

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

In 2012 Q1, Spanish economic activity continued on the declining path initiated in the closing months of 2011, in a setting of high financial tension. On the as-yet incomplete information available, the contraction in GDP is estimated to have been slightly higher than that in 2011 Q4, with a quarter-on-quarter rate of change of -0.4%. National demand fell once again (-0.9 pp), as has been the case over the past four years, although the decline was milder than in the preceding quarter, while the contribution of net external demand was positive once more (0.6 pp), but likewise lower than that in the previous three months. After posting rises for seven consecutive quarters in year-on-year terms, GDP fell back to a rate of -0.5% (0.3% in the previous quarter).

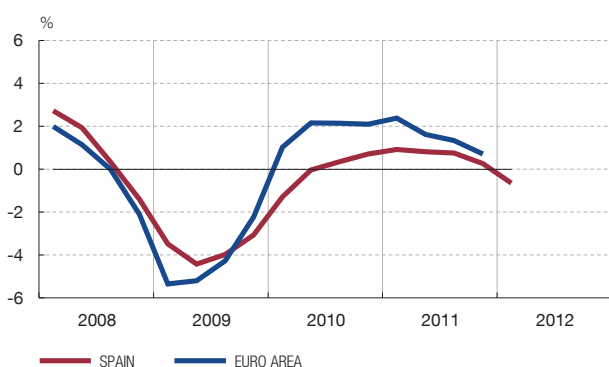
Employment fell once more, sharply so, posting an estimated year-on-year decline of close to 4%. And compensation per employee slowed across the economy, leading, in combination with high productivity growth, to a significant reduction in unit labour costs, prolonging the trajectory of the last eight quarters. The considerable sluggishness of domestic spending prompted a slowdown in the year-on-year rate of change of consumer prices from December to March, and the CPI stood at a 12-month growth rate of 1.9% in this latter month. Easing was more visible in the CPI excluding unprocessed food and energy, the year-on-year growth rate of which fell to 1.2%. In terms of the HICP, the inflation differential with the euro area stood in March at -0.9 pp, reflecting a reduction which was extensive to all the main HICP components.

On the international economic front, the situation on euro area markets improved somewhat compared with the stress peaks experienced in the closing months of 2011. Here, the ECB's conventional and non-conventional monetary policy measures contributed notably, as did the approval of the second bail-out programme for Greece following the restructuring of its debt in private hands and the progress in the ongoing reform of economic governance in the euro area. However, instability returned in the opening days of April, affecting Spain and Italy acutely owing to the doubts arising over the adjustment processes under way in both countries.

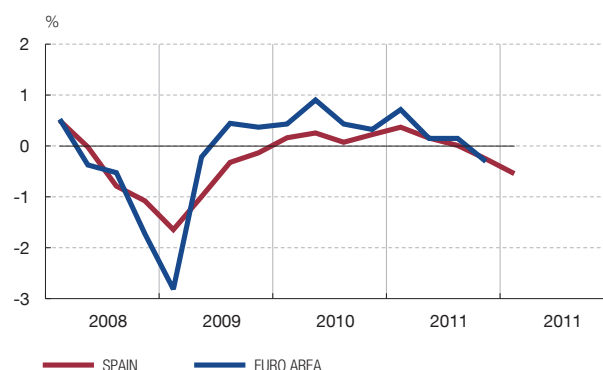
The indicators available suggest economic activity in the euro area stabilised – or fell off very moderately – in the opening months of 2012, following the fall in GDP in 2012 Q4; nonetheless, cyclical divergences between the member countries continued to widen. Outside the euro area there was a moderate recovery in the United States, some improvement in Japan and a gradual slowdown in activity in the emerging economies, which nevertheless remain very buoyant. Global inflation continued to slacken, although the rise in oil prices, which peaked at \$125 per barrel in February to dip slightly thereafter, poses a risk.

Turning to economic policies, measures in the euro area played a key role throughout the quarter. In terms of European governance, the seriousness of the sovereign debt crisis led control over public finances to be strengthened. This took the form of the signing, on 2 March, of the Treaty of Stability, Coordination and Governance in the Economic and Monetary Union. The Treaty incorporates the Fiscal Compact, under which 25 Member States, including Spain, have committed themselves to transposing into national legal frameworks a balanced-budget rule and an automatic correction mechanism for deviations at national level. Further, to reinforce surveillance of non-fiscal macroeconomic imbalances, the Commission presented in February its first *Annual Alert Mechanism Report*, designed to detect

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE



SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

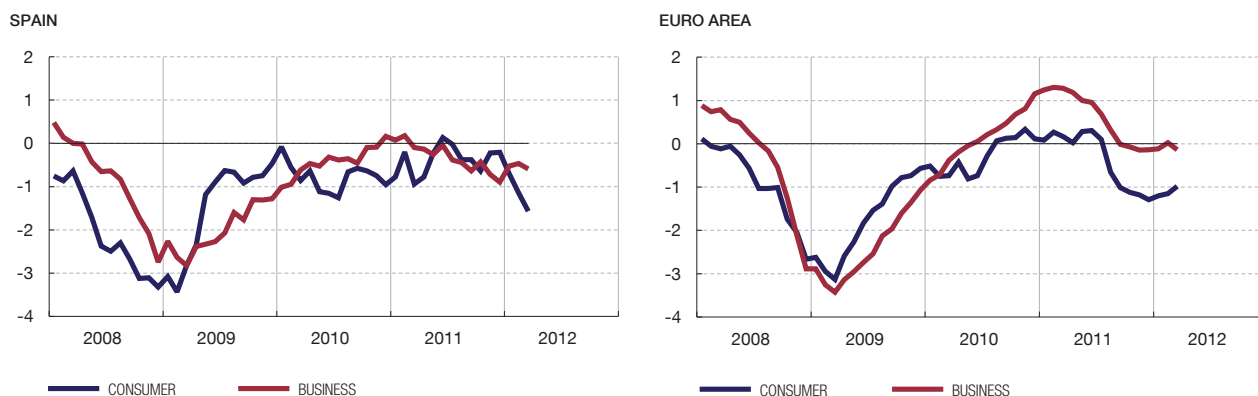
and correct situations of risk in this area. The report identifies 12 EU countries, including Spain, which should be examined in greater depth to determine whether the degree of severity of the imbalances detected calls for the initiation of an excessive imbalance procedure. As to crisis-prevention and resolution mechanisms, significant headway in setting up the European Stability Mechanism (ESM) was also made. The ESM required amendments to the Treaty on European Union, and its full operationality as a permanent facility has been brought forward one year (to July 2012) and its financial capacity (€500 billion) has been temporarily raised with the resources not used by the European Financial Stability Facility (see Box 2).

The ECB adopted a broad range of measures to restore monetary policy transmission channels and to reduce the likelihood of a traumatic contraction in credit supply that could have ensued given the growing feedback loop between sovereign risk and banking risk in the euro area that became discernible in the closing months of 2011. Among its standard policy measures, the ECB Governing Council held interest rates at an all-time low of 1% for its main refinancing operations, following the cuts made in November and December. This was in a setting in which euro area inflation, at 2.7% in March, was chiefly attributed to increases in the more volatile components, and in which inflation expectations remained anchored over the policy-relevant horizon. As to non-standard measures, in February the ECB approved specific criteria for the temporary acceptance of additional credit claims as collateral and implemented the second three-year longer-term refinancing operation with full allotment. Taken together, the two tenders considerably increased the liquidity buffer available to banks to undertake their refinancing operations, and they proved key to overcoming the moments of peak tension experienced last November.

Lastly, at the level of the countries most affected by the instability, major steps in economic reforms continued to be taken. In Spain, in particular, there was further headway in the ongoing clean-up, restructuring and recapitalisation of the credit system following a new Royal Decree-Law aimed at strengthening banks' capital and provisions.¹ On the structural reform front, an ambitious labour market reform was approved.² In terms of the greater possibilities for decentralising collective bargaining, the increase in internal flexibility

¹ Royal Decree-Law 2/2012 of 3 February 2012 on the balance-sheet clean-up of the financial sector.

² Royal Decree-Law 3/2012 of 10 February 2012 on urgent labour market reform measures.



SOURCE: European Commission.

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

and the rationalisation of the conditions governing the termination of permanent contracts it provides, the reform should contribute to the adjustment of working conditions to firms' specific circumstances and shape an environment more conducive to job creation and job stability, once the prevailing economic downturn has been overcome. Lastly, as regards the sustainability of public finances, key steps have been taken to strengthen the national budgetary framework through the approval of the Draft Organic Law on Budgetary Stability³, currently in the final stages of its passage through Parliament. This legislation, implementing the changes introduced into the Constitution last autumn, sets ceilings on the budget deficit and public debt and strengthens the instruments for compliance by all levels of government with their fiscal commitments.⁴

However, in early April there was, as indicated, a fresh heightening of euro area financial tensions which singularly and severely affected Spain. Over this past quarter, 10-year government debt yields briefly rose to over 6%, widening the spread over the German benchmark bond to around 440 bp, and stock markets have slumped, with losses for the IBEX 35 in 2012 to date running at around 20%. Moreover, against a background of high financial uncertainty, the recent decline in interbank rates has not yet passed through to the cost of new loans extended to households and firms. On the information available to February, interest rates on loans to households edged up slightly while those on transactions with businesses dipped marginally. In the real estate market, according to data released by the Ministry of Development, house prices fell back in 2012 Q1. As a result, their year-on-year decline stood in March at 7.2%, compared with 6.8% in December, and the cumulative fall from their 2008 peak amounts to 21.5%. Over the quarter as a whole, therefore, net household wealth declined, as a result of the fall in value both of financial instruments and, above all, of real estate assets.

Overall, the prevailing instability on financial markets shapes a setting in which financing conditions remain strict and in which agents' confidence is still very weak. Against this backdrop, private-sector spending declined further in the opening months of the year. In the case of households, consumption was notably sluggish (falling at an estimated

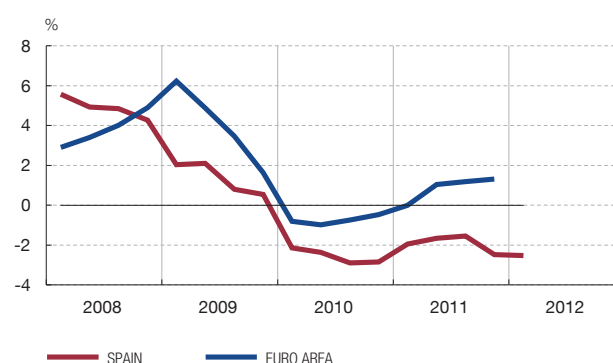
³ Draft Organic Law on Budgetary Stability and Financial Sustainability.

⁴ In addition, the Government has set in train changes relating to transparency in access to public information and good governance.

HARMONISED INDICES OF CONSUMER PRICES (a)



UNIT LABOUR COSTS (b)



SOURCES: Eurostat, ECB and INE.

a Year-on-year rate of change.

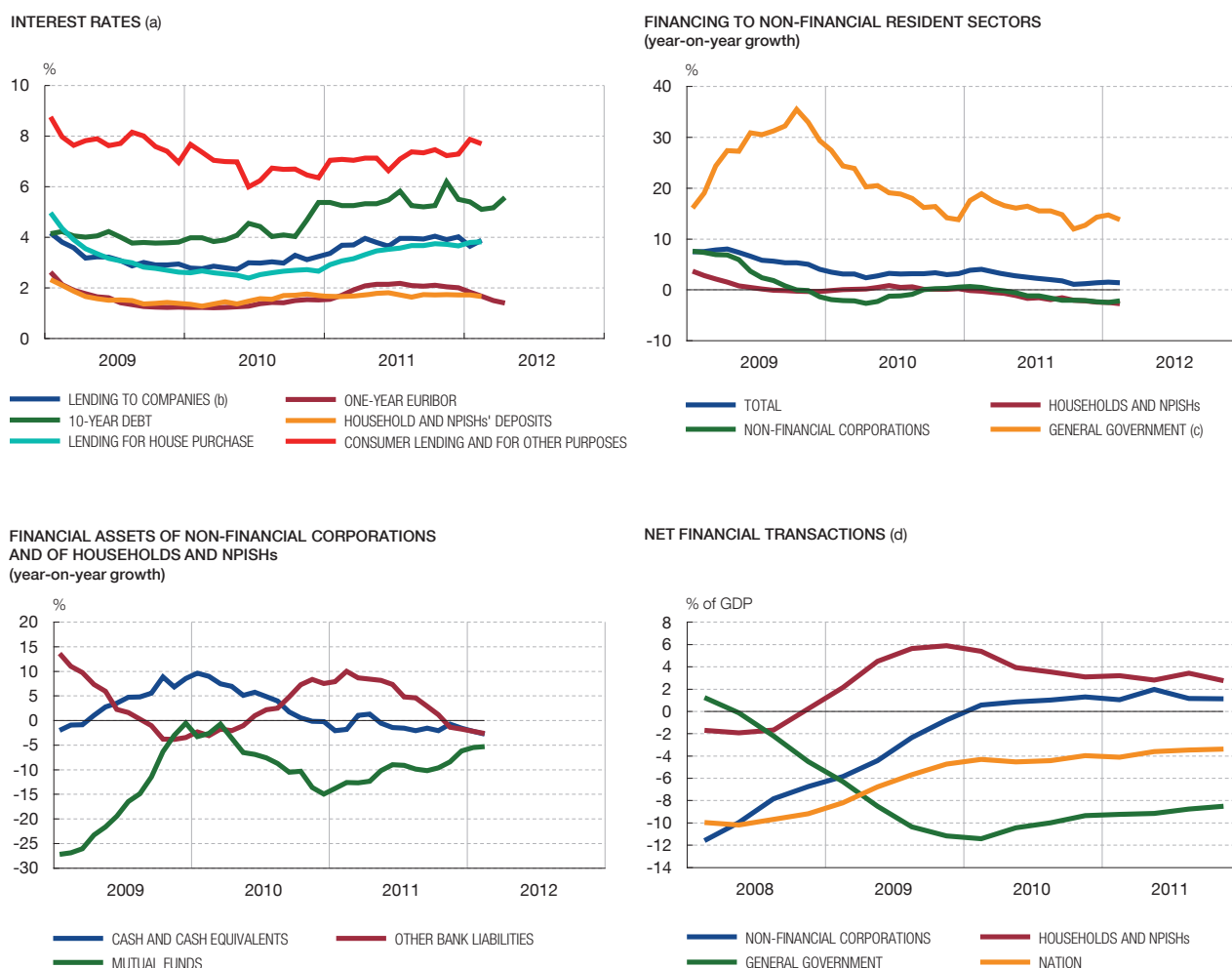
b Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

quarter-on-quarter rate of 0.4%) due to the worsening labour market situation, to the effect of higher personal income tax rates on disposable income, to diminished wealth and, generally, to the climate of greater uncertainty. These same factors are an obstacle to any recovery in residential investment, which continued to contract in the early months of the year.

Household liabilities declined to February (the latest month for which information is available) by 2.7% year-on-year, a somewhat sharper fall than that at the close of 2011 owing to the behaviour both of loans for house purchases and of credit for consumption and other purposes. On preliminary figures, the fall in household debt should have allowed the declining path of this sector's debt ratio to continue into early 2012, following the pattern seen already in 2011.

Business investment was also affected by the economic downturn and worsening financial tensions. Investment in capital goods held on a declining trajectory in the opening months of the year, at an estimated quarter-on-quarter rate of -3.5%, influenced additionally by the slowdown in world trade. This contractionary behaviour likewise affected the component of investment in other construction, where the private sector is undertaking numerous projects in collaboration with general government, projects logically much affected by the fiscal consolidation plans under way. Corporate debt continued to decline, taking the year-on-year rate of contraction to 2.2% in February, practically unchanged on end-2011. Corporations' debt ratio is expected to have held on the declining trajectory observed the previous year, although it remains at historically high levels.

The contractionary course over recent quarters of the public component of national demand, namely government consumption and public investment, steepened. This reflected the impact of the fiscal adjustment plan and the measures adopted in late December, once the notable end-year deviation in public finances from the established target (6% of GDP) was confirmed. This deviation ultimately amounted to 2.5 pp of GDP, once it became known in late March that the general government deficit had risen to 8.5% of GDP. The fiscal package adopted in December included, in addition to temporary tax measures (with an estimated revenue-raising impact of €8.1 billion), public spending cuts (implemented through an agreement not to use appropriations for an estimated value of €8.9 billion), a



SOURCE: Banco de España.

- a In June 2010 the statistical requirements relating to interest rates applied by credit institutions to their customers were amended, potentially causing breaks in the attendant series. Of particular significance was the change in the interest rates on consumer credit and other loans, as a result of which, from that month, operations transacted using credit cards have not been included. APR for loans (includes commissions and other expenses) and NDER for deposits.
- b Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commissions 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.

freeze on public-sector wages and the introduction of a series of restrictions on public-sector employment.

This budgetary consolidation strategy will be further pursued in the coming months once the 2012 State Budget measures approved by the Council of Ministers on 30 March begin to be implemented, and once the regional and local government budget outturns are adjusted to the new Budgetary Stability targets and incorporate, where necessary, the additional adjustments to which they have committed as a condition for their participation in the financial support plan for payments to suppliers (see Box 4).⁵ The Governor's testimony before Parliament, included in this Bulletin, offers a more detailed assessment of the Budget and the Draft Budgetary Stability Law. Overall, the conduct of all levels of government

5 On 24 February the Government approved Royal Decree-Law 4/2012, which sets in place an extraordinary financing plan to meet payments to local government suppliers. This was followed on 9 March by Royal Decree-Law 7/2012, creating a public fund for the execution of the plan and extending its application to regional governments.

must be consistent with the budget deficit target of 5.3% of GDP set for this year, compliance with which entails a most sizeable adjustment of the primary structural balance.

As regards trade with the rest of the world, the contribution of net external demand eased in the first quarter of this year, with a slight fall-off in exports and a somewhat sharper decline in imports compared with the previous quarter. The loss of momentum in exports witnessed in the last quarter came about amid the slowdown in our export markets – owing to the weakness of certain euro area countries – and despite the price-competitiveness gains that continue to accrue. The fall in imports shows, for its part, the sluggishness of domestic demand. On the whole, net external demand continued to make a significant contribution to GDP growth in Q1, of 3.2 pp in terms of the year-on-year rate of change.

On the supply side, all the productive sectors, except for agriculture, contributed to the decline in output. There was a slight reduction in the rate of contraction in industry and in construction, although the decline in this latter sector remains very high, turning principally on the non-residential segment, due to the effects of the fiscal austerity plans. Market services worsened slightly in the opening months of the year, meaning their related growth rate will almost have turned negative in quarter-on-quarter terms. On the basis of figures for Social Security registrations, the declining path of employment in the second half of 2011 continued, largely among foreigners and dependent employees. EPA data for Q1 are not yet available, but a further increase in the unemployment rate from the level of 22.8% recorded at end-2011 should not be ruled out.

Finally, in connection with labour costs, a moderate slowdown in compensation per employee is projected for 2012 Q1. This is as a result of some containment of wage settlements, the rate of which to March stood at 2.2%, still influenced by the delay that has built up the collective bargaining process and the high presence of multi-annual agreements signed in previous years. These wage increases are, in any event, high set against the conditions in the economy. Further moderation is, however, expected over the rest of the year once the labour market reform takes effect, through the prevalence of firm-level agreements, opt-out possibilities from the conditions set in agreements or through changes to such conditions.

In sum, the Spanish economy has begun 2012 in a renewed recessionary situation. The pattern of contraction of economic activity is marked, on the expenditure side, by very muted national demand, the impact of which on output is only softened by the greater relative resilience of the external sector. It is vital in the present circumstances to maintain the buoyancy of net external demand, meaning further gains in competitiveness must be secured using all the economic policy instruments available. The reforms rolled out in recent months, in particular concerning the labour market, are essential for placing the Spanish economy on a path of job creation and improved competitiveness, although their effects may not be immediate. Developments in the Spanish economy over the coming quarters will be subject to uncertainty and to downside risks associated with the possible ups and downs of the sovereign debt crisis. The priority should therefore be to dispel the doubts over the Spanish economy's adjustment capacity by concluding the clean-up, restructuring and recapitalisation of the banking system, and by strict compliance with the budgetary targets for 2012. Here it will be crucial to prevent the risks of a potential budgetary deviation in a setting of weaker-than-expected revenue or of difficulties in cutting specific expenditure items that are subject to high inertia. Rigorous application of the Budget is therefore required, which will be assisted by the improvements in transparency and monitoring provided for in the new Budgetary Stability Law.

2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

In 2012 Q1 the international economic and financial developments were favourable overall, although the deterioration since end-March due to a fresh bout of instability associated with the European sovereign crisis partially reversed the earlier advances. Up to that time the financial markets posted a notable improvement, reflected in lower volatility, which took them back up to the levels prior to the Lehman Brothers bankruptcy. Also noteworthy was the rise in US long-term bond yields (which has reversed in the past month) and the surge in oil prices up to the beginning of March. On the economic front, growth steadied at moderate levels in the USA and improved somewhat in Japan, while the emerging economies held on a gradually slowing course, which was steeper in eastern Europe. Against this background, during the quarter the central banks of the United States, the United Kingdom and Japan took new measures to assist the recovery, while the monetary policies of emerging countries continued their accommodative stance, somewhat milder than expected at the beginning of the year, with the notable exception of Brazil, where interest rate cuts were more marked.

Despite the persistence of the sovereign debt crisis in Europe, the international financial markets ended 2012 Q1 with a certain improvement in the main indicators as a result of the good reception afforded to the European Central Bank's longer-term refinancing operations (LTROs) in December and February and of the publication of positive macroeconomic data in some advanced economies. The re-awakening of the appetite for risk was reflected in stock market gains, accompanied by lower volatility, and in the depreciation of the dollar against the main currencies except for the yen. However, the current situation of the markets remains fragile and in the past month these movements have been partially corrected amidst a fresh outbreak of instability associated with the European crisis and feeding off worse-than-expected economic data in the United States and China, which stimulated a fresh flight to quality. In this line, the 10-year interest rate in the United States, which rose to nearly 2.4% at the beginning of the quarter, coinciding with an improvement in domestic growth expectations, again approached 2% at the beginning of April. The emerging markets were also more buoyant, both in prices, with stock market gains and sovereign spread falls, and in volumes, with a strong recovery in flows to emerging economies (see Box 1) and in debt securities issued, which set a new record high in the quarter. However, as in the markets of the advanced economies, this positive trend was partly corrected from end-March. Meanwhile, industrial metal and oil prices on the commodity markets rose in the quarter. The price of Brent oil moved above US\$ 125 per barrel in February and since then has dropped slightly to around US\$ 120.

In the United States, GDP posted annualised quarterly growth of 3% (1.6% year-on-year) in Q4, driven basically by private consumption and stockbuilding, with negative contributions from external demand and public expenditure. The Q1 indicators continue to point to a moderate recovery. Industrial production, capacity utilisation and business confidence improved in the quarter as a whole, although they weakened somewhat as it drew to a close. The indicators of consumption remain firm, although the decrease in real disposable income casts some doubt on its strength. The information on the labour market points to a firming of the recovery in this market (although the March data weakened this signal), with an increase in the rate of net job creation and a reduction in the unemployment rate to 8.2%. In the housing market, the overhang of unsold housing decreased, spurred by the ongoing adjustment of house prices and by the improving labour market, despite the tight credit conditions. Inflation moderated to 2.7% year-on-year in March, while core inflation continued at 2.3%. The Federal Reserve maintained its expansionary monetary policy stance and changed its communication strategy

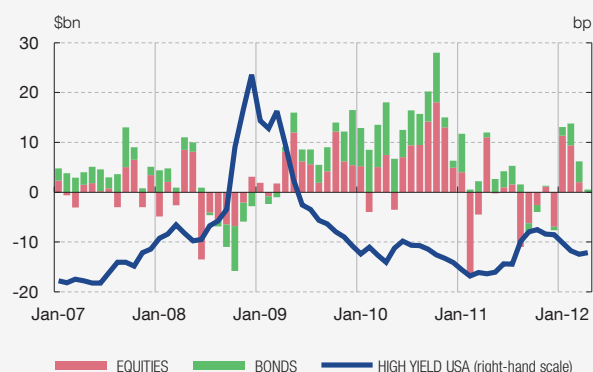
Capital flows to the emerging economies have been highly volatile since the crisis, with phases of net inflows alternating sharply with phases of net outflows (see left-hand panel of Chart 1). In particular, in 2011 capital flows showed a negative behaviour. At the beginning of the year, the improved growth outlook in the developed economies gave rise to outflows of funds from the stock market and to smaller inflows into the debt markets than in previous years. Subsequently, owing to the financial tensions during the summer, there was a retraction in flows (including also fixed-income flows) of an amount similar to that seen following the September 2008 crisis. However, since December inflows have picked up strongly, and in 2012 Q1 inflows into the debt market amounted to nearly US\$ 10 bn and those channelled to the stock market to nearly US\$ 23 bn, representing nearly 20% of the total flows received in 2010, when the all-time record was set. This behaviour is closely linked to the perception of global risk on the international markets –as reflected, for example, in

US high-yield bond interest rates– and is obvious in the contrast between the second half of last year and the beginning of this year.

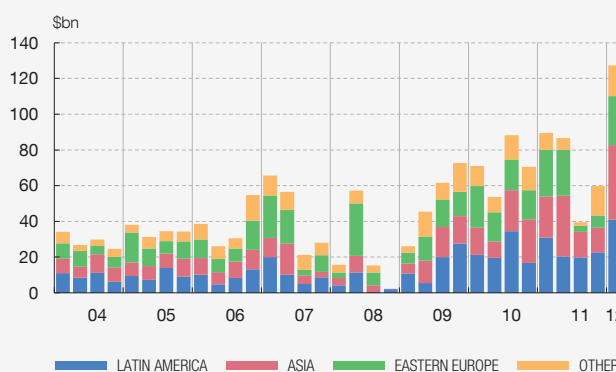
The intensity of the recovery of the appetite for risk at the beginning of 2012 is also reflected in the volume of corporate and sovereign debt securities issued by emerging economies. As seen in the right-hand panel of Chart 1, issues exceeded US\$ 125 bn in the quarter, a new historical record for transactions of this type, in which all the regions shared more or less equally. Also notable was the access of firmly-entrenched companies to new markets (*dim-sum* in yuan), the two largest issues of emerging countries –the Brazilian oil company Petrobras and Russia, each for an amount of US\$ 7 bn– and an increase in the companies accessing these markets for the first time. However, despite the sharp increase in securities issues, investors were somewhat more cautious than at other times of large-scale placements. Thus, firstly, sovereign bond issues –which, in principle,

1 INFLOWS TO EMERGING ECONOMIES

FUNDS TO EMERGING MARKETS



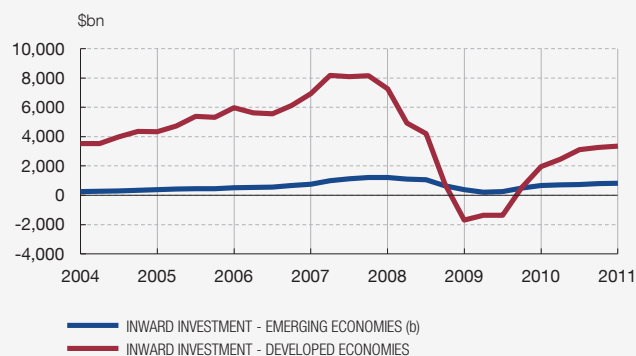
EMERGING ECONOMIES FIXED INCOME ISSUANCE



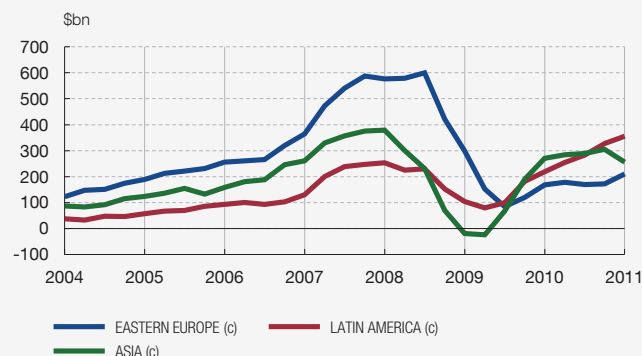
SOURCES: Dealogic, Datastream and IIF.

2 FINANCIAL INFLOWS

FINANCIAL INFLOWS - EMERGING AND DEVELOPED ECONOMIES (a)



FINANCIAL INFLOWS INTO EMERGING ECONOMIES BY AREA (a)



SOURCES: International Financial Statistics (IMF).

- a Cumulative annual figures, quarterly data.
- b Emerging economies do not include China.
- c Sample of countries from the region. Asia does not include China.

represent a lower risk than corporate bonds— amounted to one-third of the total, somewhat more than the long-term average; and secondly, corporate issues were predominantly those of companies with a fairly high credit rating.

Although these developments correlate with the changing risk aversion of recent years, from a broader standpoint, it can be argued that the determinants of capital flows favour a trend increase in emerging country inflows. Firstly, the relative risk-return relationship between emerging and advanced economies has changed substantially in favour of the former; the vulnerabilities and growth difficulties in advanced economies contrast with the generally fairly solid fundamentals and the notably more favourable growth prospects of emerging economies. Secondly, in response to the crisis, the monetary policies of the developed economies have been extraordinarily expansionary and the related large liquidity injections hasten the transfer of flows to emerging economies.

The size of these changes is reflected in the behaviour of gross capital flows. The left-hand panel of Chart 2 shows capital inflows into developed and emerging economies from 2004 to the beginning of 2011.¹ In 2007 the developed economies received US\$ 8 trillion annually, following sharp growth from the start of the century, particularly in the years before the crisis (at an annual rate exceeding 30%). The flows to emerging economies, at around US\$ 1.2 trillion, accounted for a much lower share, although they were growing at an even faster rate (up five-fold since 2004). The financial crisis initiated in summer 2007 brought this to a halt and then prompted a sharp adjustment of capital flows, which became considerably negative in the developed economies (disinvestments exceeded investments)

¹ The sample used in each group is large, although (due to a lack of quarterly data) some major countries, such as China, are not included. Data are gross, i.e. they are aggregate annual inflows into each country (flows between countries are not netted off) and therefore indicate the level of financial integration of each group. The figures are cumulative annual flows, with a quarterly frequency.

and were checked in the emerging economies. Yet more notable was the difference in the pattern of recovery. Whereas the developed countries levelled off at below US\$ 4 trillion at the beginning of last year (a decrease of more than half with respect to the previous peak), the emerging economies were drawing near to US\$ 1 trillion, one-third less than before the crisis, but growing. Hence the difference between the flows to emerging and to developed countries is decreasing notably.

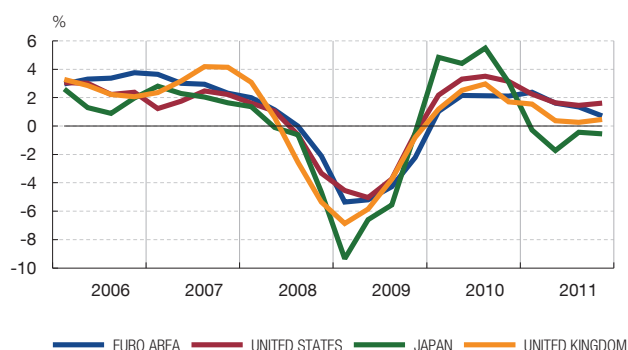
The recovery of the emerging economies as a whole conceals significant differences between regions, depending on the impact of the crisis. The right-hand panel of Chart 2 shows that the eastern European economies, which were harder hit by the crisis and continue to be more highly exposed because of their proximity to the euro area, saw a greater decline in their inflows, from which they have scarcely recovered. By contrast, the Latin American countries have amply exceeded the level of inflows before the crisis and posted a new record high at the beginning of 2012. The sample of Asian countries (excluding China) is in an intermediate position: flows turned negative at the beginning of 2009, and, although recovering strongly, have not regained their previous levels.

In short, the crisis brought a regression and notable rearrangement in the process of international financial integration. Whereas the flows to (and between) developed economies have fallen notably, some emerging economies—particularly Latin America—continue to increase their financial integration. It is difficult to assess the extent to which these changes are structural or are the result of an overly rapid integration during the years preceding the crisis in the advanced economies (fuelled, for example, by the proliferation of complex financial products), or involve a downward over-reaction in a setting of crisis, readjustment and uncertainty. Unquestionably, these latter factors have also shaped the recent behaviour of flows to emerging economies. Nevertheless, this group of countries continues to make progress in international financial integration, in many cases thanks to the relative strength of their fundamentals.

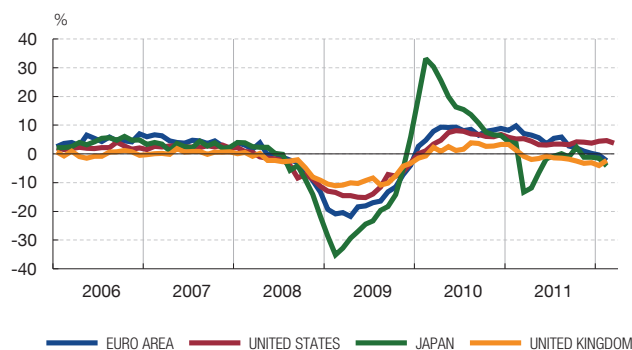
by setting a numerical long-term inflation target—for the personal consumption expenditure deflator— of 2% and publishing the forecasts for the official rate, which are for it to remain at its current level until 2014. Notable in the fiscal arena are the agreement to extend certain fiscal aid to the end of 2012 and the submission of the draft budget law for 2013.

In Japan, GDP contracted by 0.2% quarter-on-quarter (-0.6% year-on-year) in Q4 due to the negative contribution from external demand and inventories, while private domestic demand held on its expansionary path. The higher-frequency indicators, such as industrial production and the business confidence surveys, indicate that activity recovered in Q1, although doubts persist as to the dynamism of external demand. On the demand side, consumption performed fairly strongly, partly because car purchases were boosted by government subsidies, and investment in housing began to rise, underpinned by reconstruction-driven demand. On the external front, the trade balance remained in deficit during the quarter, despite the incipient

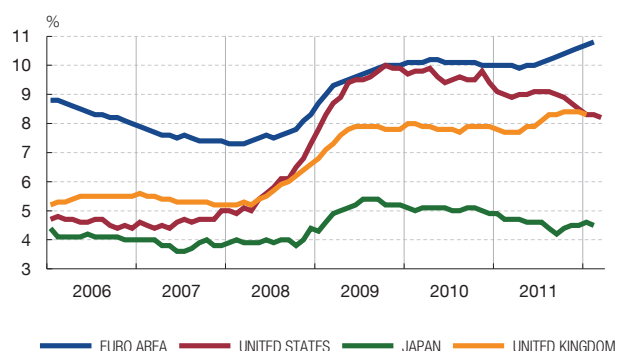
GROSS DOMESTIC PRODUCT
Year-on-year rate



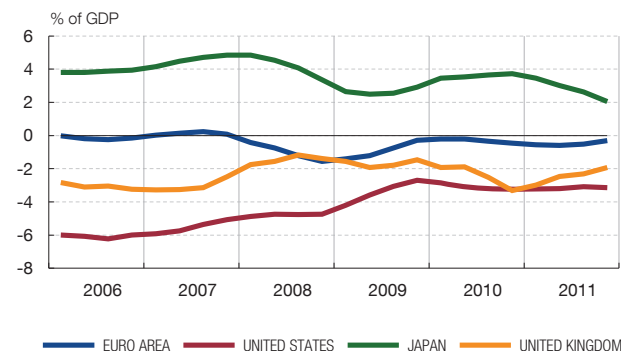
INDUSTRIAL PRODUCTION
Year-on-year rate



UNEMPLOYMENT (a)



CURRENT ACCOUNT BALANCE



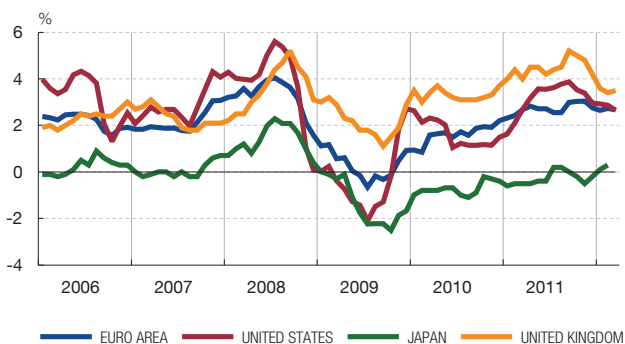
SOURCES: Datastream and Banco de España.

a Percentage of labour force.

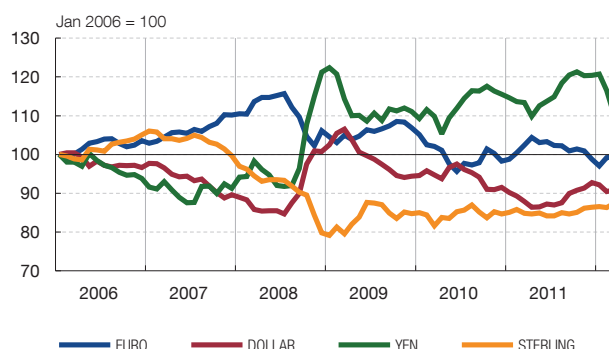
improvement in exports. In the labour market, the unemployment rate stood at around 4.5% during the quarter, after a recovery in employment and in the labour force. Inflation stood at 0.3% year-on-year in February, while the core rate declined more slowly at -0.6% year-on-year. The Bank of Japan held its official interest rate in the 0-0.1% range, expanded its asset purchase programme to 30 trillion yen (equivalent to 6.4% of GDP) and fixed its long-term price stability target at 1% on average.

In the United Kingdom, GDP contracted in Q4 by 0.3% quarter-on-quarter (0.5% year-on-year) because of the negative contribution from the changes in inventories. The higher-frequency indicators for Q1 give varying signals. The business confidence indicators indicate a wide-spread expansion of activity across sectors, which in manufacturing has not been confirmed by the industrial production data. Retail sales fell in February after two months of rises, and consumer confidence followed suit in March. The labour market continues to show weakness, since the unemployment rate remained close to 8.3% in February, wages were moderating, and the level of employment, in spite of its recent pick-up, continues to be burdened by the public sector job losses. Inflation moderated over the quarter to 3.5% in March and the core rate dropped to 2.5%, although inflationary pressure is beginning to build up in industrial prices. The Bank of England held its official rate at 0.5% and expanded its asset purchase programme by 50 billion pounds to 325 billion pounds. Finally, in March the government submitted an austere budget for fiscal year 2012/2013, in line with its commitment to fiscal consolidation.

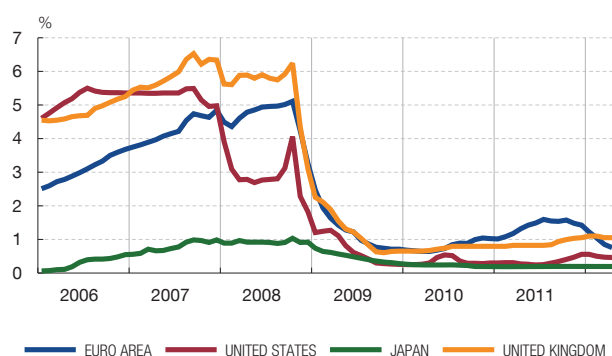
CONSUMER PRICES
Year-on-year rate



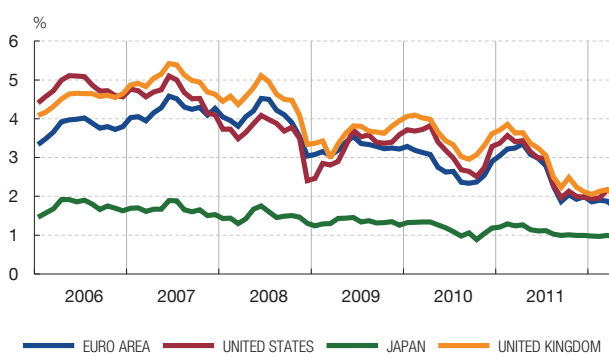
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES



SHORT-TERM INTEREST RATES (a)



LONG-TERM INTEREST RATES (b)

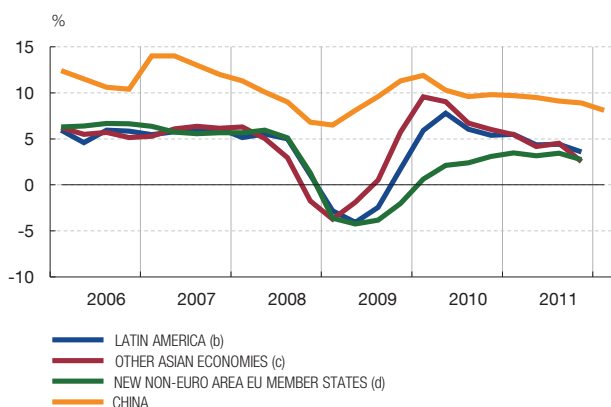


SOURCES: Datastream and Banco de España.

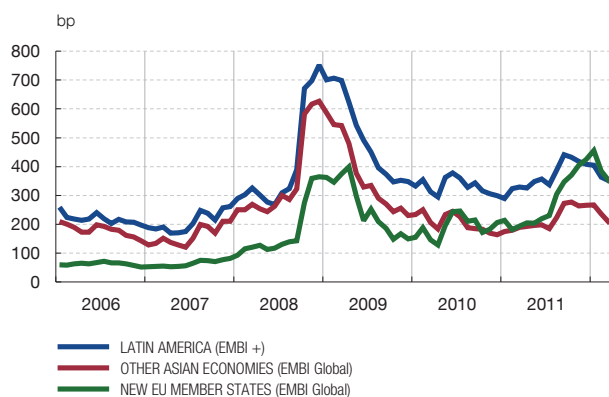
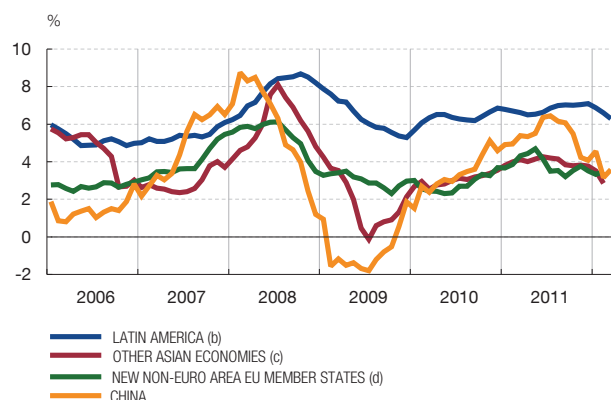
- a Three-month interbank market interest rates.
- b Ten-year government debt yields.

In the new EU Member States not belonging to the euro area, GDP grew on average by 2.8% year-on-year in 2011 Q4, down from 3.4% in Q3. The slowdown was widespread, with the most notable quarter-on-quarter contractions being in Romania and the Czech Republic (in the latter, for the second consecutive quarter). The most recent industrial production data point to a fresh moderation of activity in the opening months of 2012. Inflation in the region increased in the first two months of the year, mainly as a result of the higher tax rates in the Czech Republic and Hungary. The central banks held their official rates unchanged, with the exception of Romania, which trimmed them by 50 bp to 5.25% against a background of economic weakness and low inflation. Finally, mention should be made of the European Council's decision to suspend the grant of around €500 million (equivalent to 0.5% of GDP) by the Cohesion Fund to Hungary because of the lack of an effective commitment by its government to reducing the deficit.

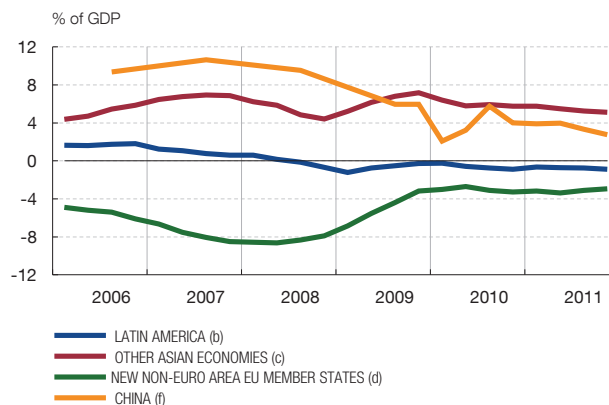
In China, GDP for 2012 Q1 increased by 8.1% year-on-year (compared with 9.1% in the previous quarter), the smallest rise in the last three years, evidencing an intensification of the moderating trend in growth, which continues to be based mainly on the strength of domestic demand, since external demand continued its adjustment, largely because of the fall in exports to Europe. The inflation rate continued its gradual decline during the quarter (with a certain resurgence in March) to 3.6%, due to the increase in food prices, although remaining below the target for 2012 (4%). Against a background of downside risk for growth, due to the slug-

GROSS DOMESTIC PRODUCT
Year-on-year rate

INTEREST RATE SPREADS OVER THE DOLLAR (e)

CONSUMER PRICES
Year-on-year rate

CURRENT ACCOUNT BALANCE



SOURCES: Datastream, Banco de España, IMF and JP Morgan.

- a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d Poland, Hungary, Czech Republic, Slovak Republic, 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, Irak, 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.

gish external demand and the lower activity in the real estate market, the central bank reduced the commercial bank reserve requirement by 50 bp (to 2 pp in some cases); it also doubled the daily fluctuation band of the yuan to 1%. Finally, the government reduced the official GDP growth target for 2012 to 7.5%, compared with the 8% in place since 2005, although this figure has been systematically exceeded. In the other emerging Asian economies, year-on-year GDP growth slowed to 4.3% year-on-year in 2011 Q4. The January and February industrial production figures suggest a prolongation of this moderation in activity. Also, in 2012 Q1 the gentle decrease in year-on-year inflation continued in most countries in the area, although it rose in India in February and in Thailand and Indonesia in March owing to higher food and energy prices. Official rates decreased in India, Thailand and the Philippines, and monetary policy stance remained unchanged in the rest of the region.

In Latin America, GDP grew by 0.6% quarter-on-quarter because of less dynamic activity in Mexico, Argentina and Brazil, confirming the decelerating trend first seen in the previous quar-

ter and contrasting with the strength shown in 2011 H1. In year-on-year terms, growth was 3.6%, compared with 4.4% in the previous quarter. However, the higher-frequency indicators for 2012 Q1 suggest a certain recovery in activity. Meanwhile, inflation in the area showed an appreciable correction to 6.2% year-on-year in Q1, compared with 7.1% in the previous quarter. In the monetary policy arena, the Chilean central bank unexpectedly cut official interest rates by 25 bp to 5% in January and held them unchanged in subsequent meetings in view of the dynamism of domestic demand. In Brazil, the central bank continued the cycle of cuts in the official rate, which it reduced by a total of 200 bp to 9%. In Colombia the upward cycle continued until February, being interrupted in March. On the fiscal side, the Brazilian government announced an industrial investment stimulus plan which includes selective tax cuts and an injection of funds into the Brazilian Development Bank (BNDES) equivalent to 1% of GDP. Lastly, in Argentina the reform of the Convertibility Law and of the central bank Charter, which broadens the scope of the financing which the central bank can grant to the Treasury and allows a more discretionary use of international reserves; the central bank's objectives have been broadened beyond monetary stability and it has been afforded a bigger role in directing credit to certain activities. Also, the progressive withdrawal of many of YPF's operating licences by various Argentinean provinces culminated in the Argentinean government sending to Congress a draft law to expropriate from Repsol 51% of the capital of YPF (Repsol held 57.43%) and the seizure of control of the company by Decree (*Decreto de Necesidad de Urgencia*). The amount of compensation and the source of the funds for paying it are not known.

3 THE EURO AREA AND THE MONETARY POLICY OF THE EUROPEAN CENTRAL BANK

In 2012 Q1 there was a slight easing of the financial tensions which had affected the euro area particularly strongly in the second half of 2011. The relief was reflected in the performance of most financial indicators, although it was manifested most clearly in the improvement in the conditions for banks' access to financing, which reduced the risk of a credit crunch in the euro area as a whole (see Box 3). The standard and non-standard monetary policy measures adopted by the ECB in the closing months of 2011 and, in particular, the two three-year longer-term refinancing operations, the approval of the second programme of assistance for Greece following the successful restructuring of its debt to the private sector, and progress in the design of economic governance of the area represented important steps for restoring confidence. However, the situation remains unstable as shown by the fresh outbreak of tensions in April which have affected Spain and Italy in particular, as a result of uncertainty about the adjustment processes in which these economies are currently immersed.

Against this backdrop, the performance of the economic indicators published most recently points to a stagnation or a slight contraction of the area's activity in 2012 Q1. More in the medium term, the projections published by various international organisations and private analysts coincide in anticipating a slightly negative growth rate of GDP for 2012 as a whole which is compatible with a gradual recovery in the second half of the year that is estimated to be driven by the positive impact of low interest rates, the measures adopted on various fronts to restore the normal functioning of the financial system and to recover agents' confidence, and stronger world trade. However, this baseline scenario is surrounded by great uncertainty and downside risks prevail associated with a renewed intensification of tensions in the sovereign debt market and with a potential increase in commodity prices.

Inflation in the euro area is likely to remain at above 2% until the beginning of 2013, driven mainly by higher energy prices and the rises in indirect taxes. More in the medium term, as a result of modest growth in the euro area underlying inflationary tensions are not anticipated in a context in which long-term inflation expectations remain well-anchored at levels consistent with the price stability objective. Deeming that the risks in respect of this objective are balanced over the appropriate monetary policy horizon, the Governing Council of the ECB left interest rates unchanged at its February, March and April meetings.

The European Union has continued to take steps to reform governance of the euro area and to strengthen the crisis management and resolution mechanisms created during the current crisis. On 2 March 2012, 25 Member States signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, including the fiscal compact, whereby they undertook to transfer to their national legal frameworks a stricter balanced budget rule, than the existing one in the Stability and Growth Pact, which favours equilibrium in public finances throughout the cycle. The Treaty will foreseeably come into force on 1 March 2013, when at least 12 of the 17 Member States of the euro area will have ratified it. Along these lines of strengthening the surveillance function, on 14 February 2012 the Commission presented its first annual *Alert Mechanism Report*. The alert mechanism is designed to detect and correct risk situations in the macroeconomic sphere and will give rise in coming months to an in-depth revision by the Commission of the countries

	2010		2011				2012	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.4	0.3	0.7	0.1	0.1	-0.3		
Private consumption	0.3	0.4	0.0	-0.5	0.2	-0.5		
Government consumption	0.1	0.1	0.0	0.0	-0.2	-0.3		
GFCF	0.1	-0.5	1.6	-0.2	-0.2	-0.5		
Imports	1.6	1.5	0.7	0.4	0.7	-1.4		
Exports	2.1	1.5	1.3	1.2	1.4	-0.4		
Contributions to quarter-on-quarter change in GDP (pp)								
Domestic demand, excluding stocks	0.2	0.2	0.3	-0.3	0.0	-0.4		
Stockbuilding	-0.1	0.1	0.1	0.1	-0.2	-0.3		
Net foreign demand	0.3	0.1	0.3	0.4	0.4	0.4		
GDP (year-on-year rate of change)	2.1	2.1	2.4	1.6	1.3	0.7		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working day adjusted	0.8	1.8	1.1	0.2	0.7	-2.0	-0.6	
Economic sentiment	101.9	105.3	106.9	105.2	98.4	93.6	94.1	
Composite PMI	55.7	54.9	57.6	55.6	50.3	47.2	49.6	
Employment	0.0	0.2	0.0	0.2	-0.2	-0.2		
Unemployment rate	10.1	10.1	10.0	10.0	10.2	10.5	10.8	
PRICE INDICATORS (year-on-year change in end-period data)								
HICP	1.9	2.2	2.7	2.7	3.0	2.7	2.7	
PPI	4.3	5.4	6.8	5.9	5.8	4.3	3.6	
Oil price (USD value)	78.4	92.3	115.4	114.9	114.8	108.7	126.8	121.6
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	3.5	4.1	4.6	4.4	4.0	4.1	3.3	3.4
US-euro area ten-year bond spread	-1.01	-0.78	-1.14	-1.30	-2.06	-2.17	-1.12	-1.39
Dollar/euro exchange rate	1.365	1.336	1.421	1.445	1.350	1.294	1.336	1.309
Appreciation/ depreciation of the NEER-20 (b)	-6.3	-8.2	3.4	3.7	0.7	-2.1	0.9	-0.4
Dow Jones EURO STOXX 50 index (b)	-7.4	-5.8	4.2	2.0	-22.0	-17.1	6.9	-1.4

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

a Information to 19 April 2012.

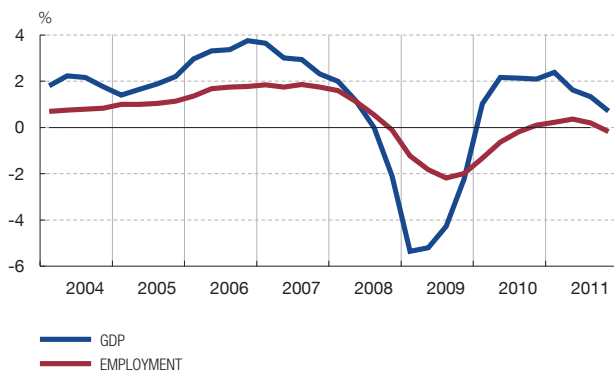
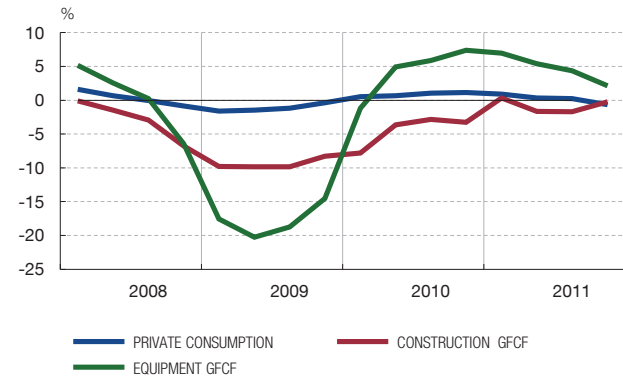
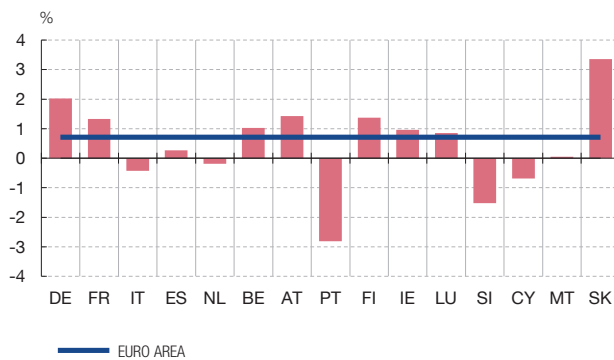
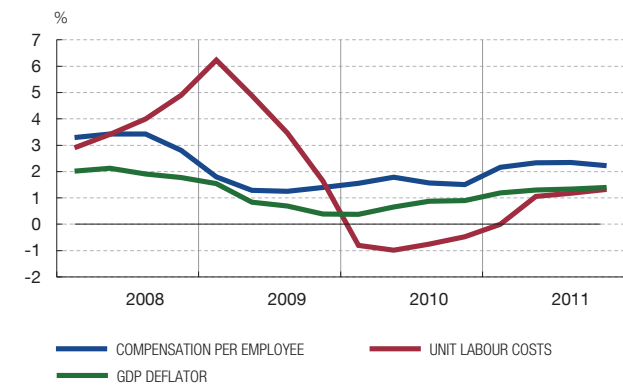
b Percentage change in year to date.

identified. On 30 March 2012, the Eurogroup decided to strengthen the lending capacity of the current crisis management mechanisms (see Box 2).

On the fiscal front, the widespread deterioration of public finances during the crisis has made fiscal consolidation the top priority of economic policy in those countries which have experienced greater difficulties. In a setting in which the adjustments required are highly substantial in several cases, it is essential that the measures to be implemented are designed with a view to ensuring the long-term growth capacity of the economies at the same time as attempts are made to minimise their inevitable short-term effects. The European Council meeting in March set out the strategy in this respect.

3.1 Economic developments

On euro area National Accounts data, GDP declined 0.3% in 2011 Q4, after having increased by 0.1% three months earlier; it thus decelerated sharply in the second half of 2011 (see Table 1). The contraction affected all domestic demand components, whereas net external demand made a positive contribution to GDP as a result of exports falling less than imports. Against this backdrop, employment was a further 0.2% down on the previous

OUTPUT AND EMPLOYMENT
(Year-on-year growth)PRIVATE CONSUMPTION AND INVESTMENT
(Year-on-year growth)YEAR-ON-YEAR GROWTH RATES OF GDP
2011 Q4WAGES AND COSTS
Year-on-year growth

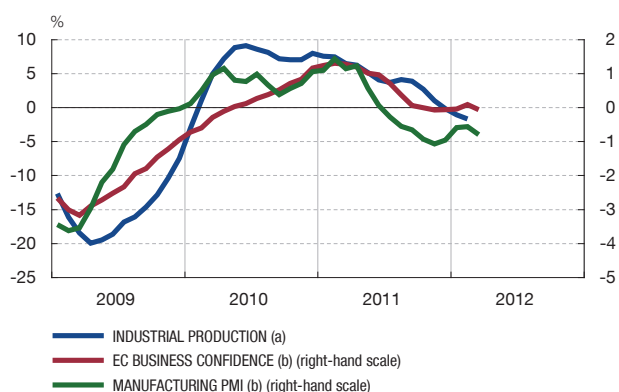
SOURCES: Eurostat and national statistics.

quarter which resulted in the first negative year-on-year rate of change since 2010 (see Chart 8). The decline in GDP was widespread among the large euro area countries except for France which posted moderate growth. For the year on average, the area as a whole grew by 1.5% (1.9% in 2010) although the cross-country differences were striking: Germany and Austria performed robustly, as did France to a lesser degree, while dynamism in Spain and Italy was muted and the countries under programmes, especially Greece and Portugal, were in recession.

The latest conjunctural information suggests there are some signs of activity stabilising at a low level (see Chart 9). On the supply side, industrial production increased slightly in January and February, but new industrial orders remained very weak at the beginning of 2012. The confidence indicators compiled by the European Commission and those based on surveys of purchasing managers in industry and services held at levels below the theoretical threshold for growth, after rising in Q1 as a whole, and slipping slightly in March. Construction, despite the slight improvements with respect to Q4, remained extremely weak. As for employment, the indicators of job creation expectations in industry and services slightly stemmed the decline posted in the previous quarter, while the unemployment rate rose again by 0.1 pp in February to 10.8%.

On the demand side, consumption indicators showed considerable weakness similar to that in the closing months of 2011. Thus, the improvements in retail sales at the beginning

INDUSTRIAL ACTIVITY INDICATORS



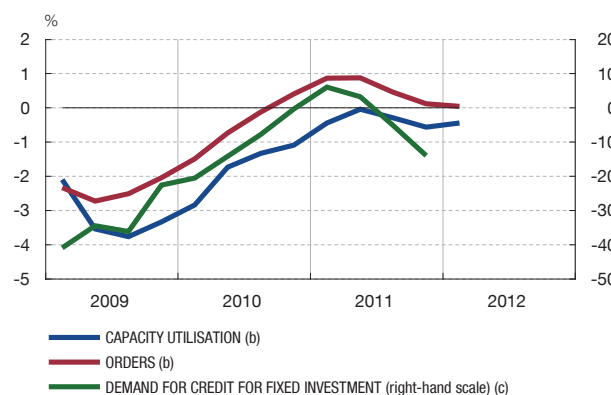
SERVICES SECTOR INDICATORS



CONSUMPTION INDICATORS



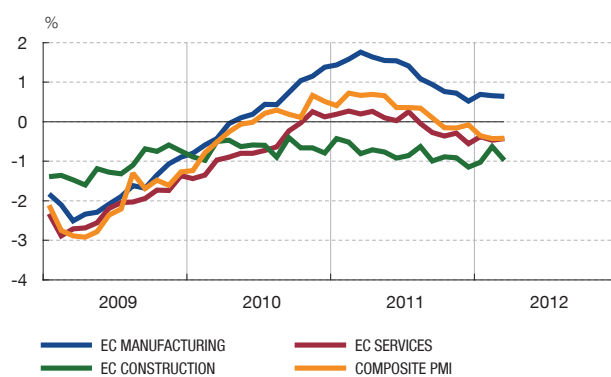
INVESTMENT INDICATORS



EXPORT INDICATORS



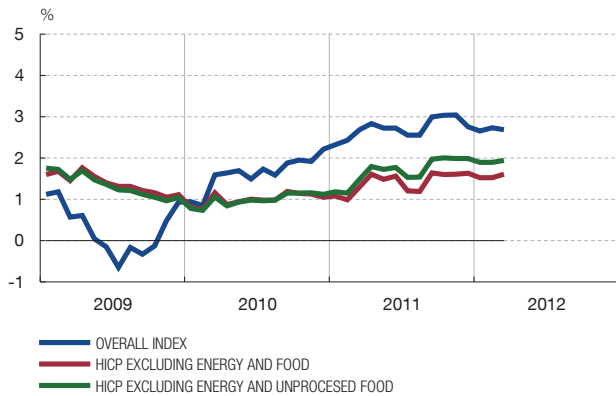
EMPLOYMENT EXPECTATIONS INDICATORS (b)



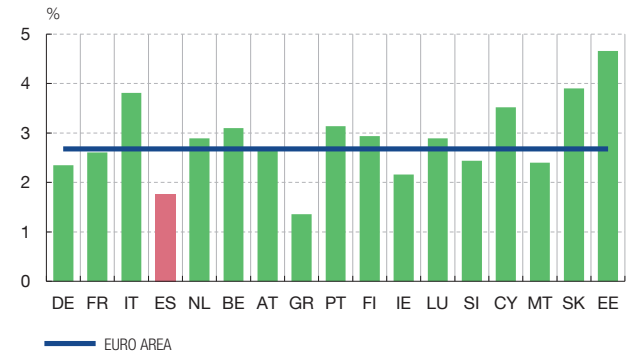
SOURCES: European Commission, Eurostat and Markit Economics.

- a Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
- b Normalised data.
- c Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase × 0.5 – percentage of banks reporting some decrease × 0.5 – percentage of banks reporting a considerable decrease. A positive value denotes an increase.
- d Year-on-year rates of the original series. Quarterly average.

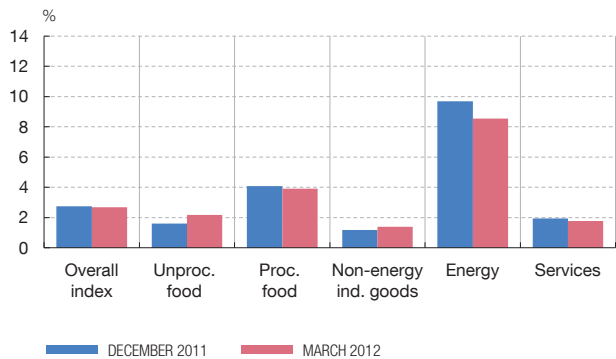
HARMONISED INDICES OF CONSUMER PRICES



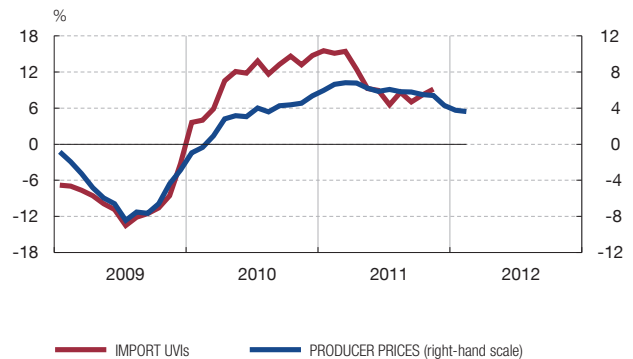
OVERALL HICP (March 2012)



HICP AND ITS COMPONENTS



OTHER PRICE INDICATORS



SOURCES: Eurostat and ECB.

of the year were not consolidated in February and consumer confidence remained below its historic average. New car registrations and the readiness to buy durable goods remained very depressed over the quarter. In general, weak real income, as a result of the fragile labour market and the increase in inflation, is dampening any boost from private consumption to GDP growth. Against a backdrop in which several euro area countries are making considerable efforts in fiscal consolidation, government consumption and investment will not foreseeably become stronger either. As for private investment indicators, whose performance seems to be highly conditioned by the behaviour of external demand, although capacity utilisation held below its historical average, it rose slightly following the break seen from mid-2011 and quarterly average orders deteriorated further. Lastly, there was some positive data from the trade balance which suggests that exports increased for the period January-March in line with stronger world trade. An indication of that, is the trade surplus recorded in February. Export expectations gained strength at the beginning of the year, although export orders remained lacklustre, following the poor results in the closing months of the year.

In short, the available indicators point to a stagnation or slight contraction of GDP in the euro area in the first quarter of the year (see Table 1). More in the medium term, the most recent projections published by various international agencies and private analysts maintain a baseline scenario of a mild recession in 2012 overall, which is consistent with a slight

	2012		2013	
	GDP	HICP	GDP	HICP
ECB (March 2012)	-0.5-0.3	2.1-2.7	0.0-2.2	0.9-2.3
European Commission (February 2012)	-0.3	2.1	1.3	1.6
IMF (January 2012)	-0.5	1.5	0.8	1.7
OECD (November 2012)	0.2	1.6	1.4	1.2
Consensus Forecast (April 2011)	-0.4	2.3	0.9	1.7
Eurobarometer (April 2012)	-0.3	2.3	0.9	1.8

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

a Year-on-year rate of change.

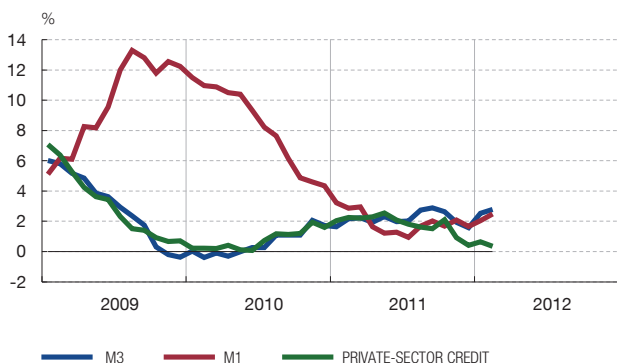
recovery in the second half of the year, boosted by the accommodative monetary policy stance, the deployment of a wide-ranging set of extraordinary measures adopted on different fronts to restore the normal functioning of the financial system and to improve confidence in the euro area along with stronger world trade. Conversely, the process of balance sheet adjustment in the financial and non-financial sectors and high unemployment in certain countries of the euro area may continue to act as a drag on the growth rate. Downside risks prevail around this baseline scenario, which are related in particular with the possible strains in euro area debt markets, their impact on credit conditions and the possibility that they might spread to the real economy, and – externally – to potential further rises in commodity prices.

HICP inflation in the euro area stood at 2.7% in March, coinciding with that recorded in the previous three months. This data was consistent with core inflation, measured by the CPI excluding unprocessed food and energy, which stabilised around 1.9% in 2012 Q1 (see Chart 10). In the short term inflation is likely to hold above 2% until the beginning of 2013, mainly due to recent increases in energy prices and tax rises. More in the medium term, however, the outlook indicates that it will be at levels that are consistent with price stability with risks broadly considered balanced (see Table 2). The long-term inflation expectations remain well-anchored at levels consistent with the price stability objective.

The euro area current account, according to estimates published by the ECB, built up a deficit of €16 billion (1% of euro area GDP) between January and February 2012, down on the shortfall of €22.3 billion (1.5% of GDP) seen in the same period of the previous year. This improvement was the result, with the exception of the services balance whose surplus decreased slightly, of the more favourable performance of the other components. As for the financial account during the same period, net capital outflows in the form of direct investment rose to €11.7 billion compared with €32.4 billion recorded between January and February 2011, while there was a net outflow of portfolio investment of €25.3 billion against inflows of €63.2 billion in the same period of the previous year. Consequently, the negative basic balance, which combines these two types of investment with the current account balance, increased to €53 billion following a surplus of €8.5 billion recorded between January and February 2011 (see Chart 11).

According to the measures included in the budgets, the fiscal policy stance for 2012 will remain markedly tight, it is envisaged that the public deficit will decline again for the area as a whole and that public debt will build up more slowly (see Table 3). In particular, on the

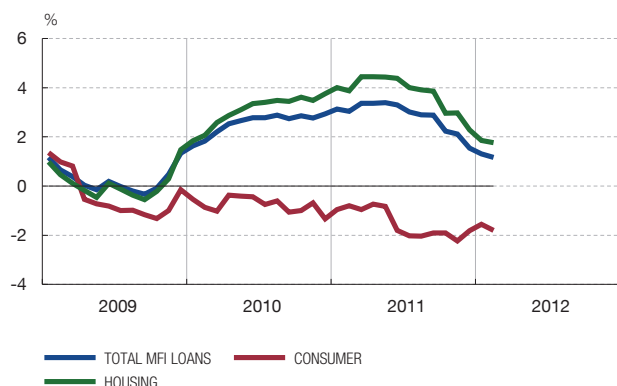
MONETARY AND CREDIT AGGREGATES
Year-on-year growth



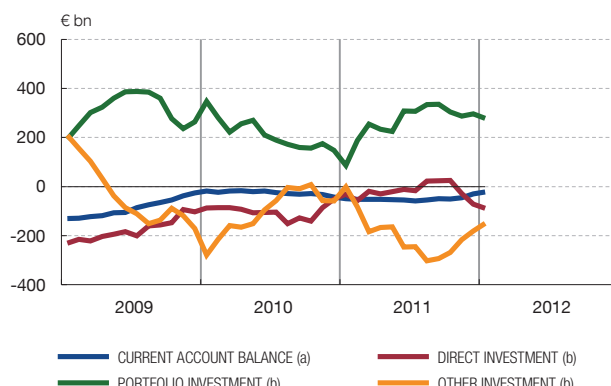
FINANCING OF NON-FINANCIAL CORPORATIONS
Year-on-year growth



FINANCING OF HOUSEHOLDS
Year-on-year growth



BALANCE OF PAYMENTS
Cumulative amounts for the last twelve months



SOURCES: ECB and Banco de España.

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

European Commission's projections of Autumn 2011, the deficit stood at 4.1% of GDP in 2011 and is expected to be 3.4% for 2012, while debt will climb to 90.4% this year. This aggregate performance conceals notable differences between euro area countries. In Greece the new programme anticipates a reduction of 2 pp in the deficit in 2012 to 7.3% of GDP, based on adjustments in spending on drugs, pensions, public investment and defence. For its part, in Portugal, the budget for 2012 includes new consolidation measures to bring the deficit to 4.5% of GDP, which include most notably a further cut to public wages and pensions. In Ireland, following the EU and IMF's positive assessment in the context of the financial assistance programme, more than half of the fiscal consolidation measures in 2012 involve spending cuts and the remainder include increases in VAT and certain administered prices. Likewise, the measures announced in Italy for this year include a pension reform and increases in indirect taxes to save 1.3 pp of GDP in 2012. By contrast, the general government finances in Germany were better than expected due to the favourable performance of revenue, whereas in France the government has approved a package of budget-neutral measures to support employment and competitiveness.

In April Member States must submit stability programmes which detail their medium-term budget plans to the European Commission. Countries against which an excessive deficit procedure has been initiated, which currently includes all EU countries except for Finland,

% of GDP

	2009		2010		2011		2012	
			EDP (b)	EC (d)	IMF (c)	EDP (b)	EC (d)	IMF (c)
Belgium	-5.8	-4.1	-3.6	-3.5	-3.5	-4.6	-3.4	
Germany	-3.2	-4.3	-1.3	-1.7	-1.3	-1.0	-1.1	
Estonia	-2.0	0.2	0.8	-0.1	0.2	-1.8	-2.3	
Ireland	-14.2	-31.3	-10.3	-10.3	-10.0	-8.6	-8.6	
Greece	-15.8	-10.6	-8.9	-8.0	-8.6	-7.0	-6.9	
Spain	-11.2	-9.3	-6.6	-6.1	-6.0	-5.9	-5.2	
France	-7.5	-7.1	-5.8	-5.9	-5.7	-5.3	-4.6	
Italy	-5.4	-4.6	-4.0	-4.0	-3.9	-2.3	-2.4	
Cyprus	-6.1	-5.3	-6.7	-6.6	-6.5	-4.9	-4.5	
Luxembourg	-0.9	-1.1	-0.6	-0.7	-0.6	-1.1	-1.2	
Malta	-3.7	-3.6	-3.0	-2.9	-2.8	-3.5	-2.9	
Netherlands	-5.6	-5.1	-4.3	-3.8	-4.2	-3.1	-2.8	
Austria	-4.1	-4.4	-3.4	-3.5	-3.6	-3.1	-3.2	
Portugal	-10.1	-9.8	-5.8	-5.9	-5.9	-4.5	-4.5	
Slovenia	-6.1	-5.8	-5.7	-6.2	-5.5	-5.3	-4.7	
Slovakia	-8.0	-7.7	-5.8	-4.9	-5.8	-4.9	-3.8	
Finland	-2.5	-2.5	-1.0	-1.0	-1.1	-0.7	0.3	
MEMORANDUM ITEM: euro area								
Primary balance	-3.5		-1.3	-1.5		-0.3	-0.3	
Total balance	-6.4	-6.2	-4.3	-4.1	-4.0	-3.4	-3.1	
Public debt	79.3	85.6	88.0	88.6	87.6	90.4	90.0	

SOURCES: European Commission, Eurostat and IMF.

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

Luxembourg, Estonia and Sweden, also have to specify the measures which will be taken to correct them in the timeframe envisaged in each case.

Finally, in recent months steps have been taken to reform economic governance in the euro area reflecting member countries' greater commitment to moving towards increased coordination of national economic policies in keeping with the high degree of interdependence of their economies. In particular, following the signing on 2 March of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, which includes the fiscal compact that the Heads of State or Government had agreed upon on 9 December, the Member States undertook to introduce within one year, and preferably at constitutional level, a balanced budget rule and an automatic mechanism to take corrective action at national level. In practice, that means a strengthening of the budget rule above and beyond what had been agreed in the excessive deficit procedure within the SGP and considerable voluntary restraint of governments with respect to the debt and deficit criteria. The Treaty also contains the commitment to deepen economic coordination by institutionalising for this purpose specific euro area meetings. At the ECOFIN meeting of 21 February an important agreement was reached on the inclusion, foreseeably in summer of two new legislative proposals on budget supervision and greater surveillance of countries in the euro area. The first envisages aligning calen-

dars for the preparation of national budgets to be assessed at European level, prior to their definitive approval and the second envisages increasing the surveillance of countries with difficulties in terms of financial stability. Furthermore, on 14 February the Commission published its first report on the alert mechanism within the framework of the new macroeconomic imbalances procedure so that, leaving aside the countries with a financial assistance programme, twelve countries must be subject to an in-depth revision to determine whether they present imbalances which require further action. Lastly, the creation of the European Stability Mechanism has been brought forward by one year and on 30 March the suitability of a global ceiling was reassessed, and it was decided to raise it at the same time as an agreement was reached on speeding up outstanding capital payments (see Box 2).

Lastly, at the March meeting of the European Council, within the new framework of the European semester, strategies were established jointly to design the respective national economic and budgetary policies and the need to adopt structural reforms to revive growth and employment was underlined. In order to make fiscal consolidation compatible with a programme of economic and employment growth, different approaches were indicated which included most notably: the design of unemployment benefits which provide greater incentives to looking for work, the fight against tax evasion and tax fraud and reconciling budget restraint with maintaining investment in education, research and development and in innovation. Ways of improving competitiveness were analysed, underlining positive experiences such as lowering the fiscal burden on employment, particularly for lower incomes, opening up protected sectors such as professional services and retail trade, improving the business environment and reducing administrative barriers and extending e-government. The need to take full advantage of the Single Market was emphasised.

3.2 Monetary and financial developments

The easing of tensions on sovereign debt markets during 2012 Q1 was reflected across the board in financial markets which experienced lower volatility in asset prices in the period as a whole, better financing conditions in capital markets and a recovery in stock market indexes and the euro exchange rate. Nevertheless, in April there were once again bouts of instability in response to idiosyncratic factors which affected Italy, in particular, and Spain especially. More generally, in addition to the progress which had continued in the area of governance, there were two more specific factors which contributed to largely reversing the situation of grave financial instability which affected the area, as a whole, in the second half of 2011. Firstly, the ECB's monetary policy decisions and, in particular, the two three-year operations to inject liquidity in December 2011 and February 2012, were decisive in reducing the refinancing risks facing the area's banking system in the context of fragmentation of financial markets. And, secondly, as a result of the successful completion of the bond exchange agreement with private bondholders in order to reduce Greek public debt, in March the second EU/IMF aid programme for Greece was approved with €130 billion of funds for the period 2012-2015. Consequently, one of the greatest sources of uncertainty which was affecting the performance of financial markets was removed. Greek debt was finally restructured successfully with a haircut, in discounted present value terms, of close to 78% for private creditors, most of whom participated. Following the far-reaching measures adopted in December, during the early months of 2012, the Governing Council of the ECB maintained the expansionary stance of monetary policy since it considered that the risks to meeting the price stability target were balanced and that inflationary pressures in prices and wages were unlikely in the current context of economic weakness. Thus, the rate on main refinancing operations held at 1% and the rate on credit and deposit facilities was 0.25% and

The euro area sovereign debt crisis has prompted a far-reaching response from economic authorities which has required combining action both at national and euro-area level. At the level of the euro area, as a whole, action has centred in turn on two interdependent fronts: on one hand, strengthening the governance of the euro area, and on the other, creating crisis management and resolution mechanisms which were not envisaged in the Treaty in order to provide financial assistance to troubled Member States by incorporating some elements of solidarity and mutualisation of risks. With regard to the latter, the European authorities have established firstly, on a temporary basis, the European Financial Stability Facility (EFSF) and, then on a permanent footing, the European Stability Mechanism (ESM).

The negotiation process which led to the creation of the EFSF and the ESM has been protracted and difficult, since the design of these mechanisms raises the politically delicate questions of moral hazard and *ex ante* burden sharing rules that the materialisation of the financial risks assumed would involve. From the outset a consensus was reached that strict conditionality, based on ambitious programmes of fiscal consolidation and structural reforms to facilitate medium-term growth should be combined with sufficient financial power to provide the necessary resources, potentially of a high magnitude, when required by one or more countries. Conversely, it was some time before opinions converged on the relative weight which should be assigned to each of these components. The initial design of the EFSF tended to weight the former more with the result that this device seemed to have been conceived to tackle localised liquidity problems,

which would be resolved by extending loans on non-concessional terms. However, the increasingly systemic nature of the crisis underlined the need to increase its firepower, to make it function more flexibly and to moderate the conditions of financial assistance.

The process, which required amendments to the Treaty on the Functioning of the European Union, culminated in the signing of the Treaty establishing the European Stability Mechanism ("the Treaty") on 2 February 2012. The ESM, whose main characteristics are included in the table below, is structured as a supranational financial institution whose aim is to give financial assistance to those euro area countries which are experiencing or are threatened by serious financial difficulties, provided that doing so is essential to safeguarding the financial stability of the euro area as a whole. The Treaty will come into force once it has been ratified by euro area countries representing at least 90% of capital subscriptions which is expected to take place in July 2012.

This mechanism will have the operational flexibility granted to the EFSF at the summit of Heads of State or Government in July 2011. In particular, the ESM may grant precautionary financial assistance to resolve liquidity problems in countries with sound economic fundamentals, to purchase sovereign debt on primary and secondary markets, and to provide governments with loans for bank recapitalisations. The Treaty also envisages the possibility of leverage of the ESM. One substantial difference with respect to the EFSF is the ESM's capital structure which makes it sounder and more effective. In particular, compared

MAIN CHARACTERISTICS OF THE EUROPEAN STABILITY MECHANISM

Capital structure	Paid-in capital: €80 billion. It will be paid in 5 tranches: the first two in July and October 2012, the next two in 2013 and the last one in mid-2014. Callable capital: €620 billion.
Distribution by country of capital contributions	In proportion to their participating interest in the ECB with a temporary downward adjustment for lower-income countries.
Lending capacity	Maximum of €500 billion. The joint lending capacity of the ESM and EFSF is set at €700 billion. The rights, obligations and commitments of the EFSF will be transferred to the ESM until the former has been completely run down.
Financial assistance instruments	Loans. Precautionary credit lines. Loans extended specifically for recapitalisation of financial institutions. Purchase of bonds on primary and secondary markets.
Cost and term of financial assistance	The interest rate will be set so as to cover financial and operating costs and to ensure an appropriate margin. The term may be extended to 30 years.
Borrowing operations	The ESM may borrow on the capital markets from banks, financial institutions and other persons or institutions.
Main governing body	Council of Governors comprising the Ministers of Economy and Finance of ESM member countries.
Decision-making procedures	By mutual agreement of the Board of Governors, defined as the unanimity of the members participating in the vote, excluding abstentions. An emergency procedure is envisaged which will be used where the European Commission and the ECB consider that the financial assistance must be granted urgently. In this case decisions will be taken by a qualified majority of 85% of the votes.

SOURCE: European Commission.

with the former's cascade structure of guarantees, the existence of capital (both the initial paid-in capital and the additional callable capital) makes the ESM less vulnerable to the risk of a request for financial assistance from a Member State potentially unleashing successive downgrades of credit ratings of its members that ultimately result in the downgrade of the ESM's own credit rating.

The process whereby the ESM grants financial aid will begin with a request made by a Member State to the ESM's Board of Governors. The latter will entrust the Commission and the ECB to assess the risk to the financial stability of the euro area, the sustainability of the public finances of the country concerned and its actual and potential financing needs. On this basis, the ESM will decide whether it is necessary to provide financial assistance to the Member State. If so, it will entrust the Commission, in liaison with the ECB and, if appropriate, the IMF to negotiate and sign with the country a memorandum of understanding (MoU) that includes the conditions that must be met for the assistance to be granted. Finally, the ESM will approve the assistance agreement which will specify the financial aspects thereof.

The conditions included in the MoU will vary according to the severity of the difficulties faced by the country and also to the financial instrument used for the assistance to be granted. Thus, if the ESM's financial support is a loan, under the Treaty stricter conditionality in terms of economic policy must be established in the form of the implementation of a far-reaching programme of economic adjustment. Where other instruments of assistance are employed – credit lines, loans to recapitalise banks or bond

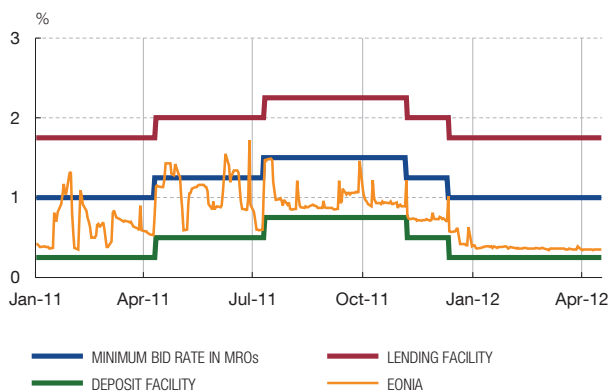
purchases – the conditionality will not necessarily be as stringent and may be limited to continuous compliance with certain criteria set out in the MoU. In any of these cases, the Treaty establishes as a requirement for the granting of assistance that as of 1 March 2013, the country assisted has ratified the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (known as the fiscal compact and which is one of the tools for strengthening governance in the euro area) and implemented the balanced budget rule included therein.

The ESM will cooperate closely with the IMF, seeking its active participation both at technical and financial level, as with the assistance programmes currently in force. The ESM will have preferred creditor status in respect of the financing granted, although the IMF will, in turn, enjoy seniority over the ESM. In accordance with IMF practice, the involvement of private creditors in the framework of aid programmes will be considered on a case-by-case basis so as to guarantee balanced burden sharing between the former and taxpayers. This involvement may take the form of voluntarily maintaining bond holdings of the country concerned or a renegotiation process of the payment conditions thereof. This process may include a moratorium, a lengthening of the maturity, a decrease of the interest rate or a partial default. In order to facilitate these negotiations, under the ESM Treaty "Collective Action Clauses" (CACs) must be included from 1 January 2013 in government securities with a maturity of more than one year issued by euro area countries, whereby any change to the conditions of the debt accepted by a specified majority of holders will be binding for all of them.

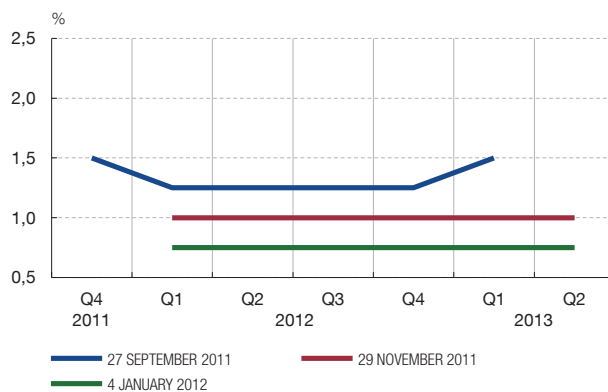
1.75%, respectively (see Chart 12). Furthermore, in February it approved specific national eligibility criteria for the temporary acceptance of additional credit claims as collateral. In February, 800 banks in total participated in the second three-year longer-term refinancing operation which was carried out with full allotment. This tender, together with the first one conducted on 21 December, contributed gross liquidity of slightly more than €1 trillion, or slightly more than €500 billion in net terms, aimed at overcoming the refinancing difficulties facing the banking system at end-2011.

The improvement in the financing conditions of banks was reflected, on one hand, by the increase in unsecured debt issuance in January and February and, on the other, by the fall in their short and long-term financing costs. Similarly, in government debt markets spreads over the German bund narrowed, initially across the board and ECB purchases within the Securities Market Programme were discontinued (see Chart 12). The initial easing was particularly sharp in Greece – following the debt restructuring – and more gradual in Italy, in line with progress made in fiscal policy and structural reforms. By contrast, the sovereign risk premium held relatively stable in Portugal, faced with doubts about the need to negotiate a second bailout, and in Spain. At end-March tensions suddenly flared up again

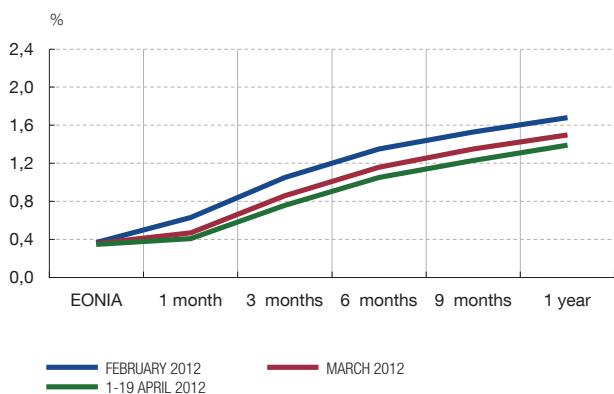
EONIA AND ECB INTEREST RATES



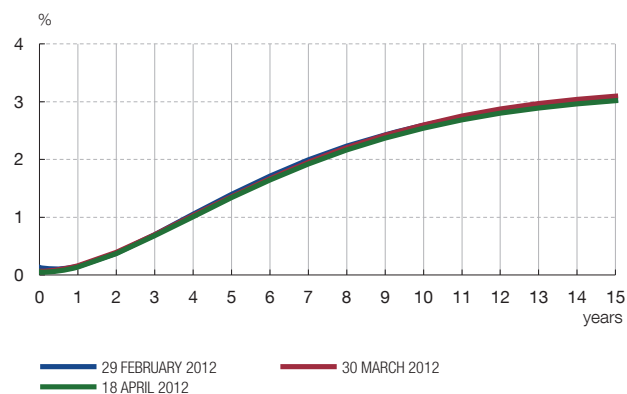
EXPECTED END-QUARTER ECB RATE. REUTERS SURVEYS



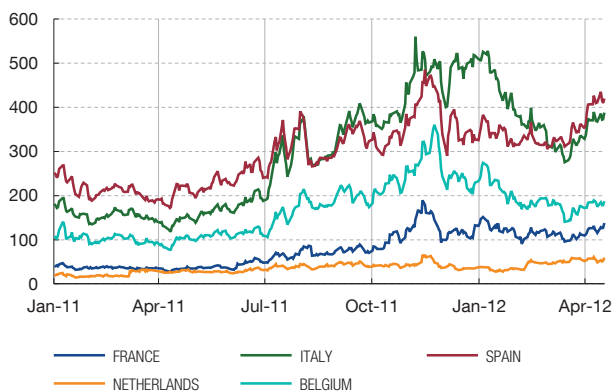
INTERBANK MARKET



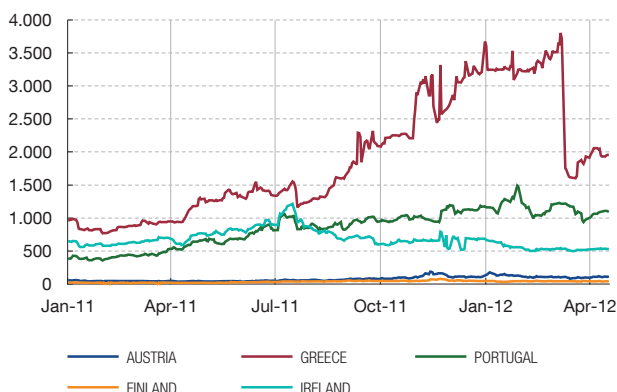
ZERO COUPON CURVE (a)



SOVEREIGN SPREADS OVER GERMANY



SOVEREIGN SPREADS OVER GERMANY



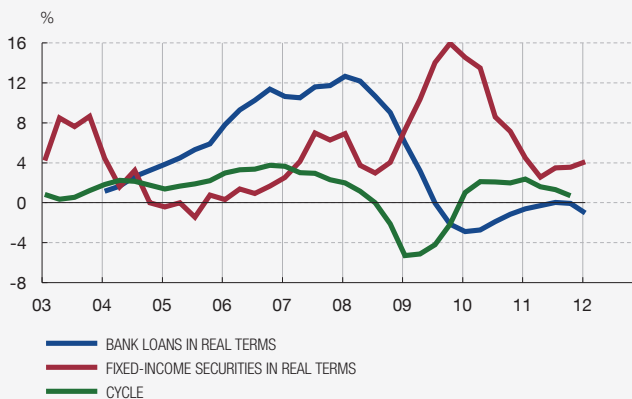
SOURCES: ECB and Banco de España.

a ECB estimate using swap market data.

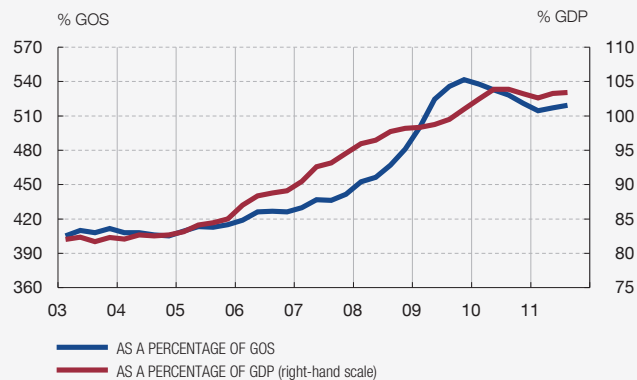
Credit extended to non-financial corporations (NFCs) in the euro area embarked on a smooth recovery in 2010, with its cyclical pattern duly lagging – by approximately three quarters – economic activity (see Panel 1). However, growth was subdued and recorded

a year-on-year rate of increase of 2% in October 2011. Demand for financing was bolstered by the incipient improvement in economic activity and the accommodative stance of monetary policy, although these boosts were countered by the absence of an eas-

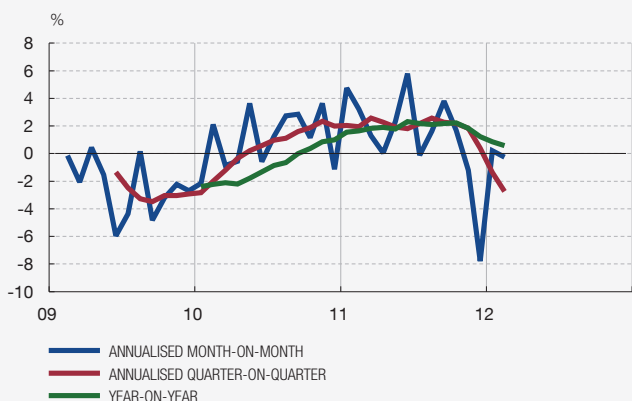
1 FINANCING AND THE CYCLE



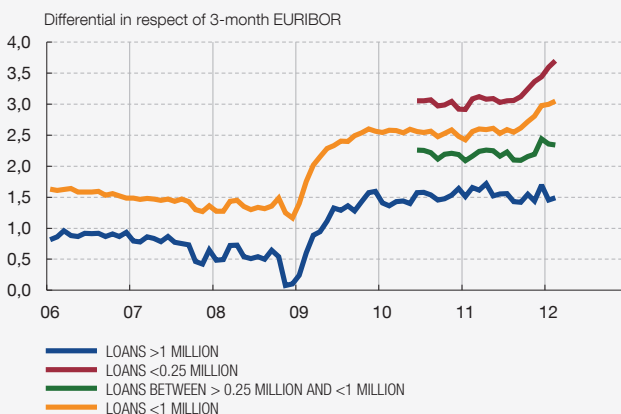
2 DEBT RATIOS



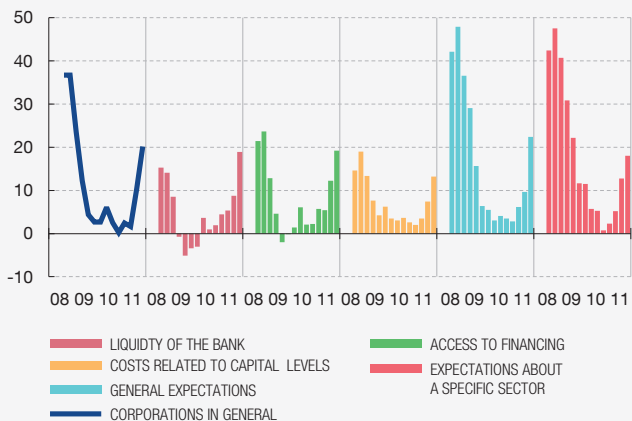
3 BANK LOANS



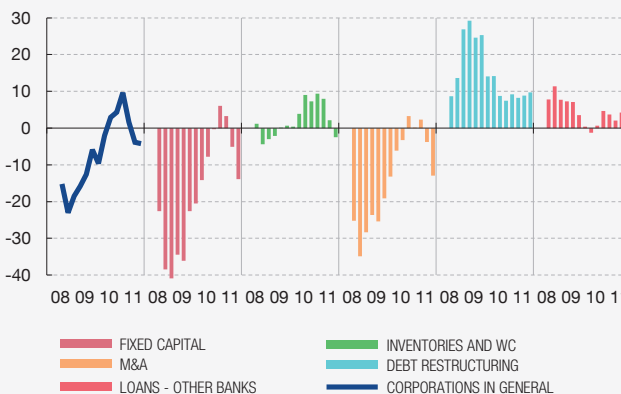
4 BANK RATES. NEW LOANS



5 BANK LENDING SURVEY AND SUPPLY FACTORS



6 BANK LENDING SURVEY AND DEMAND FACTORS



SOURCES: ECB and Banco de España.

ing of supply conditions and the high indebtedness of corporations (see Panel 2). The weak recovery of bank loans was accompanied by a slight slowdown of bond issuance, following relatively significant resort to this alternative source of financing during the crisis. Debt in the form of bonds issued by NFCs grew 5% year-on-year in 2011, although these operations were mainly conducted by large companies and this instrument only accounts for 10% of the sector's total outstanding debt, up from 9% in 2007.

The recovery of the financing of NFCs in the euro area was interrupted in autumn 2011. The annualised average month-on-month growth rate of bank loans in Q4 was -2.3%, which is equivalent to a negative quarterly net flow of €30 billion. The year-on-year rate of increase in loans declined to 0.6% in February 2012 from 2% in October 2011. This deterioration was quite widespread among countries, although a portion of the negative flow might have been temporary since it includes the decline in contracts in some countries due to year-end balance sheet operations and to their replacement by increased issuance on primary markets. Behind the change of trend in lending to corporations, there are supply and demand factors which are difficult to distinguish and are related to the worsening of the sovereign debt crisis and its impact on the fragile situation of the banking system, the double-dip in economic activity and the deterioration of the macroeconomic outlook.

Thus, according to the Bank Lending Survey (BLS) for 2011 Q3 and Q4, the tight credit conditions applied by banks to their customers became more restrictive in the second half of 2011. This will foreseeably continue into 2012 Q1 (see Panel 3). The tightening of lending standards was sharper for longer maturities and in operations with large corporations. In general, the credit supply contracted in response, on one hand, to poorer expectations about economic activity and the specific circumstances of various sectors and, on the other, to the deteriorated situation of banks' capi-

tal and liquidity in a context marked by the intensification of the sovereign debt crisis in the area and the difficulties in meeting substantial large volumes of debt maturities and exceptionally tighter capital requirements. The margins applied to new credit transactions increased, reflecting the pass-through of sovereign tensions to the cost of loans and of the adjustment in risk valuation in line with the downturn in activity and higher uncertainty (see Panel 4). The interest rate on new transactions increased 21 bp in 2011 Q4 (26 bp on contracts of less than €1 million) to 3.5%. The latest available information on interest rates relating to February shows a fresh tightening of transactions for a lower amount, which is particularly significant for SMEs.

However, the weakness of loans in 2011 Q4 and the early months of 2012 also reflects a moderation in demand for funds from NFCs. According to the BLS, the factor that might have most contributed is the drop in the demand for funds for new investments in fixed capital, which became more important at end-2011 in keeping with the deterioration in the economic outlook. Likewise, there were other factors which triggered a reduction in demand, such as the smaller borrowing requirement for investment in inventories and working capital or for mergers and acquisitions and the increase in available own funds. However, as has been the case since the beginning of the crisis, debt restructuring requests continued to increase.

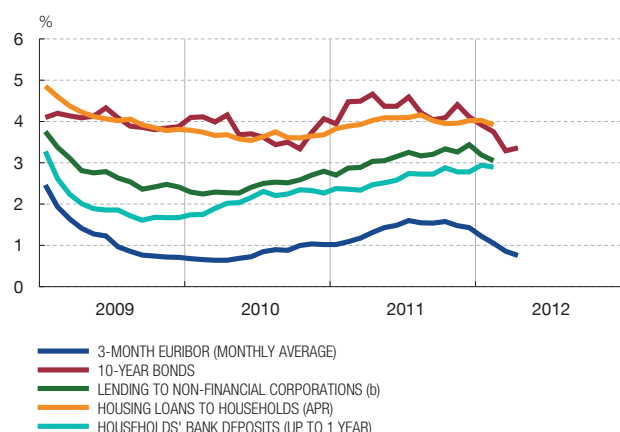
In short, the recovery of bank loans to NFCs in the euro area came to a halt in 2011 Q4, as a result of supply and demand factors connected to the financial situation of banks, the double dip in economic activity and the deterioration of the macroeconomic outlook. The ECB's reduction of official interest rates at end-2011 and the non-conventional measures introduced to guarantee the effectiveness of the monetary policy transmission mechanism are contributing, however, to limit the scope of some of these factors.

and had a particularly strong effect on Spain, whose risk premium rose again above Italy's, reversing the trend seen since the summer months.

Developments on the stock market have been similar, with significant improvements at the beginning of the year which, however, began to reverse in March with the result that so far this year the Eurostoxx 50 index has lost 3.3%, dragged down by the sharp fall in the IBEX 35 and to a lesser degree by the Italian bourse (see Chart 13). To date, the euro-dollar exchange rate appreciated 1.2% against a less volatile backdrop.

Interbank market interest rates continued along the downward path begun at end-2011. The 3-month and 1-year EURIBOR stood, respectively around 0.74% and 1.36% in April, their lowest levels since end-2010. The spread between the 1-year EURIBOR and the return on repo operations narrowed particularly significantly, although it remains at histori-

EURIBOR AND BANK INTEREST RATES (a)



CORPORATE BOND YIELD SPREADS OVER SWAP ASSETS



EURO STOXX 50 INDEX AND IMPLIED VOLATILITY



NOMINAL EXCHANGE RATES OF THE EURO



SOURCES: ECB and Banco de España.

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

cally very high levels above 100 bp. However, the pass-through of this decline to rates on bank loans, for the moment, has been very limited.

According to the Bank Lending Survey, banks' lending policies tightened in 2011 Q4, a process which, based on the projections of participant institutions, is expected to continue during the early months of 2012. Demand for loans also weakened as a result of greater uncertainty and the worsening of macroeconomic conditions. In these circumstances, bank loans to households continued to slow down, posting a growth rate of less than 1.8% in February – adjusted for securitisations and sales –. As explained in greater detail in Box 3, the weakness was more acute in loans extended to non-financial corporations whose year-on-year growth rate stood at 0.6% in February.

4 THE SPANISH ECONOMY

On the still incomplete information currently available, economic activity is estimated to have shrunk in 2012 Q1 by slightly more than in 2011 Q4, with a quarter-on-quarter GDP decline of 0.4% (see Chart 14). The contributions of national demand and external demand to this rate of change had the same sign as a quarter earlier, but were somewhat smaller. Thus, national demand declined less sharply than in the period October-December (–0.9% quarter-on-quarter, as against –1.7%), while the positive contribution of external demand moderated to 0.6 pp, down 0.9 pp from 2011 Q4. Having risen for seven quarters in a row, GDP fell again, in year-on-year terms, at a rate of –0.5%, which was 0.8 pp less than in the previous period.

Employment declined sharply again. The quarter-on-quarter rate of fall was slightly less pronounced than in Q4, entailing a year-on-year decrease of close to 4%. At the same time, compensation per employee slowed in the economy as a whole. This, along with the high growth in observed productivity, led to a significant decline in unit labour costs. Consumer prices moderated by 0.5 pp between December and March, the CPI reaching a year-on-year rate of 1.9% in the latter month. The annual growth of the CPI excluding unprocessed food and energy fell by 0.4 pp, to 1.2%. These developments enabled Spanish inflation to be 0.8 pp lower in March than that of the euro area, with the annual growth rates of prices for all the main components below those observed in the euro area.

4.1 Demand

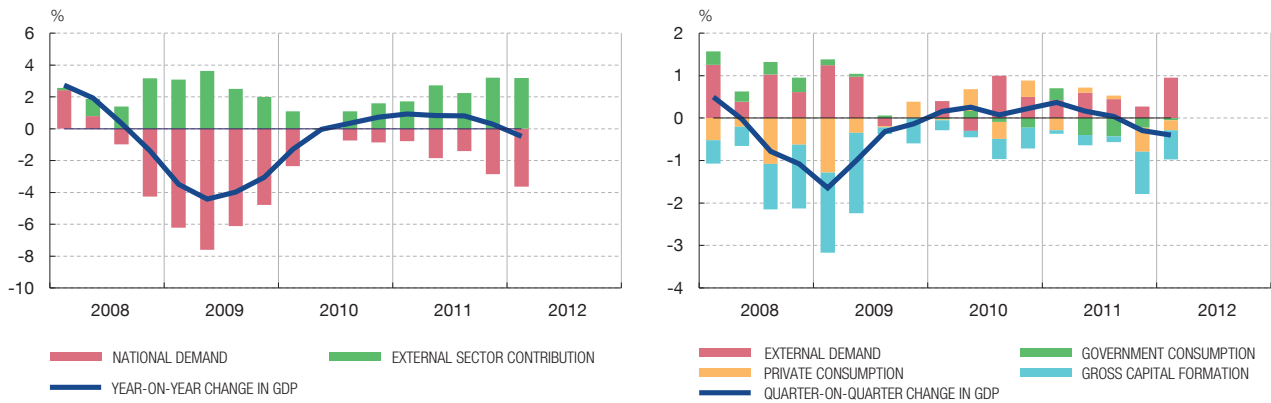
In 2012 Q1 household consumption continued to display notable weakness (see Chart 15). Specifically, this component of demand is estimated to have fallen by –0.4% quarter-on-quarter, an adverse performance that is attributable to the further deterioration in the labour market since autumn 2011, the fall in household wealth (both in its real estate component and in that part held in the form of financial instruments), the coming into effect of the increase in personal income tax rates and, in general, the climate of greater uncertainty. This latter aspect was reflected in a worsening of the retail confidence index and, especially, of the consumer confidence index, which at the end of Q1 stood at its lowest level since April 2009. As for quantitative indicators, the quarter-on-quarter decline in seasonally adjusted new private car registrations accelerated to –4.8%. In year-on-year terms, the decline accelerated by 1 pp, to –6.6%. For their part, sales of consumer goods and services by large firms, an indicator compiled by the tax authorities, declined on average by 2.5% year-on-year in real terms in January and February, a less pronounced decline than in 2011 Q4 (–3.8%). The average level of the retail trade index in January and February shows similar behaviour, a fall of 5.3%, which is somewhat less sharp than the one seen in the final quarter of last year.

In 2011 as a whole, nominal household income grew moderately, according to data of the non-financial accounts of the institutional sectors (0.4%). As against this low growth in nominal income, household consumption, also measured in nominal terms, continued to rise, leading to a further decline in the sector's saving rate, to 11.6% of disposable income, down 2.3 pp from 2010. In 2011 household net lending (the difference between the sector's saving and investment) was positive for the fourth year running, although, at 2.3% of GDP, its level was 1.5 pp lower than in 2010.

Investment in capital goods displayed a downward trend during Q1, with a quarter-on-quarter fall of 3.5%, similar to the one observed in 2011 Q4 (see Chart 16). The worse

MAIN DEMAND AGGREGATES. CONTRIBUTION TO GDP GROWTH

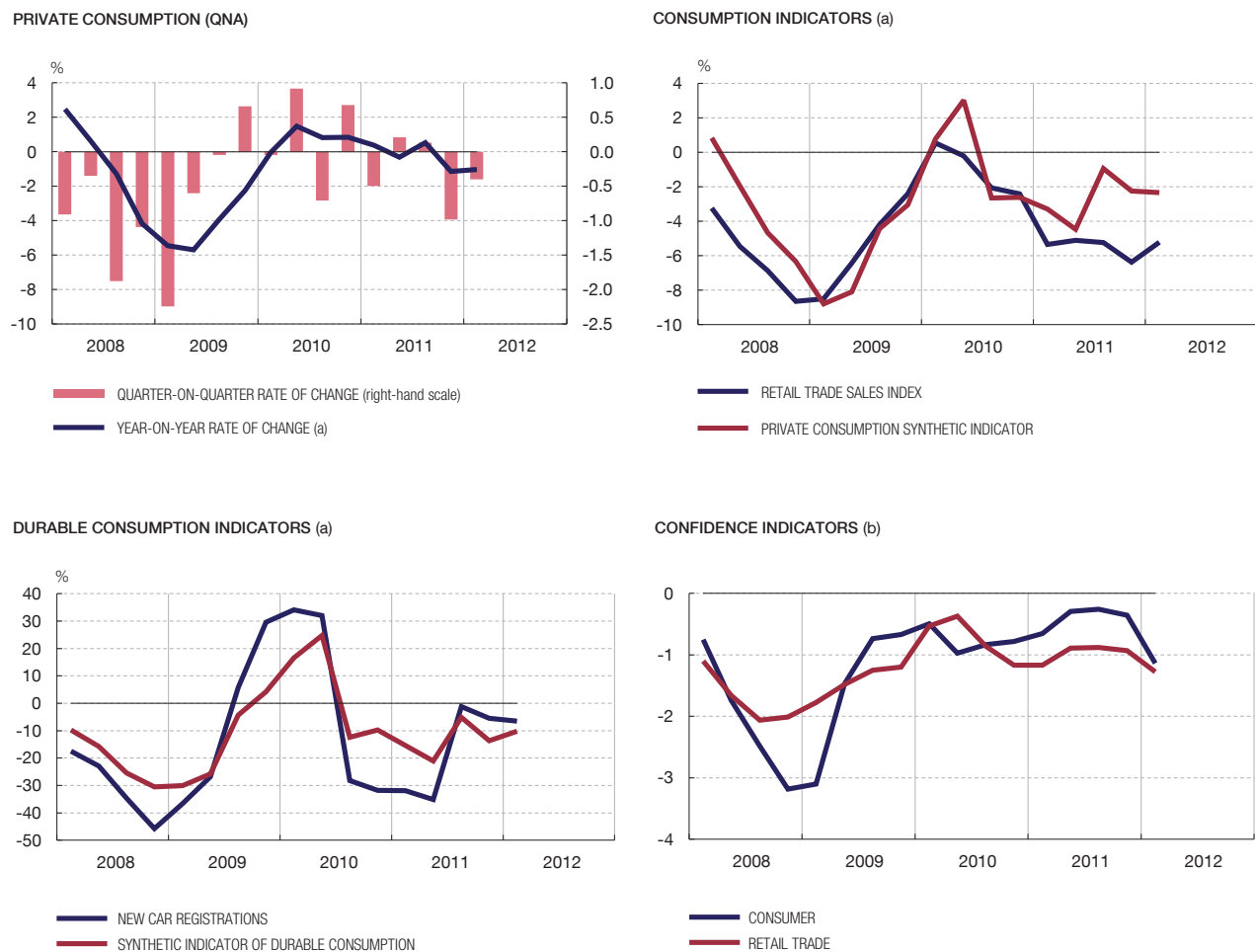
CHART 14



SOURCES: INE and Banco de España.

PRIVATE CONSUMPTION

CHART 15



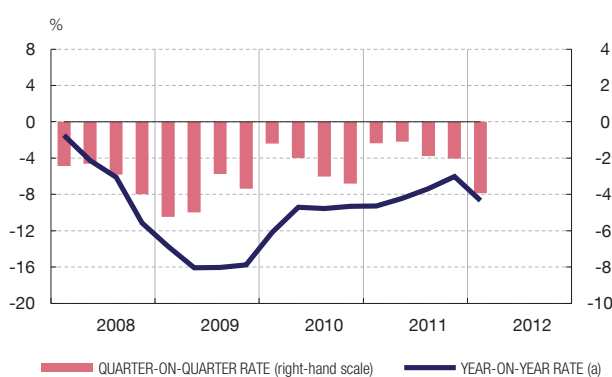
SOURCES: INE, European Commission, ANFAC and Banco de España.

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

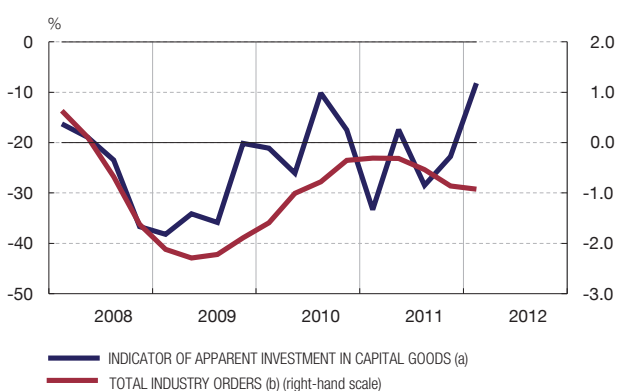
CAPITAL GOODS



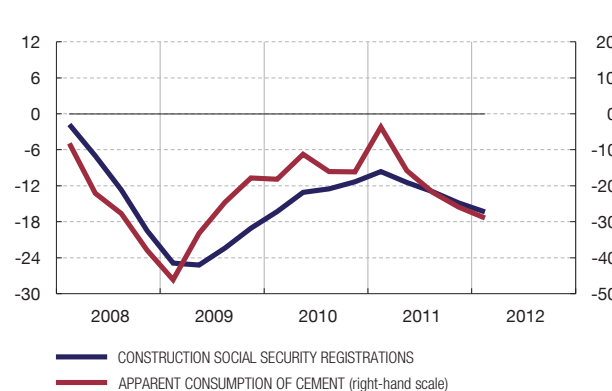
CONSTRUCTION



CAPITAL GOODS INDICATORS



CONSTRUCTION INDICATORS (a)



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, SEPE 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 indicator (difference between the indicator and its mean, divided by the standard deviation).

economic outlook in Spain, the slowdown in world trade and the resurgence of financial tensions are some of the factors that may have dampened the launch of new investment projects. Both the industrial production of this type of good and imports fell sharply on average in January and February (-9.5% and -17.2%, respectively, in year-on-year terms). Also, commercial vehicle registrations displayed a high rate of contraction in the first few months of 2012. Also the industrial confidence indicator remained at low levels in the period January-March (both in the sector as a whole and in the capital goods segment), although it did not worsen with respect to 2011 Q4.

On information from the non-financial accounts of the institutional sectors, the net lending of non-financial corporations amounted to 1.6% of GDP in 2011 (up 1 pp from 2010). This improvement was essentially based on the profit margin and may be indicative of the firms' efforts to clean up their balance sheets and to strengthen their cash flow generation capacity given the difficulty of obtaining borrowed funds. However, in the final quarter of the year the gradual improvement observed during the year was interrupted, with lower saving attributable to the increase in taxes paid and dividends distributed.

Construction investment maintained the contractionary trend of recent quarters, associated with the process of adjustment in the residential segment and fiscal consolidation in

the area of civil engineering works. In recent months, the employment indicators for the sector as a whole have displayed quarter-on-quarter declines similar to those of Q4, while the rate of fall of the indicators relating to the use of inputs slowed somewhat. By type of work, the quarter-on-quarter rate of fall of residential investment is estimated to have decelerated, although this adjustment process is projected to continue over the next few quarters, given the scant progress that had been made in reducing the gap between housing completions and starts by the end of 2011. As for transactions, in 2011 Q4 around 45,000 new homes were sold, 22% fewer than in the same period of 2010, although it should be remembered that the figure for the latter period was abnormally high owing to the partial disappearance of tax relief at the beginning of 2011. Meanwhile, permits for non-residential construction continued to fall sharply in January, as did the government tenders of civil engineering works. Finally, the direct contribution of general government to national demand remained negative in Q3, on account of the behaviour of both investment and government consumption.

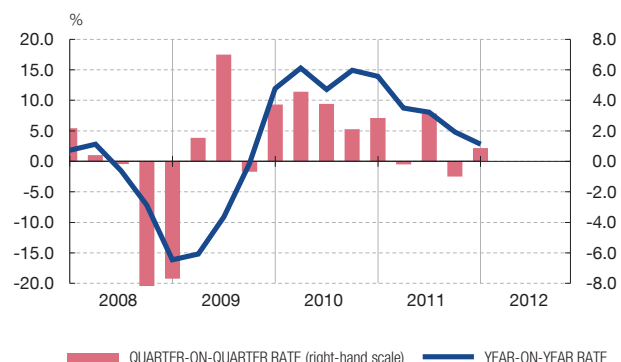
Turning to developments in the external sector, the latest information available suggests that the contribution of net external demand to quarter-on-quarter GDP growth moderated in 2012 Q1, to 0.6 pp, with a slight decline in exports and a somewhat larger decline in imports. Year-on-year, the rate of growth of sales abroad was 3%, half of the rate at the end of 2011, while imports declined at a rate of close to 7.5%, as against -5.9% in Q4, so that, in year-on-year terms, net external demand continued to make a significant contribution to GDP growth in 2012 Q1, of 3.2 pp (see Chart 17). The loss of momentum in exports over the last half year has occurred against a background of slowing growth of world markets, in particular of Spanish markets (owing to the weakness of some euro area countries), and despite Spain's price-competitiveness gains, both vis-à-vis the developed countries and the euro area.

On Customs data, real goods exports continued to decelerate during the first two months of the year, with year-on-year growth of 0.8%, as against 5.4% in 2011 Q4. By product group, exports of intermediate goods were the most dynamic, while sales of capital goods and consumer durables declined. By geographical area, nominal exports to the euro area fell slightly in year-on-year terms (-1.3%) on average in January and February, held back by the decreases in exports to Portugal (-9%) and to Italy (-8%), despite the increase in sales to Germany (close to 8%). By contrast, exports to the rest of the EU and the rest of the world displayed positive growth rates (of 13% and 10%, respectively).

As for real exports of tourism services, the information available points to a certain moderation, in year-on-year terms, in the first quarter of the year, owing to the worsening of growth expectations in the main tourist source countries. Arrivals of foreign tourists and overnight hotel stays increased year-on-year in the period January-February (by 3.1% and 3.6%, respectively), but by less than in the previous quarter. By country of residence, the balance of developments in the main markets providing tourists was negative, since the number of tourists from Germany fell while that of British tourists barely increased. Also the nominal spending of tourists grew during the first two months of the year by 4.7% year-on-year, less than in 2011 Q4, according to the tourism expenditure survey (EGATUR). Balance of payments data, to January only, confirm the moderation in the rate of growth of nominal receipts. Also exports of non-tourism services are projected to have slowed in Q1, in line with the developments in goods exports and international passenger transport.

Purchases of goods from abroad declined on average in January and February by 4.7% year-on-year, according to Customs data, a somewhat more pronounced drop than in the

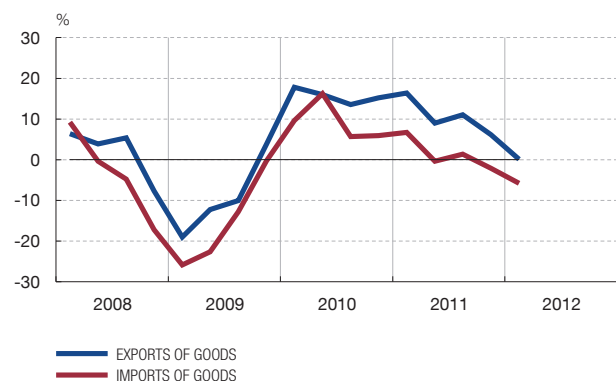
EXPORTS OF GOODS AND SERVICES (a)



IMPORTS OF GOODS AND SERVICES (a)



CUSTOMS INDICATORS (b)



TOURISM INDICATORS (c)



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

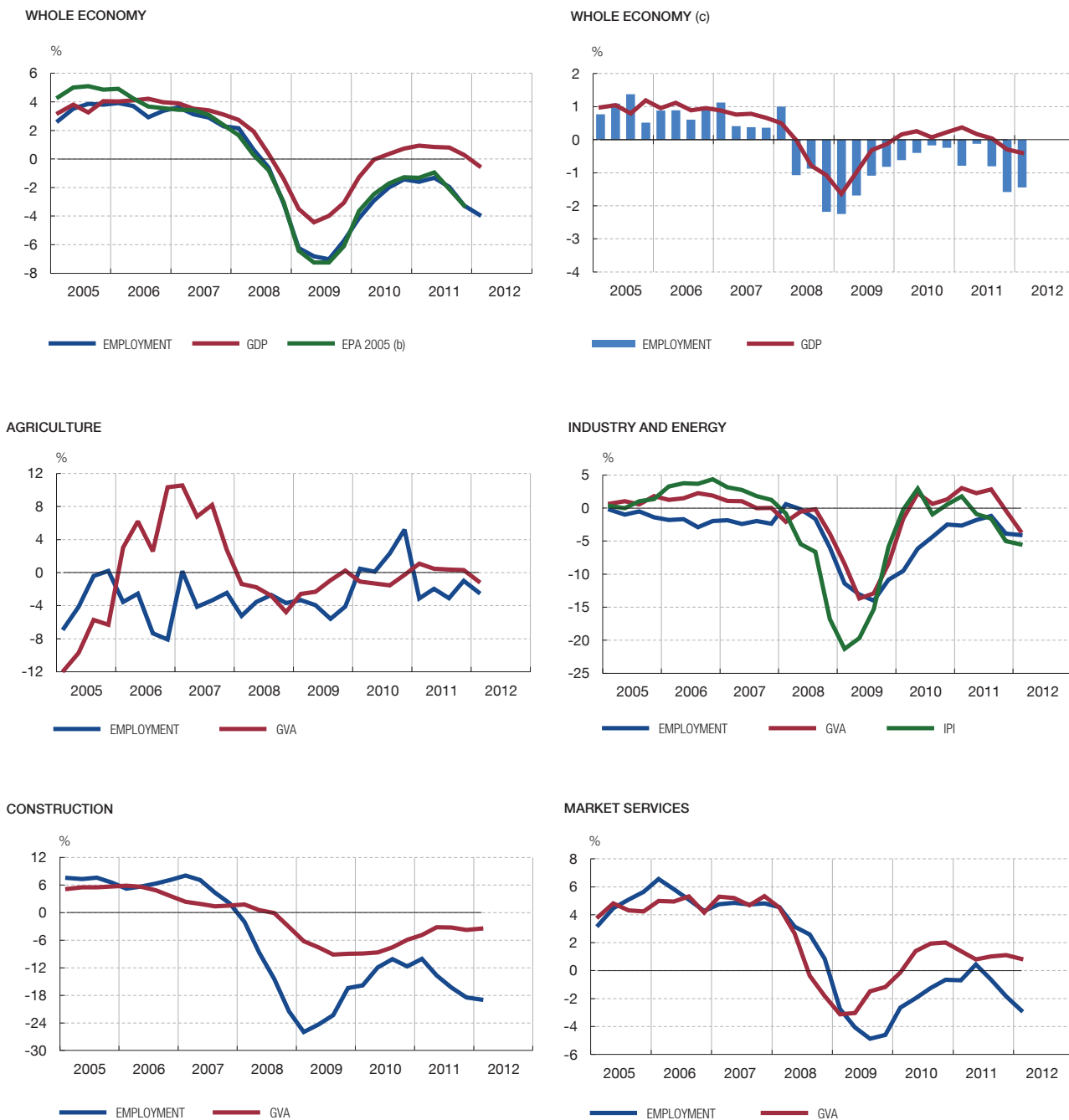
- a QNA data at constant prices. Seasonally adjusted series.
- b Deflated seasonally adjusted series.
- c Seasonally adjusted series.

final quarter of 2011 (-3.1%). Only in the case of purchases of consumer durables (in particular, cars) was a year-on-year increase recorded, while the rest of the components displayed declines, which were especially pronounced in the case of capital goods imports (-9%). Finally, real services imports are projected to have fallen more sharply in the first quarter of the year, with decreases in both purchases of tourism services and other services, in line with the weakness of domestic demand.

4.2 Output and employment

During 2012 Q1, the contractionary trend in the gross value added of the market economy⁶ remained practically unchanged from the previous quarter. The flow of indicators relating to developments in economic activity in the first few months of the year points to widespread weakness in all productive sectors, although the rate of decline may have moderated slightly in industry and construction (the sector that, nonetheless, continues to display the steepest declines), while it may have edged up in the case of market services (see Chart 18).

⁶ The Quarterly National Accounts (base 2008) do not provide estimates for the "market economy" aggregate. This branch is approximated by excluding from the whole economy services associated with education, defence, health and social services, compulsory social security and general government activities.



SOURCES: INE and Banco de España.

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

As regards industrial activity, the indicators available on the first quarter of the year suggest, with the exception of those relating to employment, a slight moderation in the quarter-on-quarter rate of decline. Despite its recent weakness, external demand would have helped to underpin the output of this sector, whose most dynamic branches were food consumer goods and intermediate goods. The manufacturing PMI recorded a slight improvement, although it remained clearly below 50, which is considered to indicate that the sector is contracting. This is confirmed by the Social Security

registrations data, which showed an acceleration of their year-on-year fall during the quarter.

The indicators available for market services suggest that in the first quarter of the year there was a small quarter-on-quarter decline in the GVA of this sector. Among the qualitative indicators, although the services PMI rose from the previous quarter, it remained below 50. The number of Social Security registrations fell more sharply than in Q4, both in quarter-on-quarter and year-on-year terms. Finally, the indicator of the sales of large firms (on January and February data) and of the activity of the services sector (on January data only) recorded substantial rates of year-on-year decline, with more pronounced weakness in the wholesale and retail trade.

In relation to the labour market, the latest EPA information available corresponds to 2011 Q4 and shows a year-on-year decline in employment of 3.3%, which is 1.2 pp greater than that observed in the previous quarter. This reflects a deterioration across the various sectors, which was most pronounced in industry and services, including non-market services, where employment fell in year-on-year terms for the first time. As a result, the rate of unemployment at the end of 2011 stood at 22.8%, up 2.5 pp from 2010 Q4.

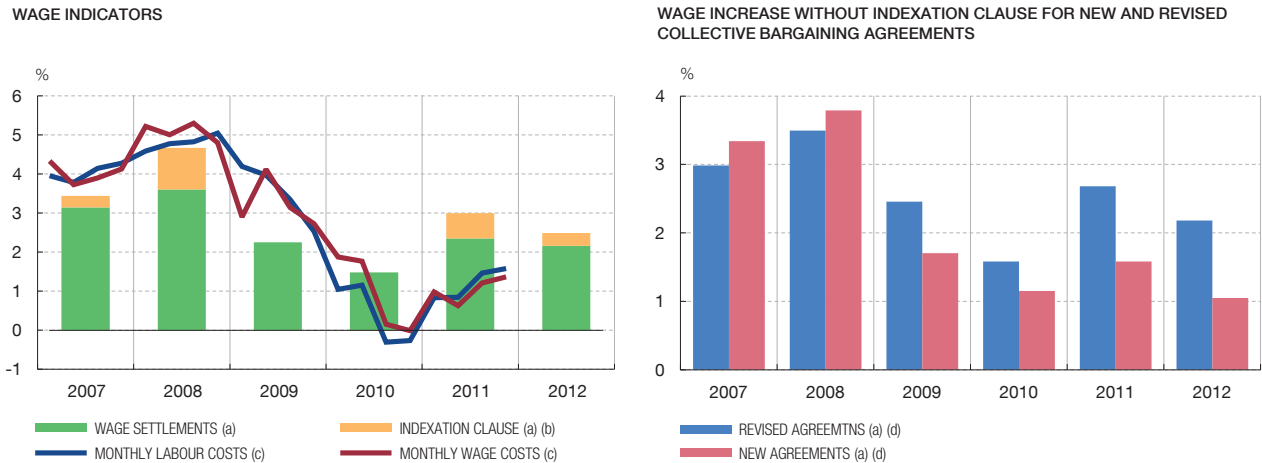
The latest information corresponds to monthly indicators of Social Security registrations, registered unemployment and hiring for the first quarter, which point to prolongation of the negative developments observed since mid-2011. The quarter-on-quarter fall in Social Security registrations in the first three months of the year is estimated to have been -0.9%, similar in magnitude to that observed in 2011 Q4 (see Chart 18). In year-on-year terms the fall in registrations was 2.6%, which was 0.7 pp larger than in the previous quarter. By sector, the deterioration in registrations in the first quarter of the year was broad-based, reflecting the net destruction of employment that took place in year-on-year terms in all sectors, except for general government services,⁷ which displayed practically zero growth. Construction continued to be the sector with the largest falls in employment. The decline in registrations continued to be concentrated among foreign workers and the self-employed.

Developments in new hires registered at the National Public Employment Service (SEPE) were unfavourable in the first quarter of the year. The year-on-year decline in the number of contracts accelerated by 5 pp, to -7.8%. The fall in temporary contracts steepened to -6.7%, as compared with a slight moderation in the sharp decline in permanent employees, which enabled their weight in total new hires to rise to 9.6%, up 4 pp from the end of 2011, when it reached its lowest level since May 1997. It is still too soon to associate this development with the effects of the labour reform approved by means of Royal Decree-Law 3/2012 of February 2012, since, for one thing, there is no detailed information to allow the use of the new permanent contract designed for small and medium-sized enterprises to be assessed.⁸ At the same time, part-time hiring remained more buoyant than full-time, with year-on-year growth of 1.5% in the first quarter of the year.

Finally, the number of persons registered as unemployed at the SEPE increased again substantially during the first quarter of the year (by almost 290,000). As a result, the

7 Aggregation of the sectors general government and defence, education and health of the general and autonomous regimes.

8 Among other measures, the labour reform approved the creation of a new type of permanent contract, designed for small and medium-sized enterprises, with various fiscal incentives and benefits, and with a trial period extended to one year from the maximum of six months in force hitherto.



SOURCES: INE and Ministerio de Empleo y Seguridad Social.

- a Latest year, with information on collective bargaining agreements to March 2012.
- b Previous year's indexation clause.
- c Quarterly labour costs survey (ETCL). 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 first or only year in which they are applicable.

year-on-year growth rate of this group accelerated to 9.2%. These developments in unemployment would be compatible with an unemployment rate, according to the EPA, of around 24% in 2012 Q1, despite the slight decline projected for the participation rate, as a consequence of the net outflow of immigrants and the behaviour of male unemployment.

4.3 Costs and prices

The collective agreements registered between January and March 2012 incorporate an average settlement for this year of 2.2%. This is a large settlement, given current cyclical conditions, but the trend was one of smooth moderation over the quarter. In any case, it should be stressed that these data are hardly representative, since progress in collective bargaining has been scant. Specifically, the agreements registered to March affect only 2.1 million workers, a much lower figure than in the first quarter of previous years, and almost all of them correspond to revisions of multi-year agreements signed in previous years, in which the average settlement was 2.2%, in line with the annual growth in the CPI in December 2011 (2.4%). In newly signed agreements the settlement was substantially lower (1.1%), although these only affect 42,000 workers, so that it is not possible to assess the degree of compliance with the wage guidelines agreed in the latest Agreement for Employment and Collective Bargaining (AENC) for the period 2012-2014, or the impact of the latest labour market reform. Strict compliance with these recommendations and the use of the possibilities for internal flexibility provided by the latter, which permit employment conditions to be brought more closely into line with the cyclical situation, is crucial.

In comparison with collective agreements, other indicators of wage costs (such as the Quarterly Labour Costs Survey (ETCL), tax authority data and the compensation per employee statistic in the Quarterly National Accounts) show lower wage increases, which can be partly explained by the above-mentioned delay in bargaining (see Chart 19). In the market economy as a whole, year-on-year growth of compensation is estimated to have slowed slightly in Q1 (see Chart 20).

COMPENSATION PER EMPLOYEE AND PRODUCTIVITY (a)



UNIT LABOUR COSTS AND PRICES (a)



SOURCES: INE and Banco de España.

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

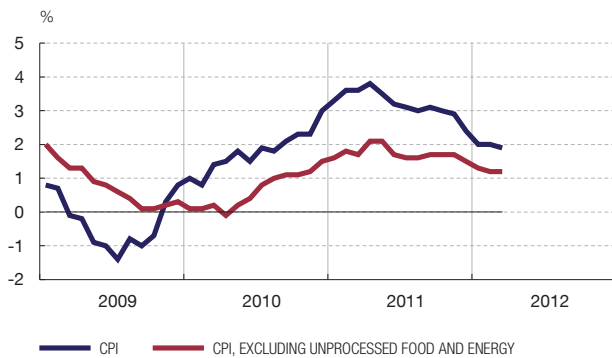
During the first few months of 2012 the rates of change of the deflators of the main components of demand appear to have continued to decline, as a result of the slowdown both in domestic producer prices (approximated by the GDP deflator), the growth rate of which appears to have fallen by 0.4 pp with respect to the preceding quarter, and the prices of imported goods, which displayed somewhat more moderate growth.

In 2012 Q1, consumer price inflation continued to follow a downward course as in previous months. The year-on-year growth rate of the CPI in March was 1.9%, down 0.5 pp from December 2011 (see Chart 21). In the same period the CPI excluding unprocessed food and energy slowed by 0.4 pp, to 1.2%. Notable among the components of this index was the slowdown of half a percentage point in services prices. The prices of non-energy industrial goods, for their part, maintained their rate of growth, against a background in which, although the domestic producer prices for this type of product moderated, the import prices grew at a higher rate. The slower rate of growth of processed food prices in 2012 Q1 stemmed from the moderation in domestic producer prices and import prices for this type of goods. At the same time the energy component of the CPI slowed sharply, by 3.8 pp to 7.5%, while the growth rate of unprocessed food prices increased.

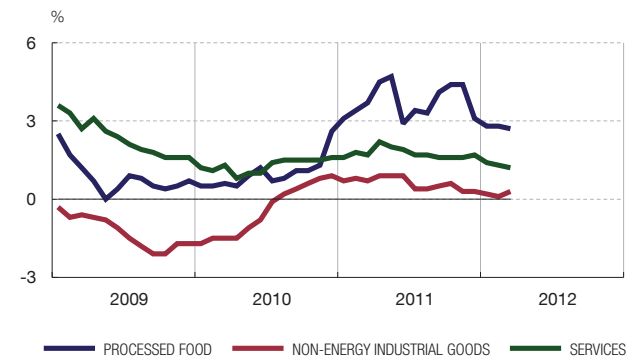
In terms of the harmonised index of consumer prices (HICP), the moderation in inflation in the first few months of 2012 was more pronounced in Spain than in the euro area, so that the differential continued to be reduced. In March, Spanish inflation was 0.9 pp lower than in the euro area, almost the largest gap in Spain's favour since the euro was introduced, which was 0.9 pp (see Chart 22). The differential in terms of the CPI excluding unprocessed food and energy was also negative (-0.8 pp). The differentials for all the components were negative in March, their amount ranging from 0.7 pp in the case of services to 1 pp in that of energy products. At the same time the energy component of the CPI slowed sharply, by 3.8 pp, to 7.5%, while the growth rate of unprocessed food prices increased.

The year-on-year rate of change of the producer price index continued to decline in the first few months of 2012, to reach 3.4% in February, down 1.8 pp from December 2011. These developments are basically attributable to the downward path of energy and intermediate product prices. The rates of change of the prices of consumer industrial goods and capital goods also moderated, although to a lesser extent. For their part, the rates of change of the import and

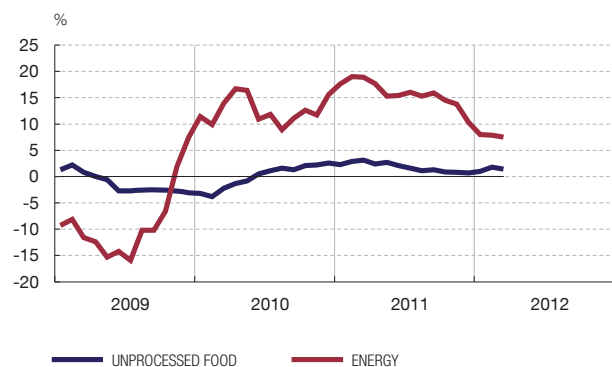
CONSUMER PRICE INDEX



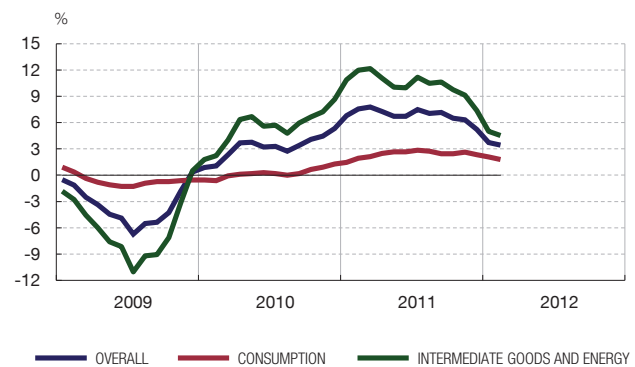
CONSUMER PRICE INDEX



CONSUMER PRICE INDEX



PRODUCER PRICE INDEX



SOURCE: INE.

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

export price indices for industrial products also fell, to 5.5% and 2.9% in January, respectively. In both cases, the prices of energy products continued to display very high rates of change.

4.4 The State budget

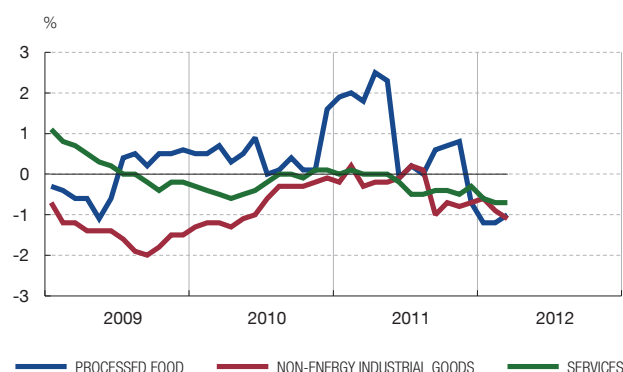
The latest statistical data available for the general government sector as a whole is to end-2011 and indicates, as mentioned above, a substantial deviation (of 2.5 pp) from the deficit target, with an overall deficit of 8.5% of GDP. Around 90% of the budget deviation in 2011 was attributable to the extreme weakness of public revenue, which fell by somewhat more than one percentage point from 2010, to 35.1% of GDP. Public spending, for its part, fell by 2.3% in 2011, the under-execution of capital expenditure largely offsetting the upward deviations in interest payments. Central government exceeded its deficit target by 0.3 pp, with a deficit of 5.1% of GDP, while social security funds recorded a deficit of 0.1% of GDP, when a 0.4% surplus had been projected. Regional government, for its part exceeded its target by 1.6 pp, with a deficit of 2.9% of GDP. Finally, local government deviated from its initial target by 0.1 pp, recording a deficit of 0.4% of GDP.

Somewhat more recent information, for the first few months of 2012, is available for the State and for the Social Security system (see Tables 4, 5 and 6). As regards the State, the latest information (to February of this year) shows a deficit of €9.2 billion,

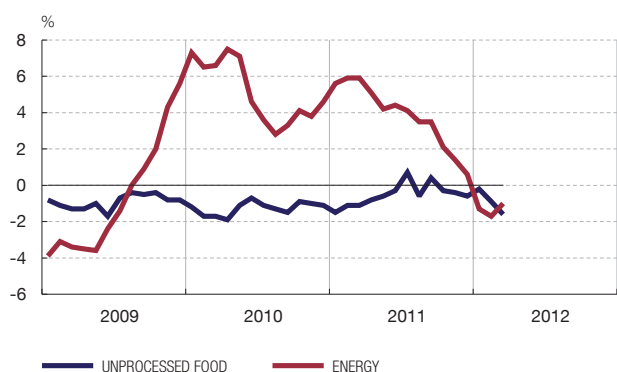
HARMONISED INDEX OF CONSUMER PRICES



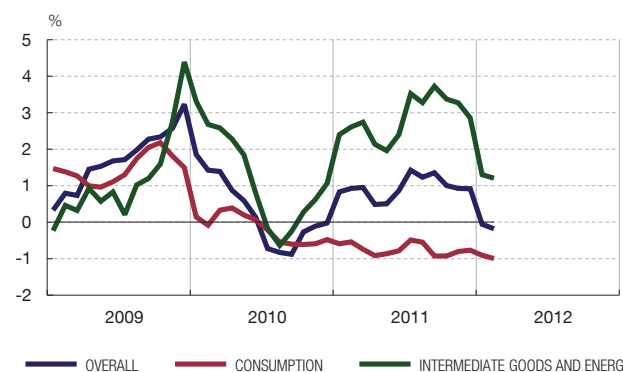
HARMONISED INDEX OF CONSUMER PRICES



HARMONISED INDEX OF CONSUMER PRICES



PRODUCER PRICE INDEX



SOURCES: Eurostat and Banco de España.

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

which was higher than the deficit of €5.6 billion recorded in the same period of last year, largely on account of the early payment of current transfers to regional government and to the Social Security system. However, given that the figures for the first few months are highly erratic, they may not be representative of future trends in the budget outturn. Note, for example, that the corporate income tax figure is negative owing to higher refunds than gross revenues, which in these months are very small relative to the annual total. Even taking into account these caveats, negative rates are observed on the revenue side for the main items (including the shares of regional and local government), with falls of 2.7% in personal income tax (since the impact of higher rates was still indiscernible in February), of 9.8% in VAT and of 3.3% in excise duties. Notable on the expenditure side were the containment of wages and salaries and the large cuts in capital expenditure, while interest payments continued to increase at high rates.

Social Security system data are received with a somewhat longer lag than those for the State and are only available for January. That month the system showed a surplus of €2.6 billion, up from €1.6 billion in the same month last year, owing to the sharp increase in revenue. Part of this revenue, as mentioned above, arose from the early receipt of State transfers. Another part, however, was attributable to the increase in social contributions,

The economic crisis has seen an increase in the “trade debt” of general government (especially in the case of regional and local government), with the consequent negative effect on the liquidity of the creditor businesses. On the latest information available, the total other accounts payable of regional government vis-à-vis non-financial corporations and households amounted to €30,018 million and, in the case of local government, to €22,770 million, as compared with €23,167 million and €16,381 million at the end of 2007, respectively. To address this situation, the government has in recent months launched various initiatives to facilitate payment of the outstanding debts of regional and local governments with their suppliers. This box reviews the basic features of these initiatives.

First, in February 2012, a temporary mechanism was set up to provide financing directly to regional governments through the Official Credit Institute (ICO by its Spanish initials). The facility, with funds of €10 billion (extendable to €15 billion), has two tranches. The first one enables regional debt incurred before 1 January 2012 and falling due before 30 June 2012 to be repaid (refinancing tranche). The second is intended to supply liquidity to regional governments to enable them to settle other accounts payable vis-à-vis their suppliers. Regional governments using this credit facility will require authorisation from the Secretariat General of the Treasury for new borrowing transactions, including any change to a transaction prior to the arrangement of this credit facility. In the event that a regional government fails to observe the conditions set out, penalties may be applied such as early maturity of the credits granted through this facility.

The second initiative was taken at the Council of Ministers of 24 February and embodied in Royal Decree 4/2012, which establishes an extraordinary plan to finance the payment of local government suppliers. Subsequently, on 6 March, the Fiscal and Financial Policy Council resolved to extend this plan, on similar terms, to regional government. The mechanism for financing the plan was approved by Royal Decree 7/2012 of 9 March 2012, and consists of the creation of a Fund for the Financing of Payments to Suppliers, with capacity to borrow, with a State guarantee, up to €35 billion on the capital markets (€20 billion to pay local government suppliers and €15 billion to pay the unsettled bills of regional governments).

This Fund, through the ICO, and with prior authorisation from the Ministry for Finance and Public Administration (MHAP), will pay the suppliers of regional and local governments that wish to make use of the proposed financing mechanism, thereby generating a claim on the regional or local government in question. The latter will have 10 years in which to repay the credit, with a two-year grace period, interest accruing at the Treasury rate plus 115 basis points plus a maximum intermediation margin of 30 basis points. Payment of the amounts due to the Fund by the regional and local governments which use this financing mechanism will be guaranteed by their shares of State revenue. The outstanding debts eligible to be paid through this mechanism must be due and payable, as well as being net, enforceable and prior to 1 January 2012.⁴ All local governments with debts that meet these requirements, as well as the regional governments that decide to use this mechanism, must send the MHAP a certified list of all their other accounts payable. In ad-

dition, contractors may consult this list and, in the event of disagreement or omissions, request individual certification.

After sending the list of outstanding bills, regional and local governments are required to approve an adjustment plan to ensure the availability of the revenues necessary to make the payments throughout the life of the credit. Both this adjustment plan and the annual report (quarterly in the case of regional governments and municipalities that have a population of more than 75,000 or are provincial capitals) on its implementation must be approved by the MHAP. Without such approval, the MHAP has the right to intervene and carry out checks, through the National Audit Office.

In terms of deadlines, local governments were required to send to the MHAP before 15 March a list certified by their internal auditor of all other accounts payable that meet the above-mentioned requirements. Local councils had to present before 31 March 2012 adjustment plans, which had to be approved by the MHAP within 30 days of receipt. In the case of regional governments, the deadline for presentation of the bills ended on 15 April, while the adjustment plan had to be sent to the MHAP before 30 April. The MHAP has presented an initial evaluation of the plan to pay suppliers. A total of 4,622 local governments had presented bills with a total amount of €9,584 million, corresponding to more than 177,000 firms. However, somewhat fewer than half of these local governments (with an aggregate debt of €900 million) did not present their adjustment plans by the deadline established for the purpose. In the case of regional governments, the unpaid bills amount to €17,255 million.

Overall, the measures taken may prove to be very effective in providing liquidity to the suppliers of local and regional governments, which have seen their unpaid bills increase significantly during the economic crisis. However, it is essential to ensure that this type of assistance does not give rise to the wrong incentives for regional and local governments. In this respect, as already mentioned, the financing mechanisms agreed require compliance with adjustment plans. It is now crucial to ensure that these plans are strictly complied with.

Finally, it is important to mention that these initiatives will have an impact on the composition of general government liabilities. Other accounts payable were recorded in the general government deficit for the respective years, in accordance with the accruals convention. At the same time, the debts of this nature were recorded, in accordance with the rules agreed by Eurostat within the context of the Excessive Deficit Procedure (EDP), as general government liabilities, but do not form part of public debt for the purposes of the EDP, as can be seen in the statistical publications of the Banco de España, which present both EDP debt and total general government liabilities. The mechanism for payment through the Fund for the Financing of Payments to Suppliers will lead to a change in composition as a consequence of the transformation of these commercial liabilities into EDP debt.

¹ In addition, they must relate to contracts for work, services or supplies that come within the scope of application of the consolidated text of the Law on Public Sector Contracts.

GENERAL GOVERNMENT. NON-FINANCIAL ACCOUNT IN TERMS OF NATIONAL ACCOUNTS

TABLE 4

€m and %

	Outturn 2009	Outturn 2010	Percentage change 2010/2009	Outturn 2011	Percentage change 2011/2010	Change in level 2011-2010
	1	2	3 = 2/1	4	5 = 4/2	6 = 4 - 2
1 TOTAL RESOURCES	367,661	381,427	3.7	377,085	-1.1	-4,342
Current resources	367,525	381,293	3.7	378,391	-0.8	-2,902
Taxes on production and imports	92,355	108,699	17.7	104,971	-3.4	-3,728
Income and wealth taxes	101,078	99,698	-1.4	101,610	1.9	1,912
Social security contributions	140,144	140,170	0.0	139,868	-0.2	-302
Other current resources	33,948	32,726	-3.6	31,942	-2.4	-784
Capital resources	136	134	-1.5	-1,306	—	-1,440
2 TOTAL USES	484,759	479,645	-1.1	468,505	-2.3	-11,140
Current uses	422,763	426,997	1.0	429,216	0.5	2,219
Employee compensation	125,710	124,781	-0.7	122,926	-1.5	-1,855
Other final consumption expenditure (a)	93,717	91,355	-2.5	88,315	-3.3	-3,040
Social benefits (not in kind)	153,685	160,974	4.7	163,486	1.6	2,512
Interest payments	18,520	20,120	8.6	25,867	28.6	5,747
Subsidies	11,838	12,147	2.6	11,325	-6.8	-822
Other uses and current transfers	19,293	17,620	-8.7	17,297	-1.8	-323
Capital uses	61,996	52,648	-15.1	39,289	-25.4	-13,359
Gross capital formation	48,145	41,191	-14.4	28,700	-30.3	-12,491
Other capital expenditure (b)	13,851	11,457	-17.3	10,589	-7.6	-868
3 NET LENDING (+)/NET BORROWING (-) (3 = 1 - 2)	-117,098	-98,218	16.1	-91,420	6.9	6,798
(As a percentage of nominal GDP)	-11.2	-9.3		-8.5		
MEMORANDUM ITEM						
Primary balance	-98,578	-78,098	20.8	-65,553	16.1	12,545
Final consumption expenditure	223,603	221,715	-0.8	217,675	-1.8	-4,040

SOURCE: Ministerio de Hacienda y Administraciones Públicas.

- a Includes intermediate consumption, market producers' social transfers in kind and other taxes on production. Excludes consumption of fixed capital, market output (residual sales) and payments for other market output.
- b Includes net acquisitions of non-financial non-produced assets (K2).

SOCIAL SECURITY SYSTEM BUDGET OUTTURN

TABLE 5

€m and %

	Percentage change between budget 2011/2010	Initial budget 2012	Percentage change between budget 2012/2011	Outturn Jan-Dec. Percentage change 2011/2010	Outturn		Percentage change 2012/2011
	2	3	4 = 3/1	5	2011 January	2012 January	8 = 7/6
1 REVENUE	3.3	119,883	-2.9	-0.4	9,595	10,921	13.8
Social security contributions	3.2	107,725	-3.6	-0.4	8,887	9,195	3.5
Current transfers	-2.4	8,930	9.5	-3.9	705	1,665	136.2
Other revenue	25.6	3,228	-7.1	8.0	3	61	—
2 EXPENDITURE	1.9	119,882	0.9	2.2	7,947	8,279	4.2
Wages and salaries	-4.2	2,358	-0.8	-2.1	145	147	1.4
Goods and services	-15.4	1,541	-10.4	-8.8	47	53	14.2
Current transfers	2.4	115,683	1.2	2.6	7,755	8,077	4.2
Contributory pensions	4.0	101,954	2.9	4.0	6,943	7,268	4.7
Sickness	-4.9	5,799	-17.3	-8.0	153	145	-5.2
Other	-7.7	7,930	-3.1	-4.4	659	664	0.7
Other expenditure	-15.0	300	-33.2	-24.6	1	2	98.7
3 BALANCE (3 = 1 - 2)	—	1	—	—	1,647	2,642	—

SOURCES: Ministerio de Hacienda y Administraciones Públicas, Ministerio de Empleo y Seguridad Social and Banco de España.

STATE BUDGET OUTTURN

TABLE 6

€m and %

	Outturn 2011	Percentage change 2011/2010	Initial budget 2012	Percentage change 2011/2010	2011 Jan-Feb	2012 Jan-Feb	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	104,145	-18.2	119,233	14.5	22,930	23,063	0.6
Direct taxes	53,382	-9.9	54,846	2.7	10,020	9,179	-8.4
Personal income tax	33,545	-14.7	29,232	-12.9	9,045	9,002	-0.5
Corporate income tax	16,611	2.5	19,564	17.8	354	-389	—
Other (a)	3,227	-13.7	6,050	87.5	621	566	-8.9
Indirect taxes	34,644	-33.2	21,095	-39.1	11,202	9,970	-11.0
VAT	25,355	-34.1	13,633	-46.2	9,668	8,544	-11.6
Excise duties	6,325	-38.8	4,502	-28.8	1,025	931	-9.2
Other (b)	2,965	-1.2	2,960	-0.2	509	496	-2.6
Other net revenue (c)	16,118	-0.8	43,292	168.6	1,708	3,914	129.2
2 EXPENDITURE	151,095	-15.9	152,630	1.0	28,512	32,258	13.1
Wages and salaries	27,420	1.7	27,339	-0.3	4,021	3,963	-1.4
Goods and services	4,319	-6.8	3,238	-25.0	604	331	-45.1
Interest payments	22,204	13.1	28,876	30.0	5,713	6,686	17.0
Current transfers	79,892	-23.7	80,498	0.8	13,644	19,337	41.7
Contingency fund	—	—	2,377	—	—	—	—
Investment	6,895	-21.5	5,280	-23.4	1,637	1,092	-33.3
Capital transfers	10,365	-30.4	5,022	-51.5	2,893	849	-70.7
3 CASH-BASIS BALANCE (3 = 1 – 2)	-46,950	—	-33,397	—	-5,582	-9,196	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)							
TOTAL	138,079	1.6	139,223	0.8	32,040	30,183	-5.8
Personal income tax	69,803	4.2	73,106	4.7	15,219	14,811	-2.7
VAT	49,302	0.5	47,691	-3.3	13,690	12,343	-9.8
Excise duties	18,974	-4.2	18,426	-2.9	3,132	3,029	-3.3

SOURCE: Ministerio de Hacienda y Administraciones Públicas.

- a Includes revenue from the tax on the income of non-residents.
b Includes taxes on insurance premiums and tariffs.
c Includes charges, profits and dividends, and current and capital transfers.

despite the weakness of registrations and of wage developments, so that a slowdown can be expected over the coming months. As regards expenditure, growth was determined by the trend in contributory pensions, which grew by 4.7% year-on-year. Notable among the other spending items was the continued contraction in expenditure on sickness benefits, as in previous years.

4.5 Current and capital account balances

In January 2012, the Spanish economy's net borrowing continued to fall (see Table 7). The overall deficit on current and capital accounts was €5.7 billion, down 5.5% from the same month of 2011. This decline is explained, above all, by the fall in the trade deficit and by the widening of the services surplus, which more than offset the deterioration in the income deficit. For its part, the capital account surplus fell.

The trade deficit decreased in the first month of the year by 27.5%, to €3.2 billion, basically on account of the improvement in its non-energy component which, on Customs data, moved into surplus. Goods trade with the rest of the euro area was again in surplus,

BALANCE OF PAYMENTS: MAIN COMPONENTS (a)

TABLE 7

€m

		January		Rate of change
		2011	2012	2012/2011(b)
CREDITS	Current account	27,283	28,395	4.1
	Goods	16,476	17,342	5.3
	Services	7,072	7,062	-0.1
	Tourism	2,591	2,677	3.3
	Other services	4,480	4,386	-2.1
	Income	2,631	2,838	7.9
	Current transfers	1,105	1,153	4.3
	Capital account	283	178	-37.0
	Current + capital accounts	27,566	28,573	3.7
DEBITS	Current account	33,454	34,122	2.0
	Goods	20,881	20,535	-1.7
	Services	5,436	5,221	-4.0
	Tourism	893	832	-6.8
	Other services	4,544	4,389	-3.4
	Income	4,924	6,118	24.3
	Current transfers	2,212	2,249	1.7
	Capital account	101	110	8.8
	Current + capital accounts	33,555	34,232	2.0
BALANCES	Current account	-6,171	-5,727	443
	Goods	-4,406	-3,193	1,213
	Services	1,635	1,842	207
	Tourism	1,698	1,845	146
	Other services	-63	-3	61
	Income	-2,293	-3,280	-987
	Current transfers	-1,107	-1,096	11
	Capital account	181	68	-113
	Current + capital accounts	-5,989	-5,659	330

SOURCE: Banco de España.

a Provisional data.

b Absolute changes for balances.

while the deficit with non-EU countries improved slightly. The services surplus reached €1.8 billion, up 12.6% from the same month of 2011, thanks to the improvement in the tourism surplus and the decline in the other services deficit. By contrast, the income deficit rose to €3.3 billion (from €2.3 billion in January 2011), reflecting the rise in interest rates and Spain's large external liabilities. Finally, there was a 1% correction in the current transfers deficit, which took it to €1.1 billion.

5 FINANCIAL DEVELOPMENTS

5.1 Highlights

Following the severe tensions afflicting the financial markets last year, the opening months of 2012 saw a more stable situation, not exempt from volatility. This allowed ten-year government debt yields and their spread over the German Bund of the same term to stand more clearly below the highs reached in November. However, both rose in the last few days of March and, at the end of the quarter, stood at 5.4% and 361 bp, respectively, somewhat more than 30 bp above the levels at the close of the previous year. During the quarter the Spanish State managed to raise large volumes of funds at a lower cost than in previous issues, given the high demand for these securities, and the wholesale funding conditions faced by banks also improved. Specifically, the funds raised on the fixed income markets increased after the marked sluggishness of the previous year. In the interbank market, the spread between 1-year EURIBOR and EUREPO (cost of secured transactions) of the same term narrowed to 125 bp from nearly 180 bp at the end of the previous year. This meant that EURIBOR fell by half a percentage point up to March, since EUREPO barely changed. However, fund raising in this market continued to decline in the early months of the year, against a background in which banks have built up a very high volume of funds through the liquidity provided by the ECB. By contrast, on the stock market, the IBEX 35 lost 7.6% from end-December to end-March, in contrast to the performance of the EUROSTOXX 50 and the S&P 500, which gained 5.9% and 11.6%, respectively (see Chart 23).

In April to date, however, financial tensions have broken out again. Ten-year government debt yields have risen, at one point exceeding 6%, and the spread over the German Bund has climbed to around 440 bp, these levels not being seen since last November. Stock market indices fell, most sharply in the IBEX 35 and the EUROSTOXX 50 (by 13.7% and 7.8%, respectively) and somewhat more moderately in the S&P 500, which was down by 2.2%.

In the real estate market, on data published by the Ministry of Infrastructure and Transport, housing prices again fell in 2012 Q1. Thus the year-on-year rate of decline stood at 7.2% in March compared with 6.8% in December (see Chart 23). In quarter-on-quarter terms, the drop was 3.1%. Hence the cumulative fall from the peak in 2008 was 21.5% (26.8% in real terms).

The latest available information on private sector financing costs, which relates to February, shows that, against a backdrop characterised by a high degree of real and financial uncertainty, the recent decrease in interbank market interest rates has not passed through completely to corporate and household loans. Household loan interest rates increased slightly, while those of corporate loans dropped slightly.

Private sector financing continued its contractionary trend. The fall in household liabilities in February (the latest month for which data are available) was slightly sharper, in year-on-year terms, than that at the end of the previous year, due to the loss of vigour of house purchase loans and of consumer credit and other lending. By contrast, the year-on-year decline in corporate debt scarcely changed with respect to the December figure. By instrument, the balance of the loans granted by resident credit institutions continued to fall, although more slowly than at the end of last year, whereas debt securities accelerated. The most recent information on loan purpose, relating to 2011 Q4, confirms that bank financing kept falling in all productive sectors in this period.

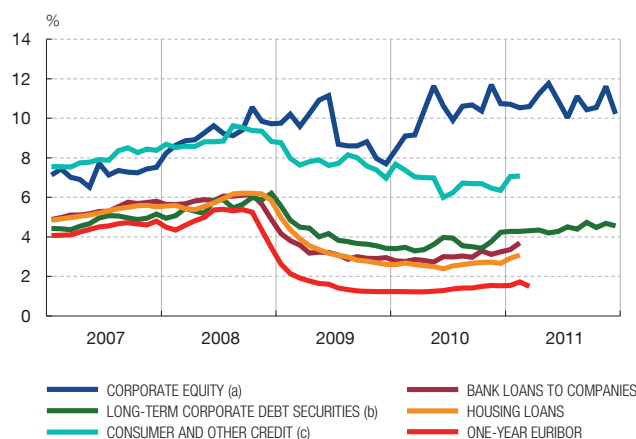
STOCK EXCHANGE INDICES



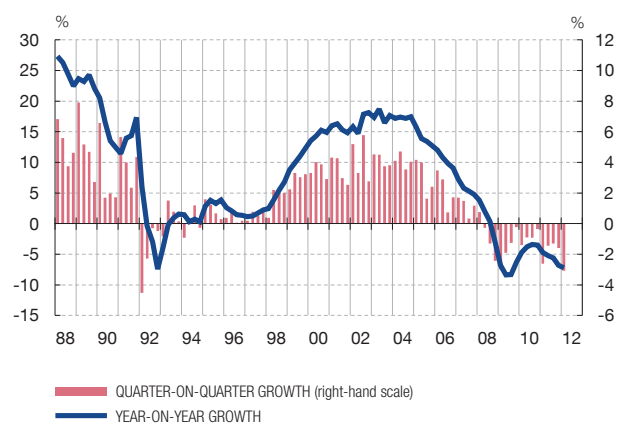
10-YEAR GOVERNMENT BOND



COST OF FINANCING



PRICE PER SQUARE METRE OF APPRAISED HOUSING (d)



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

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

The decrease in firms' and households' debt further reduced the debt and debt burden ratios of these sectors in 2011 Q4. The preliminary estimates for 2012 Q1 point to a continuation of this trend. The net wealth of households dropped slightly as a result of decreases in the value of financial instruments and, above all, of real estate assets. In the case of firms, the data for the sample of corporations reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), among which the biggest have a notable weight, reveal a fall in activity and in corporate profits in 2011 with respect to the previous year.

The volume of doubtful loans continued to rise in the early months of the year, and this, along with the decrease in debt, meant that the doubtful assets ratio moved further upwards. Specifically, for total other resident sectors (which includes households and firms), this indicator, at 8.2% in February, was 0.6 pp higher than in December 2011.

General government debt decelerated slightly, although its rate of expansion remained high, partly because in 2012 Q1 the State increased the volume of its issuances to take

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 8

% of GDP

	2006	2007	2008	2009	2010	2011			
					Q4	Q1	Q2	Q3	Q4
National economy	-8.4	-9.6	-9.2	-4.7	-4.0	-4.1	-3.6	-3.5	-3.4
Non-financial corporations and households and NPISHs	-11.5	-13.4	-6.5	5.1	4.4	4.3	4.8	4.6	3.9
Non-financial corporations	-9.8	-11.5	-6.7	-0.8	1.3	1.1	2.0	1.2	1.1
Households and NPISHs	-1.7	-1.9	0.2	5.9	3.1	3.2	2.8	3.4	2.8
Financial institutions	0.7	1.9	1.8	1.3	1.0	0.9	0.8	0.7	1.3
General government	2.4	1.9	-4.5	-11.2	-9.3	-9.2	-9.2	-8.8	-8.5
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-17.4	-17.9	-11.4	-2.1	-2.1	-2.7	-1.1	-0.4	0.6

SOURCE: Banco de España.

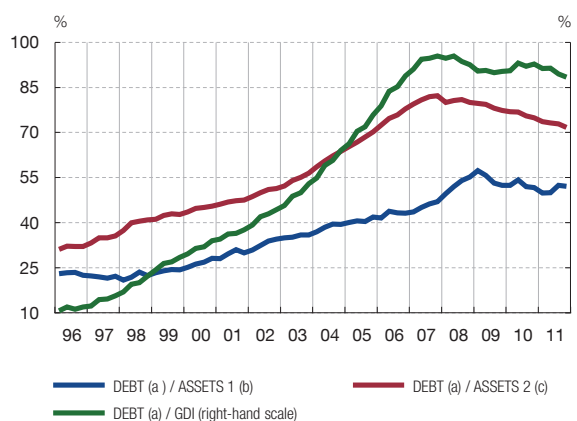
a Financial resources that cover the gap between expanded gross capital formation (real investment and permanent financial investment) and gross saving.

advantage of the more favourable conditions and the high demand for assets of this type. By instrument, the most notable development was the strong growth of long-term financing, while net short-term issues lost relative importance. The expansion of general government liabilities, along with the weakness shown by GDP, gave rise to further increases in the debt and debt burden ratios.

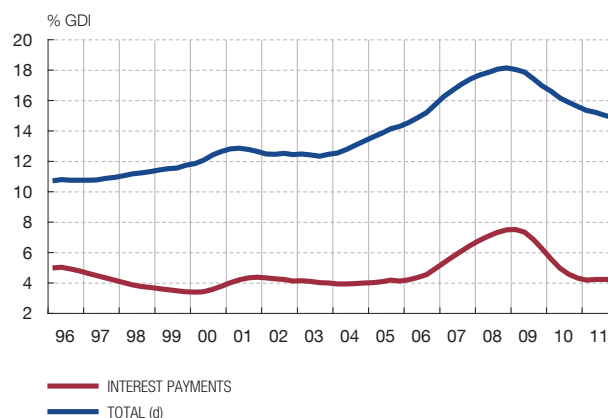
Meanwhile, according to the most recent Financial Accounts information, in 2011 Q4 the nation's net borrowing continued on its downward path to stand at 3.4% of GDP in 12-month cumulated terms, down 0.1 pp from September (see Table 8). This behaviour was the result of a decrease in the debtor position of general government (to 8.5% of GDP, down 0.3 pp from Q3), a decrease in corporate and household net lending, and a higher credit balance of financial institutions. The breakdown by instrument shows that in 2011 Q4 the bulk of foreign capital inflows were channelled through increases in the Banco de España's intra-system debtor position, while decreases were seen in both funds raised on the interbank market and those obtained from secured transactions settled in central counterparty clearing houses. These developments partly reflect the result of the ECB's extraordinary 3-year liquidity tender in December, in which resident institutions raised a large volume of funds to bolster their liquid assets and which they used, in part, to replace funding from other sources, such as, in particular, that from the interbank market in the broad sense (including that channelled through central counterparty clearing houses).

To summarise, in 2012 Q1 the financial markets were more stable and this allowed the wholesale funding conditions faced by resident sectors to improve. However, the strong re-emergence of tensions from end-March has been reflected in a further increase in long-term government debt yields and in the spread over the German bund, making conditions more difficult for raising funds on the markets. In the case of financial institutions, the higher liquidity obtained in the Eurosystem 3-year tenders provides a substantial buffer which reduces the refinancing risks faced by these institutions, mitigating the likelihood of a significant contraction in credit supply. However, the backdrop of economic weakness and the need to keep reducing the high levels of private sector debt continue to constrain the buoyancy credit in the short run.

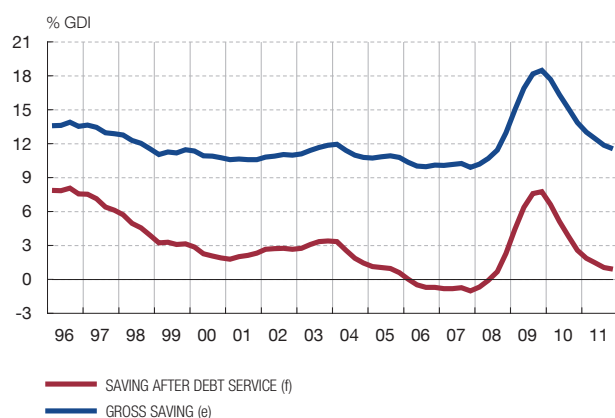
DEBT RATIOS



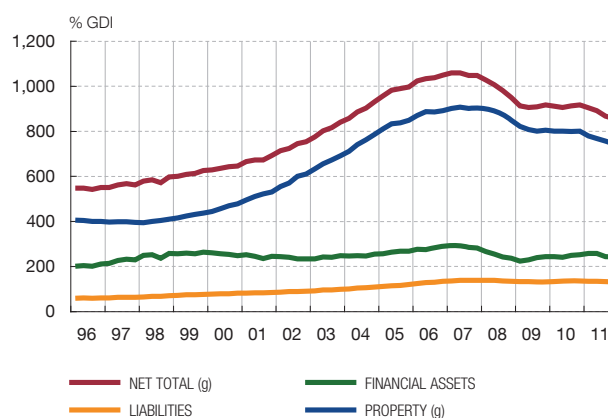
DEBT BURDEN



SAVING



WEALTH



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

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

5.2 Households

The interest rates on loans to households trended slightly upwards until February. Thus, in the case of house purchase loans and of consumer credit and other lending, the cost increased by 16 bp and 42 bp, respectively, compared with the levels of December, to stand at 3.8% and 7.7%.

Household debt continued to decrease and in February the year-on-year rate of contraction stood at 2.7%, a slightly sharper fall than that at the end of the previous year (2.4%). This was a result of the loss of vigour both of house purchase loans and of consumer credit and other lending, which showed year-on-year declines of 2% and 5.2%, respectively, compared with decreases of 1.7% and 4.6% in December 2011. The annualised quarter-on-quarter rates are similar to those obtained from the year-on-year indicators.

The decrease in household liabilities, along with the stagnation of income, brought a further fall in the ratio of debt to gross disposable income (GDI) in this sector (see Chart 24). This decrease also explains the behaviour of the debt burden relative to GDI, which con-

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

TABLE 9

% of GDP

	2008	2009	2010	2011		
				Q2	Q3	Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	2.4	4.6	3.3	1.7	1.8	1.2
Cash and cash equivalents	-0.4	4.2	-0.1	-0.3	-0.1	-0.1
Other deposits and fixed-income securities (a)	6.3	-0.8	3.0	2.9	2.2	1.2
Shares and other equity (b)	0.1	1.1	0.8	-0.6	0.3	0.1
Mutual funds	-3.5	-0.1	-1.7	-1.3	-0.7	-0.4
Insurance technical reserves	0.5	0.8	0.4	0.3	0.0	0.0
<i>Of which:</i>						
<i>Life assurance</i>	0.3	0.6	0.1	0.3	0.3	0.6
<i>Retirement</i>	0.1	0.2	0.3	0.0	-0.3	-0.6
Other	-0.6	-0.6	1.0	0.7	0.1	0.3
Financial transactions (liabilities)	2.2	-1.3	0.2	-1.1	-1.7	-1.5
Credit from resident financial institutions (c)	3.4	-0.5	0.1	-1.2	-1.3	-2.1
<i>House purchase credit (c)</i>	2.7	0.1	0.5	-0.4	-0.5	-1.1
<i>Consumer and other credit (c)</i>	0.8	-0.4	-0.3	-1.0	-0.8	-0.9
Other	-1.3	-0.8	0.1	0.1	-0.4	0.5
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	-1.1	-9.9	7.1	5.8	2.6	1.1
Cash and cash equivalents	-1.1	-0.3	-0.1	-0.5	-0.7	-0.7
Other deposits and fixed-income securities (a)	2.0	-0.7	2.0	2.3	1.7	1.7
Shares and other equity	3.7	0.4	3.6	2.0	0.9	0.0
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	3.5	0.2	3.0	1.8	0.6	-0.1
Trade and intercompany credit	-6.3	-9.6	1.0	0.4	0.1	-1.0
Other	0.6	0.3	0.4	1.6	0.6	1.1
Financial transactions (liabilities)	5.6	-9.2	5.7	3.8	1.4	0.0
Credit from resident financial institutions (c)	5.5	-3.0	-0.9	-2.2	-3.1	-3.7
Foreign loans	3.0	-0.1	1.0	1.3	0.9	0.5
Fixed-income securities (d)	0.3	1.3	0.5	0.6	0.5	0.5
Shares and other equity	2.4	2.5	3.3	3.2	3.5	3.0
Trade and intercompany credit	-6.4	-9.3	1.2	0.3	-0.1	-0.9
Other	0.8	-0.5	0.7	0.6	-0.2	0.6
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%)						
Financing (e)	6.6	-0.9	0.4	-1.4	-1.8	-2.4
Households and NPISHs	4.4	-0.3	0.2	-1.6	-1.5	-2.4
Non-financial corporations	8.2	-1.4	0.6	-1.2	-2.0	-2.3

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.

tinued to diminish slightly due to the smaller debt principal repayments. The gross saving rate and the saving after debt service also continued to fall, in line with the trend prevailing since the beginning of 2010. Household net wealth also fell again as a result of a decline in the value of both financial instruments and real estate assets.

According to the Financial Accounts, household investment in financial assets decreased in 2011 Q4 to 1.2% of GDP in 12-month cumulated terms (see Table 9). Deposits declined again, prolonging the trend initiated three months earlier which basically reflects a certain shift towards other bank and non-bank instruments (see Box 5).

The balance of deposits held by the non-financial private sector at resident credit institutions showed a rising trend until June 2011, against a backdrop of strong competition among banks to raise retail funds. Since then this pattern has reversed, household deposits declined (3.2%, between June 2011 and February 2012) and corporations' deposits fell more sharply (12.7%), although the balance of the latter is considerably lower (see Panel 1).

The adverse macroeconomic conditions in the second half of the year contribute to partly explaining the most recent developments in deposits. Thus, in a setting in which household gross saving has decreased (as well as their liabilities and those of corporations), households and corporations have gradually reduced their investment in financial assets, although it remained positive in the last six month of 2011 (see Panel 2) and, consequently, the decline in deposits in this period also reflects a slight restructuring of both sectors' financial portfolios.

One initial factor which may have contributed to explaining the drop in households' and non-financial corporations' deposits at resident credit institutions from July 2011 is the regulatory changes introduced in relation to the contributions that these institutions must make to the Deposit Guarantee Fund (DGF) and, specifically, the entry into force of Royal Decree 771/2011 in July 2011 and Decree Law 16/2011 in December 2011. The former establishes additional contributions to the DGF for those banks which arrange these instruments or remunerate sight accounts in excess of specified interest rates, whereas under the latter the contributions that banks must make to the DGF were raised. Both decrees could have contributed to discouraging deposit-taking, by favouring, in return, more buoyancy in banks' issuance of fixed-income securities. In line with this assumption, the Financial Accounts data show high investment in this type of instruments by both sectors in the second half of 2011 (and, specifically, between October and December). Thus, in the case of corporations, it practically offset the decline in their deposits at resident credit institutions, while for households, it reached an amount equivalent to one third of this decrease (see Panel 2). For the

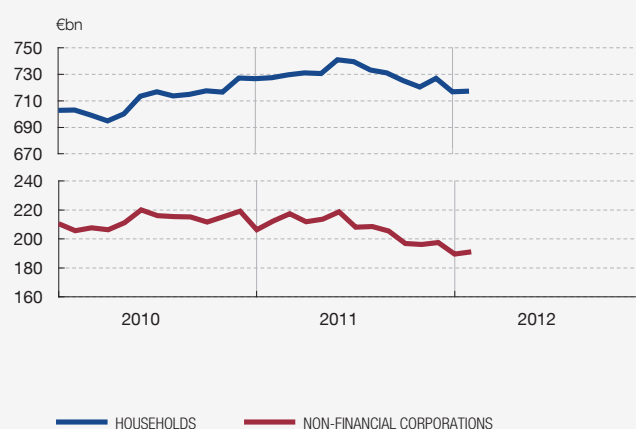
latter, the acquisition of shares and other equity issued by the banks was highly notable and reached a historically high amount (more than €11,000 million, the bulk of «Other» in Panel 2). Accordingly, a large part of the contraction of deposits has been counterbalanced by an increase in credit institutions' other liability items.

The shift towards instruments issued by general government, in a period in which the latter have offered higher returns, also seems to have contributed to explaining the drop in the balance of deposits held at resident credit institutions, especially in the case of households. Thus, in the second half of 2011, this sector's investment in these securities amounted to 34% (29% in treasury bills and 5% in medium- and long-term bonds) of their divestment of resident institutions' deposits. As for corporations, this percentage was much smaller (9%).

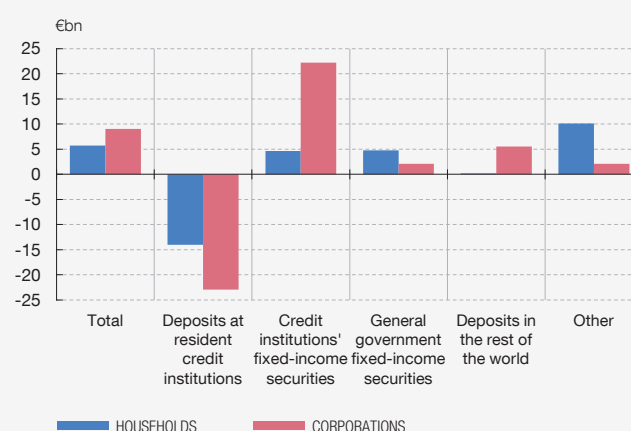
The Financial Accounts information also shows that deposits in the rest of the world, both of non-financial corporations and, to a lesser degree, of households have increased slightly in recent months. In the case of households, investment abroad in these liquid assets since mid-2011 has reached an amount equivalent to scarcely 1% of the decrease in deposits held in Spain. This percentage is higher for corporations (24%), although it must be considered that, in this case, the flows may be influenced by cash decisions adopted by large multinational groups as part of their global strategies.

In sum, the drop since mid-2011 in deposits held by households and non-financial corporations at resident credit institutions seems to be in response to a combination of factors. These factors include most notably, on one hand, an adverse macroeconomic setting, which has led to a reduction of their investment in financial assets, and on the other, households and non-financial corporations have reallocated their portfolios slightly towards resident institutions' other liabilities (such as fixed-income securities and equity issued by the latter); government debt securities; and – to a lesser degree – deposits in the rest of the world (especially in the case of corporations).

1 DEPOSITS AT RESIDENT CREDIT INSTITUTIONS



2 FINANCIAL ASSETS OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS
Flow in second half of 2011 (a)



SOURCE: Banco de España.

a Does not include trade credit or inter-company loans.

Finally, in 2011 Q4 the doubtful assets ratio increased for house purchase loans (by 0.11 pp to 2.8%), but decreased somewhat for consumer credit and other lending (by 0.08 pp to 6.9%).

5.3 Non-financial corporations

Interest rates on loans to firms decreased slightly until February. Thus they dropped by 6 bp for loans up to €1 million and by 31 bp for loans exceeding this amount, to stand at 5.4% and 3.1%, respectively. The cost of debt security issuance decreased for both short-term maturities (by 30 bp) and long-term maturities (by 80 bp), while the cost of equity issuance increased (by 23 bp).

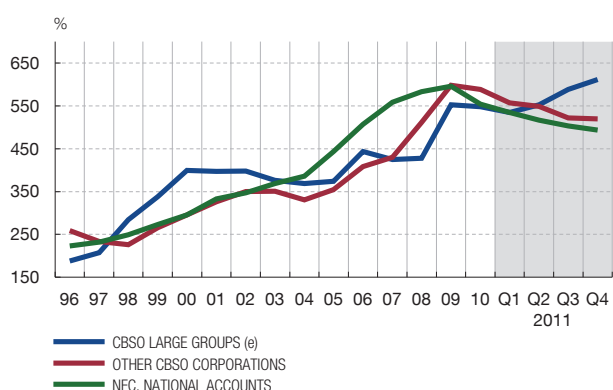
Corporate debt continued to fall in the opening months of 2012, and in February the year-on-year rate of contraction stood at 2.2%, this fall being practically the same as that seen at end-2011, which was 2.3%. The breakdown by instrument shows that in bank loans the year-on-year rate of decrease was 4.7%, i.e. 0.3 pp less than in December, while fund-raising through debt securities (the method used by the larger firms) accelerated, the balance growing by 9% with respect to the same month a year earlier. The latest information on lending by loan type, relating to end-2011, confirms that in the latter stages of last year the outstanding balance of bank financing continued to fall in all productive sectors. Once again, the largest year-on-year fall-off was in construction (14%), although it moderated somewhat with respect to previous quarters. In industry, however, the pace of contraction quickened to 6%, faster even than that of the real estate sector, which posted a fall of 5.5%. In other services, the diminution was more moderate (2.4%).

On the latest Financial Accounts information, relating to 2011 Q4, the credit balance of the corporate sector's net financial transactions decreased slightly to 1.1% of GDP in twelve-month cumulated terms, down 0.1 pp on September. Despite this, the drop in purchases in the rest of the world brought a widening of the financing gap, the indicator which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, which changed sign to post a positive balance equivalent to 0.6% of GDP, compared with -0.4% three months earlier.

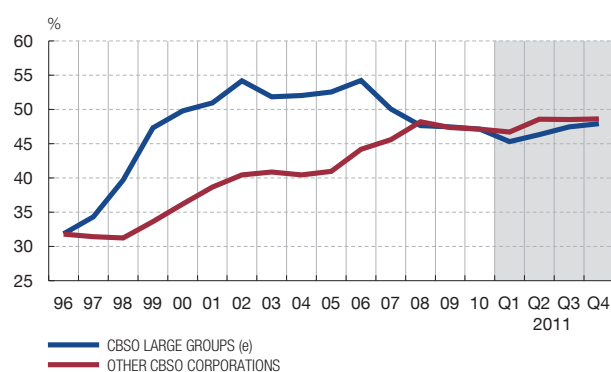
The debt ratio continued to decrease slowly in 2011 Q4 as a result of the fall in this sector's liabilities and of the rise in corporate income per the National Accounts. These same factors also explain the slightly downward trend in the debt burden (see Chart 25). By contrast, the Central Balance Sheet Data Office Quarterly Survey (CBQ) data show that the reporting firms' surpluses fell in 2011. Thus ordinary net profit was down by 7%, compared with a rise of 8.9% in 2010. This led to a decrease of more than 1.5 pp in return on equity, which fell to 7.4%. The debt-to-earnings ratio showed, for sample firms excluding large groups,¹ a downward trend in 2011 as a result of the decline in their interest-bearing liabilities. The ratio of debt to assets underwent insignificant changes, growing slightly mainly due to a fall in the denominator. The adverse trend of surpluses, along with the higher interest expense, pushed up the debt burden, particularly in the fourth quarter of the year. Despite this, the indicators of financial pressure on investment and employment decreased somewhat as a result of the favourable performance of firms in a more vulnerable position. In any event, these indicators stand at historically high levels. Meanwhile, analysts have revised downwards their expectations regarding the short-term perfor-

¹ The debt-to-earnings ratio of the firms belonging to the so-called large groups (Endesa, Iberdrola, Repsol and Telefónica) increased. This was due to a slight rise in interest-bearing liabilities of these firms and to the strong impact on these firms of their weaker ordinary profit, particularly in the second half of the year.

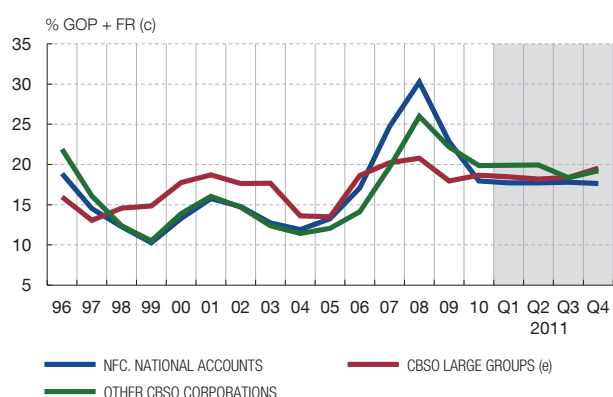
DEBT (b) / GOP + FR (c)



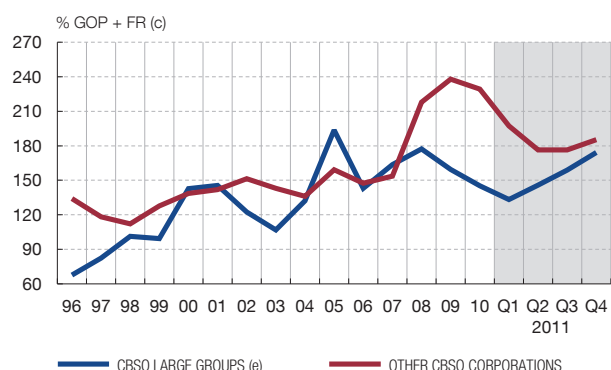
DEBT (b) / ASSETS (d)



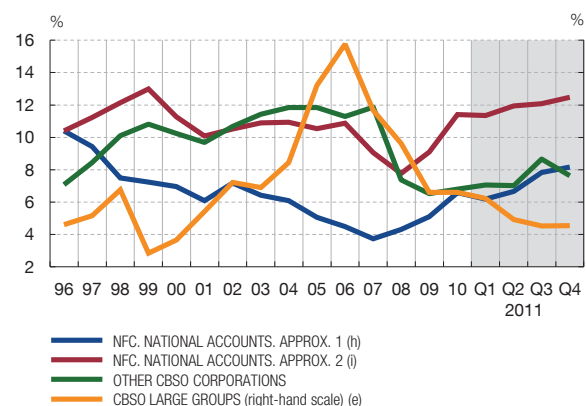
INTEREST DEBT BURDEN



TOTAL DEBT BURDEN (f)



NET ORDINARY PROFIT / OWN FUNDS (g)



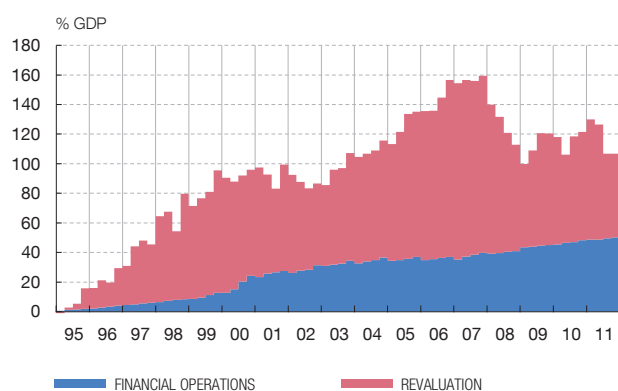
SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (j)



SOURCES: INE and Banco de España.

- a The indicators calculated from the CBSO sample were constructed until 2009 using CBA information; thereafter they have been extrapolated using CBQ information.
- b Interest-bearing borrowed funds.
- c Gross operating profit plus financial revenue.
- d Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
- e 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.
- f Includes interest plus interest-bearing short-term debt.
- g NOP, using National Accounts data, is defined as GOS + interest and dividends received - interest paid - fixed capital consumption.
- h Own funds valued at market prices.
- i Own funds calculated by accumulating flows from the 1996 stock onwards.
- j Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

CUMULATIVE CHANGE IN NET WORTH (a)



PROFIT GROWTH EXPECTATIONS OF LISTED FIRMS



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.

mance of listed firms' profits, whereas those for the longer term reflect a slight improvement (see Chart 26).

The doubtful assets ratio of non-financial corporations continued to rise in the closing months of 2011. This increase was seen in all productive sectors. Thus, in construction and real estate services it rose by 1.85 pp to 20.1%, while in other productive activities it moved up by 0.27% to 5%.

5.4 General government

The Financial Accounts show that in 2011 Q4 general government borrowing decreased slightly by 0.3 pp of GDP in 12-month cumulated terms, although it remains high (8.5% of GDP; see Table 8).

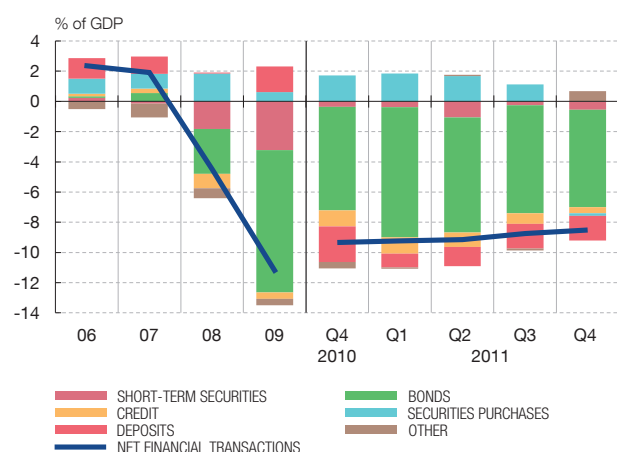
As usual, the main method of financing used by general government was bond issuance, through which funds equivalent to 6.4% of GDP were obtained, down 0.8 pp from September (see Chart 27). The funds raised through short-term debt securities increased by 0.2 pp, while those obtained through loans decreased by 0.3 pp, to account for 0.5% and 0.4% of GDP, respectively. On the asset side, net acquisitions of securities decreased by 1.3 pp to -0.2% of GDP and the stock of deposits also dropped, this time by the equivalent of 1.6% of GDP, the same percentage as in Q3.

In the opening months of 2012 general government debt continued to grow quickly, albeit somewhat more moderately than at end-2011, the year-on-year rate of expansion standing at 13.8% in February. Noteworthy among the various instruments was the strong growth of long-term financing (up 16.4%) while net short-term issuance lost momentum, being up by 0.5% in year-on-year terms. The breakdown by holder shows that in the last few months resident credit institutions acquired most of the new issues, whereas non-residents continued to disinvest in these assets. The expansion of general government liabilities, together with the weakness of GDP, led to fresh rises in the debt ratio (68.5% of GDP in December) and in the debt burden (2.5% of GDP).

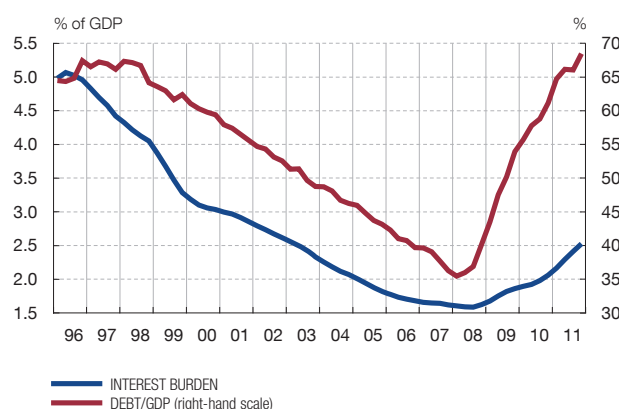
5.5 The rest of the world

On the latest Financial Accounts information, 2011 Q4 saw a continuation of the downward path of the nation's net borrowing, which stood at 3.4% of GDP in 12-month cumulated terms, down 0.1 pp from September (see Table 8). This behaviour was the result of a

NET FINANCIAL TRANSACTIONS. CONTRIBUTIONS BY INSTRUMENT (a)



INTEREST BURDEN AND DEBT RATIO



SOURCE: Banco de España.

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

slight decrease in the debtor position of general government, a drop in net lending by non-financial corporations and particularly by households, and an increase in the credit balance of financial institutions.

The funds raised in the rest of the world by resident sectors other than the Banco de España were insufficient to cover the nation's net outflows of funds and its excess of expenditure over revenue. As a result, the Banco de España's net financial transactions with the rest of the world again showed a debit balance, this time for a considerable amount: €74 bn. As noted above, this development is partly influenced by the result of the extraordinary 3-year ECB liquidity tender, in which resident institutions raised a large volume of funds. The latest balance of payments information shows that this pattern did not persist in January, there being very moderate international flows.

The breakdown by instrument shows that in 2011 Q4 the bulk of external financing was channelled through the Banco de España intra-system position. €85 bn of funds were raised in this way. By contrast, there were significant falls in the balance of net interbank funding and in the debit position vis-à-vis central counterparty clearing houses, each amounting to 6.7% of GDP, although in the past year as a whole there was an increase in credit institutions' debt in the form of collateralised transactions settled with these clearing houses (see Table 10). Also seen was a disinvestment by non-residents in debt securities issued by credit institutions and general government. By contrast, the funds raised through shares and other equity continued to be positive, although they fell slightly in twelve-month cumulated terms and were basically in the form of assets issued by non-financial corporations. Foreign direct investment in Spain fell by 0.1 pp to 1.8% of GDP in annual terms.

Financing by residents to the rest of the world decreased between September and December 2011 to 0.4% of GDP, and it also fell in twelve-month cumulated terms to 2.3% of GDP. Analysis by instrument shows that net investment in debt securities turned negative because disinvestment by institutional investors exceeded acquisition by other sectors.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 10

% of GDP

	2008	2009	2010	2011		
				Q2	Q3	Q4
NET FINANCIAL TRANSACTIONS	-9.2	-4.7	-4.0	-3.6	-3.5	-3.4
Financial transactions (assets)	0.8	-1.1	-2.5	2.0	2.9	2.3
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-1.3	-3.2	-1.4	0.4	1.5	0.4
<i>Of which:</i>						
Interbank - credit institutions	-0.5	-1.7	-1.3	0.2	0.9	0.0
Securities other than shares	1.3	0.0	-7.1	-4.6	-2.5	-1.1
<i>Of which:</i>						
Credit institutions	1.5	1.2	-3.1	-0.3	0.1	0.6
Institutional investors	-0.5	-1.0	-2.9	-2.8	-1.7	-1.2
Shares and other equity	1.7	1.6	3.2	3.2	1.5	1.1
<i>Of which:</i>						
Non-financial corporations	3.5	0.2	3.0	1.8	0.6	-0.1
Institutional investors	-2.3	0.5	1.0	1.0	0.6	0.5
Loans	0.8	0.3	1.0	2.0	1.5	1.4
Financial transactions (liabilities)	10.0	3.6	1.5	5.6	6.4	5.6
Deposits	8.0	-0.5	-0.5	0.8	4.9	8.7
<i>Of which:</i>						
Interbank - credit institutions (a)	6.2	0.7	-7.4	-1.8	-5.4	-3.6
Repos - credit institutions (b)	0.2	0.1	5.8	8.3	8.4	2.7
Interbank - BE (intra-system position)	1.9	-0.8	0.2	-6.5	1.7	10.5
Securities other than shares	-2.7	3.5	-2.0	-0.3	-2.8	-6.9
<i>Of which:</i>						
General government	1.1	5.1	1.9	2.0	1.4	-0.4
Credit institutions	-1.9	1.0	-1.3	-1.0	-1.7	-3.1
Other non-monetary financial institutions	-1.9	-2.6	-2.6	-1.2	-2.5	-3.4
Shares and other equity	3.2	1.0	2.3	3.1	2.8	2.6
<i>Of which:</i>						
Non-financial corporations	2.4	0.4	2.3	2.8	2.6	2.5
Loans	2.9	0.1	1.3	1.6	1.2	1.0
Other, net (c)	0.3	-0.7	-1.5	-0.7	-0.6	-0.3
MEMORANDUM ITEMS						
Spanish direct investment abroad	4.7	0.7	1.6	3.5	1.8	2.4
Foreign direct investment in Spain	4.8	0.6	1.8	2.4	1.9	1.8

SOURCE: Banco de España.

a Including bilateral repos.

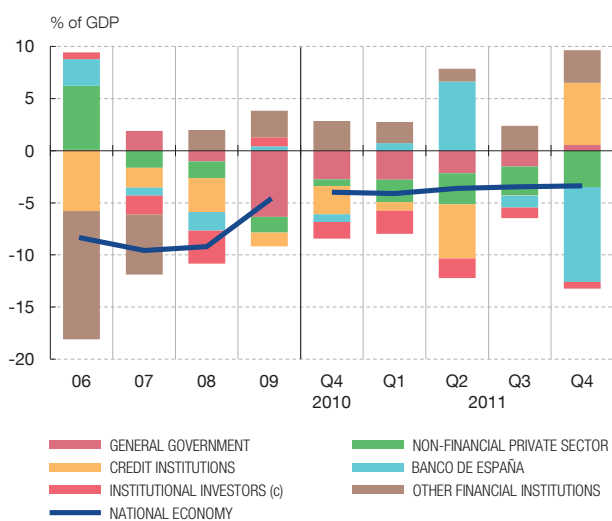
b Including transactions with central counterparty clearing houses.

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

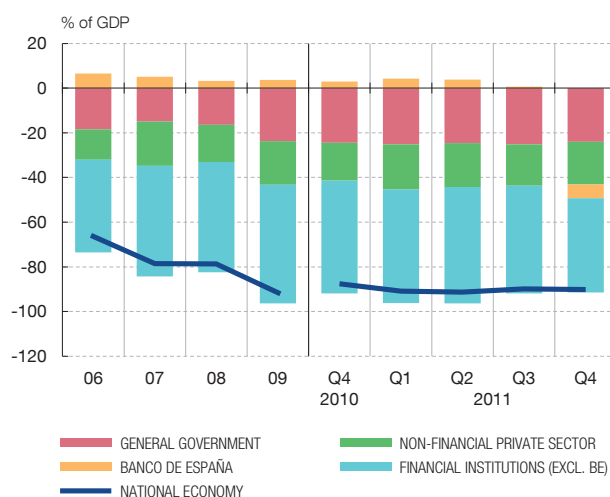
Contrastingly, purchases of shares and other equity increased slightly, compared with a decline in the previous quarter. Also up was Spanish foreign direct investment, which rose to 2.4% of GDP in annual terms, up 0.6 pp on September.

As a result of the developments in cross-border flows and of the changes in asset prices and in exchange rates, the value of the Spanish economy's net liabilities to the rest of the world was equivalent to 90.2% of GDP in December 2011, up 0.4 pp on September (see Chart 28). This slight increase was basically due to the Banco de España posting a debit

NET FINANCIAL TRANSACTIONS (b)



NET FINANCIAL ASSETS



SOURCE: Banco de España.

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

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

c Insurance companies and collective investment institutions.

balance vis-à-vis the rest of the world (equal to 6.1% of GDP) after it had been practically zero in the previous quarter. By contrast, the financial sector (excluding the Banco de España) and general government reduced their debit position vis-à-vis non-residents, while the net external debt of the non-financial private sector showed no significant changes.

19.4.2012

