 2010 with information to June 2011.

of the collective agreement is less than two years, or fourteen months in other cases. Furthermore, in order to facilitate the conclusion of agreements, the collective bargaining agreement must include the compulsory adoption of conflict resolution mechanisms agreed upon in inter-professional agreements at national or regional level which will be implemented once the periods for reaching an agreement have elapsed.

Accordingly, within these mechanisms, the social partners have to determine the arbitration procedures and, in particular, whether they are compulsory or voluntary; if there is no accord, it is assumed that they are compulsory. Furthermore, a transition period is established (until 30 June 2012) during which arbitration will be compulsory for those collective bargaining agreements whose deadlines for negotiation have not been met. During this transition period the social partners must negotiate which conflict resolution mechanisms will prevail at each level of negotiations. In this way another window of opportunity is also opened which will help pave the way for freeing up the renegotiation of numerous collective bargaining agreements which have expired and are currently at an impasse. Lastly, as a palliative measure to improve the internal flexibility at companies while a new agreement is being negotiated, it is possible to adopt partial agreements to modify certain content of the arrangements which have expired and for which notice of termination has been provided in order to adapt them to firms' current conditions. Notwithstanding the foregoing, although all of these measures are a step forward compared with the previous situation in terms of the duration of the collective bargaining agreement, it should be underlined that the principle of "ultra-activity" continues to apply, since once all the deadlines have expired, the previous collective bargaining agreement does not lapse but remains in force.

To sum up, the Royal Decree clears the way for significant changes in the collective bargaining system. The materialisation of these changes, however, will hinge on the willingness of the social partners. In order to mitigate this uncertainty, it would be desirable to press ahead with some of the more positive aspects of the Royal Decree during its passage through Parliament. Significantly, however, the reform does not include any changes on wage indexation, despite its importance.

IMPACT OF INFLATION AND CYCLICAL CONDITIONS ON NEGOTIATED WAGE INCREASES (a) TABLE 3

Dependent variable: negotiated wage increase	REVISED AGREEMENTS		NEWLY SIGNED AGREEMENTS	
EXPLANATORY VARIABLES	Coefficient	t-statistic	Coefficient	t-statistic
Positive deviation of inflation at t-1	0.94	108.6	1.13	148.9
Negative deviation of inflation at t-1	-0.19	-3.0	-0.35	-4.6
Change in unemployment rate at t-1	0.01	1.4	-0.24	-34.3
Change in sectoral productivity at t-1	0.004	1.6	0.003	1.1
Constant	2.66	30.8	2.38	29.6
Observations	37,256		52,570	
Adjusted coefficient of determination	0.29		0.33	

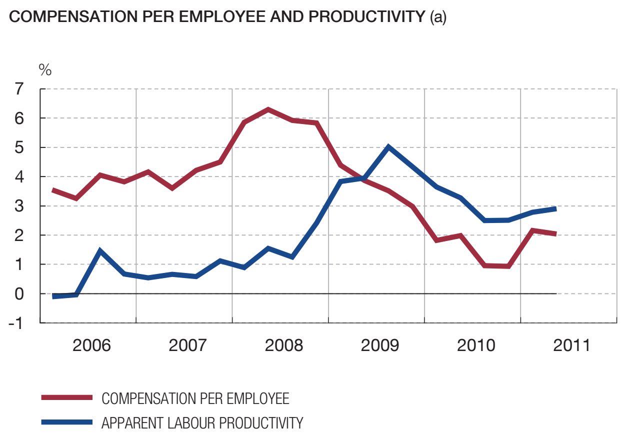
SOURCE: Bentolila et al. (2010).

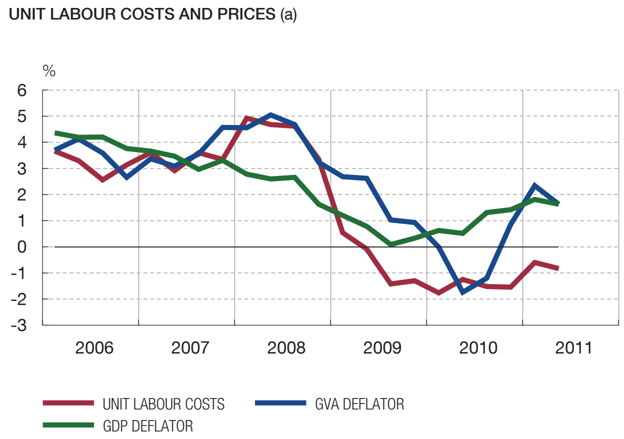
a The regressions include dummy variables for the sector of activity (NACE-3 two-digit level), the bargaining level and the presence of indexation clause.

In 2011 Q2, the main consumer price indicators ended their upward trend recorded in previous months. Thus, the year-on-year change in the CPI in June was 3.2%, 0.6 pp down on the April figure (see Chart 21). This downward trajectory is largely attributable to changes in the energy component whose year-on-year rate in June was 15.4%, 3.5 pp down on the figure for March. However, this deceleration is due to the high prices of this component a year earlier, against a background in which dearer oil on international markets contributed to supporting the high prices of vehicle fuel and other liquid fuel, such as heating gas-oil. The year-on-year rate of change of the CPI, excluding energy and unprocessed food prices, stood at 1.7% in June, the same as in March. However, this stability is the result of the divergent behaviour of its main components. On one hand, the inflationary behaviour of unprocessed food prices moderated substantially since they benefited considerably from the decreases in tobacco prices in June (which were subsequently re-

WAGES AND LABOUR COSTS IN THE MARKET ECONOMY

CHART 20





SOURCES: INE and Banco de España.

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

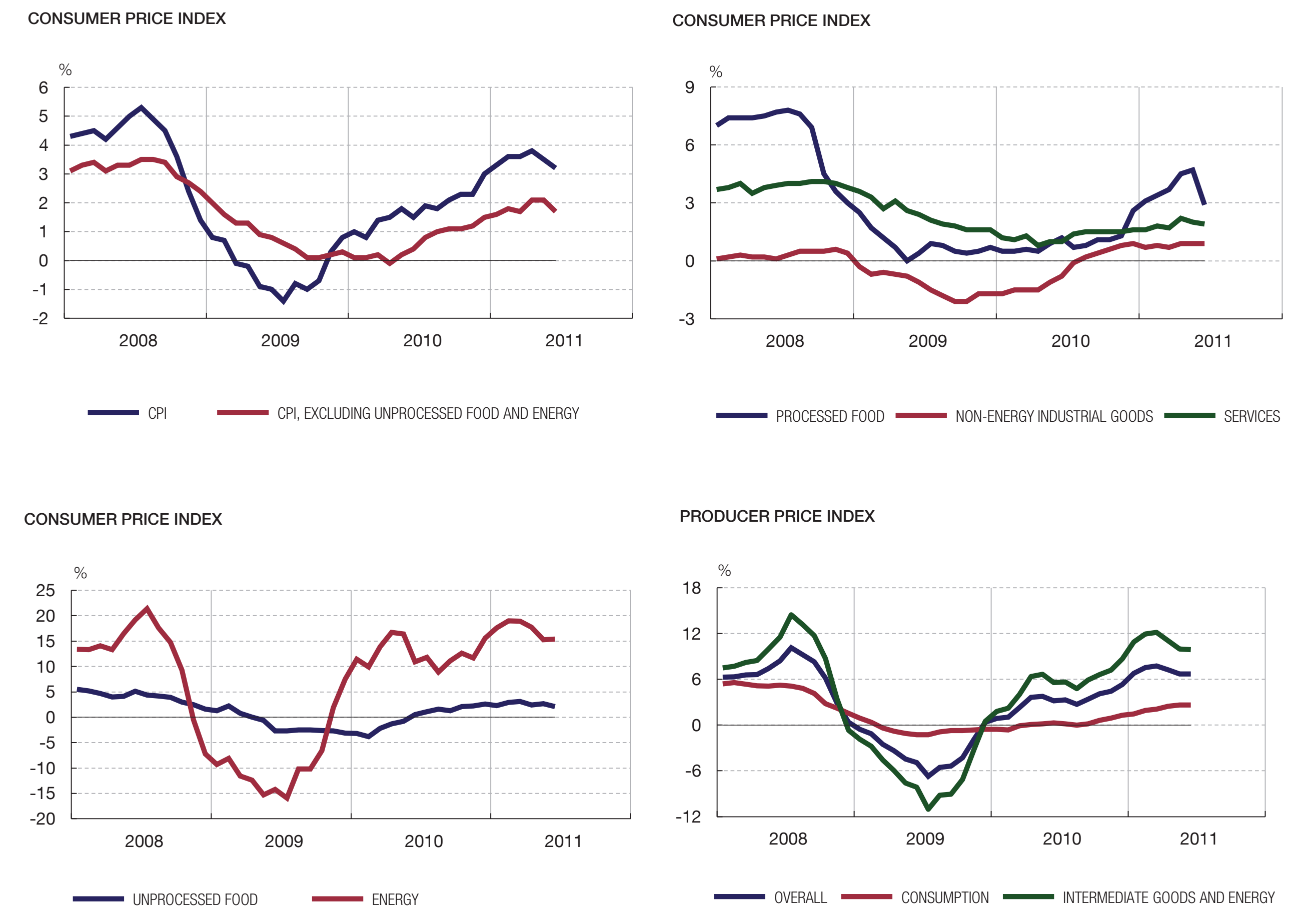
versed in July). On the other, non-energy industrial goods prices – against a backdrop of higher producer prices for this type of goods – performed slightly less moderately as did the prices of services. In any event, if, to approximate inflationary pressures on consumer prices, the (in principle temporary) impact of the increases in VAT rates and in tobacco prices in July and December last year is removed from the CPI excluding energy and unprocessed food prices, the resulting price developments would be moderate, with growth of 1.1% in June. The leading indicator of the CPI showed a further reduction of inflation in July to 3.1%, which was 0.1 pp less than in the previous month.

In terms of HICP, inflation in Spain also moderated by 0.3 pp in Q2 to 3%. This contrasts with the stable performance of this variable in the euro area, as a result of which the differential between March and June decreased by 0.3 pp to 0.3 pp (see Chart 22). Component by component, the increase in energy prices in Spain continued to be higher than that in the euro area, placing the differential at 4.4 pp which, however, is 1.5 pp lower than in March. By contrast, the differentials in terms of services and non-energy goods, were negative at -0.2 pp and -0.1 pp, respectively. It is estimated that they would have even higher negative values, if they were adjusted for the effect of tax changes. Lastly, the increases in food prices in Spain were also slightly lower than in the euro area. According to the respective leading indicators of the HICP for July, the differential was forecast to widen by 0.2 pp to 0.5 pp since inflation was expected to hold at 3% in Spain, while in the euro area as a whole it was projected to decrease by 0.2 pp to 2.5%.

The producer price index also posted a slight deceleration in Q2 as its year-on-year rate of change slid by slightly more than 1 pp between March and June to 6.7%. This slowdown reflected lower growth rates of the prices of energy products, as a result of the changes in oil prices, and of intermediate goods, although the rates of increase are still very high in both cases. Conversely, the quickening of producer prices of consumer goods, which began nearly a year ago, continued. The producer price differential between Spain and the euro area decreased by 0.4 pp between March and May, as a result of the lower relative growth of Spanish energy prices. Changes in prices at the beginning of the production chain point to a slight weakening of inflationary pressures which is furthermore corroborated by the course of price indices for imports, whose year-on-year rate of change has slowed steeply since the begin-

PRICE INDICATORS (a)
Spain

CHART 21



SOURCE: INE.

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

ning of the year, affecting all of its components. Industrial imports have also slowed in recent months. In both cases, the rates of change in the prices of energy products remained very high.

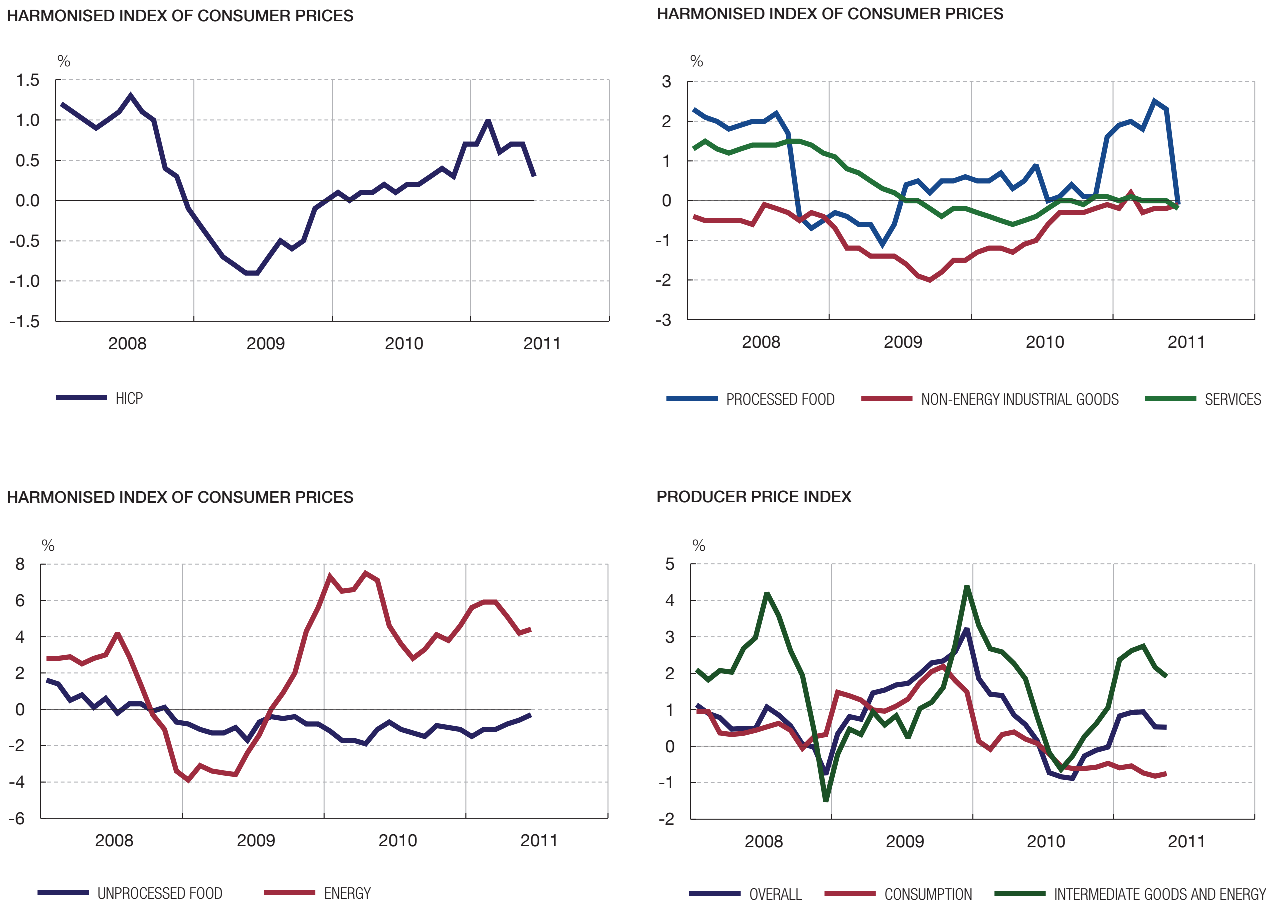
4.4 The State budget

The latest statistical information available for the overall general government sector refers to 2011 Q1. However, more recent monthly information on the budget outturn for the State and Social Security subsectors to June and May, respectively, is available.

In the period between January and June, the State posted a cumulative deficit of €24.1 billion, according to the information available on the budget outturn using the National Accounts methodology. This negative balance is €5.7 billion less than that in the same period of 2010. Expressed in cash-basis terms, the State deficit in the first six months of the year stood at €23.5 billion, 24% down on the figure posted a year earlier (see Table 4). Overall, expenditure fell by 19.7%, which in general terms is consistent with the target for the whole year. The decline observed is largely in response to the cut in transfers as a result of the new system for financing the regional (autonomous) governments. As for the other items, both wages and salaries and capital performed in the first half of 2011 as budgeted, while in the case of purchases, complying with the budget target for the whole year will require a quickening of their rate of decline in the second half of the year. Furthermore, it

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.

is highly likely that the decline observed in the first half of 2011 in interest payments will begin to reverse in the coming months so that the rate for 2011 as a whole should tend to draw nearer to the budget estimate of growth of approximately 40%. Accordingly, the interest payments calculated using the National Accounts methodology have shown very sizeable rates of change recently and, consequently, have continued to increase their weight in total expenditure (to around 15% in the first half as a whole compared with less than 10% in the same period of 2010).

In respect of total tax takings, which include those obtained by the State and the territorial governments, noteworthy was the favourable performance of VAT revenue which grew at a rate of 9.4%, largely owing to the effect of the increase in rates in July 2010. Similarly, personal income tax revenue grew by 6.5%, which is consistent with the increase of 7.1% budgeted for the year as a whole. Receipts from corporate income tax and excise duties were notably weak with cumulative rates of -15.6% and -4%, respectively.

In the case of the regional (autonomous) governments, the outturn data for 2011 Q1 show a negative balance of 0.5% of GDP (see Table 5), a figure which contrasts with the budget forecast of reducing the deficit for the year as a whole by 1.5 pp to 1.3% of GDP.

STATE BUDGET OUTTURN

TABLE 4

€m and %

	Outturn 2010	Percentage change 2010/2009	Budget outturn projection	Percentage change 2011/2010	Outturn Jan-Mar. Percentage change 2010/2009	Outturn 2010 Jan-June	Outturn 2011 Jan-June	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	127,337	24.8	106,020	-16.7	-16.2	55,386	45,688	-17.5
Direct taxes	59,262	9.5	55,239	-6.8	-20.4	24,383	19,540	-19.9
Personal income tax	39,326	29.2	35,494	-9.7	-19.4	17,762	13,776	-22.4
Corporate income tax	16,198	-19.8	16,008	-1.2	-42.7	4,746	4,006	-15.6
Other (a)	3,738	7.5	3,737	-0.0	-16.4	1,875	1,759	-6.2
Indirect taxes	51,825	80.8	36,142	-30.3	-17.3	24,433	19,271	-21.1
VAT	38,486	143.8	24,968	-35.1	-14.1	17,926	14,709	-17.9
Excise duties	10,338	1.9	8,179	-20.9	-40.5	5,068	3,080	-39.2
Other (b)	3,001	9.5	2,995	-0.2	7.5	1,439	1,482	3.0
Other net revenue	16,251	-15.7	14,639	-9.9	3.0	6,570	6,877	4.7
2 EXPENDITURE	179,572	-5.1	150,056	-16.4	-24.2	86,180	69,183	-19.7
Wages and salaries	26,975	1.5	26,982	0.0	0.8	13,508	13,574	0.5
Goods and services	4,632	-4.7	3,384	-26.9	-10.4	1,941	1,776	-8.5
Interest payments	19,638	11.3	27,421	39.6	-23.2	9,116	8,931	-2.0
Current transfers	104,656	-6.9	74,598	-28.7	-30.3	49,698	36,895	-25.8
Investment	8,782	-16.1	5,793	-34.0	-25.3	4,604	3,371	-26.8
Capital transfers	14,890	-14.2	9,208	-38.2	-25.7	7,314	4,637	-36.6
3 CASH-BASIS BALANCE (3 = 1 - 2)	-52,235	—	-44,036	—	—	-30,794	-23,496	—
MEMORANDUM ACCOUNT: TOTAL TAXES (State plus share of regional and local governments)								
TOTAL	**135,862**	**16.3**	**141,538**	**4.2**	**3.9**	**64,604**	**68,472**	**6.0**
Personal income tax	66,977	4.9	71,761	7.1	2.4	30,337	32,297	6.5
VAT	49,079	46.2	48,952	-0.3	8.0	24,473	26,774	9.4
Excise duties	19,806	2.4	20,825	5.1	-2.8	9,794	9,401	-4.0

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.

The latest outturn figures available for the Social Security system are for May 2011 (see Table 6). In cumulative terms, since the beginning of the year the Social Security system posted a surplus of €7.5 billion, €1.3 billion less compared with the balance accumulated to May last year. On the revenue side, social security contributions fell 1% as a result of the decline in the number of social security registrations. Expenses increased by 2.9% due to the rise of 5.1% in the contributory pensions component, which was partially offset by the decrease in other current transfers.

Turning to the State Public Employment Service, the available figures to May indicate that unemployment benefit payments fell at a rate of -8.6%. This accentuates the decline with respect to Q1, which is in keeping with the decrease in the number of beneficiaries of the unemployment insurance system.

4.5 Balance of payments

During the first five months of 2011, the overall current and capital account balance posted a deficit of €21.7 billion, 3.8% down on the same period in 2010 (see Table 7). This decline is due to the narrowing of the current account deficit, insofar as the surplus on the

REGIONAL GOVERNMENT BUDGET OUTTURN

TABLE 5

€m and %

	Outturn 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010 (a)	Outturn		
					2010 Jan-March	2011 Jan-March	Percentage change (b)
	1	2	3	4 = 3/1	6	7	8 = 7/6
1 REVENUE	134,318	-11.0	138,627	3.2	—	29,536	-2.2
Current revenue	127,134	-10.9	130,110	2.3	—	28,845	-1.4
Direct taxes	29,477	-21.3	40,995	39.1	—	10,178	42.5
Indirect taxes	33,730	-13.2	51,512	52.7	—	11,983	45.0
Charges, prices and other revenue	5,551	8.0	4,972	-10.4	—	1,087	-19.4
Current transfers	57,962	-4.7	32,097	-44.6	—	5,456	-56.2
Interest and dividends	413	-12.4	535	29.4	—	140	151.5
Capital	7,184	-12.5	8,517	18.6	—	691	-27.2
Disposal of investments	287	-16.0	1,760	513.6	—	52	8.0
Capital transfers	6,897	-12.4	6,756	-2.0	—	639	-29.1
2 EXPENDITURE	157,183	-6.9	155,544	-1.0	—	34,531	5.4
Current expenditure	134,812	-4.8	131,889	-2.2	—	31,481	5.6
Wages and salaries	58,795	-2.0	56,873	-3.3	—	12,719	-3.3
Goods and services	28,011	-7.8	27,421	-2.1	—	6,867	22.8
Interest payments	2,999	14.8	4,195	39.9	—	932	75.6
Current transfers	45,007	-7.4	43,173	-4.1	—	10,962	3.9
Contingency fund	—	—	228	—	—	—	—
Capital	22,371	-17.9	23,655	5.7	—	3,050	4.2
Investment	9,685	-22.9	10,580	9.2	—	1,524	11.3
Capital transfers	12,686	-13.6	13,074	3.1	—	1,526	-2.0
3 BALANCE (3 = 1 - 2)	-22,866	—	-16,917	-26.0	—	-4,995	—

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

a The initial budget data for 2011 were obtained taking into account the initial appropriations of the 2010 budget of the Balearic and Catalan governments, since they have extended them.
b These rates published by the Ministry of Economy and Finance have not been released for 2010 Q1.

SOCIAL SECURITY SYSTEM BUDGET OUTTURN

TABLE 6

€m and %

	Initial budget 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010	Outturn		
					2010 Jan-May	2011 Jan-May	Percentage change 2011/2010
	1	2	3	4 = 3 / 1	5	6	7 = 6 / 5
1 REVENUE	119,481	-3.4	123,405	3.3	49,495	49,398	-0.2
Social security contributions	108,358	-4.4	111,778	3.2	44,487	44,047	-1.0
Current transfers	8,357	12.3	8,154	-2.4	3,834	4,029	5.1
Other revenue	2,765	-6.7	3,473	25.6	1,174	1,322	12.6
2 EXPENDITURE	116,601	1.9	118,826	1.9	40,680	41,850	2.9
Wages and salaries	2,483	1.2	2,378	-4.2	947	916	-3.3
Goods and services	2,032	1.9	1,719	-15.4	561	602	7.5
Current transfers	111,557	1.9	114,279	2.4	39,109	40,281	3.0
Contributory pensions	95,320	2.1	99,090	4.0	33,573	35,271	5.1
Sickness	7,373	-9.5	7,009	-4.9	1,871	1,614	-13.7
Other	8,864	11.0	8,181	-7.7	3,664	3,396	-7.3
Other expenditure	529	-6.1	450	-15.0	64	50	-21.9
3 BALANCE (3 = 1 - 2)	2,880	—	4,579	—	8,814	7,548	—

SOURCES: Ministerios de Hacienda y de Trabajo e Inmigración and Banco de España.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 7

€m

		January-May		Rate of change 2011/2010 (b)
		2010	2011	
CREDITS	Current account	130,845	146,089	11.7
	Goods	75,155	90,272	20.1
	Services	34,703	36,516	5.2
	Tourism	12,738	13,943	9.5
	Other services	21,965	22,573	2.8
	Income	15,504	13,557	-12.6
	Current transfers	5,482	5,743	4.8
	Capital account	4,142	2,898	-30.0
	Current + capital accounts	134,987	148,987	10.4
DEBITS	Current account	156,850	170,160	8.5
	Goods	94,801	108,420	14.4
	Services	26,556	26,329	-0.9
	Tourism	4,206	4,160	-1.1
	Other services	22,350	22,169	-0.8
	Income	24,752	24,706	-0.2
	Current transfers	10,741	10,705	-0.3
	Capital account	658	493	-25.0
	Current + capital accounts	157,508	170,653	8.3
BALANCES	Current account	-26,005	-24,071	1,934.8
	Goods	-19,646	-18,148	1,497.8
	Services	8,147	10,188	2,040.5
	Tourism	8,532	9,783	1,251.1
	Other services	-385	404	789.4
	Income	-9,248	-11,149	-1,900.6
	Current transfers	-5,258	-4,961	297.0
	Capital account	3,484	2,404	-1,079.6
	Current + capital accounts	-22,521	-21,666	855.2

SOURCE: Banco de España.

a Provisional data.
b Absolute changes for balances.

capital account decreased. In turn, the reduction in the imbalance on the current account is mainly due to the widening of the services surplus and the narrowing of the deficit on the trade balance, although another contributory factor was the narrowing of the deficit on current transfers. By contrast, the income deficit widened.

Specifically, the deficit on the trade balance decreased by 7.6% in the first five months of the year to €18.1 billion. This was the result of opposing movements in the non-energy deficit, which dropped substantially, and the energy deficit, affected by the rise in the energy bill. The surplus on the services balance widened by 25% to €10.2 billion, reflecting the rise in the tourism surplus and, to a lesser degree, the improvement in the non-tourism services balance which posted a surplus. Counter to this, the deficit on the income balance increased by 21% to €11.1 billion. The deficit on current transfers stood at €5 billion, after declining by 6%. Finally, the surplus on the capital account fell 30% to €2.4 billion.

5.1 Highlights

Financial developments in the Spanish economy in 2011 Q2 were shaped by the resurgence of tensions in European sovereign debt markets stemming from investors' doubts about the sustainability of Greek public debt. Once again, the uncertainty spread to other euro area economies, particularly Spain, triggering rises in the risk premia on both government and private sector fixed income securities and falls in stock market prices. This trend intensified throughout July as a result of the discussions over whether or not to approve a second financial support package for Greece. The tensions subsided following the decisions adopted by the heads of state and of government of the euro area on July 21 (see Box 2), although they subsequently escalated again.

Against this background, the yield on Spanish 10-year government debt rose by 37 bp in Q2, while that on the German bund of the same maturity, which is customarily used as a safe-haven security in periods of higher uncertainty, fell by nearly 40 bp. As a result, the interest rate differential between the two bonds widened by 64 bp and stood close to 250 bp at the end of June. The risk premium on private sector fixed income securities, especially those of financial firms, also rose. Also, interbank market interest rates held on an upward course. Specifically, 12-month EURIBOR rose by 17 bp between March and June to stand at 2.16%. Further, stock market prices dropped and volatility rose. The IBEX 35 fell by 2% from its levels at the end of Q1, a decline similar to that shown by the EURO STOXX 50 (2.1%) and somewhat larger than that of the S&P 500 (0.4%). Thus the rise of 5.1% in the Spanish index in June exceeded that of the European index (2%) and was similar to that of the US index (5%) (see Chart 23).

In the first few days of July the heightening of sovereign debt market tensions was particularly notable in Spain. Thus the yield spread between Spanish 10-year government debt and the German benchmark of the same maturity reached around 370 bp. At the cut-off date of this report, however, it had risen further and stood near to 400 bp. In the capital markets, stock exchange prices underwent similarly notable fluctuations which left the IBEX 35 at 8.3% below its value at the beginning of the year.

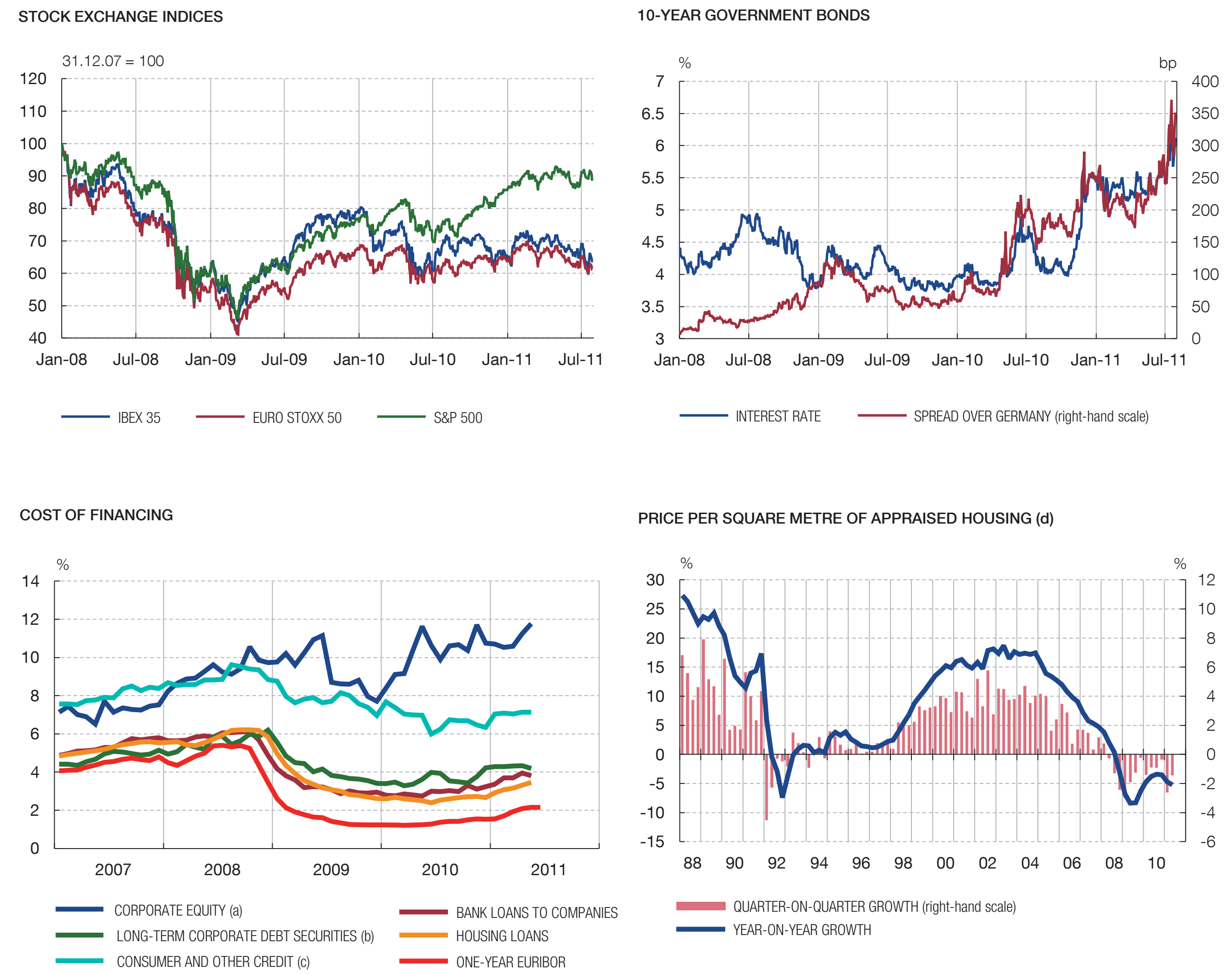
In the real estate market, the latest figures published by the Ministry of Housing showed that the rate of decline of unsubsidised house prices accelerated again in 2011 Q2. Thus the year-on-year rate of decrease was 5.2% in June, compared with a fall of 4.7% in March. Since the end of 2007, house prices have fallen by nearly 17%, equivalent to a

The latest available information shows that the cost of bank loans to firms and households increased between March and May (see Chart 23). This increase resulted basically from the higher cost of bank funding, since the spreads applied by banks to such funds scarcely changed. The last few months have also seen a rise in the cost of financing of non-financial corporations through equities and short-term securities. The July Bank Lending Survey (BLS) indicated that, despite the financial market tensions in Q2, the credit standards applied to companies remained steady in this period, in line with the expectations expressed by banks three months earlier.[1] Nor was there any change in those applied in consumer credit and other lending to households; however, the survey respondents

1. For more details, see "Encuesta sobre Préstamos Bancarios en España: julio de 2011" by Jorge Martínez Pagés, in the July edition of the *Boletín Económico* (only available in Spanish).

FINANCING CONDITIONS AND ASSET PRICES

CHART 23



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

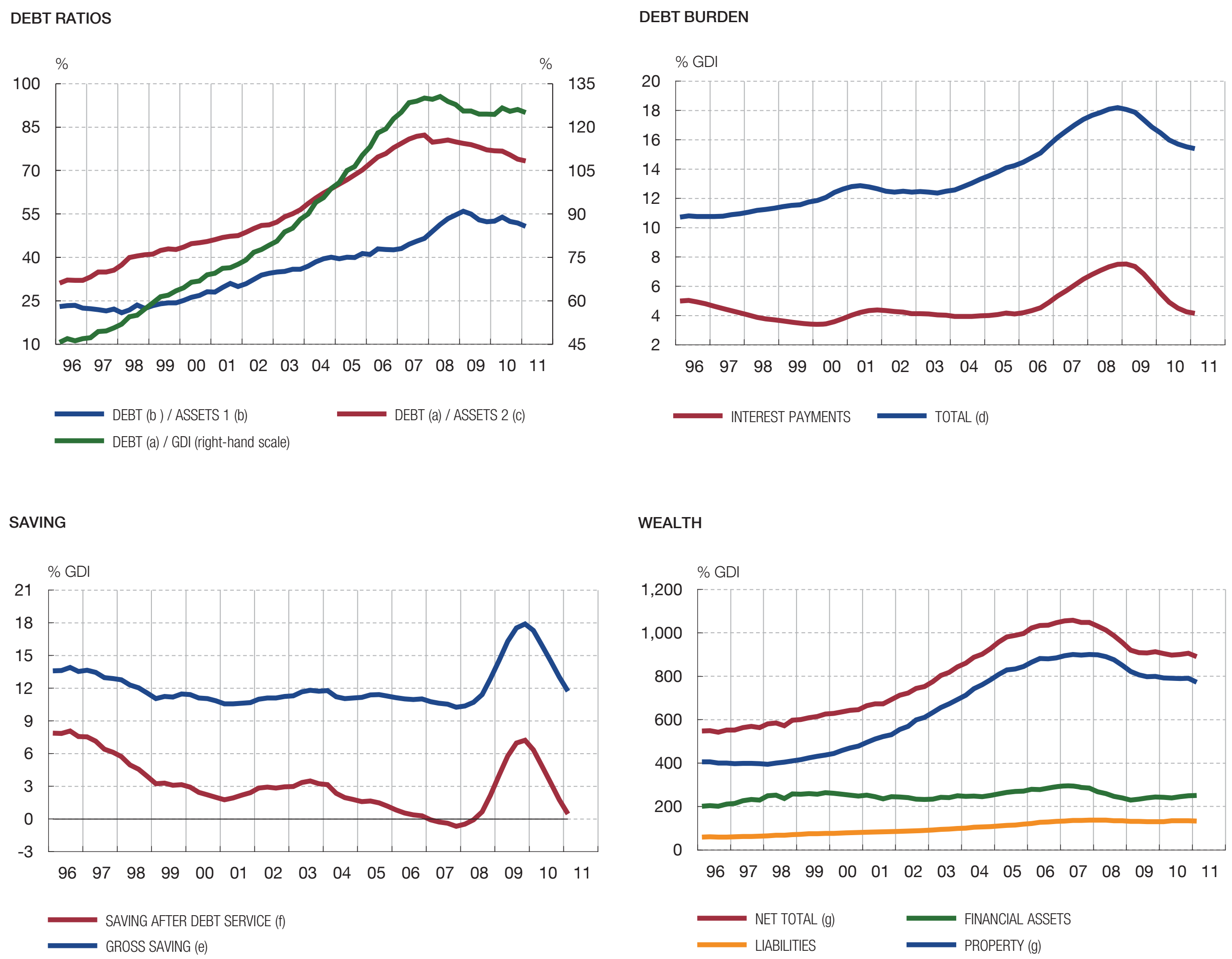
a The cost of equity is based on the three-stage Gordon dividend discount model.
b The cost of market-based long-term debt is calculated as the sum of the average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.
c In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to their customers were changed, which may cause breaks in the series. Particularly significant was the change in the interest rate on consumer credit and other lending, which from that month no longer includes credit card transactions.
d Base 2001 to December 2004; base 2005 thereafter.

reported a slight tightening in house purchase loans. As regards the current quarter, banks expect that credit standards will hold steady in both sectors.

The latest data available on private-sector financing –for May– point to a contraction in household and corporate debt in Q2. The year-on-year growth rate of household liabilities decreased to -1.1%, the reasons being that funds earmarked for consumer credit and other lending contracted more sharply than in previous months and that those for house purchase loans decreased slightly. The annualised quarter-on-quarter rates of both these components point to a somewhat sharper pace of decline. In addition, the growth rate of corporate liabilities turned slightly negative, albeit with significant differences between instruments. Thus the year-on-year rate of fall of loans from resident institutions steepened slightly to 2.2%, whereas fixed income securities (the instrument used by larger firms) continued to show more expansionary behaviour, albeit less dynamic than in Q1. The most

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 24



SOURCE: 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.

recent information on the distribution of credit by productive activity, which relates to 2011 Q1, indicates that the fall-off in bank financing became more marked in all segments in the early months of 2011, the fall being particularly sharp in construction (-13.3%). The most recent provisional information suggests that in June this contractionary pattern of household and corporate debt continued to prevail.

The fall-off in household liabilities in Q1 meant that the debt to gross disposable income ratio and the debt burden of the sector decreased (see Chart 24). Despite this, the sector's gross saving ratio and its saving after debt service remained on the downward path prevailing since the beginning of 2010. Households' net wealth also decreased in the early months of 2011 as a result of a moderate increase in the value of the financial component and a decrease in the real estate component, the latter undergoing a sharper fall than in the previous months. The provisional information for Q2 points to little change in the debt and debt burden ratios of households and to a fresh decrease in their net wealth.

In the case of companies, the relative stagnation of their liabilities, combined with a moderate increase in their income, meant that the debt ratio of the sector decreased again in 2011 Q1. As a result of this decrease in the debt ratio and of a rise in financing costs, the debt burden remained steady (see Chart 25). Also, for the sample of firms reporting to the quarterly Central Balance Sheet Data Office survey (CBQ), among which the biggest have a notable weight, ordinary profit grew in Q1 somewhat less than in the same period of 2010 and profitability held steady.

General government debt continued to grow rapidly, albeit less so than before (its year-on-year growth rate in May stood at 16%, down 1.1 pp from March). The latest information on the Financial Accounts, relating to Q1, indicates that this dynamism in fund raising, along with the weak growth of output, was reflected further increases in the debt/GDP ratio, which stood at nearly 64%, and in the debt burden ratio, which reached 2.1%.

Doubtful loans kept rising. This, combined with the decrease in debt, meant that the doubtful assets ratio continued upward. Specifically, for other resident sectors as a whole (which, in addition to households and firms, include intermediaries other than credit institutions), this indicator stood at 6.5% in May, up 0.4 pp on March.

The latest Financial Accounts information shows that between January and March the nation's net borrowing held, in 12-month cumulated terms, close to 4% of GDP. Sectoral analysis shows that this resulted from a slight increase in non-financial corporations' net lending, which was more than offset by the decrease in households' credit balance, while the governal government deficit remained at 9.2% of GDP and financial institutions' saving scarcely changed (see Table 8). The external financing of the economy was channelled basically through general government (particularly via fixed income securities) and through the sale of external assets by institutional investors. Thus the net funds of the rest of the world received by these two sectors amounted to 3.2% and 2.7% of GDP, respectively. Also noteworthy was the decrease in external funds channelled through credit institutions and securitisation SPVs, which, in net terms, decreased by 1.8 pp and 0.7 pp, respectively.

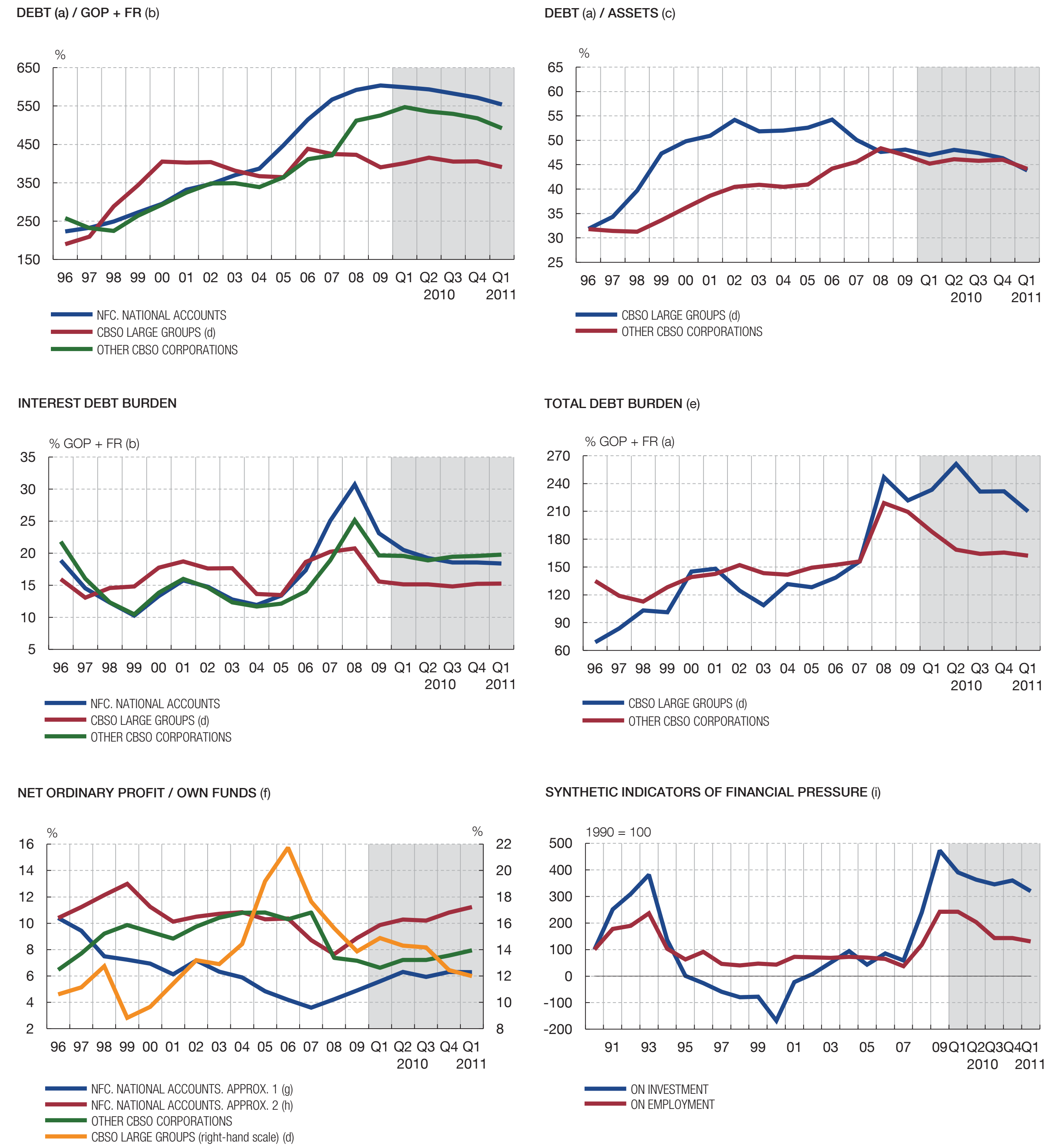
To summarise, in 2011 Q2 and, more markedly, in July to date, the Spanish economy has been strongly affected by the resurgence of tensions in the European sovereign debt markets, resulting in a rise in the risk premia on fixed income securities issued by resident sectors, which are holding at historically high levels. The persistence of these levels led banks to pass through, in the opening months of the year, a portion of the increase in funding costs to the interest rates applied by them in loans to households and firms. This development, along with the necessary deleverage of these agents, is helping to push the growth rate of their liabilities into negative territory.

5.2 Households

Between March and May, the interest rate on new loans to households rose (by 31 bp in house purchase loans and by 9 bp in consumer credit and other lending), in line with the behaviour of the benchmark market rates in this period (see Chart 23). Also, according to the July BLS, banks tightened slightly the credit standards for real estate purchase loans and held unchanged those applied in consumer credit and other lending. According to this survey, households' applications for financing declined in both cases, albeit more sharply in the former. The decrease in applications for funds to purchase real estate, although smaller than in 2011 Q1, constrasts with banks' expectations that these loan applications would remain steady. For the current quarter, banks expect that the credit supply conditions in this segment will remain steady and that demand will decrease further, albeit more moderately than in Q1.

INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

CHART 25



SOURCES: INE and Banco de España.

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

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 8

% GDP

	2006	2007	2008	2009	2010				2011
					Q1	Q2	Q3	Q4	Q1
National economy	-8.4	-9.6	-9.2	-5.1	-4.4	-4.5	-4.4	-3.9	-4.0
Non-financial corporations and households and NPISHs	-11.1	-13.4	-6.8	4.6	5.3	4.3	3.6	4.4	4.3
Non-financial corporations	-9.5	-11.5	-7.1	-1.3	0.6	0.7	0.8	1.3	1.5
Households and NPISHs	-1.7	-1.9	0.2	5.9	4.8	3.6	2.8	3.1	2.8
Financial institutions	0.7	1.9	1.8	1.4	1.2	1.2	1.1	1.0	0.9
General government	2.0	1.9	-4.2	-11.1	-11.0	-10.0	-9.1	-9.2	-9.2
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-17.8	-15.9	-11.8	-8.7	0.5	0.9	-0.9	-0.9	-1.3

SOURCE: Banco de España.

a Financial resources that cover the gap between expanded gross capital formation (real investment and permanent financial investment) and gross saving.

Against this background, household debt again decreased. Its year-on-year growth rate of -1.1% in May represented a somewhat sharper fall than that in March (when the rate stood at -0.5%). This fall-off resulted from a sharper contraction of consumer credit and other lending than in Q1 (-3.8%, as compared with -1.8%) and a slight decrease in house purchase loans (growth rate of -0.3%, as against -0.1% two months earlier). The seasonally adjusted rates point to somewhat sharper falls.

As a result of the contraction in household liabilities and of the steady household income in Q1, the debt/GDI ratio fell below 125% (see Chart 24). Also, owing to the lower interest payments, which reflect with a lag the behaviour of new loans and of interbank yields, the debt burden continued to decrease, approaching 15% of GDI. Foreseeably, in the coming months this ratio will start to reflect the upward path of the market rates customarily used as benchmarks in household financing, although with uneven intensity within the sector (see Box 5). The progressive disappearance of this factor cushioning the effects of the fall in incomes in the crisis heightens the level of financial pressure on the more indebted households. Also, households' gross saving rate and their saving after debt service held on the downward path of previous quarters. There was also a decrease in the sector's net lending, which dropped to 2.8% of GDP, 0.3 pp below the 2010 figure, and in its net wealth. The decrease in the latter resulted from moderate growth in the value of the financial component and a further decrease in real estate, which fell more sharply than in previous periods.

As regards portfolio decisions, household investment in financial assets contracted by 0.9 pp with respect to the previous three months, dropping to 3.5% of GDP in cumulated twelve-month terms (see Table 9). A preference for instruments involving lower risk was apparent. Thus time deposits continued to be the main destination of these flows, followed by insurance technical reserves, while saving in the form of equities decreased again, as did investment in investment funds, which turned negative again, reflecting the shift towards time deposits as the yields on the latter rose. Finally, the balance of means of payment (cash, sight deposits and savings deposits) remained unchanged.

In Q1 the household doubtful assets ratio remained at 3.2% as a result of stability in the house purchase loan and consumer credit and other lending segments.

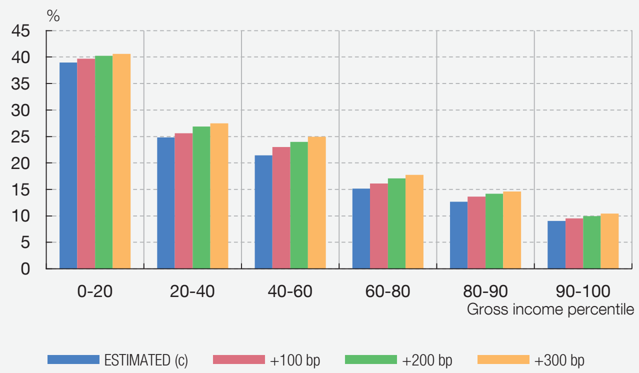
Since their historical lows of 2010, the interest rates applied by banks in loans to households have followed an upward path, showing a rise of 1.2 pp as at May 2011. Given the lag with which interest payments reflect changes in the cost of new loans and in the interbank yields to which they are tied, this increase has not yet passed through to the aggregate debt burden of the sector, but it will foreseeably begin to do so in the next few months. Against this background, it is of interest to assess the sensitivity of the household debt burden to rises in interest rates. The Spanish Survey of Household Finances ("EFF" by its Spanish abbreviation) allows this analysis to be carried out and distinguishes between different types of households.

To estimate how the debt burden ratio[1] of households would be affected at this point in time by a rise in borrowing costs, first an estimate was made of the March 2011 values of the debt burden ratio of the surveyed households that had loans outstanding at the time of the latest EFF (i.e. in 2009 Q1). To do this, it is assumed that in 2009 Q1 and in the same period of 2011, the income of all indebted households behaves in the same way as aggregate gross income per household (i.e. a projected decrease of 2.9%). Also assumed is a decrease of 2.8 pp in borrowing costs in the case of

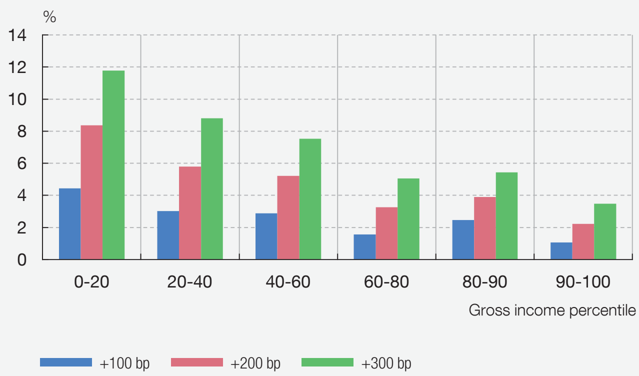
1. The debt burden ratio is defined as the payments associated with the debt in question (repayment of principle and payment of interest) divided by gross disposable income.

1 DISTRIBUTION OF HOUSEHOLD DEBT BURDEN RATIO (a) (b)

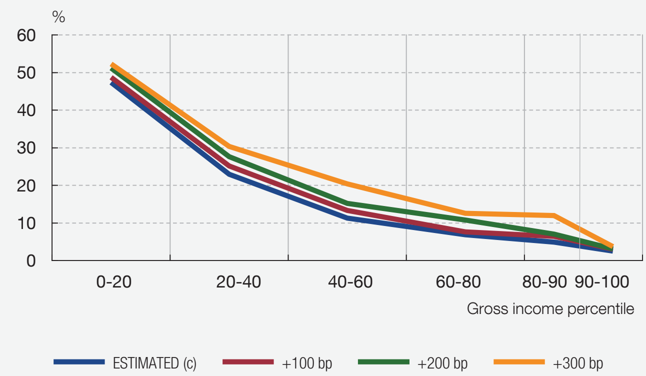
2 HOUSEHOLD DEBT BURDEN RATIO (median) (a) (b)



3 DECREASE IN HOUSEHOLD INCOME AFTER DEBT SERVICE (average) (b)



4 PERCENTAGE OF HOUSEHOLDS WHOSE DEBT BURDEN EXCEEDS 40% OF THEIR GROSS INCOME (a) (b)



SOURCE: EFF (2008)

a The debt burden ratio is defined as the payments associated with the debt in question (repayment of principle and payment of interest) divided by gross disposable income.
b Calculated for households with outstanding debt. Various interest rate scenarios are shown, increasing the estimated March 2011 rates, when they are variable, by 100, 200 and 300 basis points.
c Shows the situation which would be estimated for 2009 Q1 under the assumptions explained in the text, based on the information contained in the EFF (2008).

variable-rate loans, in line with the behaviour in this period of one-year EURIBOR, the usual benchmark for bank loans in this sector.[2] To calculate the impact that this fall would have on the payments associated with the outstanding debt, use is made of EFF information on the individual characteristics of the loans in question, such as the volume of debt, the residual term, borrowing costs and the nature of the loan agreement (fixed or variable rate).

Taking as starting point the situation estimated for March 2011, a simulation is performed of how the debt burden ratio of indebted households is impacted by rises in borrowing costs arbitarily set at 100 bp, 200 bp and 300 bp. Chart 1, which shows the 25th, 50th and 75th percentiles of this ratio for the household segment with outstanding loans in each of these scenarios, indicates that this impact is not uniform. As might be expected, the proportion of regular income absorbing the payments associated with the debts in question increases most strongly in the upper part of the debt burden ratio distribution, where most of the more highly indebted households are located.

The sensitivity of the household debt burden to interest rate rises also varies with the level of income, as seen in Chart 2. The impact of an interest rate rise would be largest in intermediate-income households, in which the ratio of interest payments to income would increase by 1.5 pp, 2.5 pp and 3.5 pp in response to rises in borrowing costs of 100 bp, 200 bp and 300 bp, respectively. At the other extreme, the smallest increases would be observed in the decile of households with the highest incomes. Also, it is observed that, despite the comparatively higher indebtedness of lower-income households, the impact of possible changes in interest rates on their debt burden is more limited than in other groups. This is because in this segment the proportion of households with non-adjustable interest rates is the highest in the sample (55% have all loans of this type, as against 21% in the highest-income decile). This, in turn, is because of the greater weight of consumer loans, the interest rates of which are predominantly non-adjustable, in this group.

2. Specifically, the difference between the average value of 1-year EURIBOR from April 2008 to March 2009 and that from April 2010 to March 2011 is calculated.

Another factor calling for analysis is the impact which these hypothetical increases in borrowing costs would have on household income after debt service. As seen in Chart 3, this impact is not evenly spread, being on average more marked in lower-income households. At the opposite extreme, the most moderate fall is in households above the 90th percentile. In any event, there is a high dispersion also within each of the groups analysed. Thus, in particular, the impact would be zero for somewhat more than half of lower-income households (those whose debts are all at non-adjustable interest rates).

It is also of interest to look at the impact of the aforementioned shocks on the proportion of households above certain thresholds. Chart 4 shows, for various income tranches and for different interest rate scenarios, the percentage of indebted households for which the debt burden would, in the simulations, exceed 40% of their gross income. It can be seen, first, that this proportion is inversely related to income level and, second, that the proportion is, in general, impacted only moderately by an increase in borrowing costs. Distinguishing by income segment, the effects are strongest in low- and intermediate-income households. In particular, for households with outstanding loans lying between the 20th and 40th income percentiles, the percentage of households above the threshold increases from the 23% estimated for 2011 to 25%, 28% and 30% with the simulated increases of 100 bp, 200 bp and 300 bp, respectively, in borrowing costs.

In short, the results set out in this Box suggest that, for the sector as a whole, the impact of simulated interest rate rises is relatively moderate. However, it is not evenly spread, but rather tends to be somewhat stronger in low- and intermediate-income households. In any event, these results should be interpreted with due caution because of the assumptions that have to be made to carry out the simulations. In particular, the behaviour of household income between 2009 Q1 and 2011 Q1 and of household borrowing costs in that period is, for the sake of simplicity, assumed to be uniform across all households. If the behaviour of these variables were to differ across the various segments of the sector, the results might be different from those obtained in this simulation exercise.

5.3 Non-financial corporations

The financing costs of firms increased between March and May. In bank loans, the rise was sharper for those below €1 million than for those above this amount (19 bp and 7 bp, respectively). In the case of fixed income, the behaviour differed depending on the term. Thus, the market interest rate on issues with maturities of less than one year rose by 8 bp, while that on issues with longer maturities decreased by 12 bp (see Chart 23). The falls in stock market prices resulted in a higher cost of raising equity capital. According to the July BLS, credit standards for this sector remained steady in Q2. Banks reported an increase in the margins applied, basically in higher risk loans. On the demand side, the survey reflected a slight recovery in requests for funds.

TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS — TABLE 9
Four-quarter data

% GDP

	2007	2008	2009	2010 Q3	2010 Q4	2011 Q1
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	7.2	2.5	4.7	4.2	4.4	3.5
Cash and cash equivalents	-1.1	-0.4	4.2	0.6	-0.1	0.0
Other deposits and fixed-income securities (a)	7.5	6.8	-1.2	2.1	3.5	3.4
Shares and other equity (b)	0.6	-0.3	1.2	1.0	0.6	0.2
Mutual funds	-1.1	-3.4	0.0	-1.2	-1.7	-1.5
Insurance technical reserves	0.9	0.2	0.9	0.6	0.8	0.8
Of which:						
Life assurance	0.2	-0.2	0.6	0.2	0.3	0.4
Retirement	0.4	0.3	0.3	0.4	0.5	0.4
Other	0.3	-0.4	-0.4	1.0	1.4	0.6
Financial transactions (liabilities)	9.1	2.3	-1.2	1.3	1.3	0.8
Credit from resident financial institutions (c)	9.4	3.4	-0.5	0.0	0.0	-0.5
House purchase credit (c)	7.1	2.7	0.1	0.5	0.5	-0.1
Consumer and other credit (c)	2.1	0.8	-0.4	-0.4	-0.3	-0.4
Other	-0.3	-1.1	-0.7	1.3	1.3	1.2
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	13.4	1.6	-8.3	5.1	7.4	6.4
Cash and cash equivalents	-0.4	-1.1	-0.3	0.2	-0.1	0.4
Other deposits and fixed-income securities (a)	2.0	2.3	-0.6	0.0	1.5	2.3
Shares and other equity	8.1	2.8	-0.4	2.0	2.7	2.6
Of which:						
Vis-à-vis the rest of the world	6.6	3.0	0.1	2.0	2.4	2.6
Trade and intercompany credit	2.1	-3.2	-7.3	2.3	3.1	1.0
Other	1.5	0.8	0.3	0.6	0.1	0.1
Financial transactions (liabilities)	24.9	8.7	-7.0	4.3	6.0	4.9
Credit from resident financial institutions (c)	13.8	5.5	-3.0	-1.3	-0.9	-1.4
Foreign loans	2.8	3.0	-0.1	-0.6	0.7	0.8
Fixed-income securities (d)	0.5	0.3	1.3	1.3	0.7	0.6
Shares and other equity	5.3	2.3	1.6	1.6	1.8	2.6
Trade and intercompany credit	3.3	-3.3	-7.0	2.4	3.3	1.1
Other	-0.8	0.9	0.0	0.9	0.5	1.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.5	6.6	-0.8	0.2	0.6	0.0
Households and NPISHs	12.5	4.4	-0.3	0.1	0.2	-0.5
Non-financial corporations	17.7	8.2	-1.2	0.2	0.9	0.3

SOURCE: Banco de España.

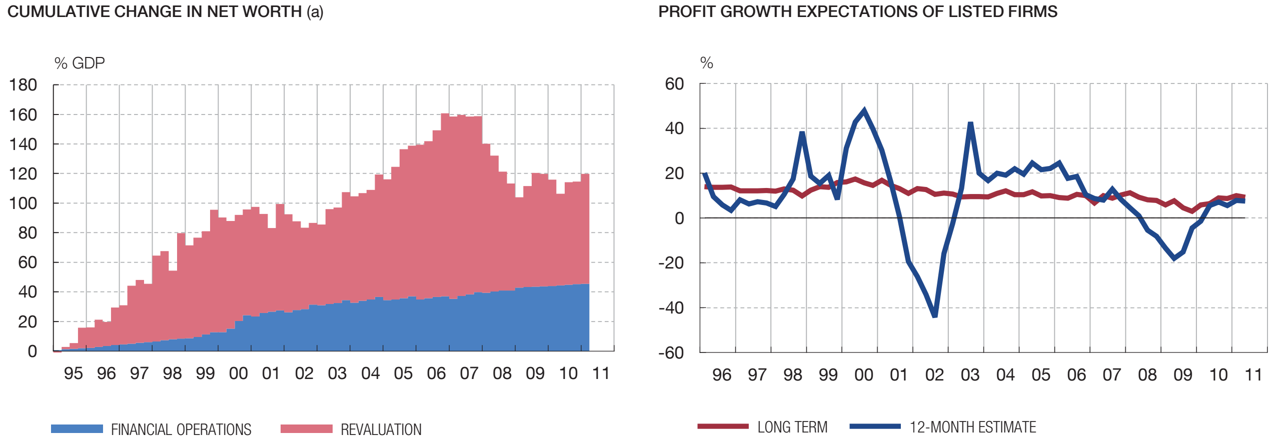
a Not including unpaid accrued interest, which is included under "other".
b Excluding mutual funds.
c Including derecognised securitised loans.
d Includes the issues of resident financial subsidiaries.
e Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income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

Against this background, the growth rate of corporate financing decreased to slightly negative figures (-0.3% in May, against 0.3% in March). There were, however, significant differences across instruments. Thus loans from resident institutions contracted more sharply, by 2.2%, in year-on-year terms (against a fall of 1.6% in Q1). Fixed income securities showed greater dynamism, which was, however, somewhat more moderate than in Q1 (they grew by 5.5%, down 4.5 pp on March). The annualised seasonally adjusted quarter-on-quarter rates show lower growth figures.

The latest information on the breakdown of credit by purpose, relating to 2011 Q1, shows that this source of financing decelerated in all branches of economic activity. The fall-off in

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.

bank financing was particularly sharp in construction (-13.3%) and more moderate for real estate services and industry (-3.2% and -2.4%, respectively). Other non-financial services was the only segment with a positive growth rate (1.2%).

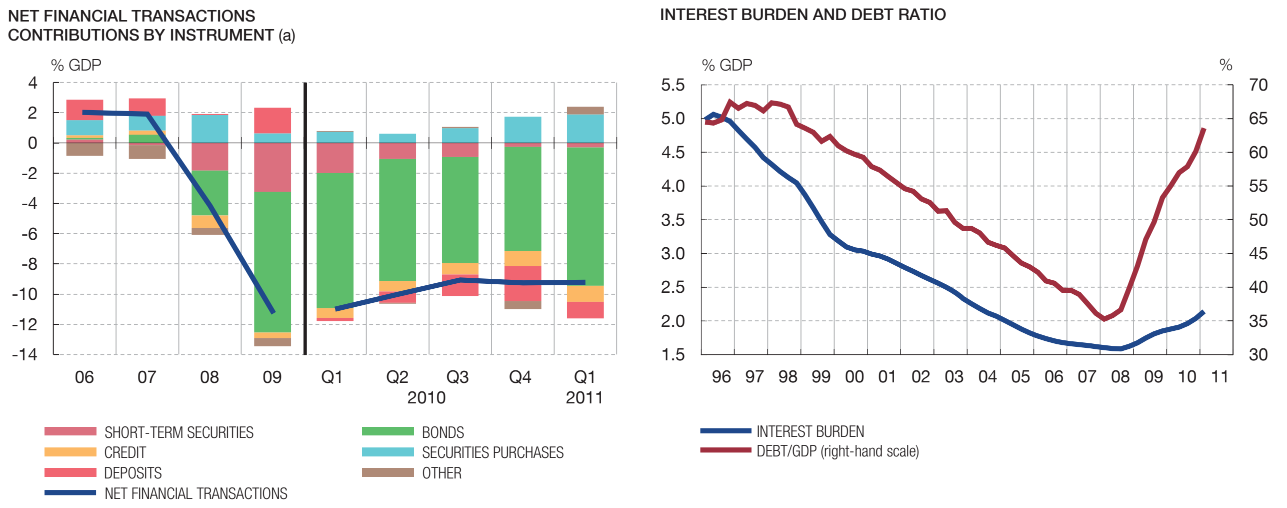
According to the Financial Accounts information, the credit balance of the net financial transactions of the business sector increased slightly in 2011 Q1, from 1.3% to 1.5% of GDP, in twelve-month cumulated terms. However, the financing gap, which approximates the funds required to bridge the difference between gross corporate saving and firms' gross capital formation plus permanent foreign investment, again showed a negative balance, the absolute value of which exceeded that of previous quarters (-1.3%, against -0.9% in 2010), as a result of increases in intra-group investment and in equity securities abroad.

The stagnation of firms' liabilities, along with the moderate increase in their income, seems to have allowed their debt ratio to decrease further in 2011 Q2 (see Chart 25). As a result of this decline and of the rise in the cost of funds in the last few months, the interest burden ratio remained steady. The improvement in business income was accompanied by an increase in equity capital, so the sector's profitability held at much the same levels as in 2010.

The sample of corporations reporting to the CBQ, among which the biggest have a notable weight, shows that, based on the data available for 2011 Q1, ordinary net profit grew in this period somewhat less than in the same months a year earlier (8.4%, against 9.7%). This growth in profit from ordinary activities meant that the return on investment stood at 4.5%, exactly the same as in March 2010. Together with this income growth, there was an increase in the liabilities of these firms, albeit less marked than in their surpluses, so the debt ratio decreased. This development, along with the higher interest rates borne, resulted in a slight rise in the debt burden. As an overall effect of these events, the composite indicators of financial pressure on investment and employment decreased. Meanwhile, in Q2 analysts maintained their expectations regarding the improvement of the sector's long-term profits and revised downward slightly those for the short term (see Chart 26).

GENERAL GOVERNMENT
Four-quarter data

CHART 27



SOURCE: Banco de España.

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

The doubtful assets ratio of non-financial corporations rose further in 2011 Q1 to 8.7%, up 0.6 pp on the figure three months earlier. The largest increase was in the construction and real estate services segment, where the ratio rose from 13.5% to 14.7%, while in the other economic areas it was very modest (up from 3.9% to 4%).

5.4 General government

According to the Financial Accounts, in 2011 Q1 general government net borrowing held at 9.2% of GDP in cumulated annual terms (see Table 8). The bulk of funds were again obtained through the issuance of long-term fixed income securities. This channel raised funds equivalent to 9.2% of GDP, which was 2.3 pp more than in 2010 (see Chart 27). By contrast, the volume received through short-term securities decreased further, continuing the downward path initiated in late 2009, and stood at 0.3% of GDP. The funds obtained through loans again amounted to 1% of GDP. On the assets side, net securities acquisitions increased slightly to 1.9% of GDP. Most of this amount relates to investment in securities issued by the general government sector itself. Finally, the divestment of deposits amounted to 1.1% of GDP in four-quarter cumulated terms.

The general government debt ratio grew to 63.6% of GDP in March 2011, up 3.5 pp on end-2010, as a result of the the sector's high deficit and of the weak GDP growth. In line with this, the associated debt burden also increased, albeit moderately (by 0.1 pp to 2.1% of GDP).

5.5 The rest of the world

In 2011 Q1 the downward trend in the nation's net borrowing during the previous two quarters was interrupted. Net borrowing in March stood at 4% of GDP in four-quarter cumulated terms, against 3.9% in 2010 (see Table 8).

The improved market situation in the early months of the year allowed the growth of external fund raising, which in March reached 3% of GDP in twelve-month cumulated terms, well above the 0.7% recorded at end-2010 (see Table 10). By instrument, particularly high capital inflows resulted from securities issued by general government (2.8% of GDP in annual terms, up 0.8 pp on 2010) and from shares (2.4% of GDP, against 0.9% of GDP in the

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 10

% GDP

	2007	2008	2009	2010		2011
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-9.6	-9.2	-5.1	-4.4	-3.9	-4.0
Financial transactions (assets)	14.1	0.7	-0.4	-2.9	-3.1	-1.0
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	1.4	-1.3	-3.2	-2.3	-1.4	0.6
Of which:						
Interbank, credit institutions (a)	4.2	-0.5	-1.7	-1.8	-1.3	0.5
Securities other than shares	1.6	1.3	0.0	-5.7	-6.9	-7.1
Of which:						
Credit institutions	1.8	1.5	1.2	-2.8	-3.0	-2.4
Institutional investors	0.0	-1.3	-0.5	-2.4	-3.3	-3.6
Shares and other equity	8.8	1.7	1.5	2.7	2.4	3.0
Of which:						
Non-financial corporations	6.6	3.0	0.1	2.0	2.4	2.6
Institutional investors	-1.1	-1.6	0.3	1.0	0.8	0.5
Loans	1.2	0.8	0.2	0.0	0.3	0.5
Financial transactions (liabilities)	23.7	9.9	4.6	1.5	0.7	3.0
Deposits	6.7	8.0	-0.5	-0.2	-0.5	-1.7
Of which:						
Interbank, credit institutions (a)	6.7	6.2	0.7	-2.9	-7.3	-7.7
Repos, credit institutions (b)	0.1	0.2	0.1	1.8	5.7	5.7
Interbank, BE (intra-system position)	-0.3	1.9	-0.8	0.5	0.2	-1.1
Securities other than shares	8.1	-2.7	3.8	0.6	-1.5	0.5
Of which:						
General government	-1.3	1.1	5.3	3.4	2.0	2.8
Credit institutions	3.6	-1.9	1.1	-0.6	-1.1	-0.6
Other non-monetary financial institutions	5.8	-1.9	-2.5	-2.2	-2.4	-1.8
Shares and other equity	4.6	3.2	1.0	0.8	0.9	2.4
Of which:						
Non-financial corporations	4.7	2.4	0.3	1.0	1.3	2.5
Loans	3.1	2.9	0.3	-0.2	1.2	1.1
Other, net (c)	0.2	0.2	-1.1	-2.0	-1.8	-1.5
MEMORANDUM ITEMS:						
Spanish direct investment abroad	9.5	4.7	0.7	1.2	1.5	2.9
Foreign direct investment in Spain	4.5	4.8	0.6	0.5	1.7	2.1

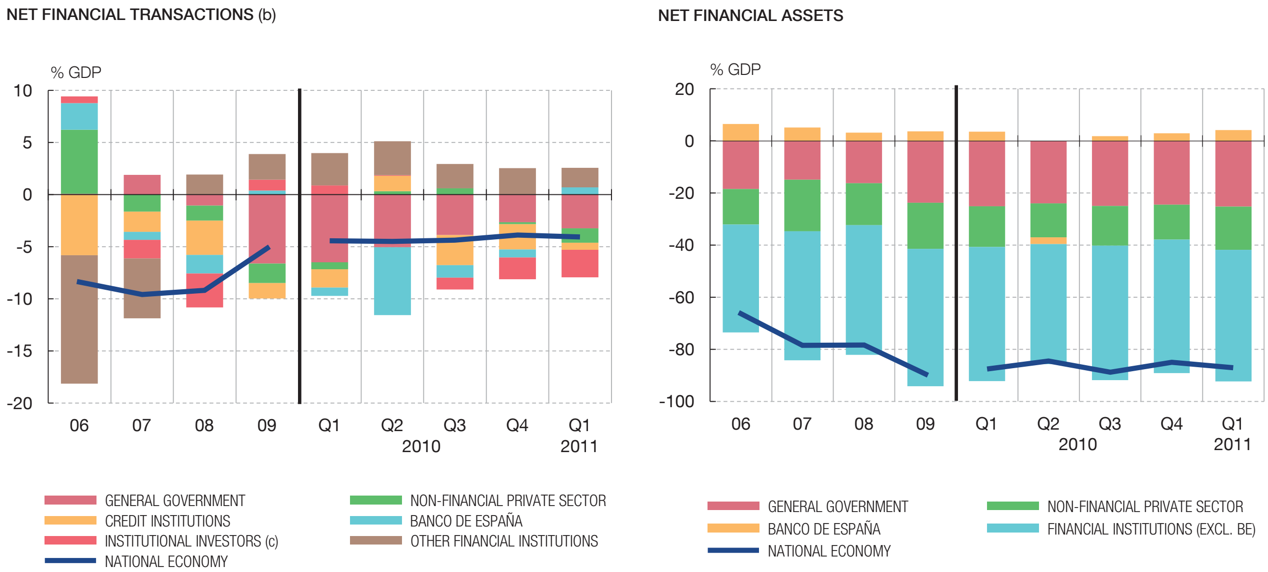
SOURCE: Banco de España.

a Excluding repos.
b Including transactions with central counterparty clearing houses.
c Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

previous quarter). By contrast, the Banco de España's debit position vis-à-vis the rest of the world decreased, as did the funds raised by credit institutions on the interbank market (excluding repos), which, in net terms, posted a negative flow equivalent to 8.1% of GDP, down 2.1 pp on December. Foreign direct investment in Spain rose by 0.4 pp to 2.1% of GDP in annual terms.

However, in four-quarter cumulated terms, the funds raised through incurrence of liabilities were insufficient to cover the nation's financing requirements, so the other funds were raised by reducing, in an amount equivalent to 1% of GDP, the portfolio of external assets

NET FINANCIAL TRANSACTIONS AND NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a) — CHART 28



SOURCE: Banco de España.

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

held by resident sectors. The contraction of the investment in external assets was concentrated in securities other than shares, which decreased by 7.1% of GDP, compared with a fall of 6.9% in 2010. This negative change was partly offset by an increase in loans and, in particular, by net acquisitions of shares (3% of GDP). In line with this development, Spanish foreign direct investment increased to 2.9% of GDP (1.4 pp more than in December).

As a result of the variations in financial flows to and from the rest of the world, in asset prices and in exchange rates, the value of the net liabilities accumulated by the Spanish economy increased to 87% of GDP, 2 pp more than in 2010 (see Chart 28). The sectoral breakdown shows that financial institutions (excluding the Banco de España) have the highest debit balance vis-à-vis the the rest of the world (50% of GDP), although they reduced it by 0.8 pp in the past three months. By contrast, general government (and, to a greater extent, the non-financial private sector) increased its net debt. In the case of this latter sector, the rise of 3.2 pp largely resulted from variations in the exchange rate and in asset prices. Finally, the Banco de España's credit position vis-à-vis the rest of the world increased by 1.2 pp of GDP.

4.8.2011