1 OVERVIEW

During 2011, the modest recovery on which the Spanish economy had embarked a year earlier lost momentum as the euro area sovereign debt crisis spread to a larger number of countries and strains on financial markets heightened. Following flat activity in Q3, the economy is estimated to have contracted in Q4, with a quarter-on-quarter decline in GDP of 0.3%. In year-on-year terms the rate of output continued to increase, by 0.3%, a figure 0.5 pp down on that of the previous quarter. On the expenditure side, national demand is estimated to have fallen at a slightly higher rate than in the July-September period (0.5% quarter-on-quarter), while the positive contribution of external demand, at 0.3 pp, was somewhat lower than that in the previous quarter, reflecting the slowdown in export markets in the closing months of the year.

As at year-end, GDP is expected to have risen by 0.7% in 2011, having fallen in the two preceding years, widening the growth gap with the core euro area countries. Behind these developments lies a further contraction (of 1.3%) in domestic demand, which may be explained practically in its entirety by the negative contribution of investment in construction and by the fall-off in government consumption. Household consumption and investment in equipment were unable to counter these effects, as the initial momentum in these variables showed signs of tailing off as the year unfolded. Conversely, for the fourth year running, net external demand softened the impact of the contraction in domestic spending on activity, with a positive contribution of 2 pp underpinned by the strength of exports and by the sluggishness of imports, in line with the flatness of final demand.

On the supply side, value added in all productive branches except construction posted slightly positive increases on average in 2011, albeit moving on a generalised diminishing trajectory in the second half of the year. Under the construction heading, the declines were more marked in the non-residential construction segment, reflecting the effect of the budget austerity plans on civil engineering works, while they slackened in the residential component, where the adjustment of the excess capacity in the sector has made significant headway following four years of correction. Against this backdrop, employment showed no signs of picking up in 2011; indeed, job destruction stepped up after the summer. There was an estimated decline in numbers employed of around 1.7% in 2011 which, should it be confirmed, would mean a level of employment somewhat over 10% below that existing at the start of the crisis. The unemployment rate rose sharply during the year, climbing to 21.5% in Q3, a figure which is likely to have been surpassed in the closing months of the year.

In these circumstances labour costs – after stabilising the previous year – rose slightly, driven by the increase in compensation per employee in the market economy, a development on which the wage inflation-adjustment processes in force had a bearing. That said, unit labour costs fell once more in 2011, reflecting the significant increase in productivity. Lastly, as expected, the inflation rate slowed markedly in the final months of the year once the base effects of the July 2010 VAT rise (evident in the year-on-year rate of inflation in the first half of 2011) and those relating to the rise in tobacco duties and in oil prices in the closing months of 2010 were stripped out. Inflation ended the year at a year-on-year rate of 2.4%, or 1.5% excluding energy and unprocessed food prices, whereby the inflation differential with the euro area was once again favourable to Spain and negative of the order of 0.3 pp.

GROSS DOMESTIC PRODUCT (a)

CHART 1

SOURCES: ECB, INE and Banco de España.

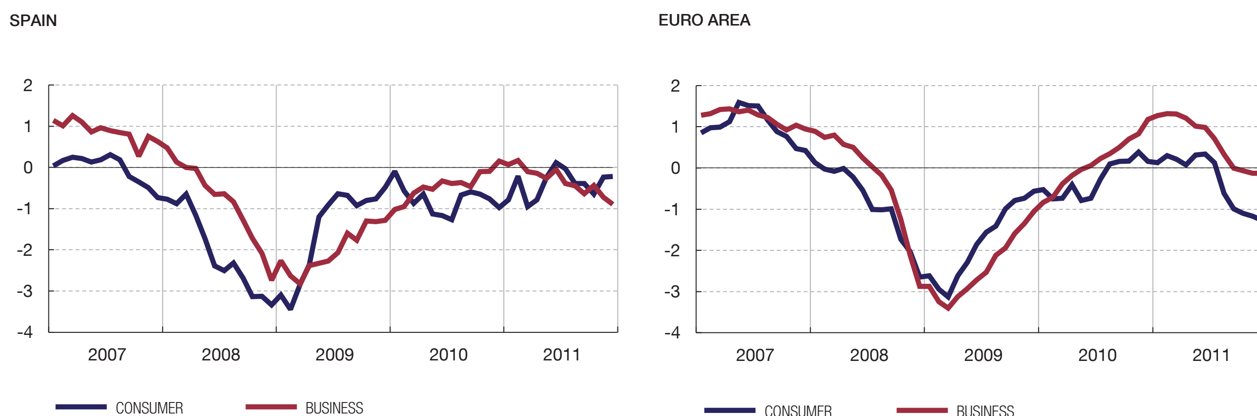
a Seasonally adjusted series.

On the international economic front, strains on European financial markets worsened in the closing months of 2011, in a setting in which the feedback loop between sovereign risk, bank risk and the loss of economic momentum affected an increasing number of euro area countries. The prolongation of this situation made it difficult for banks to access wholesale market funding and led to a downgrading of government bonds in a large number of euro area countries in mid-January 2012. Under these conditions, there was a marked downturn in economic activity in the euro area, which spread to other developed countries, in particular to the European economies, while the emerging countries maintained sustained growth.

As has been the case since the crisis broke, the worsening instability in Europe required an economic policy response at various levels. At the level of the European authorities, the euro area Heads of State or Government made further headway in improving governance in the area at the Summit on 9 December, and set out the role that the crisis-resolution mechanisms available must play. Specifically, they agreed on the key elements of a new fiscal pact aimed at reinforcing prevention instruments by means of setting ceilings on budget deficits. It was decided to establish a budgetary rule that sets a limit of 0.5% of nominal GDP on the annual structural deficit. This rule will contain a corrective mechanism that will be activated in the event of deviation and which should have constitutional rank. It is also planned to apply more automatically the sanctions envisaged in the event of an excessive deficit. As regards the measures to strengthen crisis-management tools, it was agreed to review in March this year the financing capacity of the future European Stability Mechanism (ESM) and to bring it on stream ahead of schedule in July 2012.

The ECB adopted a broad range of measures geared, on one hand, to ensuring an expansionary monetary policy stance, once the absence of inflationary risks in the context of the cyclical downturn in the economy was confirmed; and, on the other, to restoring the functioning of the channels through which monetary policy operates and, thereby, minimising the risks arising from the difficulties faced by banks in accessing funding. First, it cut interest rates on two occasions during the quarter, placing the main refinancing operations rate at 1%, and the deposit facility and marginal lending facility rates at 0.25% and 1.75%, respectively, as from 8 December. Further, it approved additional non-conventional measures supporting the supply of credit to households and financial corporations, which include the extension to three years of the term at which banks may borrow funds from the

CONFIDENCE INDICATORS (a) CHART 2



SOURCE: European Commission.

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

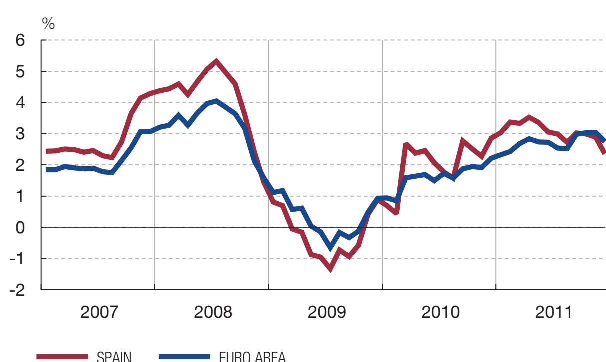
ECB, an increase in the range of eligible assets and the reduction in the reserve requirement ratio to 1%. In addition, it continued to pursue its Securities Market Programme under the previously agreed principles.

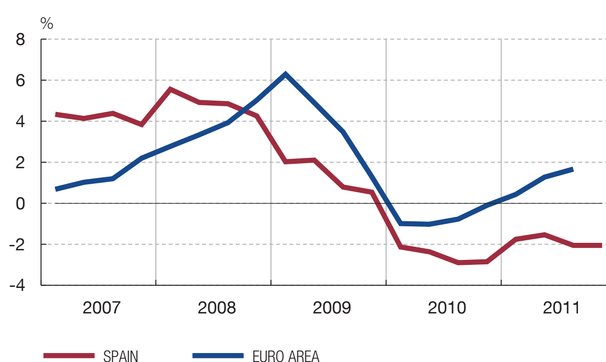
Finally, at the level of the governments most affected by instability, Italy unveiled complementary fiscal adjustment measures in the course of December, also bringing forward the schedule for applying reforms to its pensions system and announcing new structural policies. In Spain, the new Government resulting from the general election on 20 November approved a set of budgetary adjustment measures at the Council of Ministers on 30 December. It also announced a provisional estimate of the general government deficit for 2011 of around 8% of GDP, this representing a deviation of 2 pp from the target set in the latest Stability Programme. These measures involve a reduction in public spending of the order of €8.9 billion, to be implemented through the announced cancellation of appropriations in the State budget, a freeze on public-sector wages and the introduction of specific restrictions on public-sector employment. On the revenue side, there were temporary rises in tax rates on income from work and from saving under the personal income tax heading, and an increase in property tax. These will have a revenue-raising impact estimated at €8.1 billion.

Despite all these measures, high volatility continued to buffet the financial markets during 2011 Q4, while the euro underwent a marked depreciation. The instability on European financial markets fed through to the Spanish government debt and private fixed-income markets, to share prices and to the interbank market, with strains heightening severely in 2011 Q4. In 2012 to date there has been some rise in instability, in a setting which remains characterised by high volatility. Also, as part of a widespread reassessment of sovereign risk in the euro area, one of the main rating agencies downgraded the Kingdom of Spain by two notches. The IBEX 35 has fallen by 1.4% since the start of the year (after tumbling 13.1% in 2011), while Spanish government bond yields and the spread over the German *Bund* rose once more, standing at 330 bp at the time of this report going to press. Meanwhile, credit risk premia on securities issued by the private sector have fallen slightly. Against this background, credit institutions have faced further and major difficulties in raising funds on bond and interbank markets. In the real estate market, the fall in open-market house prices intensified during the closing months of 2011, ending the year posting a year-on-year decline of 6.8%. As a result, the market value of housing had, as of the close of 2011, fallen by 19% since early 2008 (25% in real terms). In these circumstances,

PRICES AND COSTS

CHART 3





SOURCES: Eurostat, ECB and INE.

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

financing conditions for the private sector tightened further, since the higher cost involved for financial institutions in raising funds meant that the interest rates on loans extended to households and firms scarcely reflected monetary policy easing.

Overall, the step-up in the sovereign debt crisis and its interaction with the financial system situation have severely affected the Spanish economy, worsening financing conditions and impairing agents' confidence. In this setting, household spending plans showed further weakness, to the extent of posting a slightly negative rate in the final months of the year. Consumption is estimated to have stagnated in 2011, following its moderate rise in 2010 (0.8%), in a context marked by heightened uncertainty and unfavourable labour market developments, the decline in disposable income and the fall in financial and non-financial wealth alike. All these developments have been present over the past four years, influencing household decision-making. Yet in 2011 there was some increase in agents' nominal disposable income, which ceased to decline as from Q2, although household purchasing power fell off owing to the rise in inflation. Set against this behaviour of the sources of household income and wealth, saving served, for yet another year, to cushion the pattern of household consumption, as has been the case since 2009 (when it peaked at an annual average of 18.5%). There was thus a fresh decline in the saving rate which, it is estimated, stood at 11.8% of disposable income, drawing close to pre-crisis levels.

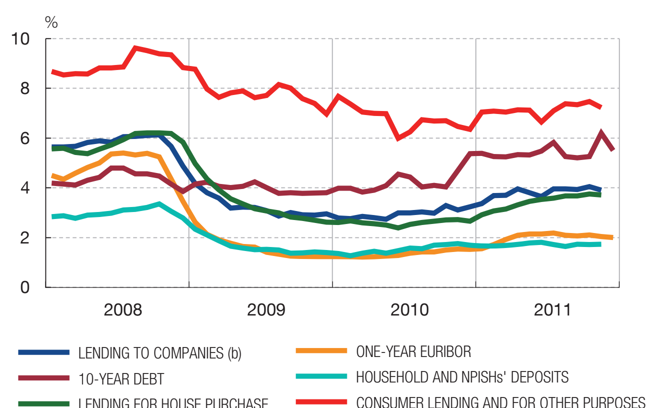
Residential investment also failed to show signs of recovery in the closing months of the year; indeed, its rate of decline compared with the previous quarters may even have steepened. This rate in 2011 is estimated at around 5%, half that of the previous year. Against this background of sluggish expenditure and tightening financial conditions, household debt posted negative rates, somewhat greater than those observed at the end of Q3. The fall-off was more marked in consumer finance (-5% in November) than in house purchases (-1.2%).

In the corporate arena, the deteriorating economic outlook, weaker foreign orders and difficult financing conditions adversely affected the start-up of new investment projects. As a result, non-financial corporations' investment both in equipment and in other constructions fell back in Q4. For 2011 as a whole, however, a positive rate of change is estimated

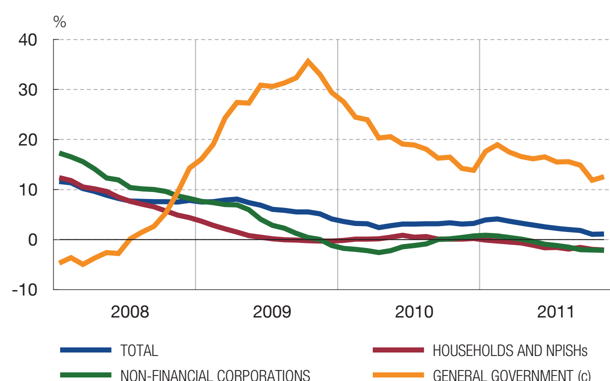
FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4

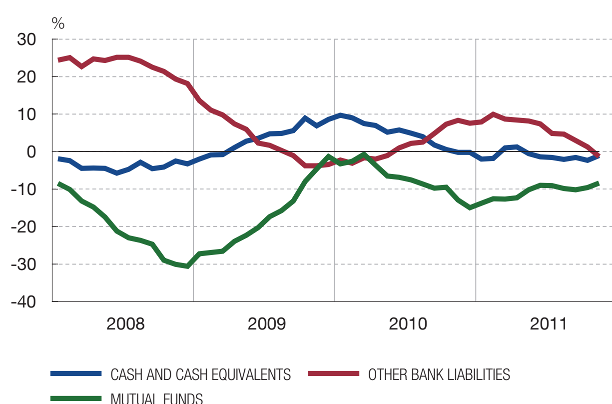
INTEREST RATES (a)



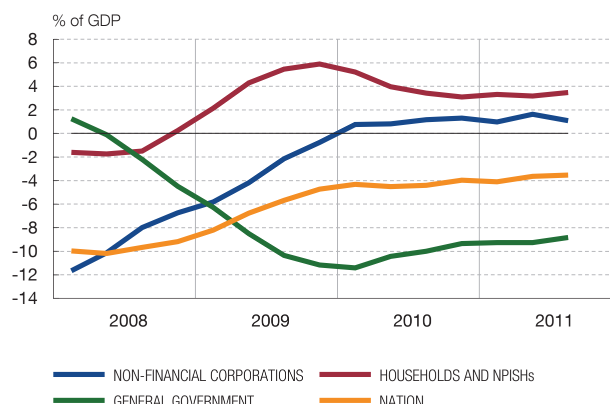
FINANCING TO NON-FINANCIAL RESIDENT SECTORS
(year-on-year growth)



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



NET FINANCIAL TRANSACTIONS (d)



SOURCE: Banco de España.

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

for private productive investment, following the declining trajectory on which other domestic demand components moved during the year. In the case of non-financial corporations, the rate of contraction in debt was sustained, standing in November at 2.1% year-on-year.

The declining pattern of borrowed funds is expected to have provided for a reduction in both household and corporate debt ratios in 2011, placing them in September at 124% of GDI and at 500% of GOS and financial revenue, respectively. In 2011 both sectors once again evidenced net lending capacity, as can be seen in the Q3 data on the non-financial accounts of the institutional sectors, namely 2.8% of GDP in the case of households, and 1.1% of GDP in that of non-financial corporations, in cumulative four-quarter terms. The improvement in these financial position variables of the non-financial private sector indicate the headway that is being made in the restructuring of these agents' balance sheets, which is a pre-requisite for further progress in the necessary financial deleveraging process.

The end-2011 general government deficit stood at around 8% of GDP, according to the preliminary estimate announced by the new Government. The information available to Q3 shows that overall general government public spending posted a year-on-year decline of 2% in the first nine months of the year, not far off the rate of -2.6% targeted for the year as a whole. Meantime, public revenue dipped by 0.8%, compared with the targeted increase of 5.4%. This would suggest that the main source of deviation in 2011 has been tax revenue, which has proven far lower than forecast. In terms of agents, and based on the same information, deviations came about at all tiers of government, although these were on a greater scale at the regional government level.

The overrun in public finances this year shows the existence of certain weaknesses in the procedures for monitoring and controlling the budget outturn, despite the effort made to strengthen transparency in the regional government accounts. These need to be remedied immediately by implementing the legislation envisaged by the constitutional amendment adopted and the strengthening of the fiscal pact agreed in the EU.

As for foreign trade, the incomplete information currently available indicates that in the closing months of 2011 external demand partially offset the effect of the contraction in domestic spending on activity, albeit with a somewhat smaller contribution than in the preceding quarters due to the slowdown in export markets. Accordingly, in 2011 the external sector again played a decisive role in cushioning the fall in activity, its contribution to average GDP growth in that year being estimated as 2 pp. Underpinning this component was the notable buoyancy of exports, which grew at a faster pace than export markets, leading to an increase in the corresponding market shares, and a recovery in tourism, which benefited from the shifts in international tourist flows in response to the geopolitical problems that arose in alternative destinations in North Africa and the Middle East. This effect was reinforced by the weakness of imports given the slackness of domestic spending. The cost and price adjustment undertaken in recent years by the producers of consumables and firms connected with the tourism industry, which is reflected in the price-competitiveness indices, is undoubtedly driving these good results, so that strategies to reduce costs and margins, diversify products and markets, and improve quality need to be persevered with in order to entrench the progress made so far.

In the setting described, the nation's net borrowing continued to decline to 2011 Q3, when it stood at 3.5% of GDP, in cumulative four-quarter terms. Following the pronounced adjustment in the external deficit in recent years, the correction trend is beginning to show signs of slowing, despite the notable improvement in the goods and services balance, as a consequence of the brake entailed by the high energy content of Spanish imports and investment income payments, two of the main vulnerabilities afflicting Spain's position vis-à-vis the rest of the world.

The progressive spending weakness during 2011 was reflected on the supply side of the economy. All the productive sectors participated in this trend. The decline in manufacturing activity in recent months, impacted by the deterioration in external demand, has been notable, as has the accentuation of the contractionary tendency in the construction sector. However, the most unfavourable aspect from the supply standpoint was the behaviour of the labour market, which far from beginning to stabilise, as had been forecast at the beginning of the year, saw an acceleration in the destruction of employment in the second half of the year. The number of persons employed is estimated to have fallen by 1.7% in 2011, which is explained by the reduction in employment in the market economy (-2.2%), since in the non-market sectors as a whole employment remained at similar levels to those of the

previous year (0.4%), reflecting only gradually the effect of restrictions on the coverage rate in public-sector employment. Given the estimated path of output and employment, apparent labour productivity growth remained relatively sharp (2.4%). This was slightly down on the previous year, though with a higher growth profile in the second half of the year.

Finally, the trend in labour costs of previous months extended into Q4, with compensation in the market economy and in non-market services diverging. Compensation per employee in the market economy posted growth of around 1.4%, while compensation in non-market services fell, to some extent still reflecting the impact of the reductions in public-sector wages in the previous year. Underlying the behaviour of labour costs in the private sector, which displayed average growth of 1.5% in 2011, as against 0.2% in 2010, are two characteristics of the wage-setting mechanism which increase wage inertia: first, the pass-through into wage increases of the price rises of an essentially temporary nature that occurred in the final months of 2010, as a consequence of the presence in a very large number of collective agreements of indexation clauses; and, second, the high proportion of multi-year agreements with a sectoral scope that hinder the adjustment of wages to cyclical changes and to the specific situation of each firm. In any case, unit labour costs fell in 2011, for the second consecutive year, with the assistance of productivity gains, which enabled the position vis-à-vis the euro area countries to improve. Perseverance along this path is also required to embed the competitiveness gains that may be generated.

2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

Global economic and financial conditions during the past quarter have continued to be marked by the delicate situation facing the euro area, which remains the main source of risk for the global economy. Against this background, there was a significant increase in risk aversion on international markets and a downturn in growth prospects, although the deterioration in markets and in economic indicators has eased in the past weeks. Performances differed in the advanced economies, with some favourable signs in the United States, distancing the possibility of a new slump, and a more worrying outlook in the United Kingdom and in Japan. A controlled slowdown was the prevailing pattern in the emerging economies, although there were some problem cases (Turkey and Hungary) and a gloomier outlook in the case of Eastern Europe, given its closer links with the euro area (see Box 1). Inflation generally eased in the developed economies, and in some emerging regions. In this context, monetary policy remained exceptionally expansionary in the advanced economies. There, the non-conventional measures announced in the preceding months have been implemented, and further stimuli are not ruled out if the slackness of economic activity persists. In the emerging regions, diminished inflationary pressures have softened the monetary policy dilemma previously faced, meaning that in some countries the cycle of monetary easing has commenced. In the fiscal arena, a key development has been the announced delay in the budgetary consolidation in the United Kingdom and the extension during January and February of the reductions in social security contributions, and the extension of unemployment benefits in the United States.

During the past quarter, financial market developments were severely affected by the continuing sovereign crisis in the euro area. However, in recent weeks this has been alleviated by the release of various less-unfavourable-than-expected macroeconomic indicators, especially in the United States, and by various central bank measures (unlimited liquidity auctions by the ECB and coordinated action to cut dollar swap rates by 50 bp). Against this backdrop, certain developed countries' (United States and United Kingdom) stock markets stabilised and there was some reduction in volatility. US 10-year bond yields moved in a narrow band around 2% throughout the period, partly as a result of flight-to-quality movements. On the foreign exchange markets, the dollar also acted as a safe haven and appreciated against the main currencies, of developed and emerging countries alike. In particular, it appreciated by more than 10% against the euro, to $1.26. Bank wholesale funding in the main currencies continue to evidence high tensions. In the emerging markets, behaviour differed from region to region during the quarter, with a downturn in share prices, sovereign yields and risk indicators that was moderate in Asia and more marked in Eastern Europe. In Latin America, stock market losses and the increase in credit risk indicators were small. Capital outflows, both from stock markets and debt, were intense from mid-November to mid-December. Elsewhere, the trend of commodities prices was divergent during the quarter. Prices of metals and foodstuffs fell due to the slowdown in economic activity, whereas Brent oil prices held within a range of $105-115 per barrel.

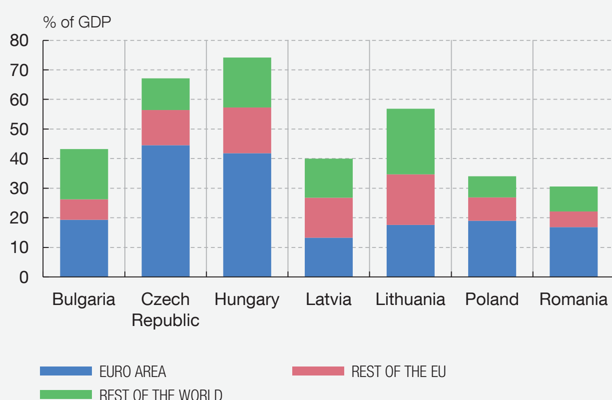
In the United States, the final estimate of GDP for Q3 showed annualised quarterly growth of 1.8%, underpinned by private consumption, non-residential fixed investment and net exports. The latest indicators show a somewhat brighter picture, although they all continue to suggest a moderate recovery. Industrial production and capacity utilisation weakened towards the end of the quarter, as did business confidence, although these variables

The new EU Member States (NMS)[1] have benefited in the past decade from a greater degree of trade and financial integration with the other EU countries, which has enabled them to make headway in real convergence. This greater integration has resulted in an improvement in their economic conditions, although it has also made them more vulnerable to shocks originating abroad, as manifest in the recent periods of financial strains. In particular, the heightening of the euro area sovereign debt crisis since August 2011 has prompted a growing deterioration in the region's financial markets, while these countries' external trade is undergoing the adverse effects of the decline in economic activity in the euro zone. Furthermore, the fragile position of the area's financial institutions might contribute to lessening the exposure of their subsidiaries with a presence in emerging Europe, with the consequent adverse repercussions on these economies. This box analyses the new Member States' trade and financial dependence on the euro area, highlighting the most evident risks arising from integration.

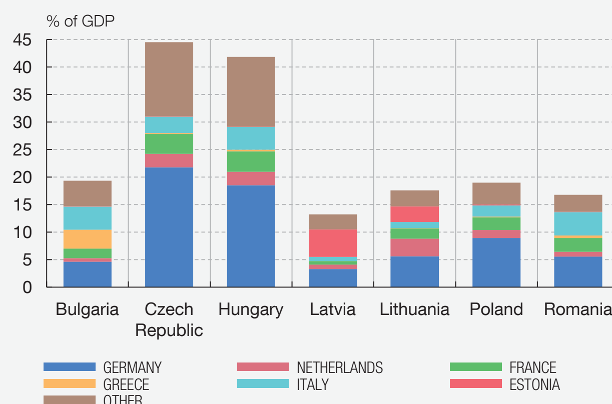
The ongoing development of the NMS in the years prior to the crisis was based, among other factors, on growing foreign capital inflows. That entailed transfers of technology and business know-how, which notably improved their capacity and productive quality and, therefore, their economic and export potential. The export share of the NMS in world markets increased most significantly from 2000 to 2010, in contrast to the slide the export shares of the

1 This box analyses those countries that have not yet adopted the euro (Poland, Hungary, Czech Republic, Latvia, Lithuania, Bulgaria and Romania).

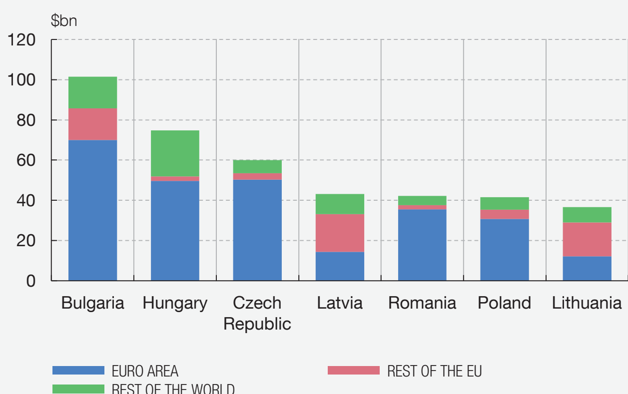
1 NMS EXPORTS IN 2010



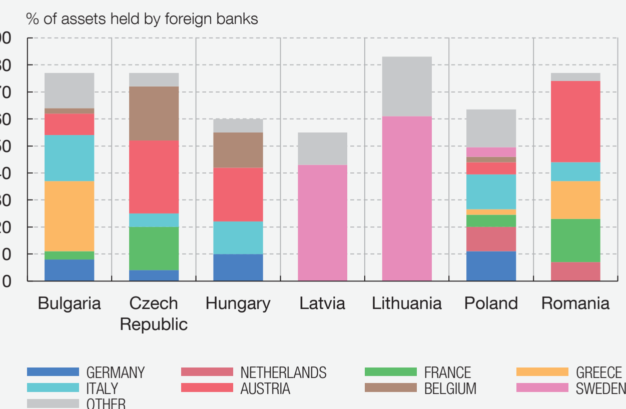
2 NMS EXPORTS TO THE EURO AREA IN 2010



3 STOCK OF FOREIGN DIRECT INVESTMENT BY SOURCE IN 2009 (a)



4 EXPOSURE OF EUROPEAN BANKS TO EASTERN EUROPEAN COUNTRIES



SOURCES: Eurostat and Fitch.

a Not including transactions by Special Purpose Entities (SPE), which are very significant in the case of Hungary.

developed economies underwent over this same period. In parallel, their imports also expanded, in step with their growing investment needs and with the growth of certain imported input-intensive industries, such as the automobile sector. Consequently, the degree of openness of these economies - measured as the sum of exports plus imports as a percentage of GDP - rose during the decade, exceeding 69% of GDP in all the countries and surpassing 120% in Hungary, the Czech Republic and Lithuania, on figures for 2010.

The expansion of foreign trade in the region was essentially based on the strengthening of their trade ties with the euro area countries. Panel 1 shows how in 2010 more than half of these economies' exports - with the exception of Latvia, Lithuania and Bulgaria - were to the euro area countries. This figure is attributable, above all, to the strong trade ties with Germany, which received 44% of the region's total exports to the euro area. Among the NMS, the Czech Republic and Hungary have the biggest trade exposure to the euro area, since their exports to this area accounted for more than 40% of GDP in 2010 (around half went to Germany), while in the remaining countries the figure was less than 20% of GDP (see panel 2).

Growing trade integration and economic transformation in the NMS have been associated with intense foreign direct investment flows, in the main from the euro area, driven by the region's economic development potential. The cumulative stock of direct investment exceeded 60% of GDP in Bulgaria, the Czech Republic and Hungary at end-2009, while in the remaining countries it stood at between 36% and 43%. The euro area is clearly predominant as regards the source of investment, accounting for more than 70% of the stock, except in Latvia and Lithuania (see panel 3). A specific aspect of this process is the sizeable presence of foreign banks, which have prompted a deep-seated restructuring of these countries' banking systems. As a result, between 55% and 85% of banking sector assets in these countries belonged in 2010 to foreign subsidiaries and branches, whose parents are practically all EU-based (see panel 4). In terms of nationality, there is a high presence of subsidiaries of Austrian, Italian, Greek and, to a lesser extent, of German and French banks; in Latvia and Lithuania, Swedish banks own more than half of bank assets.

The strong penetration by EU banks in the NMS is deemed most beneficial for these economies, since the existence of a long-term strategic interest in the region on the part of advanced economies' banks is presumed, something which ensures continued funding of subsidiaries by their parent banks. In line with this presumption, the so-called "Vienna initiative[2]" promoted an agreement in January 2009 to maintain the parent banks' exposure in the region, thereby preventing capital flight and the outbreak of potential banking and foreign exchange crises in emerging Europe. However, the recent heightening of financial strains at banks in the euro area has prompted debate about the possible adverse effects of these countries' financial exposure, with three factors of risk.

Firstly, the risk of financial deleveraging by the parent banks, in the context of the euro area crisis (which has hampered the wholesale funding of many banks), and the need to strengthen capital buffers would have unfavourable macroeconomic repercussions for the region. Austria was the first euro area country to announce restrictions on the extension of credit over certain limits to the Eastern European countries, in order to avoid exposure considered excessive. In addition, other euro area banks have acknowledged that they are reviewing their local refinancing plans so as to assess in which countries they should invest.

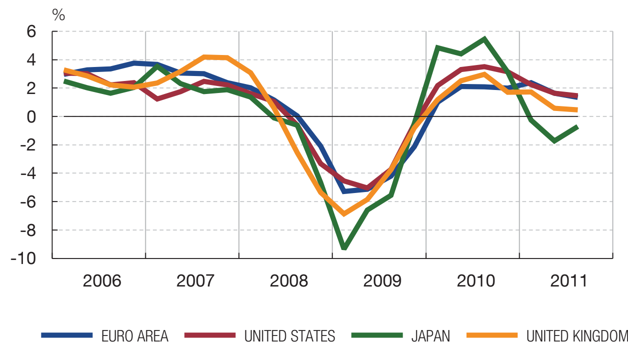
Secondly, the exacerbation of the problems that would arise from contagion via the bank credit channel: insofar as lending institutions operate in several countries, the materialisation of credit risk in one country might prompt a re-pricing of risk for the entire region. This channel may be important for countries in the south-east of the EU, with heavy exposure to Italian, Austria and Greek banks, which have a number of subsidiaries in several countries in the region.

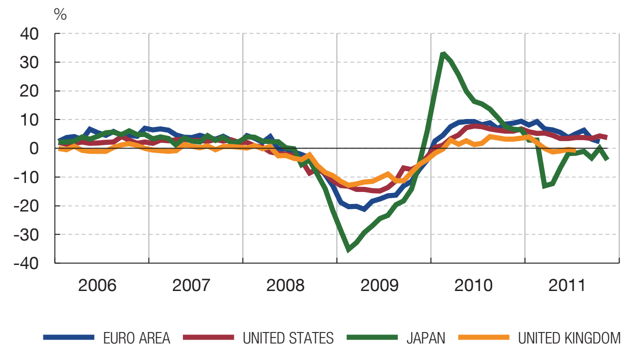
Third and finally, asymmetry in financial exposure between parent banks and subsidiaries. The exposure of foreign banks to the recipient countries of financial flows (i.e. the proportion of their investment or loan portfolio assigned to those countries) is usually far lower than the percentage that these financial flows represent to the recipient country as a proportion of total liabilities. Accordingly, minor changes in lending policy from the standpoint of the parent bank may have a major impact on the macroeconomic and financial stability of the country in which the subsidiary is present (including sudden corrections in exchange rates, with significant wealth and balance sheet effects). This asymmetry chiefly exposes small recipient countries to the risk of a strong cut in the provision of credit, even in the event of a moderate slowdown in credit by parent institutions.

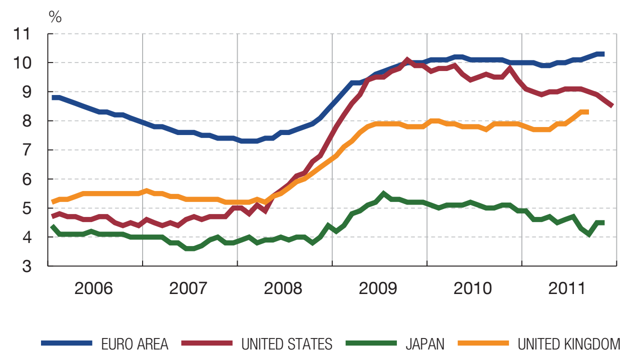
2 This was a European banking coordination initiative whose aim was to establish a voluntary coordination framework for analysing and resolving financial sector crises in emerging European countries (whether belonging to the EU or not) that were beginning to encounter serious funding difficulties. The initiative, led by the IMF, the European Bank for Reconstruction and Development (EBRD) and the Austrian Finance Ministry, succeeded in involving the public and private sectors, whereby four groups of participants were established: i) international financial organisations [IMF, European Investment Bank (EIB), World Bank and EBRD]; ii) European institutions (the European Commission and the ECB as an observer); iii) the central banks, Governments and supervisory authorities of both the home countries of the main banking groups and of the emerging European countries most affected by the crisis, and iv) the main international banking groups with interests in the region.

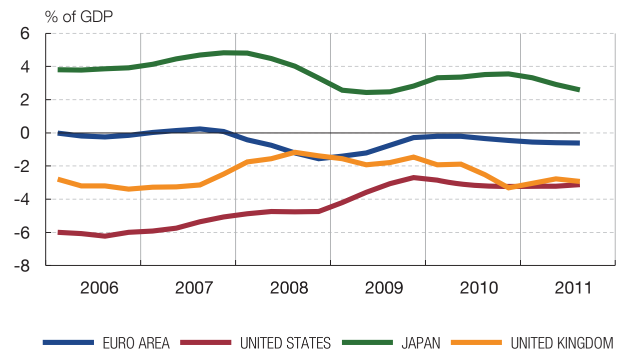
MAIN MACROECONOMIC INDICATORS

CHART 5









SOURCES: Datastream and Banco de España.

a Percentage of labour force.

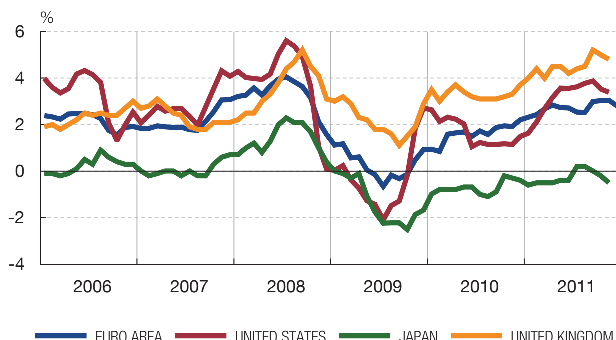
continue to point to modest growth. In parallel, retail sales rose sluggishly in December, though consumer confidence has continued to improve. There was some acceleration in net job creation in the labour market, although this remains low compared with previous episodes of recovery, and the unemployment rate dipped by 0.5 pp in the quarter (to 8.5%). On a more negative note, wage growth is far below inflation and the participation rate remains at a low level. Housing starts and sales offered marginally more positive signs, although the attendant series are still at historical lows and the downward adjustment in prices and tight credit conditions remain in place. CPI inflation stood at a year-on-year rate of 3.4% in November, while core inflation was 2.2%. Given this economic and financial fragility, the Federal Reserve kept its expansionary monetary policy stance unchanged, while announcing changes in its communications policy, involving the release of interest rate projections as from its January meeting.

In Japan, GDP expanded at a quarterly rate of 1.4% (-0.7% on year-on-year) in Q3, driven by the rise in exports and the momentum of private domestic demand. However, the Q4 indicators point to a notable downturn in activity, which is greatest in the manufacturing sector and linked to exports, which have been affected by the sluggishness of the external environment and the persistent strength of the yen, as well as by the floods in Thailand. In the labour market, the unemployment rate held in November at 4.5%, with a weak recovery in employment and in the labour force. The overall CPI return to deflationary territory

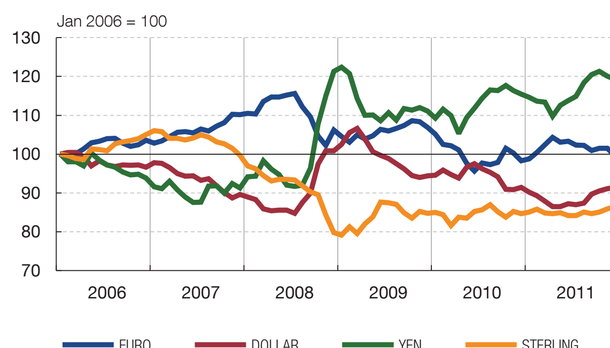
PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6

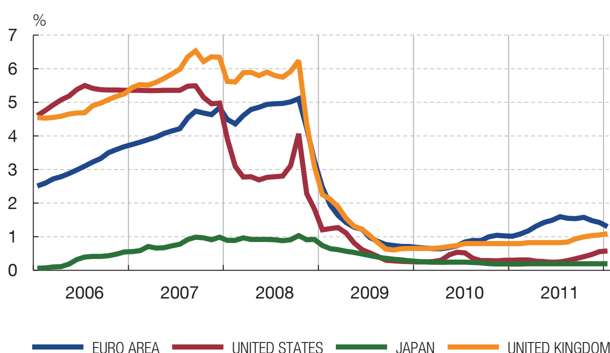
CONSUMER PRICES
Year-on-year rate



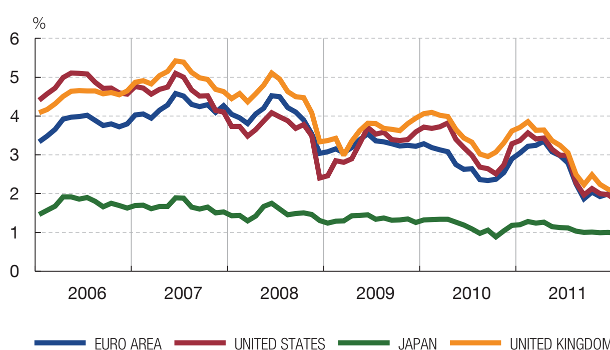
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES



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.

(-0.5% year-on-year in November) and the rate of decline of core inflation steepened. In this setting the Bank of Japan held its official interest rate in a range of 0%-0.1%, and retained its asset purchase programme. Further, the Japanese authorities intervened on the foreign exchange markets to prevent the appreciation of the yen, for an estimated amount of ¥7.7 trillion (1.6% of GDP).

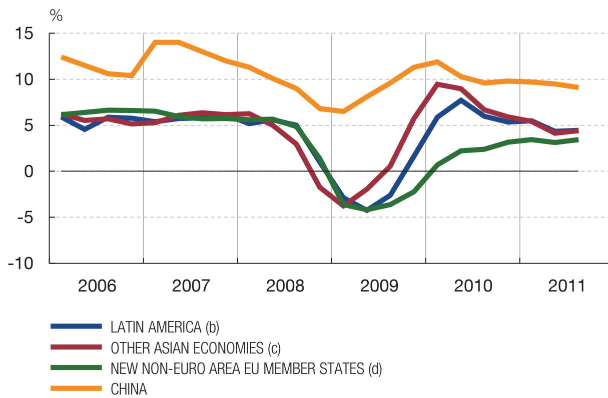
In the United Kingdom, GDP grew at a quarterly rate of 0.6% (0.5% year-on-year) in Q3, underpinned by stockbuilding and, to a lesser extent, gross fixed capital formation. The Q4 indicators broadly show activity to be notably sluggish, and augur a slight contraction in the manufacturing sector. Retail sales posted positive growth to November, despite the downturn in consumer confidence and in the labour market, where the unemployment rate climbed to 8.4% in November. Inflation eased by 1 pp from its September peak to 4.2% in December, while core inflation held at around 3%. The Bank of England pursued its public debt purchase programme (scheduled to run to February) during the quarter to the tune of £75 billion, which will account for around 60% of net Treasury issues in the period. In November, the Government put back meeting its target of eliminating the structural deficit by two years, to 2016-2017.

In the new EU Member States not belonging to the euro area, GDP grew on average by 3.4% year-on-year in Q3, compared with 3.1% in Q2. But signs of industrial production

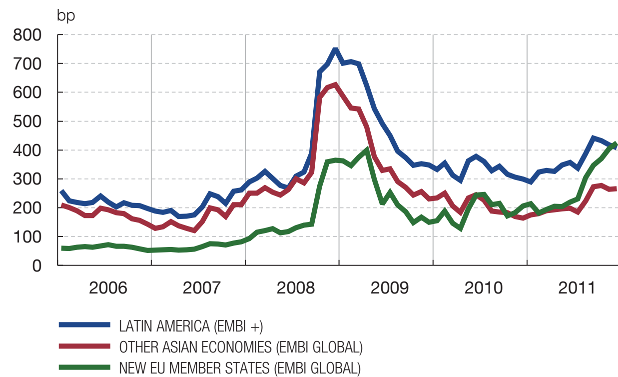
EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a)

CHART 7

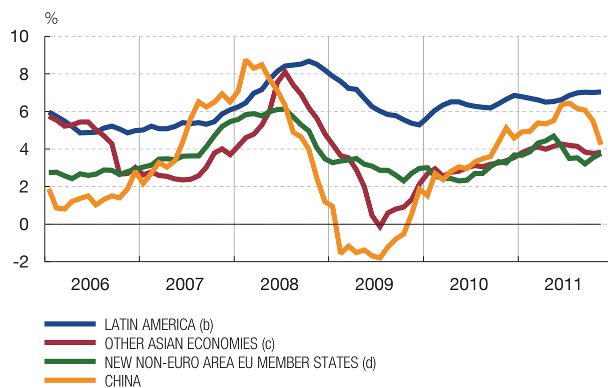
GROSS DOMESTIC PRODUCT
Year-on-year rate



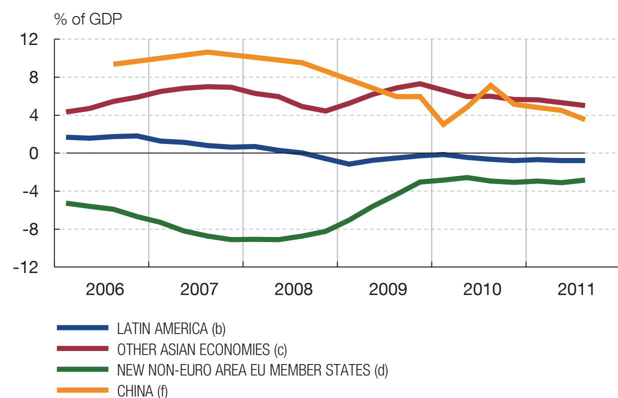
INTEREST RATE SPREADS OVER THE DOLLAR (e)



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.

and exports easing in Q4 were apparent. Throughout the final quarter, the inflation performance across these countries was mixed; however, the aggregate rate increased by 0.4 pp from September to December to 3.7% year-on-year, owing to price rises in Poland and Hungary, where the marked depreciation of their currencies was a contributing factor in the final stretch of the year. In terms of monetary policy, behaviour was also mixed: in Romania, the official interest rate was cut by a total of 50 bp to 5.75% given the notable reduction in inflation and the weakness of the external environment, while in Hungary it was raised by 100 bp to 7%, further to the severe deterioration in its financial situation, which led the Government to apply for fresh financial aid from the IMF and the EU.

In China, GDP grew at a year-on-year rate of 8.9% in Q4 (9.1% in the previous quarter). The rate of expansion of activity, which continues to be underpinned by resilient domestic demand, thus continued to move on a mildly moderating path. However, external demand, especially that from Europe, has been forcefully adjusted during the quarter. Inflation is

falling rapidly, standing at 4.1% in December, after averaging 6.2% in Q3. Against this backdrop, the monetary policy stance has gradually shifted from the control of inflation expectations to support for growth, with bank reserve requirements being cut by 50 bp in December (to 21% for the major commercial banks). In the rest of the emerging Asian economies, year-on-year growth dipped slightly in Q3 to 5.6% owing to easing in India and in Hong Kong. In Q4, it appears activity weakened gradually in most countries in the region, albeit with differing intensity. The slowdown in the Indian economy, in particular, was notable, resulting in part from the cumulative effect of official interest rate rises. Annual inflation fell in Q4 in most of the countries. In this setting, the change in monetary policy stance was patently clear in Q4, taking the form of official interest rate cuts in Indonesia and Thailand, and the end of the cycle of rises in the rest of the region.

In Latin America, GDP increased at a quarter-on-quarter rate of 0.8% in Q3, compared with 1.1% in Q2, placing the year-on-year rate at 4.4%, 0.1 pp up on the previous quarter. However, this acceleration masks differing developments from country to country, with Brazil posting zero growth and Colombia showing a notable spurt. The contribution to growth of domestic demand remained high, partly due to developments in stockbuilding, while the negative contribution of external demand increased slightly. The initial indicators for Q4 point to a further slowdown in activity and to a deterioration in most countries' trade balance, prompted by a decline in exports. Inflation edged up by 0.1 pp during the quarter to 7.1% in December. Chile and Peru overshot their inflation targets, unlike Brazil, Mexico and Colombia, although their inflation rates are in the upper range of the target intervals. Core inflation rates were lower across the board, suggesting that the relatively high inflation is largely in response to temporary factors. In any event, official interest rates were cut in Chile (by 25 bp, thereby starting the cycle of monetary easing) and in Brazil (two further cuts of 50 bp, following those adopted at the two previous meetings), and were raised in Colombia (by 25 bp, thus resuming the cycle of rises that the central bank interrupted last July).

In 2011 Q4 the climate of financial instability and high asset-price volatility – which has been affecting the euro area especially severely since the summer – continued, without any let-up in the worrying negative feedback dynamics between sovereign risk, banking risk and loss of economic momentum. The prolongation of the strains on the sovereign debt markets, which led in mid-January to a downgrading of the government bonds of a large number of euro area countries, and the difficulties banks face in accessing wholesale market funding are complicating the process of deleverage and recapitalisation that the banking system is addressing in a situation of weak economic activity (see Box 2).

The latest information from short-term indicators suggests a decline in euro area activity in Q4, following the modest growth in the summer, as predicted by most of the forecasts available. More in the medium term, the worsening of business and household confidence, the tightening of financing conditions, the short-tem effects of the fiscal consolidation processes under way and the downward revisions to external demand have led the ECB and other international organisations and private institutions to scale back their growth forecasts for the euro area, in some cases even estimating negative growth in 2012. In addition, this scenario continues to be subject to a high degree of uncertainty, with a predominance of downside risks for economic activity, largely related to the prolongation over time of financial strains and, in particular, to the possibility that the necessary adjustment of bank balance sheets will ultimately impact the supply of loans to the resident private sector, which would damage the economic recovery.

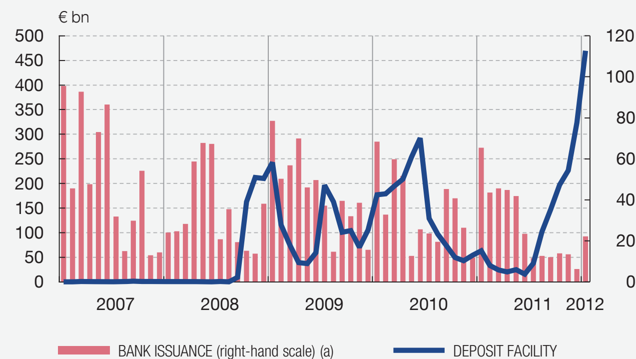
The Governing Council of the ECB, considering that it was unlikely that inflationary price and wage pressures would materialise in the current context of economic weakness, adopted a number of measures to maintain the expansionary stance of monetary policy, to restore the functioning of the transmission mechanism and to minimise the risks arising from banks' funding difficulties. Thus, on one hand, interest rates were cut twice during the quarter, to stand at 1%. On the other hand, further non-standard measures were adopted to support the supply of credit to non-financial firms and households, including a temporary expansion of the list of collateral, a reduction in the reserve ratio to 1% (from 2%) and, notably, the provision of liquidity with a very long maturity (three years) through two tenders with full allotment and a fixed rate equal to the average rate of the main refinancing operations over the life of the respective loan.

At their meeting in early December, the euro area Heads of State or Government continued to review the area's governance, as they have been doing since the beginning of the crisis. In order to strengthen the crisis resolution mechanisms available, the entry into force of the European Stability Mechanism was brought forward to mid-2012 and a review of its financing capacity, to be concluded by March, was commenced. In addition, the main elements of a new fiscal pact were agreed, which will involve additional progress on fiscal policy coordination, beyond the governance reform approved in October 2011. The pact, which must be ready, at the latest, for ratification at the March meeting, attempts to strengthen the prevention instruments, by setting ceilings on budget deficits within the fiscal framework of each euro area Member State. Its legal transposition will be supervised by the European Court of Justice and it will have adjustment mechanisms that will be automatically activated in the event of deviations. Also the application of the sanctions envisaged in the event of excessive deficits will be made more automatic (see Box 3).

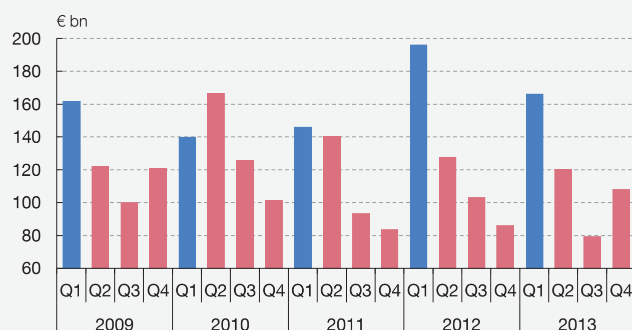
The sovereign debt crisis continued to affect the euro area in Q4 and early 2012, so that credit risk premia and the volatility of financial asset prices (including government bonds) remained at very high levels (see Panel 1). At the same time, institutional investors continued to question the soundness of the area's banking sector, which led to increasing difficulties for banks to raise funds on the market, against a background in which the capacity of the governments of the area to provide financial support to the sector (as was done in autumn 2008 following the failure of Lehman Brothers) has been reduced by the effects of the sovereign debt

1 IMPLIED VOLATILITY

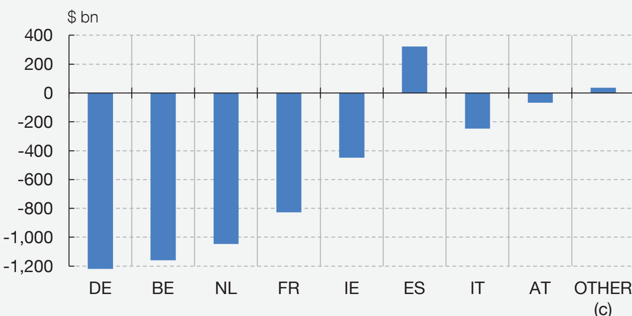
2 FUNDING AND USE OF THE DEPOSIT FACILITY OF THE ECB



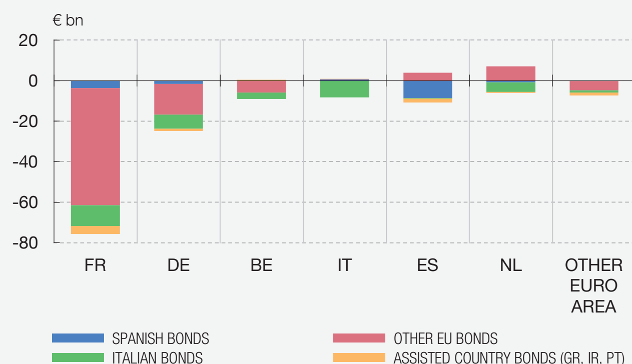
3 VOLUME OF BANK DEBT MATURING



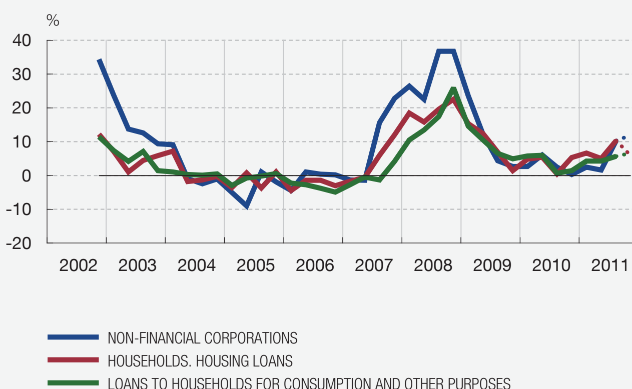
4 BANKS' FOREIGN ASSETS. CHANGES BETWEEN MARCH 2008 AND JUNE 2011



5 SOVEREIGN EXPOSURE OF BANKS. CHANGES BETWEEN END-2010 AND SEPTEMBER 2011 (b)



6 BANK LENDING SURVEY. CHANGES IN SUPPLY. EURO AREA



SOURCES: European Banking Authority, BIS, Bloomberg, Dealogic, ECB and Banco de España.

a Gross issuance of medium and long-term bonds, excluding covered bonds.
b Banks participating in the EBA's recapitalisation exercise.
c Includes FI, GR, PT.

crisis itself. The disruptions in the interbank market and the difficulty for institutions of issuing debt (see Panel 2) have encouraged the growing use of secured lending through central counterparty clearing houses and, especially, Eurosystem financing.

These circumstances have arisen, moreover, at a time when banks have to refinance a large volume of debt, competing with the public sector's demand for funds. Approximately €200 billion worth of bank bonds mature in 2012 Q1 (see Panel 3). In the year as a whole, the debt to be refinanced amounts to more than €500 billion, which is equivalent to 1.5% of total bank assets.

Along with the close connection between the sovereign crisis and bank's funding problems in the euro area, the pressures on the banks intensified in the second half of 2011 due to the interaction of other elements. On one hand, the downward revision to macroeconomic prospects and the risks surrounding such prospects have involved a deterioration in the outlook for earnings and for an improvement in the balance sheet position of the financial system. Also, in the context of the *banking package* agreed by the EU Heads of State or Government in October, the European Banking Authority (EBA) established, on a temporary basis, some stricter capital requirements. Specifically, banks must raise their core Tier 1 capital ratios to 9% and construct a further capital buffer against European sovereign debt exposure. These temporary requirements, along with the adaptation of the banks to the Capital Requirements Directive known as CRD3, entail (according to EBA calculations) an overall capital requirement of around €115 billion, to be met, at the latest, by 30 June 2012. This amount includes €30 billion of capital for the Greek banks, which was envisaged in the EU/IMF assistance programme for this country. Excluding Greek banks, the temporary capital requirement for the portfolio of European public debt, based on its end-September market valuation, amounted to almost €40 billion.

The response of the banking sector to the growing difficulties has been to accelerate the ongoing deleveraging process. Thus, for example, according to Bank for International Settlements data, euro area banks have reduced their foreign assets by around 30% since March 2008 (see Panel 4). In proportion to their total external exposure, the largest reductions have been made by the Belgian, Dutch and Irish banks. More recently, banks have also reduced their claims on sovereign issuers (see Panel 5). The banks participating in the EBA's recapitalisation exercise and stress tests reduced their European sovereign exposure by some €170 billion during the first nine months of 2011, to somewhat more than €1,550 billion. As the panel shows, French banks reduced their exposure to the largest extent (by more than €75 billion, or about 28%). Sales by German banks amounted to some €24 billion, which represented almost 6% of their total investment in government debt.

Finally, with respect to the financing of non-financial firms and households in the euro area, the complex situation in the banking sector has increased the risk that the ongoing restructuring and recapitalisation processes may impact on the capacity of banks to intermediate funds between savers and private borrowers, which would have prejudicial effects on the economic recovery and, through this channel, the financial situation of the banks themselves. As seen in the final panel, the Bank Lending Survey (BLS) data for Q3 point to a substantial additional tightening of credit supply conditions, which foreseeably intensified in Q4. However, it is premature to relate this tightening to the recent slowdown in the growth rates of lending to non-financial firms and households, since, according to the BLS, the demand for funds also contracted during the period.

In the light of the growing risks, the European authorities have adopted a number of measures within their areas of competence, in order to ensure that the deleveraging process takes place in the most orderly fashion possible, so as to minimise the probability of a contraction in the supply of credit. Thus, the ECB has pursued a policy of generous liquidity provision, ensuring that banks have access to Eurosystem financing by prolonging non-standard measures which, as described in more detail in the main text, were singularly strengthened in December with the announcement of two longer-term refinancing operations, the extension of the range of collateral accepted in monetary policy operations and a reduction in the reserve requirement. For its part, the European Commission extended and updated the special regulatory framework which, since 2008, governs state aid to the banking system in the form of recapitalisation, the treatment of impaired assets and guarantees for bank debt issues. Finally, the EBA has published a number of recommendations, addressed to national supervisors, to ensure that the new capital ratios are not satisfied through reductions in the assets held on bank balance sheets.

Apart from the need for better policy coordination and greater fiscal discipline, it has become evident, as the crisis has developed, that measures are needed to ensure that the euro area economy returns to a path of sustained growth. In this respect, on 23 November the European Commission published its 2012 Annual Growth Survey, which contains a road map for budgetary policies and structural reforms in the EU countries over the coming months, which will be evaluated and monitored within the framework of the second European semester. Notable among the priorities that countries must take into account

Since 2010 European institutions and governments have been conducting a far-reaching review of the governance and institutional architecture of the euro area, with the intention of eliminating the weaknesses that have been revealed during the sovereign crisis. The latest summit to be held was the European Council meeting of euro area Heads of State or Government on 9 December 2011. This saw the laying of foundations for a new fiscal compact to give Economic and Monetary Union and the EU a more solid disciplinary and fiscal stability framework, and the proposal of further measures to enhance the existing financial assistance mechanisms.

One of the main aspects of the fiscal compact is the commitment to establish a new fiscal rule, which will help to ensure that general government finances remain in balance or surplus over the cycle, although leeway is maintained for discretionary fiscal policies in exceptional circumstances or severe crises. Specifically, the budgetary stability objective will be deemed achieved if the annual structural deficit does not exceed 0.5% of nominal GDP (although each country may establish a stricter reference level). This rule will contain an automatic correction mechanism that will be triggered in the event of deviation, defined in accordance with the principles proposed by the European Commission. The rule must be transposed into national legal systems through binding and permanent provisions, preferably constitutional, and should be subject to the jurisdiction of the Court of Justice of the European Union.

The compact also states that countries in excessive deficit procedure must submit to the Commission and the Council, for endorsement, an economic programme detailing the structural reforms to be undertaken to ensure a durable correction of the deficit within the period established. There is also a commitment that all steps and sanctions proposed or recommended by the Commission will automatically be adopted unless a qualified majority of the euro area Member States is opposed. In addition, according to the compact, all Member States will have to report their national debt issuance plans ex ante.

The Member States have also agreed to examine swiftly the two new proposals submitted by the Commission on 23 November 2011, in order that both regulations may be in force for the next budget cycle (due to commence at the end of 2012). According to the first of these proposals, the countries must send their draft budgetary plans to the Commission no later than the date established. The Commission may adopt an opinion on them and, in the event that it identifies serious non-compliance with the obligations laid down in the Stability and Growth Pact, request revised draft plans. Also further requirements are proposed for national fiscal frameworks, in addition to those established by the Directive approved in December, so that now countries must have in place independent fiscal councils and their plans must be based on forecasts made by an independent body. The second proposal suggests establishing enhanced surveillance for Member States that are experiencing or are at risk of experiencing severe financial disturbance.

As regards the strengthening of crisis management mechanisms, the accords adopted involve progress in various areas. Thus, the launch of the European Stability Mechanism (ESM) treaty has been accelerated, so that it will enter into force as soon as it has been ratified by Member States representing 90% of the capital commitments, July 2012 having been set as the target date for this to occur. The European Financial Stability Facility (EFSF) will continue to operate until mid-2013, insofar as assistance programmes that have already been established are concerned. In addition, certain adjustments to the ESM treaty were agreed, which would modify the voting systems in order to add an emergency procedure, under which, in the event that the Commission and the European Central Bank conclude that an urgent decision relating to financial assistance for a country is needed, decisions will be taken by a qualified majority of 85% and not by mutual agreement. With respect to the involvement of the private sector in financial assistance programmes, strict adherence to IMF principles and practices was agreed, and the unique and exceptional nature of the decisions taken in this respect in relation to Greek debt was affirmed.

With regard to the financial resources of the stabilisation tools, it was decided to accelerate payments of capital to the ESM and to ensure a combined effective lending capacity for the ESM and the EFSF of €500 billion. The sufficiency of this capacity and its possible expansion will be assessed in March 2012. The euro area countries also agreed on 19 December to provide additional resources of €150 billion for the IMF to increase the financial capacity of this institution. The United Kingdom refused to make any new contributions, while other non-euro area countries announced their willingness to make them following approval by their parliaments.

Finally, the agreement refers to the need to coordinate other macroeconomic policies within the euro area. For this purpose it was agreed to hold summits at the highest political level, i.e. of euro area Heads of State or Government, at least twice a year.

The absence of unanimity among the EU Member States means that the reforms and measures agreed will be adopted by means of an intergovernmental agreement between the euro area countries, which will be incorporated into the treaties of the Union as soon as possible. The countries not belonging to the euro area, except for the United Kingdom, have indicated the possibility to take part in this process after consulting their parliaments where appropriate. The serious financial instability affecting the euro area simply goes to underline the need for rapid finalisation of the legal text currently being negotiated (with full respect for the spirit of the December political agreement), so that it is formally adopted as soon as possible and, in any event, before the agreed March 2012 deadline. However, apart from fiscal discipline, the solution to the challenges facing the euro area requires the resumption of growth-promoting structural reforms, as argued in the Annual Growth Survey presented by the European Commission in November, on which there is an article in the January 2012 *Boletín Económico.*

EURO AREA ECONOMIC INDICATORS (a)

TABLE 1

	2010			2011				2012
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.9	0.4	0.3	0.8	0.2	0.1		
Private consumption	0.1	0.4	0.3	0.0	-0.5	0.2		
Government consumption	0.2	0.1	0.0	0.2	-0.1	-0.1		
GFCF	1.9	0.2	-0.4	1.8	-0.1	-0.1		
Imports	4.2	1.7	1.3	1.1	0.5	0.8		
Exports	4.7	2.1	1.5	1.8	1.2	1.2		
Contributions to quarter-on-quarter change in GDP (pp)								
Domestic demand, excluding stocks	0.5	0.3	0.1	0.4	-0.4	0.1		
Stockbuilding	0.2	0.0	0.1	0.1	0.2	-0.1		
Net foreign demand	0.3	0.3	0.2	0.3	0.4	0.2		
GDP (year-on-year rate of change)	2.1	2.1	2.0	2.4	1.6	1.3		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working day adjusted	2.5	0.7	2.3	0.9	0.2	0.5	-1.3	
Economic sentiment	99.2	102.3	105.7	107.4	105.7	98.8	94.0	
Composite PMI	56.6	55.7	54.9	57.6	55.6	50.3	47.2	
Employment	0.1	0.0	0.1	0.1	0.2	-0.1		
Unemployment rate	10.2	10.1	10.1	10.0	10.0	10.1	10.3	
PRICE INDICATORS (year-on-year change in end-period data)								
HICP	1.5	1.9	2.2	2.7	2.7	3.0	2.7	
PPI	3.1	4.3	5.4	6.8	5.9	5.8	5.3	
Oil price (USD value)	75.0	78.4	92.3	115.4	114.9	114.8	108.7	112.1
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	3.7	3.5	4.1	4.6	4.4	4.0	4.1	3.9
US-euro area ten-year bond spread	-0.72	-1.01	-0.78	-1.14	-1.30	-2.06	-2.17	-2.00
Dollar/euro exchange rate	1.227	1.365	1.336	1.421	1.445	1.350	1.294	1.279
Appreciation/depreciation of the NEER-20 (b)	-10.3	-6.3	-8.2	3.5	3.9	0.7	-2.2	-1.1
Dow Jones EURO STOXX 50 index (b)	-13.2	-7.4	-5.8	4.2	2.0	-22.0	-17.1	3.5

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

a Information to 17 January 2012.
b Percentage change in year to date.

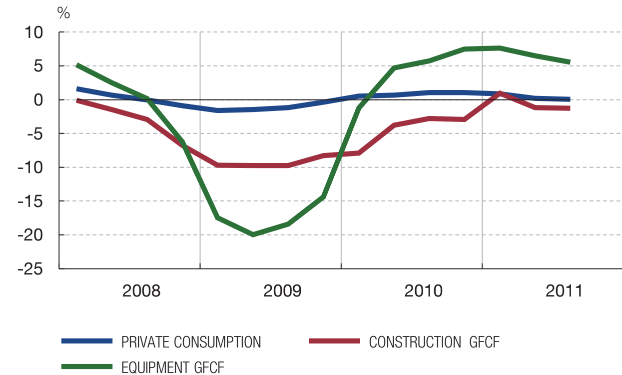
when establishing their national reform programmes and their budgetary programmes are: the design of fiscal consolidation plans compatible with more growth; progress in financial system restructuring; the promotion of competition in markets for services and in network industries; greater efficiency in general government; review of collective bargaining systems; and the promotion of active employment policies.

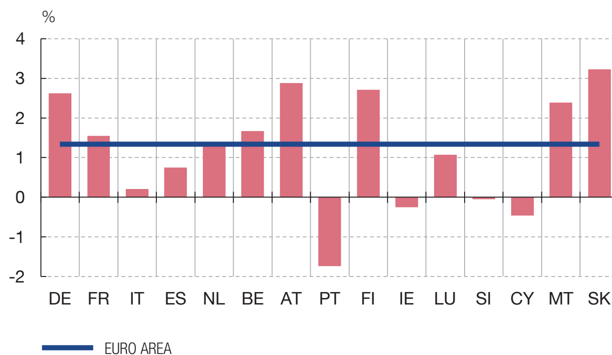
3.1 Economic developments

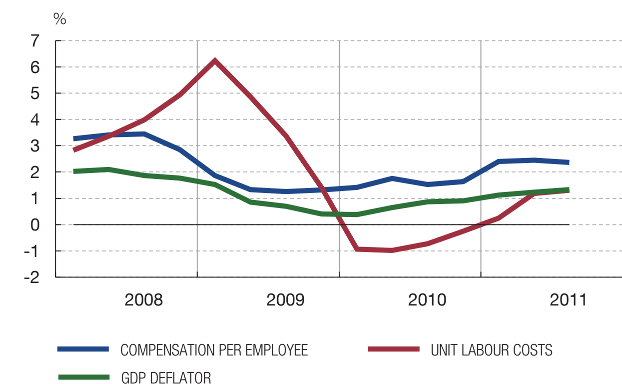
In 2011 Q3, euro area GDP grew by 0.1%, down 0.1 pp from Q2 (see Table 1). This growth was the result of an increase in private consumption and the positive contribution of net external demand, due to buoyant exports, while government consumption and gross fixed capital formation stagnated and stockbuilding made a negative contribution to GDP growth. At the country level, the acceleration of growth in Germany and in France (to 0.5% and 0.3%, respectively), underpinned by domestic demand and, to a lesser extent, by exports, was notable. In Italy, GDP fell by 0.2%, owing to the smaller contribution to growth of the net external balance and the contraction in government consumption and gross fixed capital formation.

EURO AREA NATIONAL ACCOUNTS

CHART 8







SOURCES: Eurostat and national statistics.

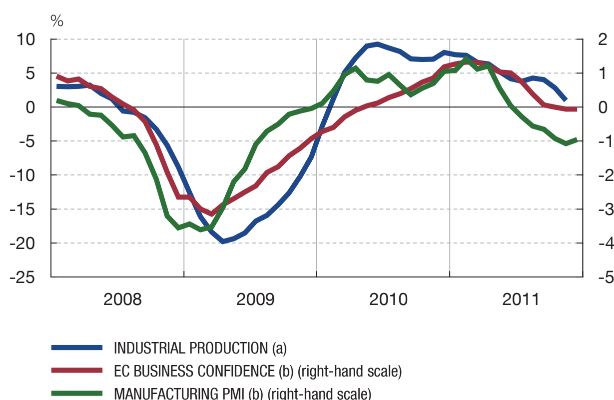
On National Accounts data, in line with the weakness of activity, the process of employment creation that commenced at the end of 2010 came to a halt in 2011 Q3. Thus, the number of employees in the euro area remained unchanged during this period, since the increase in Germany and France was offset by the decline in Spain, and the annual rate of change stood at 0.3%, as against 0.5% in the previous quarter. At the same time, the stagnation in apparent labour productivity in Q3, along with the increase in compensation per employee, led to unit labour costs increasing by more than the GDP deflator, which caused profit margins to decline (see Chart 8).

Economic indicators worsened across the board in Q4, although there was some stabilisation in December (see Chart 9). On the supply side, the growth rate of industrial production declined and the confidence indicators compiled for the sector by the European Commission on the basis of surveys of purchasing managers fell. Likewise, services sector indicators stood in Q4 below their Q3 levels, while the rate of decline of construction accelerated. In relation to demand indicators, retail sales fell relative to Q3, as did the consumer confidence index, which in December was more negative than at any other time during 2011. As regards investment indicators, capacity utilisation and the assessment of industrial order books declined in Q4. Finally, goods exports in October and November grew at a lower rate than in Q3, while expected exports lost momentum in the last few months of 2011, in line with the reduced strength of world trade, and foreign orders declined in October, November and December.

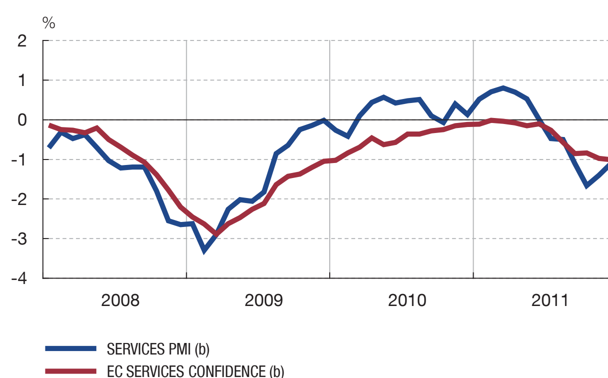
EURO AREA. ACTIVITY, DEMAND AND EMPLOYMENT INDICATORS

CHART 9

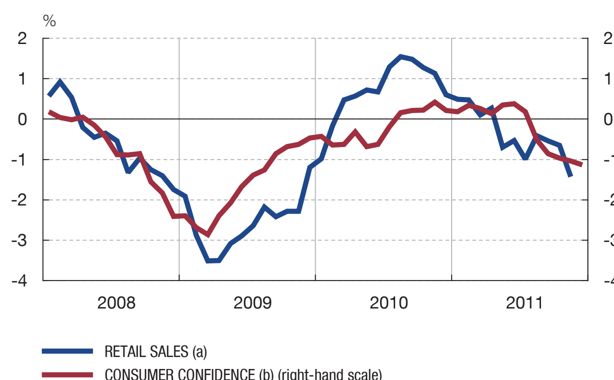
INDUSTRIAL ACTIVITY INDICATORS



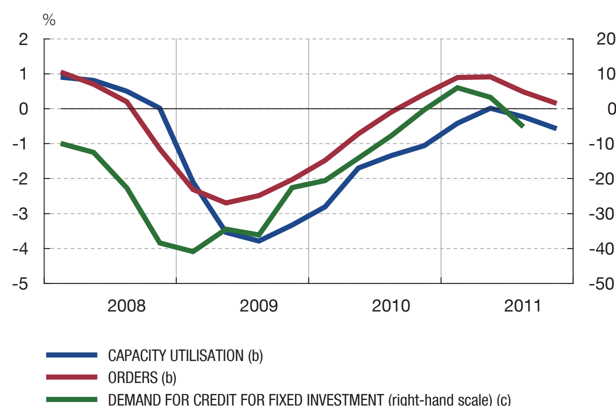
SERVICES SECTOR INDICATORS



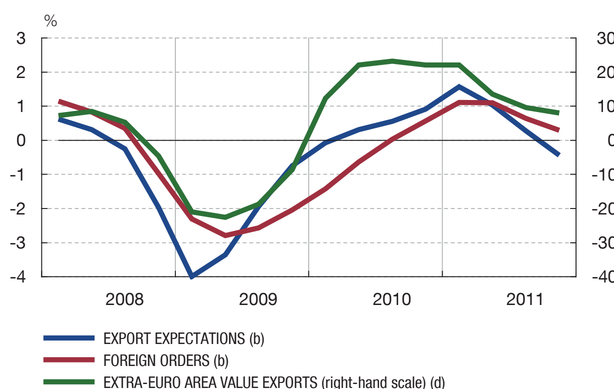
CONSUMPTION INDICATORS



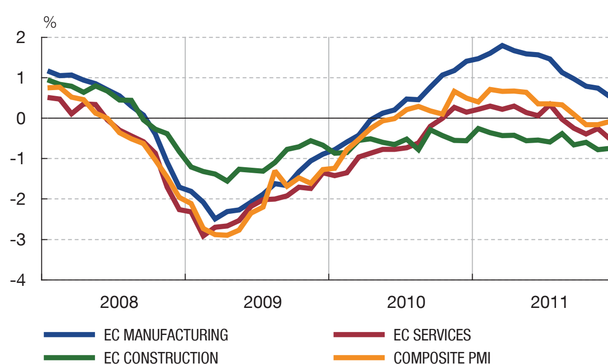
INVESTMENT INDICATORS



EXPORT INDICATORS



EMPLOYMENT EXPECTATIONS INDICATORS (b)

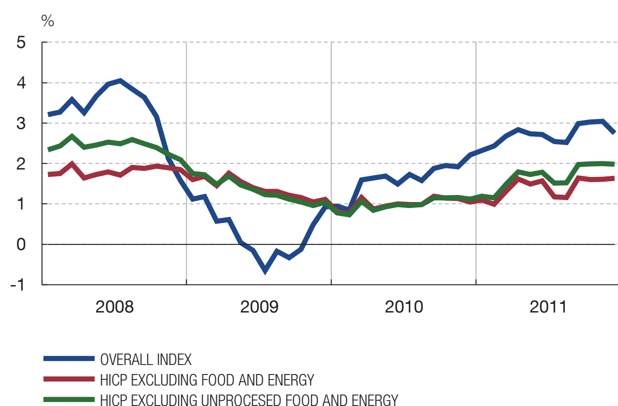


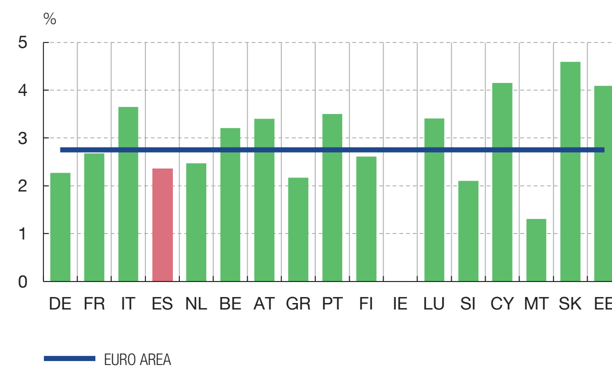
SOURCES: European Commission, Eurostat and Markit Economics.

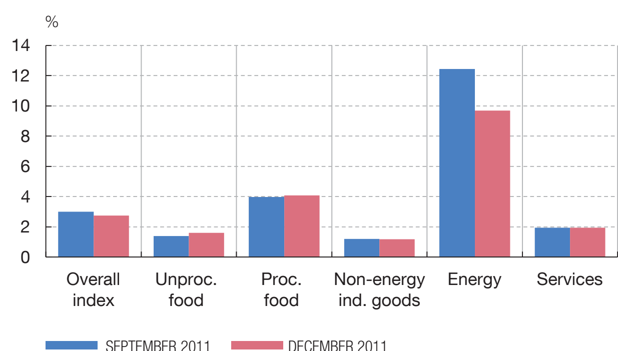
a Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b Normalised data.
c Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase × 0.5 – percentage of banks reporting 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.

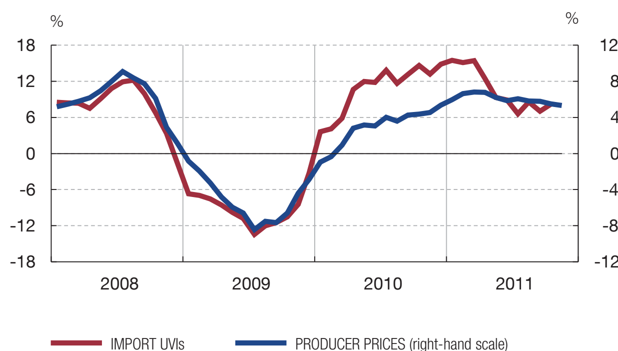
EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 10









SOURCES: Eurostat and ECB.

In short, the latest conjunctural information suggests that euro area activity declined at the end of 2011, as anticipated by certain international organisations and private institutions (see Table 1). Various factors have weakened the buoyancy of activity in the euro area, including notably the slowdown in the rate of growth of world demand, the adjustment of private sector balance sheets, the short-term effects of the ongoing fiscal consolidation processes and the unfavourable consequences that the current tensions in the sovereign debt markets are having on financing conditions and the confidence of economic agents. More in the medium term, prospects have worsened, so that international organisations and private analysts have revised their growth outlook downwards, some of them even estimating negative growth for 2012. This scenario comes against a background of great uncertainty in which there are considerable downside risks. These risks relate to a further intensification of the tensions on financial markets, which would complicate the deleveraging taking place in the banking system and could lead to a contraction in the supply of credit to businesses and households, ultimately undermining any possibility of economic recovery in the euro area in 2012.

There were no significant changes during the quarter in the annual rate of inflation, which stood at 2.7% in December. The stability of inflation in recent months has been reflected in practically all its components. The only changes were in food prices, the acceleration of which was offset by the lower rate of growth of energy prices, in line with the decline in oil

prices on international markets. Similarly, core inflation, as measured by the CPI, excluding unprocessed food and energy, remained steady at around 2% in Q4 (see Chart 10). Industrial prices grew by 5.5% in October and November, down 0.3 pp from the end of Q3. All the components posted similar growth rates to those of the previous period, although capital goods increased more moderately. In the medium term, inflation is expected to stand at below 2%. In addition, the risks are generally considered to be balanced, in an environment of weaker euro area growth, where cost, wage and price pressures are expected to remain moderate, although further increases in indirect taxes and administered prices are not ruled out, owing to the need for fiscal consolidation in the coming years (see Table 2). In this context, long-term inflation expectations remained anchored.

The euro area recorded a current account deficit of €59.2 billion (0.8% of GDP) during the first ten months of 2011, which was somewhat larger than the €42 billion deficit in the same period of the previous year (0.5% of GDP). This deterioration was basically due to the change in sign of the goods balance, which moved into deficit, while the services balance improved. During the same period, in the financial account there was a decline in net capital outflows in the form of direct investment (to €53 billion, down from €138 billion in 2010), while net inflows of portfolio investment increased by €157 billion to €290 billion. Thus, the basic balance, which combines these two types of investment with the current account balance, swung from a deficit of -€47 billion in the period January-October 2010 to a surplus of €179 billion in the same period of 2011 (see Chart 11).

According to European Commission forecasts, the budget deficit of the euro area as a whole stood at close to 4% of GDP in 2011, which is around two percentage points smaller than the deficit in 2010 (6.2%). The budgets presented by the countries for 2012 allow a further cut in the budget deficit to be projected for this year, albeit smaller than the one recorded last year. These forecasts are subject to a high degree of uncertainty, since, unlike in most of 2011, when the consolidation was based on the withdrawal of stimulus measures and a certain recovery in the economy, fiscal adjustment must be carried out in an environment in which downside risks to growth predominate.

In fact, the deterioration in the growth outlook from the summer led many countries to introduce new adjustment plans in Q4, in order to comply with the commitments established within the framework of the Stability and Growth Pact for 2012. Notable among these countries was Italy, which announced a package of fiscal measures at the beginning of December, involving a cut in spending on pensions, an increase in VAT and the reintroduction of the property tax. Ireland also stepped up its fiscal consolidation drive for 2012, with a rise in the rate of VAT on some products to 23% and cuts in certain types of social expenditure. Portugal, meanwhile, cut pensions and public-sector wages and reviewed the products subject to reduced rates of VAT. In Greece, the combination of a severe economic recession with delays in the implementation of promised measures led to a failure to meet the fiscal targets set for 2011 and to the approval of new measures to enable the targets to be met in 2012. The terms of the second official assistance programme and the participation of the private sector in the debt restructuring process in this economy are still to be determined. Finally, Cyprus and Belgium also adopted new fiscal adjustment measures.

All told, in an environment like the present one, in which the financial markets may negatively assess both a lack of commitment on the part of governments to fiscal consolidation and the impact that such consolidation may have on short-term growth, the fact that consolidation plans might take greater account of the differing impact that different adjust-

GDP AND HICP FORECASTS FOR THE EURO AREA (a)

TABLE 2

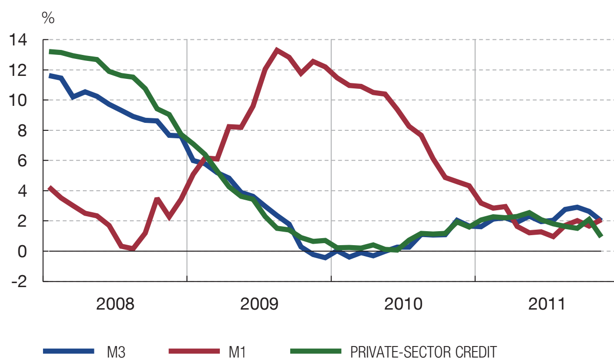
	2011		2012		2013	
	GDP	HICP	GDP	HICP	GDP	HICP
ECB (December 2011)	1.5-1.7	2.6-2.8	-0.4-1.0	1.5-2.5	0.3-2.3	0.8-2.2
European Commission (November 2011)	1.5	2.6	0.5	1.7	1.3	1.6
IMF (September 2011)	1.6	2.5	1.1	1.5	1.5	1.7
OECD (November 2011)	1.6	2.6	0.2	1.6	1.4	1.2
Consensus Forecast (January 2012)	1.6	2.7	-0.3	1.9	1.0	1.7
Eurobarometer (January 2012)	1.6	2.7	-0.3	1.8	1.0	1.7

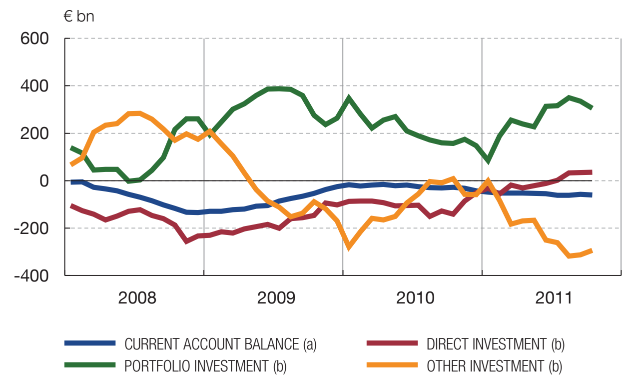
SOURCES: ECB, European Commission, Consensus Forecast, IMF, MJ Economics and OECD.

a Year-on-year rate of change.

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS

CHART 11





SOURCES: ECB and Banco de España.

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

EURO AREA MEMBERS' GENERAL GOVERNMENT BUDGET BALANCES AND PUBLIC DEBT (a) TABLE 3

% 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).

ment measures may have on growth, as proposed in the Annual Growth Survey presented by the European Commission on 23 November, is relevant.

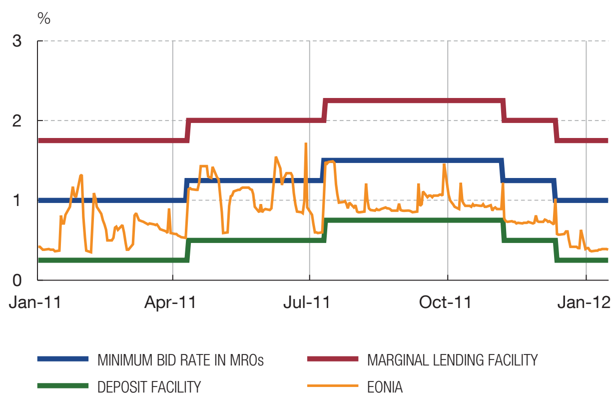
Also, progress has continued to be made in improving the instruments to achieve greater discipline and credibility in the design of budgetary policy. Thus, the reform of the Stability and Growth Pact, agreed in 2011, came into force in January 2012 and has been strengthened by the decisions taken by the European Council at the beginning of December, which are due to be ratified over the coming weeks (see Box 3). For its part, the European Commission presented two new regulations in November authorising this institution to evaluate national budgets sooner, in order to prevent the appearance of excessive deficits, and introducing additional improvements into national fiscal frameworks, including the obligation to set up independent fiscal councils to supervise national policies and to design budget plans on the basis of macroeconomic forecasts compiled by independent bodies. Finally, the proposals of the Commission identify the need for close macroeconomic surveillance of those countries that may record difficulties in the area of financial stability.

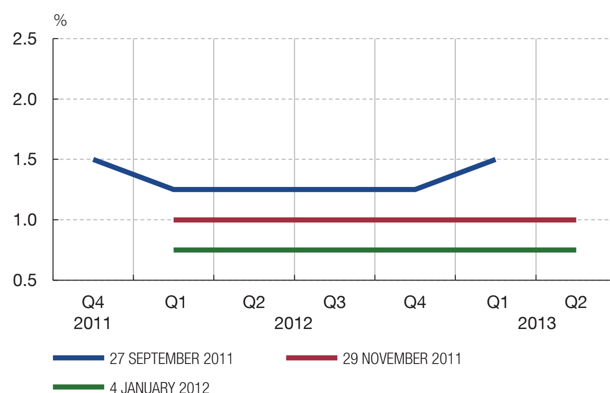
3.2 Monetary and financial developments

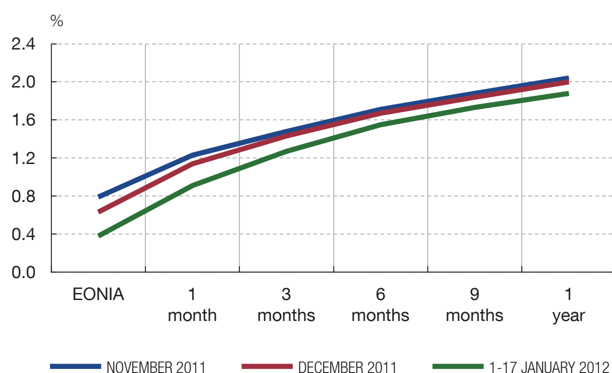
The tensions arising from the sovereign debt crisis, which had intensified and become systemic in the summer, persisted in 2011 Q4 and in early 2012. In some countries, such as France, Italy and Spain, the sovereign spread over the German Bund reached new

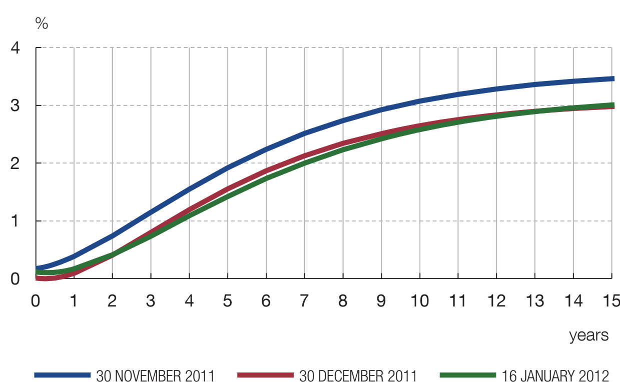
EURO AREA INTEREST RATES

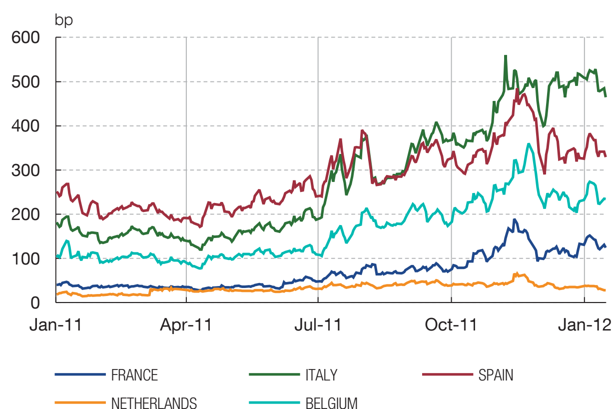
CHART 12

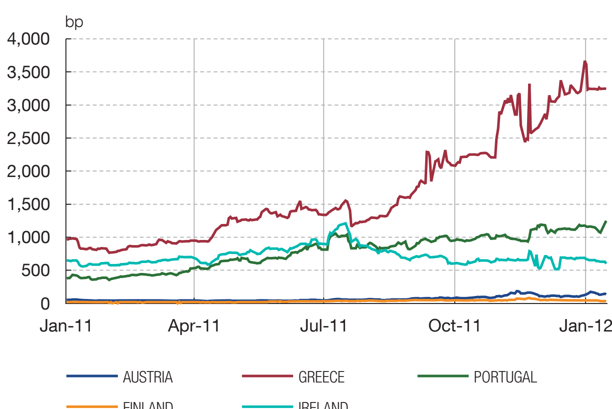












SOURCES: ECB and Banco de España.

a ECB estimate using swap market data.

highs in November and the volatility of government bond yields rose to levels unprecedented since the creation of the euro. Moreover, in certain euro area countries the fact that the government needs to raise a large amount of funds to redeem government bonds maturing in 2012 Q1 is adding to the pressure on bond yields. More than half of the euro area countries were affected by downgrades of their sovereign debt, with the latest action by S&P in January involving the loss by Austria and France of their AAA rating.

As described in greater detail in Box 2, the banking sector continued to be subject to severe strains, as a consequence of its exposure to sovereign risk, the difficulty of raising funds on the markets, the tightening of capital requirements by the European Banking Authority and the decline in expected earnings, owing to the weakening of economic activity. These circumstances, along with the fact that a large amount of bank debt matures in 2012, have accelerated the ongoing deleveraging process in the sector and have increased the risks of further tightening of financing conditions, or even a contraction in the supply of credit.

Against a background of weak activity, with inflation expected to stand below 2% in the medium term, the Governing Council of the ECB lowered official interest rates by 25 bp at two consecutive meetings, in November and December, after which they stood at 1% for main refinancing operations. The deposit and lending facility rates stood at 0.25% and 1.75%, respectively (see Chart 12). Also, the ECB adopted further temporary non-standard measures, in order to support the supply of credit to non-financial firms and households. In addition to the coordinated central bank action in November to supply foreign currency liquidity, the Governing Council decided, at its December meeting, to conduct two longer term refinancing operations with full allotment, a maturity of 36 months and the option of early repayment after one year. At the same time, the ECB widened the range of assets eligible as collateral for its refinancing operations and reduced the reserve ratio from 2% to 1%, which will release collateral and support money market activity. As a result of the first 36-month tender, conducted on 21 December, the Eurosystem lent €489 billion to a total of 523 credit institutions. A second operation with the same characteristics will be conducted on 29 February. In addition, a second covered bond purchase programme (CBPP2) was launched in November, which envisages total purchases of €40 billion (€20 billion less than in the first programme). As at the cut-off date of this bulletin, the amount outstanding under this programme was €3 billion. Finally, purchases of government debt under the securities market programme, which was reactivated in August as a consequence of the intensification of the financial tensions, amounted to somewhat more than €213 billion.

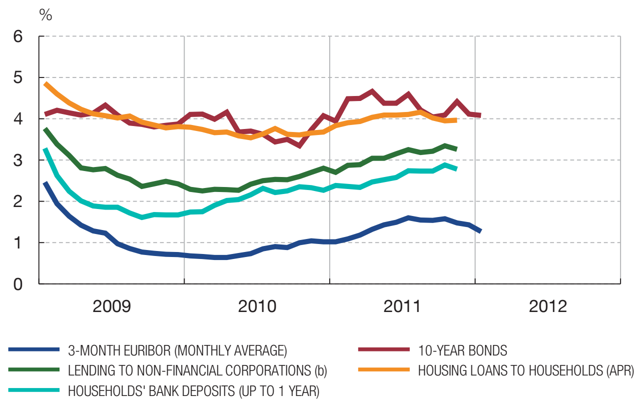
The monetary policy easing has only partly been passed through to money market interest rates (see Chart 13), as a consequence of the continuation of tensions on the interbank funding markets, which led to further increases in credit risk premiums. Thus, in an environment of heightened volatility, the spread of the EURIBOR over repo rates remained on a rising path, exceeding 150 bp in January in the case of 12-month operations. The three-month and one-year EURIBOR stood, respectively, at around 1.2% and 1.8% in January, 30 bp and 20 bp below their September levels. The interest rate on the 10-year German Bund did not change significantly during the quarter, remaining at around 2%. In other countries, however, long-term interest rates on government debt continued to rise, so that yield spreads over the German Bund widened until the beginning of December and, against a background of high volatility, have held at historically high levels since then (see Chart 12).

With regard to the funding of the private sector, the debt issuance of non-financial corporations increased by 5% year-on-year in November, in line with the increase in previous months (see Chart 11). Bank loans grew at a slower rate, reflecting above all the behaviour of those to households, which increased at a year-on-year rate of 2.1% in November, down 0.8 pp from September. This slowdown is explained by the reduced buoyancy of loans for house purchase. As for loans to non-financial corporations, there were no significant changes in their growth rate.

EURO AREA INTEREST RATES, EURO STOXX INDEX AND EURO EXCHANGE RATES

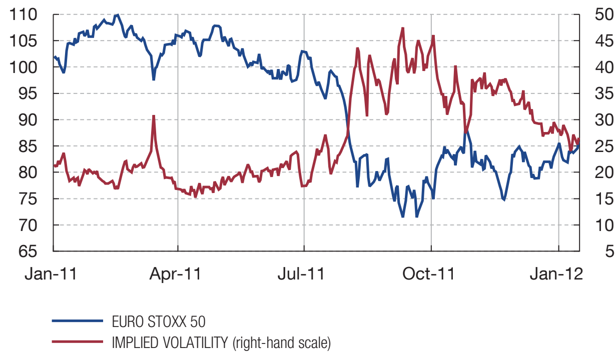
CHART 13

EURIBOR AND BANK INTEREST RATES (a)

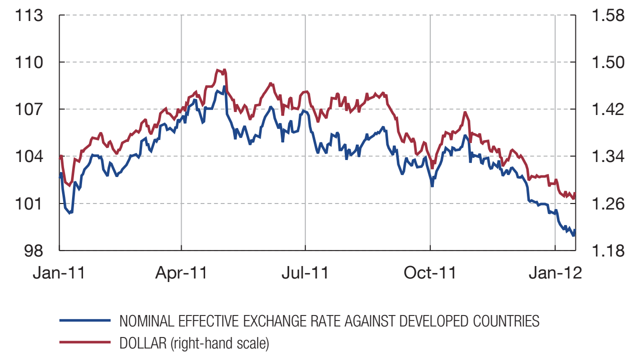


CORPORATE BOND YIELD SPREADS OVER SWAP ASSETS

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.

In private fixed-income markets, risk premiums for both financial and non-financial securities were highly volatile during the period, although their average levels remained relatively steady. The cost of bank loans to private sector households fell slightly during the two-month period October-November, while it rose slightly in the case of firms. Thus, the rate on new loans to non-financial corporations stood at 3.3% in November, as against less than 3% in spring 2011.

Stock markets, in line with financial developments during the quarter, were subject to a high degree of volatility in all countries and all sectors. The EURO STOXX 50 index rose by 10% during the quarter and the first few days of January, although it fell by 18% in 2011 as a whole (see Chart 13), and, in the case of the banking sector, by 37%. For its part, the exchange rate of the euro fell by 4% in nominal effective terms and by 5% against the dollar (see Chart 13).

Finally, the growth of M3 eased in November, to 2% year-on-year, basically due to the slowdown in negotiable instruments.

4 THE SPANISH ECONOMY

On the as-yet incomplete information currently available, economic activity is estimated to have shrunk in 2011 Q4, leading GDP to post a quarter-on-quarter change of -0.3% (see Chart 14). The contribution of external demand to GDP growth remained positive, at 0.3 pp, 0.1 pp down on the previous quarter, affected by the loss of momentum of goods exports. National demand slipped somewhat more sharply than in Q3, with a quarter-on-quarter decline of 0.5%, weighed down by the marked contraction in gross fixed capital formation. In year-on-year terms output continued to increase, with a rate of 0.3%, 0.5 pp down on the previous period.

The reduction in employment steepened in Q4; the related year-on-year rate stood at -2.4% while average labour productivity posted a year-on-year increase of 2.7%. Economy-wide compensation per employee is estimated to have held at a similar rate of increase to that of the previous quarter, whereby the year-on-year rate of unit labour costs continued to fall. The pace of increase in consumer prices slowed in the closing months of the year. Thus, in December 2011 annual CPI inflation stood at 2.4%, 0.7 pp down from September and the growth rate of the CPI excluding unprocessed food and energy declined 0.2 pp to 1.5%. This trajectory is expected to continue over the coming months as the base effects arising from the increase in oil prices at the beginning of 2011 disappear.

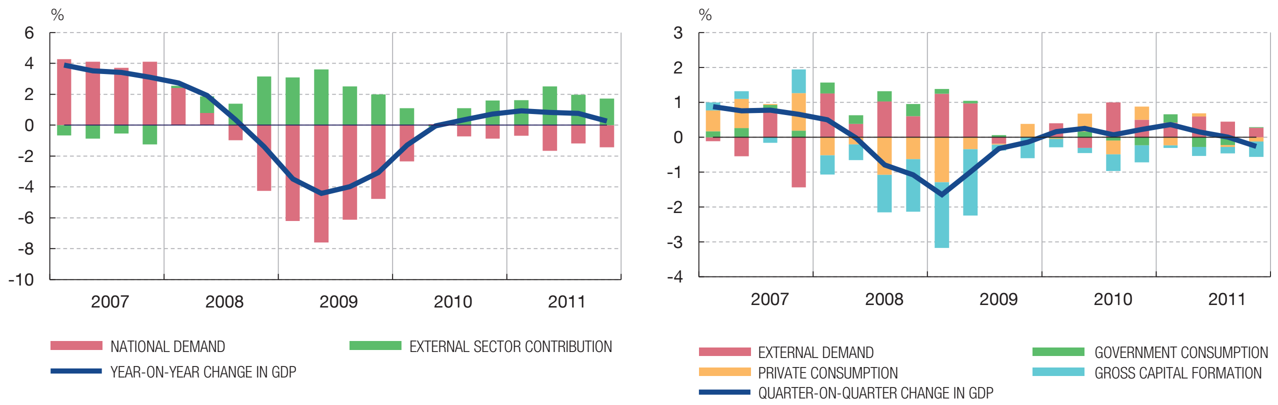
4.1 Demand

In 2011 Q4 private consumption continued to show a certain weakness which resulted in a slight fall in its quarter-on-quarter rate of change (see Chart 15). This reflected, in the second half of the year, a not very favourable backdrop for household spending that was marked by the more negative performance of the labour market, the decline in value of housing and financial wealth and the worsening of the economic outlook. Private vehicle registrations fell – by 5.2% year-on-year in Q4 and by around 2% quarter-on-quarter, based on the seasonally adjusted series – as did other consumer durables. Among the other quantitative indicators, the large corporations' sales of goods and consumer services published by the tax authorities and the retail trade index posted a sharper year-on-year decline on average in October and November than in the third quarter. Qualitative indicators, such as the European Commission's consumer and retailer confidence indices were relatively stable in the quarter on average. According to data to Q3, household income increased in nominal terms (0.7% year-on-year) for the first time in the last two years, on four-quarter cumulated figures of the non-financial accounts of institutional sectors. This increase in household nominal income was the result of a smaller decline in employee compensation and an increase in the gross surplus of the self-employed. The positive contribution of general government towards sustaining household income remained stable, as did the net negative contribution of property income. Nevertheless, nominal consumption expanded at a higher rate than household income, giving rise to a fresh decline in the saving rate which was down almost 2 pp in Q3 from the figure for 2010, and stood at 12.1% of disposable income on four-quarter cumulative data.

Investment in capital goods is estimated to have decreased by around 2% in quarter-on-quarter terms in Q4, compared with growth in Q3. Its year-on-year rate of change declined to 0.6%, its first fall since 2010 Q1 (see Chart 16). In year-on-year terms, production of capital goods fell 4.1% in October and November, and imports were down 9% in October. Similarly, commercial vehicle registrations returned to a downward path in Q4 following an increase in Q3. In the last part of the year business confidence continued to deteriorate

MAIN DEMAND AGGREGATES. CONTRIBUTION TO GDP GROWTH

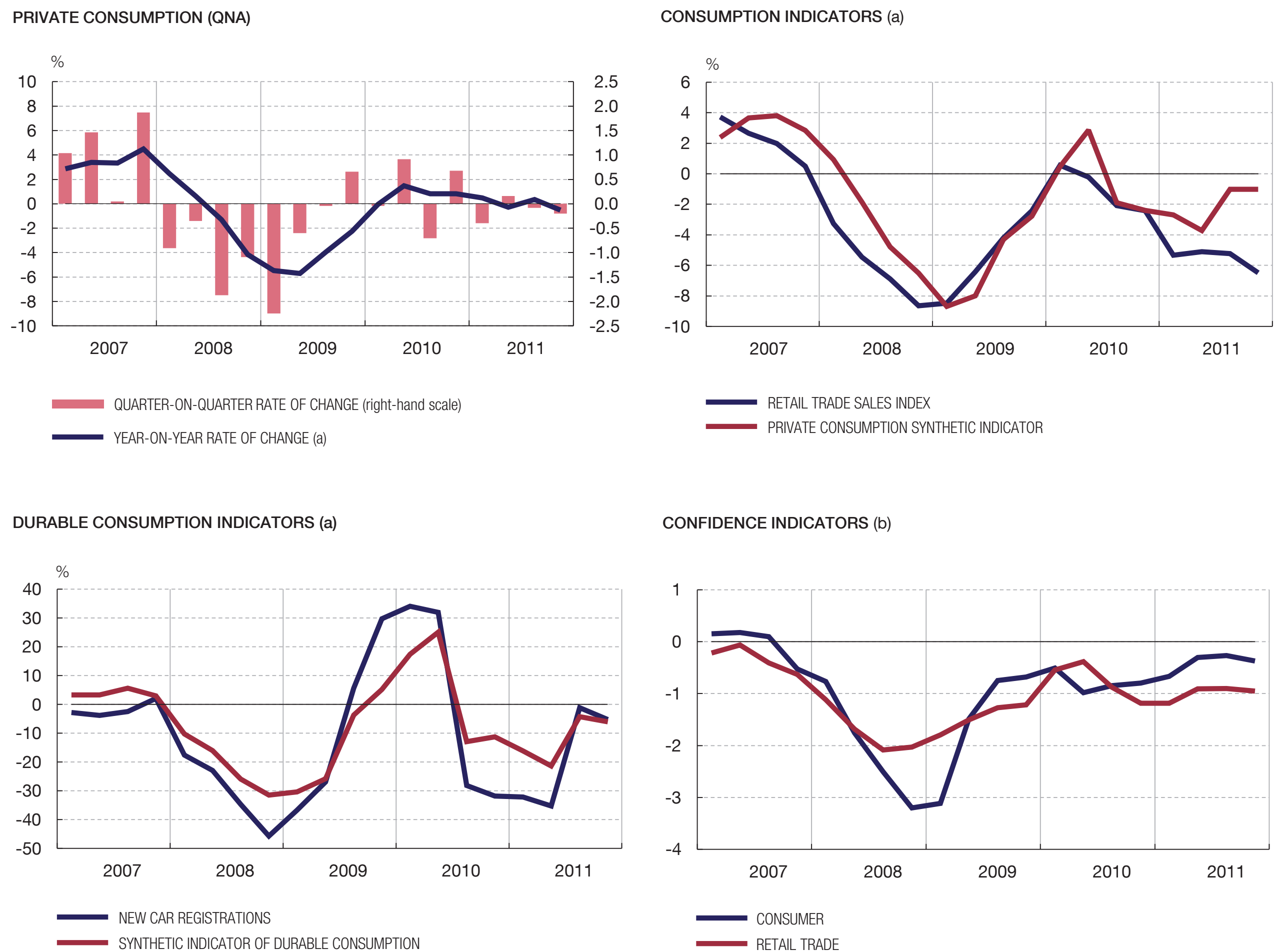
CHART 14



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).

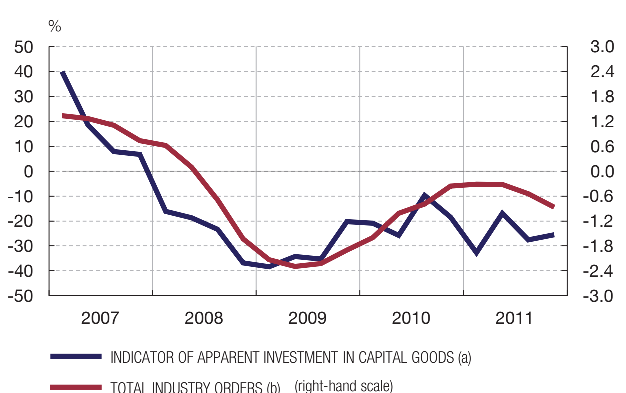
GROSS FIXED CAPITAL FORMATION

CHART 16

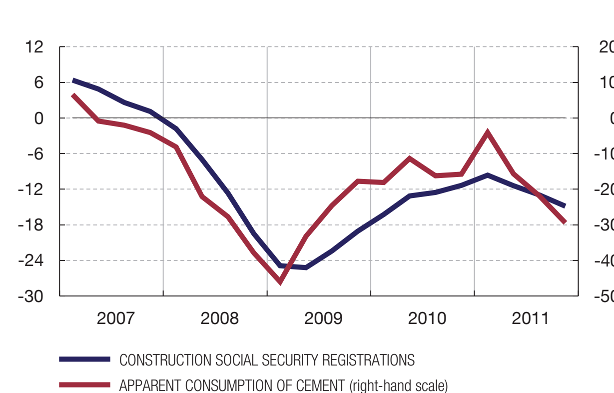
CAPITAL GOODS

CONSTRUCTION

CAPITAL GOODS INDICATORS



CONSTRUCTION INDICATORS (a)



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

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

(both in industry as a whole and in the capital goods sector) which could reflect a further worsening of business investment in the coming quarters.

On non-financial account data for the institutional sectors, the net lending of non-financial corporations increased slightly in 2011 Q3 to 1.7% of GDP on four-quarter cumulated figures (up 1 pp on 2010). This improvement was underpinned by an increase in the profit margin which could indicate firms' efforts to rebuild balance sheets and strengthen their self-financing capacity.

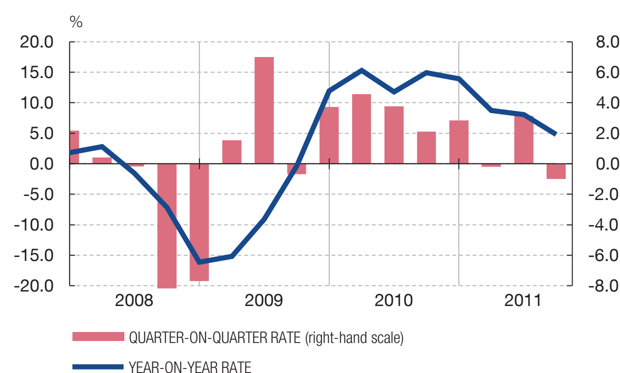
Construction investment was more contractionary than in recent quarters, given the combination of adjustment processes in the residential segment and fiscal consolidation in the area of civil engineering works (see Chart 16). In more recent months the indicators for the sector as a whole relating to employment and the use of inputs displayed quarter-on-quarter falls which were sharper than in Q3.

By type of work it is estimated that the quarter-on-quarter rate of decline in residential construction has increased. However, this type of investment is expected to become less contractionary in the coming quarters, as the gap between housing completions and starts continues to narrow. On the demand side for residential assets, transfers of new dwellings

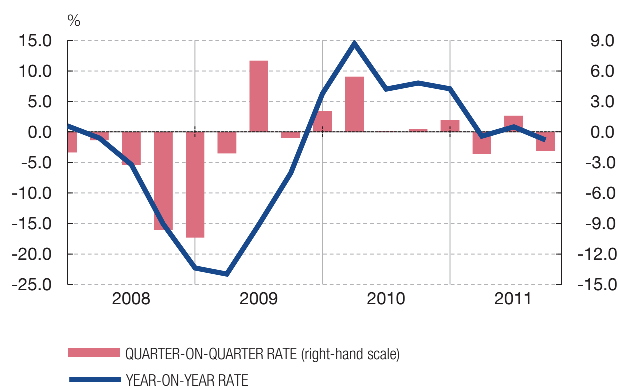
FOREIGN TRADE
Year-on-year rate of change

CHART 17

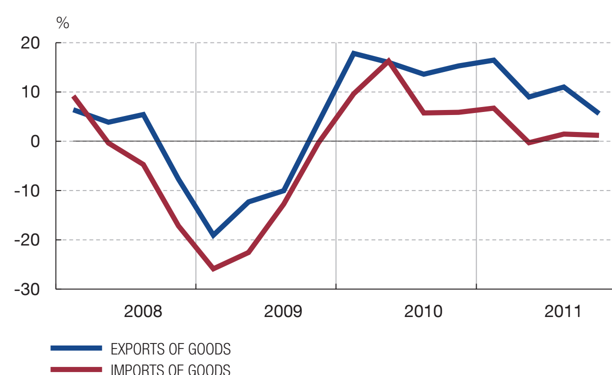
EXPORTS OF GOODS AND SERVICES (a)



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.

remained stable in the July-September period in cumulative four-quarter terms. For its part, permits for non-residential construction to October continued to contract sharply in terms of surface area, as did government civil engineering tenders.

Finally, general government spending is estimated to have contracted in Q4, particularly in respect of investment. The year-on-year rate of decrease in government consumption in this quarter is likely to be around -1%, which would indicate that it had fallen less steeply than in the previous quarter. Spending on investment is estimated to have continued to decline at rates of above 20%, as in previous quarters.

According to the information available for 2011 Q4 on net external demand, its estimated contribution to quarter-on-quarter GDP growth was 0.3 pp, 0.1 pp down from the previous quarter. In year-on-year terms its contribution also decreased, although it remained high (1.7 pp). This behaviour was the result of a somewhat stronger quarter-on-quarter decline in imports than exports, in contrast to the increase in both of types of flows in the previous quarter (see Chart 17). This took place against the backdrop of a gradual moderation of international trade in the second half of 2011, reflecting the world economic slowdown and amply offsetting the competitiveness gains linked to changes in the exchange rate in the

closing months of 2011. On available information, in Q4 the share of Spanish exports on world markets continued to climb. The most recent performance of imports shows slowing final demand and that they have become more expensive due to the trajectory of the exchange rate.

On customs data, the growth rate of goods exports moderated in October to 5.1%, which was considerably lower than that posted in 2011 Q3 (10.9%). By product group, the loss of momentum was fairly widespread, the decline in exports of capital goods being particularly notable. Exports of consumers goods decelerated as a result of weak sales of consumer durables, especially cars. By geographical area, sales to the rest of the world showed a greater loss of buoyancy than exports to EU countries.

The information available on exports of tourism services indicates that their rate of increase eased in 2011 Q4 compared with previous quarters. This can be inferred from the slowdown of tourist inflows and overnight stays to November. By country of origin, noteworthy is the rise in German and British tourists in Q4 in contrast to the less robust inflows of French and Italian tourists. The nominal expenditure of tourists continued to increase in year-on-year terms in the period October-November, albeit at a slightly more moderate pace than in previous months. It is estimated that exports of non-tourism services rose in Q4 in step with nominal balance of payments data.

Imports, on customs data, increased at a year-on-year rate of 0.5% in October, which was more moderate than the rate posted in Q3 (1.2%). By product group, the slowdown affected the main headings except for imports of consumer goods which rose notably, partly due to the effect of comparison with the previous year's poor data. Lastly, real imports of services seem to have continued to decline in 2011 Q4 in year-on-year terms, in line with the path shown by nominal balance of payments data in recent months.

4.2 Output and employment

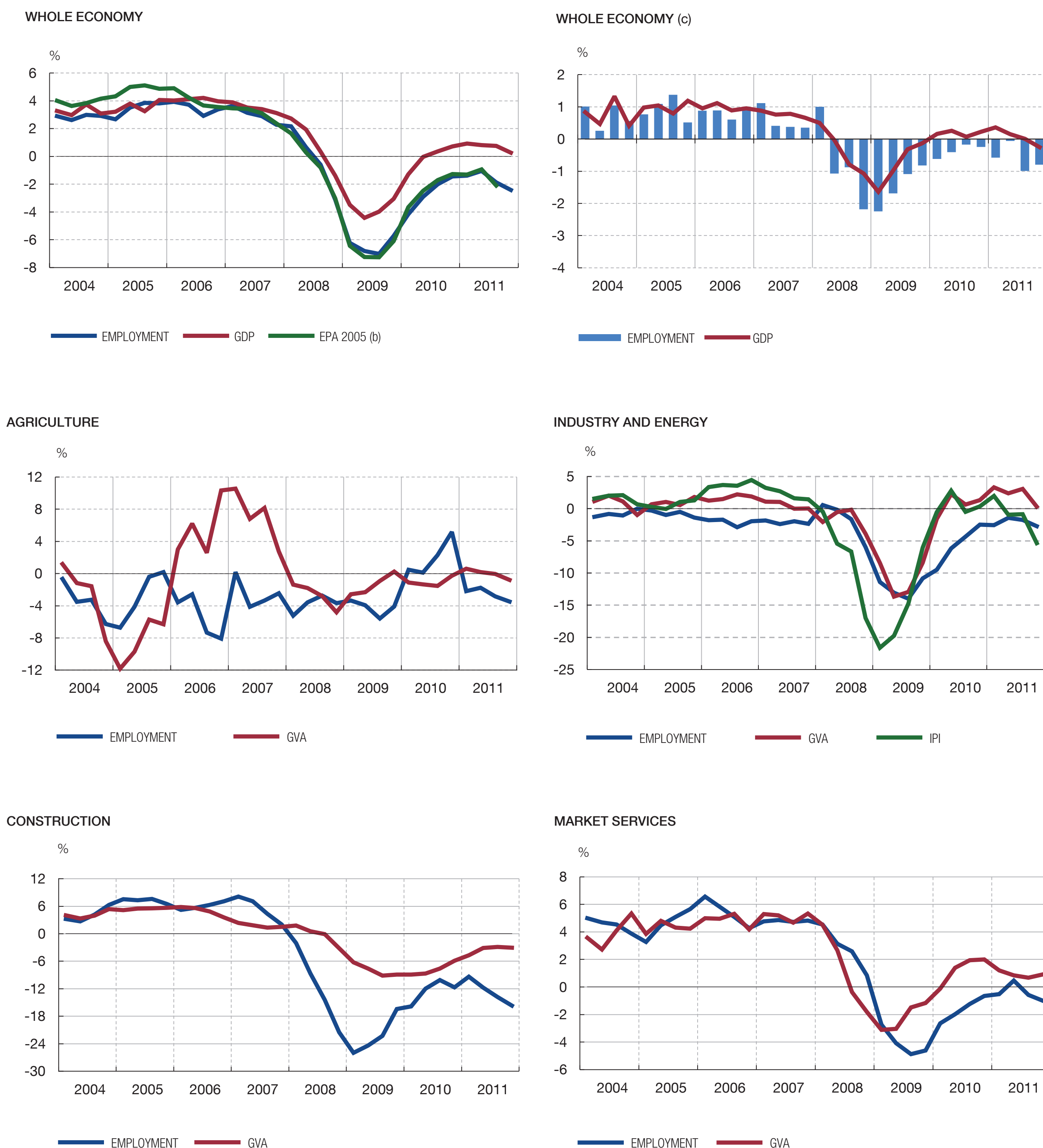
In 2011 Q4, gross value added in the market economy[1] posted a slightly higher fall than in Q3. The available quantitative data have progressively confirmed the weakness of productive sectors which was anticipated by various survey indicators. This information suggests a decline in industry and energy as well as in construction in the last part of the year, while market services seem to have remained sluggish (see Chart 18).

In the closing months of 2011, industrial activity gradually deteriorated after rising in Q3. The industrial production index fell back notably in the period October-November, especially in those activities which had performed more positively in Q3, such as the production of capital goods and non-food consumer goods. The employment figures also reflect the decline in the sector in the last quarter and there was a further decrease in Social Security registrations. Likewise, developments in respect of turnover and domestic and foreign orders underline the weakness of these branches of activity. The qualitative indicators for the industrial sector also showed declines in this period. The manufacturing PMI once again fell back and held clearly below 50, which is generally interpreted as the point between the contraction and expansion of activity.

The available market services indicators point to a further moderation of the GVA of this sector in Q4, although it is estimated to have increased modestly. On information

1 The new Quarterly National Accounts (base year 2008) do not provide estimates of the market economy aggregate. This branch is proxied by excluding services associated with the activities of education, defence, health and social services, compulsory Social Security and general government from the total for the economy.

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



SOURCES: INE and Banco de España.

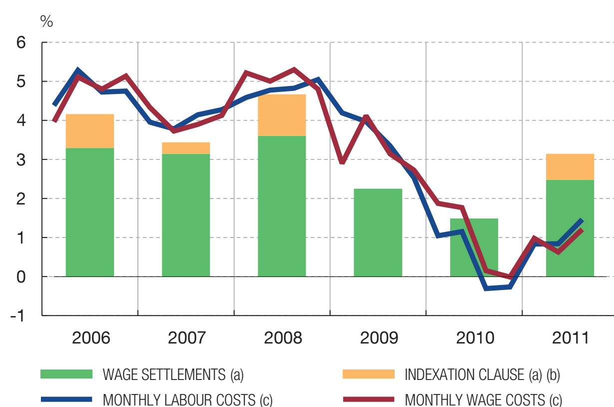
a Year-on-year percentage rates based on seasonally adjusted series except gross series in EPA. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b Series linked by the DG Economics, Statistics and Research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

to November, the rates of change in the indicators of sales of large firms and of service sector activity declined significantly, especially in wholesale and retail trade and accommodation and food service activities. Social security registrations in recent months indicate a contraction of employment which had not been recorded in previous quarters.

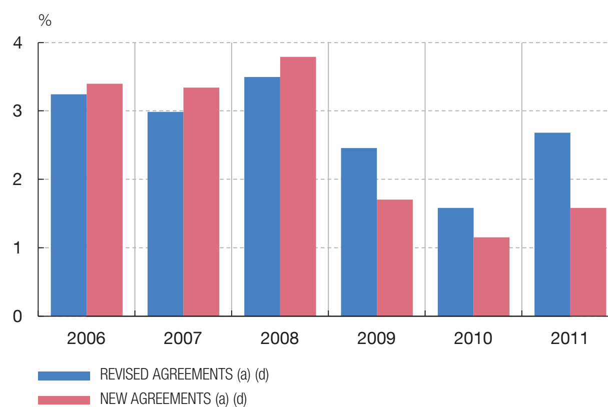
WAGE INDICATORS AND LABOUR COSTS

CHART 19

WAGE INDICATORS



WAGE INCREASE WITHOUT INDEXATION CLAUSE FOR NEW AND REVISED COLLECTIVE BARGAINING AGREEMENTS



SOURCES: INE and Ministerio de Trabajo e Inmigración.

a Latest year, with information on collective bargaining agreements to December 2011.
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.

The available monthly indicators for the labour market show that job destruction stepped up in Q4 with a year-on-year decline in social security registrations of 1.9%, up 0.7 pp on that seen in Q3. The contraction was particularly sharp in October and became slightly less intense as the quarter progressed. In quarter-on-quarter terms, there was a deterioration of a similar magnitude with a 0.8% decrease in the seasonally adjusted series compared with a change of -0.5% in the previous quarter. The data of the Labour Force Survey for Q3 had already shown a sharp deterioration with job destruction of 2.1%, more than 1 pp up on the previous quarter. The decline in employment is estimated to have stepped up again in Q4, posting a rate of change of 2.4% and employment appeared to have fallen more in the market economy.

By sector, the fall in registrations was widespread and jobs were lost in all sectors in quarter-on-quarter terms. However, construction remained the sector in which job destruction was sharpest and the number of registrations fell by around a quarter of a million with respect to the same quarter in 2010. The deterioration of employment particularly affected self-employed and foreign employees.

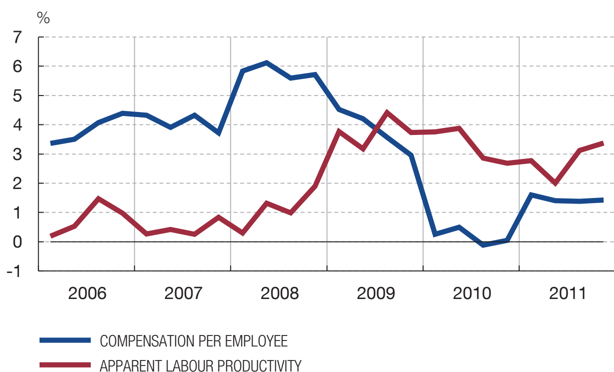
New hires registered at the National Public Employment Service (SPEE by its Spanish abbreviation) show an unfavourable scenario in 2011 Q4. The number of contracts dropped by 3% year-on-year, following the slackness in Q3 (0.2%). The decline in Q4 affected temporary contracts which had increased almost continuously for nearly two years. Permanent hires fell back substantially especially those relating to employment-promoting contracts. The weight of permanent contracts in total contracts decreased again to 5.6% in December 2011, the lowest figure since May 1997. Lastly, the year-on-year rate of decline in full-time hires intensified in the last quarter of 2011 and part-time hires, which had increased in previous quarters, decreased in Q4.

The numbers registered as unemployed with the SPEE increased by more than a quarter of a million in 2011 Q4, with the result that 4.4 million people were unemployed in December. The year-on-year rate of change in those unemployed increased by 3.2 pp to 7.4% in

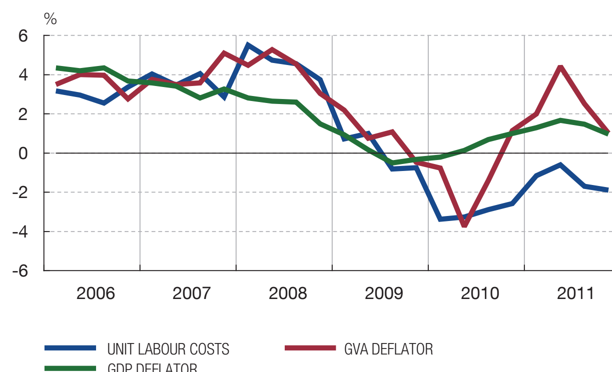
PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

CHART 20

COMPENSATION PER EMPLOYEE AND PRODUCTIVITY (a)



UNIT LABOUR COSTS AND PRICES (a)



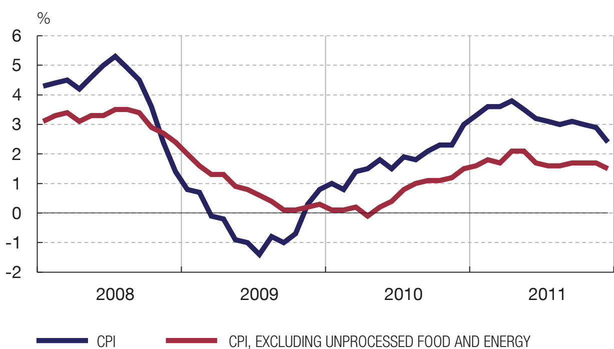
SOURCES: INE and Banco de España.

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

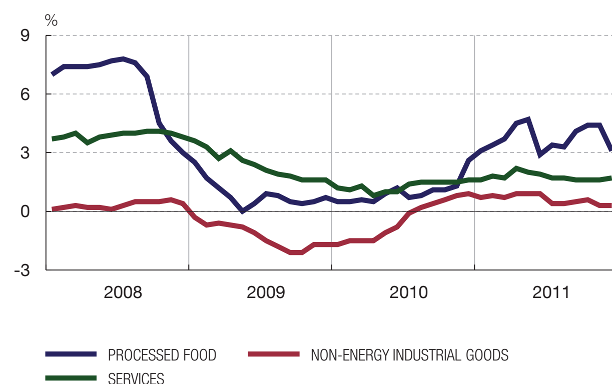
PRICE INDICATORS (a)
Spain

CHART 21

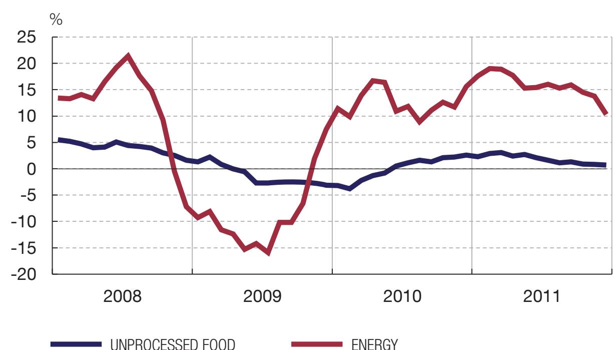
CONSUMER PRICE INDEX



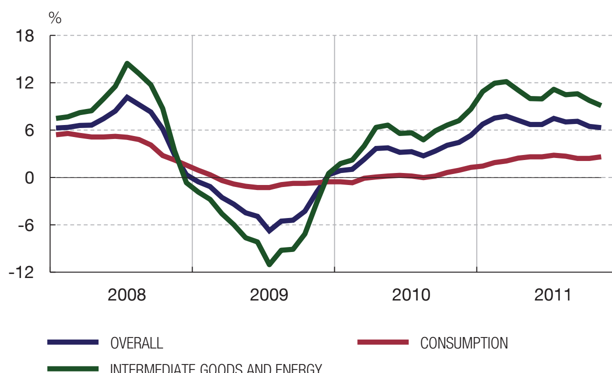
CONSUMER PRICE INDEX



CONSUMER PRICE INDEX



PRODUCER PRICE INDEX

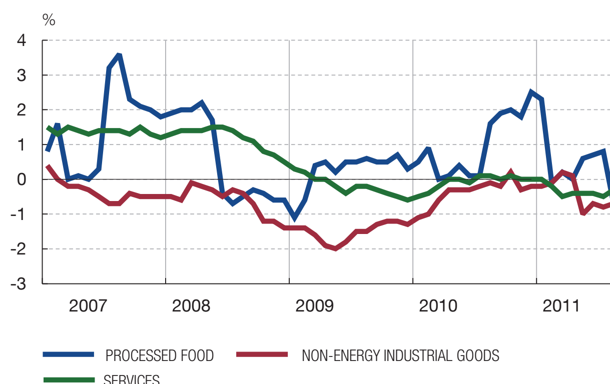


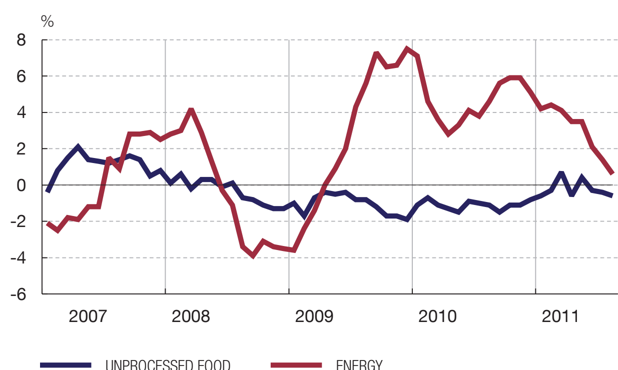
SOURCE: INE.

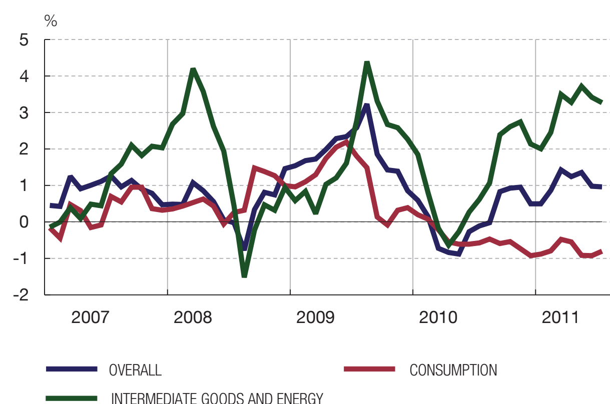
a Twelve-month percentage change based on the original series.

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

CHART 22







SOURCES: Eurostat and Banco de España.

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

2011 Q4. These developments are seemingly compatible with an unemployment rate of 22%, according to the EPA, which is around 2 pp higher than at end-2010. The labour force is estimated to have remained stable at similar levels to those of recent quarters since it seems that the rise in the female participation rate has continued to offset the decreases in the foreign labour force and in the male participation rate.

4.3 Costs and prices

The average wage settlement negotiated in collective agreements for 2011 was 2.5% in the period January to December against a backdrop in which the number of agreements reached at year end was ultimately very small. In fact, the number of workers affected was slightly more than six million, which represents nearly one million workers less than in the same month of 2010 and is the lowest figure since 1997. The average settlement in newly signed agreements – affecting slightly more than one million workers – amounted to 1.6% in line with the mid-point of the wage band recommended by the Agreement on Employment and Collective Bargaining (AENC by its Spanish initials) of 2010 (see the right-hand panel of Chart 19). However, most of the agreements registered corresponded to revisions of multi-year agreements signed in previous years, in which the settlements amounted to 2.7%. This is largely explained by the agreements being linked to the annual increase in the CPI in December 2010, which was 3%. The effect of wage indexation clauses linked to

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

TABLE 4

€m and %

	Outturn 2010	Percentage change 2010/2009	Outturn Jan-Jun. Percentage change 2011/2010	2010 Jan-Sept	2011 Jan-Sept	Percentage change
	1	2	5	6	7	8 = 7/6
1 TOTAL RESOURCES	381,427	3.7	-1.4	272,244	270,061	-0.8
Current resources	381,293	3.7	-1.5	275,155	273,308	-0.7
Taxes on production and imports	108,699	17.7	-4.3	79,625	79,243	-0.5
Income and wealth taxes	99,698	-1.4	0.7	69,977	70,201	0.3
Social security contributions	140,170	0.0	-0.4	104,126	103,593	-0.5
Other current resources	32,726	-3.6	-1.8	21,427	20,271	-5.4
Captial resources	134	-1.5	10.3	-2,911	-3,247	-11.5
2 TOTAL USES	479,645	-1.1	-1.2	333,487	326,861	-2.0
Current uses	426,997	1.0	0.7	299,019	300,191	0.4
Employee compensation	124,781	-0.7	-2.4	90,170	88,536	-1.8
Other final consumption expenditure (a)	91,355	-2.5	2.0	59,838	58,973	-1.4
Social benefits (not in kind)	160,974	4.7	0.0	114,638	115,317	0.6
Interest payments	20,120	8.6	26.3	14,727	18,457	25.3
Subsidies	12,147	2.6	-0.4	7,695	7,441	-3.3
Other uses and current transfers	17,620	-8.7	-5.6	11,951	11,467	-4.0
Capital uses	52,648	-15.1	-17.4	34,468	26,670	-22.6
Gross capital formation	40,091	-14.3	-20.7	28,699	22,321	-22.2
Other capital expenditure (b)	12,557	-17.6	-0.4	5,769	4,349	-24.6
3 NET LENDING (+) / NET BORROWING (-) (3= 1-2)	-98,218	—	—	-61,243	-56,800	7.3
(As a percentage of nominal GDP)	-9.3	—	—	-7.9	-7.1	—
MEMORANDUM ITEM:						
Primary balance	-78,098	—	—	-46,516	-38,343	—
Final consumption expenditure	221,715	-0.8	0.1	154,760	153,212	-1.0

SOURCE: Ministerio de Economía y Hacienda.

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).

2010 inflation, yet paid in 2011, is estimated to have increased to 0.7 pp. Accordingly, approximately half of the workers with a registered agreement continue to be covered by an annual wage indexation clause. Firm-level agreements continued to be more in line with the labour market situation with wage increases of 1.9% in contrast to 2.5% in sector-level agreements.

These wage developments contrast with the greater moderation displayed by other indicators, such as the quarterly wage cost survey (ETCL by its Spanish initials), which showed a 1.5% year-on-year increase in Q3 (see left-hand panel of Chart 19), although labour costs per employee and month quickened in this period. The year-on-year increase in compensation per employee in the market economy in the closing months of the year is estimated to have held at 1.4% (see Chart 20). Given that a fresh increase in productivity is expected in the quarter, unit labour costs are likely to have continued to decline in the final months of the year, posting a fall of around 2% for Q4 as a whole.

In the period analysed, the deflators of the main components of demand recorded appreciably lower year-on-year growth than in the first half of the year. This was largely a result of the developments in domestic producer prices (as proxied by the GDP deflator), the rate of growth of which declined by 0.5 pp with respect to the previous quarter, but

SOCIAL SECURITY SYSTEM BUDGET OUTTURN — TABLE 5

€m and %

	Initital budget 2010	Percentage change 2010/2009	Initital budget 2011	Percentage change 2011/2010	Outturn Jan-Sept. Percentage change 2011/2010	Outturn		
						2010 Jan-Nov	2011 Jan-Nov	Percentage change 2011/2010
	1	2	3	4 = 3 / 1	5	6	7	8 = 7 / 6
1 REVENUE	119,481	-3.4	123,405	3.3	-2.1	108,726	107,191	-1.4
Social security contributions	108,358	-4.4	111,778	3.2	-1.1	97,161	95,924	-1.3
Current transfers	8,357	12.3	8,154	-2.4	-11.8	8,370	8,050	-3.8
Other revenue	2,765	-6.7	3,473	25.6	-3.3	3,195	3,217	0.7
2 EXPENDITURE	116,601	1.9	118,826	1.9	3.1	98,006	101,271	3.3
Wages and salaries	2,483	1.2	2,378	-4.2	-1.8	2,100	2,064	-1.7
Goods and services	2,032	1.9	1,719	-15.4	-4.0	1,413	1,345	-4.8
Current transfers	111,557	1.9	114,279	2.4	3.4	94,287	97,659	3.6
Contributory pensions	95,320	2.1	99,090	4.0	5.0	81,044	85,005	4.9
Sickness	7,373	-9.5	7,009	-4.9	-9.6	5,272	4,853	-7.9
Other	8,864	11.0	8,181	-7.7	-4.6	7,971	7,801	-2.1
Other expenditure	529	-6.1	450	-15.0	-16.4	206	204	-1.0
3 BALANCE (3 = 1 – 2)	2,880	—	4,579	—	—	10,720	5,920	—

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

also of the developments in the prices of imported goods, which displayed more moderate growth.

In 2011 Q4, the declining trend in the main consumer price indicators seen in previous months intensified. The annual rate of CPI inflation was 2.4% in December, down 0.7 pp from September (see Chart 21). In the same period, the CPI excluding unprocessed food and energy slowed by 0.2 pp to 1.5%. The lower growth rate of these indicators reflects the petering out of both the base effect of the increase in excise duties on tobacco in December 2010 and the comparison effects of energy prices. The rate of increase of non-energy industrial goods prices fell somewhat despite the higher prices of domestically produced and imported non-energy industrial goods against a backdrop of a depreciation of the euro. The rate of change of services prices increased by 0.1 pp after slowing for nine months. The energy component decelerated substantially, its growth rate fell back by 5.6 pp to 10.3%. The growth rate of unprocessed food prices also fell in Q4.

In the final months of 2011, the moderation of inflation [as measured by the harmonised index of consumer prices (HICP)] was sharper in Spain than in the euro area and, consequently the differential, which was zero in September, fell in Q4. Thus, inflation in Spain in December was 0.3 pp lower than in the euro area (see Chart 22). The differential in terms of the CPI excluding unprocessed food and energy was also negative (-0.6 pp). By component, the differential was only positive in the case of energy goods, which was due partly to higher increases in gas and electricity prices, as well as to higher rises in vehicle fuel prices in Spain. The other components posted a negative differential in December which ranged from 0.3 pp in services and 0.7 pp in non-energy industrial goods and processed food. In comparison with the end of the previous quarter, the largest change in the differential was in processed food since the prices of these goods posted lower increases in Spain than in the euro area, after the effect of the one-off rise associated with the increase in tobacco prices in December 2010 in Spain disappeared in December 2011.

The regional governments managed in 2010 (the latest figures available) 37% of total general government expenditure and are responsible for 55% of general government employees[1] and for almost 94% of public spending on health and education. Also, the new ordinary-regime regional government financing system significantly increased in 2010 the percentages assigned to regional governments of personal income tax (from 33% to 50%), of VAT (from 35% to 50%) and of excise duties on manufactured products (from 40% to 58%).

This relevance of regional governments in terms of responsibility for public revenue and expenditure underlines the importance of their contribution to budgetary stability. In this context, Spain's latest Stability Programme established guidelines for reducing the regional governments' deficit, in terms of National Accounts (NA), from -3.5% of GDP in 2010 to -3.3% and -1.3% of GDP in 2011 and 2012, respectively.[2] The government announced, however, on 30 December 2011 that the regional governments would miss the target set for 2011 by around 1.2 pp. The latest available data on regional government budget outturn for 2011 Q3, indicate that the source of this deviation has centred principally on weak revenue which fell by 3% to Q3, compared with a budget projection of a slight increase for 2011 as a whole. Developments in spending to Q3 have been in line with those included in the budget for the year as a whole.[3]

In the final months of 2011, the regional governments submitted their draft budgets for 2012, according to a set timetable. The main headings of these draft budgets are in the accompanying table.[4] According to these aggregate figures, these budgets indicate that there will be a deficit of -1.2% of GDP in 2012. By heading, note that the figures in the above-mentioned table refer to the estimated initial budgets and the settlement for 2011 is not available. As significant deviations arise in 2011 from the estimated initial budgets, the informativeness of the rate of change in the estimated initial budgets shown in the table will be invalidated. Furthermore, given the delay in the approval of the State budget for 2012, the estimate of revenue in the regional governments' budgets is more uncertain than in previous years. With these caveats, noteworthy in the aggregate information are the budgeted increases in direct and, especially, indirect taxes, although they do not offset the falls in revenue envisaged in charges and current transfers and in capital. As for expenditure, a fall of 2.1% in initially budgeted expenditure is projected which would be centred on the "capital" item (-14.5%). In particular, the level of investment is estimated to stand at end-2012 at practically half of the amount budgeted in 2008. The interest burden is the only item which is expected to increase, in this case by 35%, which is similar to that of previous years and is due to the rise in debt issued.

1 According to the latest statistical bulletin of general government personnel.

2 The deficit target was -1.3% of GDP in 2011, stripping out the effect of regional government payment deferrals to the central government as a result of the final settlement of revenue for 2009. It should be noted that in 2010 and 2011 there were notable differences between the estimated budget balance and the NA balance for the regional governments. In fact, under the financing system of regional governments, the latter receive annually the funds from the taxes transferred to them based on forecasts of tax receipts included in the State Budget. Subsequently, with a two-year lag, this revenue is settled definitively on the basis of final receipts. As a result of high revenue forecasts made in 2008 and 2009, in 2010 and 2011 the definitive revenue settlement is expected to mean that the regional governments should return the surplus funds received to the State. The State, however, has allowed the regional governments to delay these refunds until 2012 (and by up to 60 months), consequently, the regional governments' payments to the State are not reflected in their budgets for 2010 and 2011 and, consequently, nor are they reflected in their budget deficits for those years. The NA criterion, however, includes these payments in the years when they should be made, namely in 2010 and 2011; therefore, the above-mentioned deficits, net of those payments, would amount to -2.4 % of GDP in 2010 and to -1.3 % of GDP in 2011, ratios which are readily comparable with the budgeted figures of the regional governments, since they are also net of those payments.

3 It is important to point out that the regional governments' budget outturn figures published quarterly by the Ministry of Economy are not directly comparable with the regional governments' initial budgets. The Ministry makes certain adjustments for standardisation purposes based on information sources which are not public. In this respect, in Q1 the Ministry is also expected to publish the regional governments' initial budgets in homogeneous terms, which will differ, therefore, for certain items from the aggregate figures presented in the accompanying table.

4 Castilla-La Mancha and Castilla y León have extended their budgets to the next year; consequently, these regional governments were included as an average of the other regional governments.

€m and %

	2008	2009	2010	2011	2012 (a)	Rates of change			
						2009/2008	2010/2009	2011/2010	2012/2011
1 REVENUE	168,225	164,814	150,158	152,191	151,416	-2.0	-8.9	1.4	-0.5
Current revenue	159,416	155,318	141,858	142,557	142,889	-2.6	-8.7	0.5	0.2
Direct taxes	32,202	38,247	29,955	40,176	41,120	18.8	-21.7	34.1	2.4
Indirect taxes	56,114	44,725	36,114	50,570	55,953	-20.3	-19.3	40.0	10.6
Charges, prices and other revenue	4,546	4,753	4,882	4,978	4,473	4.5	2.7	2.0	-10.1
Current transfers	65,997	67,001	70,356	46,056	40,281	1.5	5.0	-34.5	-12.5
Interest and dividends	557	592	551	777	1,062	6.4	-6.9	41.0	36.7
Capital	8,808	9,495	8,300	9,634	8,527	7.8	-12.6	16.1	-11.5
Disposal of investments	630	633	518	2,197	1,591	0.4	-18.1	—	-27.6
Capital transfers	8,178	8,863	7,782	7,437	6,935	8.4	-12.2	-4.4	-6.7
2 EXPENDITURE	168,544	175,029	174,608	168,011	164,554	3.8	-0.2	-3.8	-2.1
Current expenditure	136,373	143,187	144,923	144,320	144,310	5.0	1.2	-0.4	0.0
Wages and salaires	52,328	55,335	56,507	53,721	53,581	5.7	2.1	-4.9	-0.3
Goods and services	28,033	28,924	29,467	28,470	28,344	3.2	1.9	-3.4	-0.4
Interest payments	2,489	2,741	3,714	4,942	6,669	10.1	35.5	33.1	34.9
Current transfers	53,347	55,978	54,998	57,071	55,345	4.9	-1.8	3.8	-3.0
Contingency fund	175	209	237	117	371	19.2	13.6	-50.8	—
Capital	32,171	31,842	29,685	23,691	20,245	-1.0	-6.8	-20.2	-14.5
Investment	16,381	15,975	13,276	9,899	8,381	-2.5	-16.9	-25.4	-15.3
Capital transfers	15,790	15,867	16,409	13,792	11,863	0.5	3.4	-15.9	-14.0
3 BALANCE (1-2)	-319	-10,215	-24,450	-15,820	-13,138	—	—	—	—
% of GDP	0.0	-1.0	-2.3	-1.5	-1.2	—	—	—	—
MEMORANDUM ITEMS (% of GDP):									
NA BALANCE (b)	-1.6	-2.0	-3.1	-3.3	-1.3	—	—	—	—
NA BALANCE with deferrals (% of GDP) (c)	-1.6	-2.0	-2.4	-1.3	-1.3	—	—	—	—

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

a All regional governments. The budget headings for Castilla-La Mancha and Castilla y León are taken as an average of those of the other regional governments.
b The NA balance includes deferrals among regional governments' payments, although they are not reflected in the budgets.
c The budget stability target included in the latest Updated Stability Programme is shown for 2012.

The producer price index moderated in Q4, posting a year-on-year rate of change of 6.3% in November, down 0.8 pp from September. This is essentially attributable to the lower rise in the prices of energy and intermediate products. The prices of consumer industrial goods and capital goods held at similar year-on-year rates of change to those of the previous quarter. For their part, the import and export price indices for industrial products moderated, to reach year-on-year rates of 8.8% and 4.4%, respectively, in November. In both cases the prices of energy products also displayed very high rates of change.

4.4 The State budget

At the meeting of the Council of Ministers of 30 December it was announced that the deficit of the general government sector as a whole, in National Accounts terms, was estimated to stand in 2011 at approximately 8% of GDP, which is a significant deviation from the official target of 6% of GDP. On information provided by the Government, all the constituent agents of general government appear to have experienced significant deviations,

STATE BUDGET OUTTURN

TABLE 6

€m and %

	Outturn 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010	Outturn Jan-Sept. Percentage change 2010/2009	2010 Jan-Nov	2011 Jan-Nov	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	127,337	24.8	106,020	-16.7	-20.1	119,210	97,314	-18.4
Direct taxes	59,262	9.5	55,239	-6.8	-14.6	57,057	49,592	-13.1
Personal income tax	39,326	29.2	35,494	-9.7	-15.6	37,055	32,055	-13.5
Corporate income tax	16,198	-19.8	16,008	-1.2	-12.3	16,489	14,611	-11.4
Other (a)	3,738	7.5	3,737	-0.0	-13.1	3,512	2,926	-16.7
Indirect taxes	51,825	80.8	36,142	-30.3	-32.0	49,735	34,815	-30.0
VAT	38,486	143.8	24,968	-35.1	-33.4	37,445	26,190	-30.1
Excise duties	10,338	1.9	8,179	-20.9	-36.1	9,515	5,884	-38.2
Other (b)	3,001	9.5	2,995	-0.2	0.8	2,775	2,740	-1.2
Other net revenue	16,251	-15.7	14,639	-9.9	4.2	12,419	12,908	3.9
2 EXPENDITURE	179,572	-5.1	150,056	-16.4	-19.5	162,257	135,863	-16.3
Wages and salaries	26,975	1.5	26,982	0.0	0.9	23,181	23,767	2.5
Goods and services	4,632	-4.7	3,384	-26.9	-10.1	3,542	3,308	-6.6
Interest payments	19,638	11.3	27,421	39.6	5.7	19,516	21,955	12.5
Current transfers	104,656	-6.9	74,598	-28.7	-27.9	95,404	72,905	-23.6
Investment	8,782	-16.1	5,793	-34.0	-26.9	7,352	5,472	-25.6
Capital transfers	14,890	-14.2	9,208	-38.2	-35.5	13,263	8,455	-36.2
3 CASH-BASIS BALANCE (3 = 1 – 2)	-52,235	—	-44,036	—	—	-43,047	-38,549	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)								
TOTAL	**135,862**	**16.3**	**141,538**	**4.2**	**2.3**	**127,752**	**130,832**	**2.4**
Personal income tax	66,977	4.9	71,761	7.1	4.1	62,610	65,226	4.2
VAT	49,079	46.2	48,952	-0.3	1.9	46,947	48,126	2.5
Excise duties	19,806	2.4	20,825	5.1	-3.0	18,195	17,480	-3.9

SOURCE: Ministerio de Economía y Hacienda.

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

in particular regional and local governments which were responsible for two thirds of the total deviation. Full information about end-2011 will be available in March. This section reviews the latest statistical information published on the State budget.

The latest available data for the general government sector as a whole, in National Accounts terms, were published on 30 December and refer to 2011 Q3. According to this information source, the general government sector is estimated to have posted a deficit in the period January-September 2011 of 7.1% of GDP, 0.8 pp down on the deficit of 7.9% of GDP recorded in the same period of 2010 (see Table 4). Noteworthy by component were weak government receipts which fell by 0.8% between January and September, in contrast to the projection included in the latest Stability Programme of an increase in 2011 as a whole of more than 5%. For their part, total uses of general government decreased by 2% in the first three quarters of the year, more in line with the 2.5% reduction included in the Stability Programme.

By subsector, information is available to November on the budget outturn of the Social Security system (see Table 5). According to this information, worth noting is the weak

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) **TABLE 7**

€m

		January-October		Rate of change 2011/2010 (b)
		2010	2011	
CREDITS	Current account	278,444	314,498	12.9
	Goods	155,988	184,595	18.3
	Services	79,481	85,882	8.1
	Tourism	35,037	38,264	9.2
	Other services	44,444	47,619	7.1
	Income	30,974	29,142	-5.9
	Current transfers	12,000	14,878	24.0
	Capital account	6,455	5,445	-15.6
	Current + capital accounts	284,899	319,943	12.3
DEBITS	Current account	319,888	346,581	8.3
	Goods	195,188	218,637	12.0
	Services	54,247	54,620	0.7
	Tourism	10,596	10,344	-2.4
	Other services	43,651	44,276	1.4
	Income	49,511	52,868	6.8
	Current transfers	20,941	20,455	-2.3
	Capital account	1,356	1,164	-14.1
	Current + capital accounts	321,243	347,745	8.2
BALANCES	Current account	-41,444	-32,083	9,361
	Goods	-39,200	-34,043	5,157
	Services	25,234	31,262	6,028
	Tourism	24,441	27,920	3,479
	Other services	794	3,342	2,549
	Income	-18,537	-23,726	-5,188
	Current transfers	-8,941	-5,577	3,364
	Capital account	5,100	4,281	-818
	Current + capital accounts	-36,344	-27,802	8,542

SOURCE: Banco de España.

a Provisional data.
b Absolute changes for balances.

revenue from social security contributions which are likely to have contracted by slightly more than 1% in 2011 due to the negative trend in social security registrations. As for expenditure, contributory pensions seemingly grew by approximately 5%, although pensions (except for the minimum ones) had been frozen in 2011, reflecting a modest rise in the number of pensions paid and a slight increase in the average pension received, while spending on unemployment and other welfare benefits (mainly sickness benefits) is likely to have fallen substantially. Weak revenue, given the relatively persistent spending on benefits is estimated to have generated, according to the Government's estimate at end-2011, a deficit of the social security funds, as a whole, amounting to €0.7 billion, which would mean a negative deviation from the subsector's target, in National Accounts terms, of 0.5 pp of GDP.

For its part, the State recorded a deficit of €52.4 billion to November 2011, in National Accounts terms, which represented 4.8% of GDP (5.2% in the same period of 2010) compared with the target of 2.3% of GDP for the whole year. However, in December the State

will record revenue from settlements under the regional government financing system, which on official figures is estimated to exceed 2 pp of GDP. In cash basis terms, the State posted a deficit between January and November 2011 of €38.5 billion (see Table 6) compared with the deficit budgeted for the whole of 2011 of €44 billion.

Information is also available to November 2011 on revenue from taxes shared by the State and regional and local governments, in budgetary accounting terms, which is likely to confirm the weak tax revenue for 2011 overall. In the area of indirect taxes, the growth rate of receipts from excise duties is estimated to be well below budget targets (-3.9% in the period January-November, compared with 5.1% budgeted for 2011), while VAT receipts are expected to be higher than projected (2.5% to November). Personal income tax receipts grew by 4.2% to November, compared with a growth rate of 7.2% projected for the year as a whole. Finally, corporate income tax receipts (State) fell in the period January–November by 11.4%, which was below the projected increase of 1.2% included in the budget. This was despite a slight rise in corporate income tax receipts in Q4 as a result of the changes in the timing of partial payments included in Royal Decree-Law 9/2011 of 19 August 2011.

4.5 Balance of payments

During the first ten months of 2011 there was an overall deficit on current and capital accounts of €27.8 billion, 24% down on the same period of 2010 (see Table 7). This decline is explained by the narrowing of the current account deficit which offset the contraction in the current account surplus. In turn, the fall in the current account deficit reflected the widening of the surplus on services and the reduction of the trade and current transfers deficits, which offset the increase in the income deficit.

In the first ten months of 2011, the trade deficit decreased by 13% to €34 billion, owing to the notable correction of the non-energy balance which amply offset the increase in the energy bill. The services surplus increased by 24% to €31 billion, thanks to the improvement in the tourism and other services balances. The current transfers deficit fell by 38% to €5.6 billion, while the income deficit widened by 28% to €24 billion. Finally, the capital account surplus decreased by 16% to €4.3 billion.

5.1 Highlights

Spain was again among the countries most strongly affected by the financial strains in the euro area associated with the sovereign debt crisis. This was reflected in high volatility of government debt yields, which in 10-year bonds reached nearly 7% at the peak of the tension in the second half of November. However, in 2011 Q4 the Treasury raised substantial funds in its auctions, which continued to meet with high demand (see Box 5). The turmoil also affected the credit risk premia on fixed-income securities issued by financial corporations, which rose during the fourth quarter of the year, while those on securities issued by non-financial corporations fell slightly. In the stock markets, the IBEX 35 exhibited considerable variability, and at end-2011 stood very near its end-September level, compared with gains of 6.3% and 11.2% by the EURO STOXX 50 and S&P 500, respectively. Thus the loss for the year amounted to 13.1% for the Spanish index and 17.1% for the European one, while the US indicator ended the year around its end-2010 level (see Chart 23).

2012 has so far seen high price volatility on the financial markets, a phenomenon accompanied by the downgrading by two notches of the rating assigned to the Kingdom of Spain by one of the main credit rating agencies, within the framework of a general upward reassessment of sovereign risk in the euro area. At the date this report went to press, the IBEX 35 had lost 0.4% since the beginning of the year (the S&P 500 and EURO STOXX 50 showed slight gains), while the yields on Spanish 10-year government debt and its spread over German debt of the same term stood at levels near to those at the end of last year. Meanwhile, the credit risk premia on private-sector securities decreased moderately.

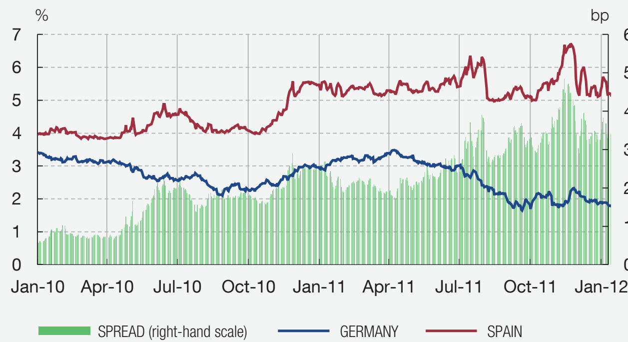
Against this background, credit institutions again encountered significant difficulties in raising funds on the fixed-income and interbank markets. On the fixed-income markets, however, net issuance was positive in October and November (latest available information), although it should be taken into account that relatively little debt matured in this period. On the interbank market, the net debtor position of banks vis-à-vis the rest of the world decreased in the same period as a result of the fall-off in funds raised in secured interbank transactions (for the first time since mid-2010) and, to a greater extent, in other funding. The considerable tensions persisting in this market have been reflected in a further widening of the spread between 1-year EURIBOR and EUREPO (cost of secured transactions) of the same term, which reached 174 bp at year-end. Thus the former scarcely fell (down by 14 bp in Q4 to 1.95%), despite the 50 bp drop in official interest rates in these months, while the EUREPO dropped more sharply (by 35 bp). Faced with this situation, banks turned to the Eurosystem to cover a significant part of their liquidity needs.

In the real estate market, unsubsidised housing prices continued to fall in the closing months of 2011, according to the latest data published by the Ministry of Infrastructure and Transport. Thus the year-on-year rate of decline stood at 6.8% in December, compared with a decrease of 5.6% at the end of the third quarter (see Chart 23). In quarter-on-quarter terms, the fall was 1.6%, somewhat more than that of September (1.3%). Hence the market value of this asset showed a cumulative fall of 19% from the beginning of 2008 to the end of last year (25% in real terms).

The interest rates on credit extended to households and firms showed scantly significant changes between September and November (latest available data). The moderate decline

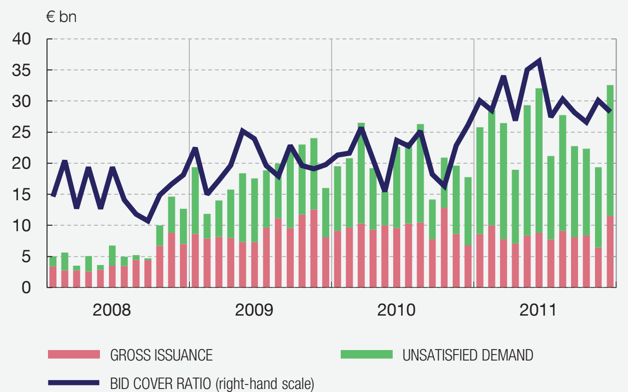
The closing months of 2011 were characterised by notable price volatility in the secondary government debt markets of Spain and other euro area countries. Thus, although Spanish 10-year government bond yields ended the year around their levels at the beginning of the fourth quarter (slightly above 5%, as shown by panel 1 of the accompanying chart), in the second half of November they reached nearly 7%, a level not seen since 1997. The yield spread over Germany, given the relative stability of German debt yields, moved above 450 basis points, amply exceeding the highs recorded last summer. This behaviour resulted from changes in agents'

1 10-YEAR GOVERNMENT BOND YIELDS AND SPREAD OVER GERMANY

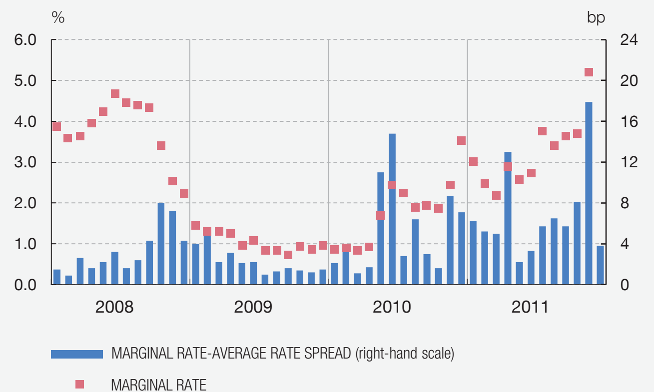


2 10-YEAR GOVERNMENT BONDS. BID-ASK SPREAD (a)

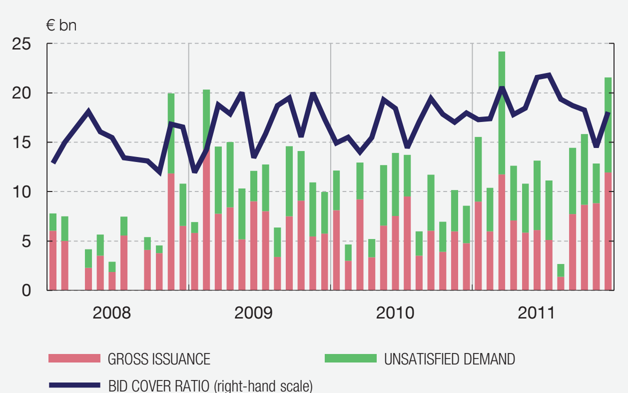
3 TREASURY BILL ISSUANCE



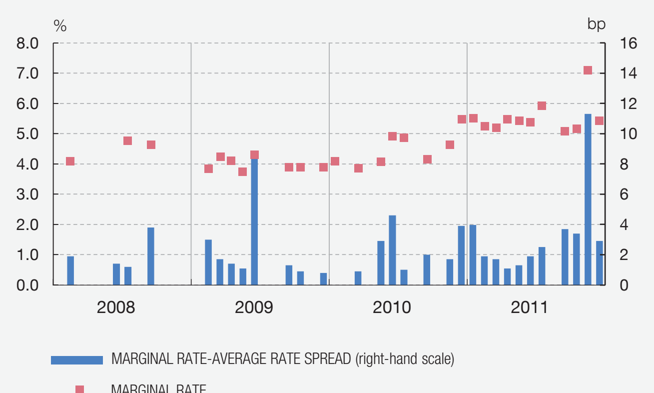
4 12-MONTH TREASURY BILL ISSUANCE



5 GOVERNMENT BOND ISSUANCE



6 10-YEAR GOVERNMENT BOND ISSUANCE



SOURCES: Bloomberg, Reuters and Banco de España.

a 5-day moving average.

perception of the challenges facing the euro area economies and of the scope and effectiveness of the measures adopted or being implemented.

Against this background, the main credit rating agencies downgraded the rating of Spanish government securities between one and two notches in October last year, based on a worsening of the medium-term growth outlook, on the risks associated with fiscal consolidation and on the intensification of the euro area crisis. Subsequently, in the framework of a general review of euro area sovereign risk, two of these agencies announced a new period of downward revision which, in one of the cases, resulted in Spanish sovereign debt being downgraded by another two notches on 13 January 2012.

The financial tensions also adversely impacted secondary market liquidity, although the behaviour of instruments was uneven. Thus the average monthly volumes traded in outright bond transactions decreased by 14% in October-November (latest available figures) with respect to the previous quarter, while they rose by 5% in Treasury bills. Nevertheless, in both cases the figures recorded were notably higher than in the closing months of 2010 (up 25% and 54%, respectively). Simultaneously, panel 2 of the accompanying chart shows that in the 10-year bond segment the bid-ask spread[1] (a more direct indicator of lack of liquidity) increased notably, returning to levels close to those in past bouts of high tension, as in May and December 2010.

Despite these tensions, the Spanish government managed to issue a total gross volume of €56 billion in those three months (40% more than in the previous quarter and 23% more than in the same period of 2010), and the €16 billion of net funds raised enabled it to meet satisfactorily the financing needs for the year as a whole. Thus total net issuance (of bills and bonds) in 2011 was €48.6 billion, slightly more than the target of €47.2 billion set at the beginning of the year.

A look at the instruments shows that net issuance in Q4 continued to focus on bonds, since less than €1 billion of bills were issued in net terms. Hence, despite the higher interest rates demanded for those maturities, the Treasury continued financing itself at relatively long terms (the average life of the debt at the end of the quarter was 6.4 years, compared with 6.5 year in September 2011). This strategy helped to reduce refinancing risk by limiting repayments in the upcoming quarters.

This was made possible because investor demand for funds continued to be significant. However, this demand decreased somewhat in the November auctions, coinciding with the moments of greatest secondary market tension. This is seen most clearly in panels 3 to 6 of the accompanying chart. In that month, the bid-cover ratio (volume of bids received in the auction divided by the volume of bids accepted) remained high in Treasury bill placements, but only at the expense of a reduction in the amounts allotted and a significant rise in the yields offered. Also, the spread between the marginal interest rate and the average of the bids accepted (which is also usually an indicator of the issuer's difficulty in placing the desired volumes on the market) widened to 18 basis points, the largest seen in the last four years. In the bond auctions conducted during that month, demand also fell appreciably, so the bid-cover ratio fell and the marginal rates and their spread over the average rate at issue rose. This situation reversed, however, in the last month of the year, in which (probably attracted by the high yields and by credit institutions' readier access to the Eurosystem derived from the latest unconventional measures approved by the ECB) bids increased notably and the Spanish Treasury was able to trim its financing costs moderately, while at the same time making the largest monthly gross issue of the year (€23 billion). Thus the marginal interest rate on 12-month Treasury bills fell to 4.05%, against 5.20% in November, with even more significant falls on 3- and 6-month bills. Meanwhile, the marginal rate of 5.4% in the 10-year bond auction was also notably lower than in November (7.09%).

Judging from the results of the first government debt auctions in 2012 (bonds on 12 January and bills on 17 January), this situation seems to have continued in the beginning of the current year. In those auctions, the Spanish government placed nearly €15 billion (above the envisaged maximum), with a strong demand and marginal yields around 1.5-2 percentage points lower than in the previous auction.

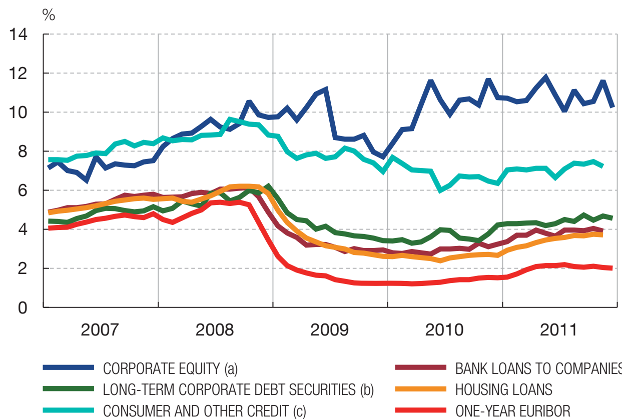
The estimated average issuance cost for the State in 2011 Q4[2] was 5.2% (against 5% in the preceding quarter and 3.8% in 2010), the highest since 2001. Having said that, the relatively long average life of the securities issued means that only a small part of this higher cost passes through to the total financing cost of the State. The future behaviour of the State's total financing cost will depend largely on euro area sovereign debt market tensions.

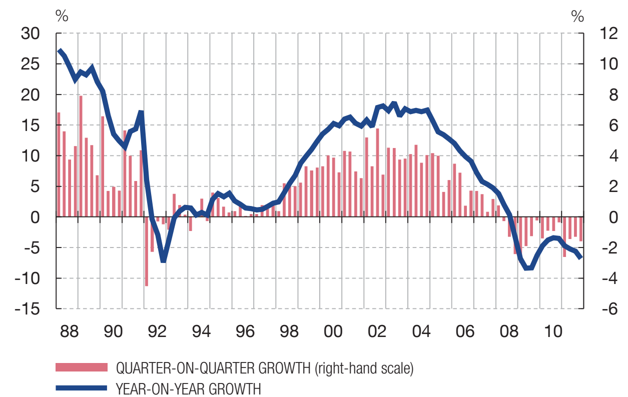
1 Difference between the ask price and bid price at which market-makers trade. The more liquid a market, the smaller this spread.

2 Calculated as the average cost resulting from each of the auctions of the various instruments, weighted by the outstanding balance at each maturity.

FINANCING CONDITIONS AND ASSET PRICES

CHART 23





SOURCES: Blommberg, Reuters, Datastrem, MSCI Blue Book, Ministerio de Vivienda 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.

in the interbank interest rates used as a benchmark in these transactions, which incorporated only partially the monetary policy easing in this period, was accompanied in most segments by a slight rise in the spreads applied to those benchmark rates by credit institutions. There was an increase in the cost of fixed-income security issuance by firms to end-2011 and a decrease in the cost of equity issuance.

The latest available data on financing to households and firms, relating to November, show rates of decline somewhat larger than those at the end of Q3. In the case of households, the contraction of credit stood, in year-on-year terms, at 2.1%, against 1.5% in September, as a result of the larger fall-offs in both house purchase loans and in consumer credit and other lending. Similarly, the year-on-year fall in corporate debt amounted to 2.1%, compared with 2% in September. By instrument, the fall in bank loans was 4.5%, whereas the growth rate of fixed-income securities slowed to 6%. The most recent information on loan purpose, relating to 2011 Q3, reflects contractions in the outstanding balance of bank loans in all economic sectors, sharper than those in June.

The behaviour of firms' and households' debt, in conjunction with that of their income and average financing costs, allowed their debt and debt burden ratios to fall further in 2011 Q3. In the case of households, net wealth continued to decline as a result of decreases in the value of both the real estate and the financial components. The prolongation of the patterns seen in debt and the behaviour of real asset prices suggest that the aforementioned trends will continue in the closing months of the year. In the case of firms, for the sample of corporations reporting to the CBQ, among which the biggest have a notable weight, there was a fall in activity and in corporate profits in the first three quarters of 2011 with respect to the same months of the previous year. This gave rise to a decrease in the return on equity. In addition, the debt to assets ratio and the debt to income ratios of these firms scarcely changed, while the associated debt burden edged up slightly. The overall outcome of these developments was that the indicators of financial pressure on investment and employment increased, interrupting the downward path followed until then.

Therefore, although the process of deleverage of households and firms proceeded in 2011 Q2, both sectors continued to be subject to considerable financial pressure, as reflected by the level of their doubtful assets ratios. Thus, the volume of loans classified as doubtful continued to rise in October, and this, along with the decrease in the overall debt granted to other resident sectors (in which firms and households are included), resulted in a rise of 0.26 pp in the doubtful assets ratio for this aggregate, pushing it up to 7.4%.

Although continuing to decelerate, general government debt grew at a brisk pace (12.6% year-on-year in November, 2.3 pp less than in September). By instrument, the rate of expansion decreased across the board, albeit particularly sharply in short-term securities, which slowed by 2.9 pp to 3.6%. The quarter-on-quarter stagnation of the general government liabilities and of GDP between June and September meant that in 2011 Q3 the sector's debt ratio failed to increase for the first time since the beginning of 2008, although the rise in the average cost of funds contributed to the further growth of the associated financial burden.

Further, according to the most recent financial accounts information, in 2011 Q3 the nation's net borrowing continued on its downward path to stand at 3.5% of GDP in 12-month cumulated terms, down 0.1 pp from June (see Table 8). This behaviour was the result of a decrease in the debtor position of general government (to 8.8% of GDP, down 0.4 pp from mid-year), an increase in household net lending, a fall in corporate net lending and scant changes in the credit balance of financial institutions. The breakdown by instrument shows that between June and September the bulk of foreign capital inflows were channelled through reductions in the interbank position of the Banco de España and, to a lesser degree, in secured transactions settled in central counterparty clearing houses.

To summarise, in 2011 Q4 financial developments in Spain were again marked by the intensification of financial tensions. This affected above all the cost of debt of the various resident sectors, since the potential impact on flows was cushioned by the access to Eurosystem funding, which has recently been made easier by the introduction of 3-year liquidity tenders.

5.2 Households

The cost of bank financing to households showed scantly significant changes between September and November. Thus the interest rate on house purchase loans increased by 5 bp, while that on consumer credit and other lending, which is more variable, decreased by 12 bp. These changes resulted from movements in the same direction in the spreads applied by credit institutions to interbank benchmark rates and from a slight decline in the latter.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 8

% of GDP

	2006	2007	2008	2009	2010		2011		
					Q3	Q4	Q1	Q2	Q3
National economy	-8.4	-9.6	-9.2	-4.7	-4.4	-4.0	-4.1	-3.6	-3.5
Non-financial corporations and households and NPISHs	-11.5	-13.4	-6.5	5.1	4.6	4.4	4.3	4.8	4.6
Non-financial corporations	-9.8	-11.5	-6.7	-0.8	1.2	1.3	1.0	1.6	1.1
Households and NPISHs	-1.7	-1.9	0.2	5.9	3.4	3.1	3.3	3.2	3.5
Financial institutions	0.7	1.9	1.8	1.3	1.0	1.0	0.9	0.8	0.7
General government	2.4	1.9	-4.5	-11.2	-10.0	-9.3	-9.3	-9.3	-8.8
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-17.4	-15.5	-11.9	-8.3	-0.4	-1.1	-1.5	-0.8	0.2

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.

Household debt decreased in November, in year-on-year terms, by 2.1%, 0.6 pp more than at the end of Q3, as a result of the larger falls in house purchase loans (down 1.2%, compared with 0.8% two months earlier) and in consumer credit and other lending (down 5%, 1 pp more than in September). In annualised quarter-on-quarter terms, the debt growth rates of the sector were also negative and, in absolute terms, were somewhat higher than in September and very similar to the year-on-year rates.

The contraction of household liabilities, along with a slight increase in income, resulted in a decrease of 2 pp in the ratio of debt to gross disposable income (GDI) between June and September, thereby extending the pattern of gradual deleveraging (see Chart 24). The debt burden contracted slightly relative to GDI due to a decrease in debt principal repayments, while the gross saving rate and the saving after debt service held on their downward path since the beginning of 2010. This was again compatible with an increase in net lending, since investment in housing continued to fall. Household net wealth also fell again in these months as a result of a decline in both the real estate and the financial components.

According to the Financial Accounts, for which information is available up to Q3, household investment in financial assets decreased further to 1.1% of GDP in 12-month cumulated terms (see Table 9). In fact, between June and September there was disinvestment in financial assets, the largest falls being in cash holdings (4.1% of GDP), sight deposits (3.6% of GDP) and long-term debt securities (1.1% of GDP). By contrast, investment in shares and other equity recovered and became positive after five consecutive quarters of disinvestment.

Finally, the sector's doubtful assets ratio rose further between June and September to stand around 2.7% for house purchase loans and at 7% for consumer credit and other lending, 0.17 pp and 0.41 pp, respectively, above the values in Q2.

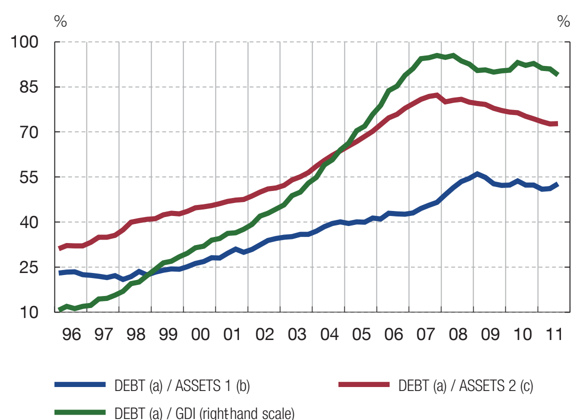
5.3 Non-financial corporations

Between September and November interest rates on loans to firms behaved differently depending on the amount of the transaction. Thus there was an increase of 10 bp in the cost of loans up to €1 million and a decrease of 13 bp for loans exceeding this amount. These developments resulted from changes in the same direction in the spreads applied

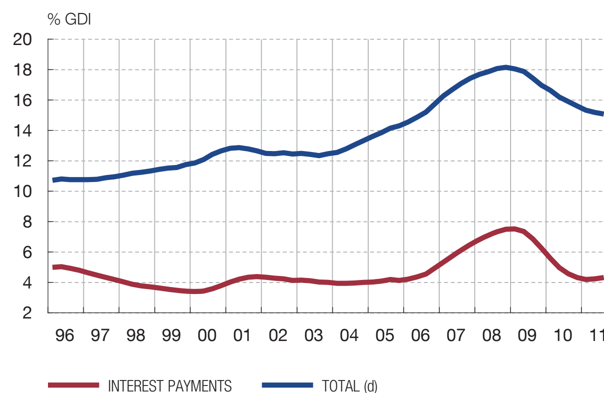
INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 24

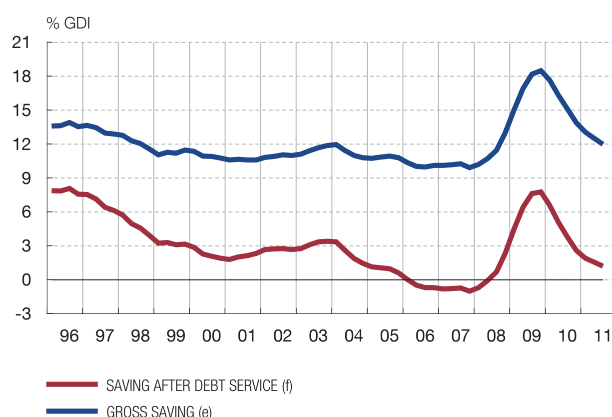
DEBT RATIOS



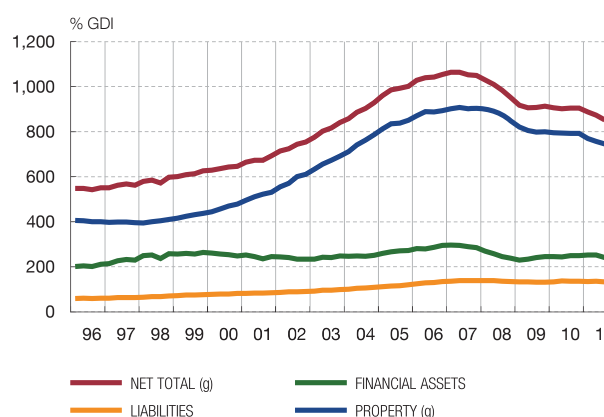
DEBT BURDEN



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 Gross saving less estimated debt repayments.
g Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.

by credit institutions to interbank benchmark rates and from a slight decline in the latter. As regards the cost of other sources of corporate finance, that of short-term debt security issuance increased by 67 bp between September and November, and that of long-term maturities rose by 9 bp between September and December. By contrast, the cost of equity decreased by 33 bp in the quarter as a whole, but showed notable volatility, in keeping with the volatility of share prices in these months.

According to the latest survey on SMEs' access to finance conducted by the ECB, Spanish SMEs reported a fresh decline in the availability of credit between April and September 2011, although at a somewhat slower rate than in the previous half, and expected this situation to continue between October 2011 and March 2012. Despite this, the proportion of Spanish SMEs whose loan applications were denied fell to 11%, compared with 16% in the previous half (and well below the 25% denial rate in 2009 H2). Also, the proportion of SMEs that declined a loan granted to them because they considered the associated cost

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

% of GDP

	2008	2009	2010	2011		
				Q1	Q2	Q3
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	2.6	4.7	3.4	3.1	1.8	1.1
Cash and cash equivalents	-0.4	4.2	-0.1	0.0	-0.3	-0.1
Other deposits and fixed-income securities (a)	6.2	-0.8	3.2	3.5	2.8	1.8
Shares and other equity (b)	0.1	1.1	0.6	0.3	-0.5	-0.1
Mutual funds	-3.3	-0.1	-1.7	-1.6	-1.3	-0.7
Insurance technical reserves	0.5	0.8	0.4	0.3	0.3	0.0
Of which:						
Life assurance	0.3	0.6	0.1	0.1	0.3	0.3
Retirement	0.1	0.2	0.3	0.1	0.0	-0.3
Other	-0.5	-0.5	1.2	0.6	0.9	0.3
Financial transactions (liabilities)	2.4	-1.2	0.3	-0.2	-1.4	-2.3
Credit from resident financial institutions (c)	3.4	-0.5	0.1	-0.5	-1.3	-1.3
House purchase credit (c)	2.7	0.1	0.5	-0.1	-0.4	-0.5
Consumer and other credit (c)	0.8	-0.4	-0.3	-0.4	-1.0	-0.8
Other	-1.1	-0.7	0.2	0.2	0.0	-1.0
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	2.0	-8.7	7.9	6.5	4.2	-0.6
Cash and cash equivalents	-1.1	-0.3	-0.1	0.4	-0.5	-0.7
Other deposits and fixed-income securities (a)	2.1	-0.5	2.0	2.5	2.4	1.5
Shares and other equity	3.6	-0.5	3.0	2.5	1.4	0.3
Of which:						
Vis-à-vis the rest of the world	3.5	0.0	2.6	2.3	1.8	0.2
Trade and intercompany credit	-3.2	-7.4	3.2	1.0	0.1	-2.2
Other	0.6	0.1	-0.2	0.2	0.9	0.5
Financial transactions (liabilities)	8.7	-7.9	6.6	5.6	2.6	-1.7
Credit from resident financial institutions (c)	5.5	-3.0	-0.9	-1.5	-2.8	-3.7
Foreign loans	3.0	0.0	0.7	1.2	1.2	0.8
Fixed-income securities (d)	0.3	1.4	0.7	0.6	0.6	0.6
Shares and other equity	2.3	1.6	1.8	2.7	2.7	3.1
Trade and intercompany credit	-3.3	-7.0	3.3	1.1	0.1	-2.2
Other	0.9	-0.8	1.0	1.5	0.8	-0.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	6.6	-0.8	0.5	0.0	-1.2	-1.8
Households and NPISHs	4.4	-0.3	0.2	-0.5	-1.6	-1.5
Non-financial corporations	8.2	-1.2	0.8	0.4	-0.9	-2.0

SOURCE: Banco de España.

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

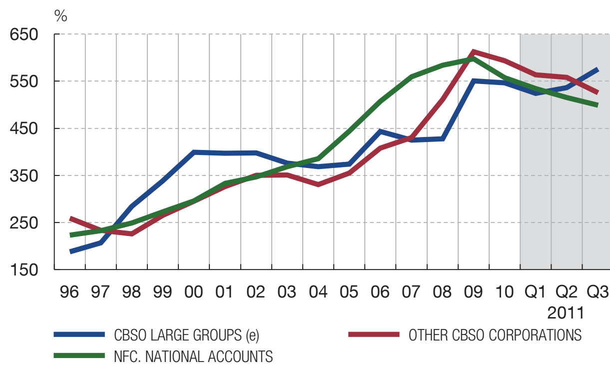
to be too high increased by 4 pp to 5%. SMEs perceived a notable tightening of the credit conditions applied in loans, similar to that reported by larger firms. Thus, in net terms, 80% of them had to pay higher interest rates on financing received and 45% had to provide more collateral.

The latest available data on corporate financing, relating to November, show year-on-year rates of contraction similar to those at the end of Q3 (2.1%, compared with 2% in September). By instrument, the fall in bank lending by resident credit institutions was 4.5%, 0.2 pp more than two months earlier, while the growth of debt securities slowed by 1.9 pp to 6%.

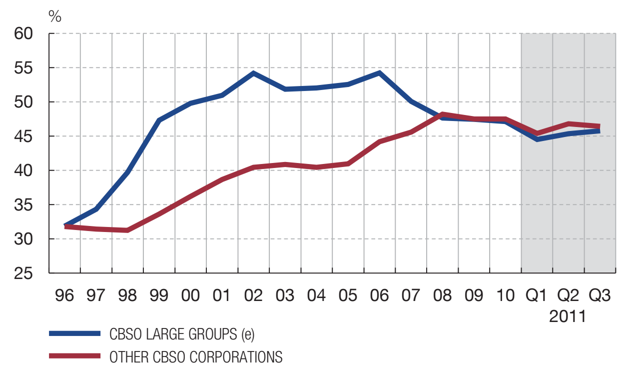
INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS (a)

CHART 25

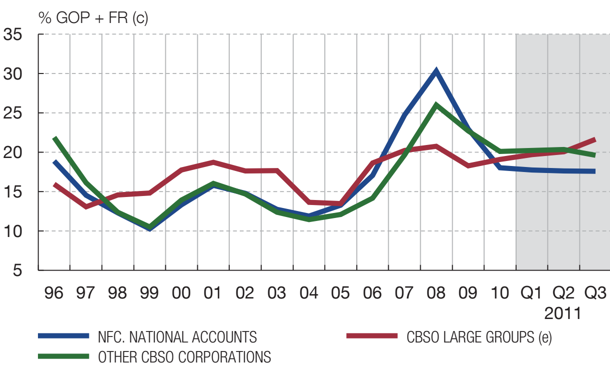
DEBT (b) / GOP + FR (c)



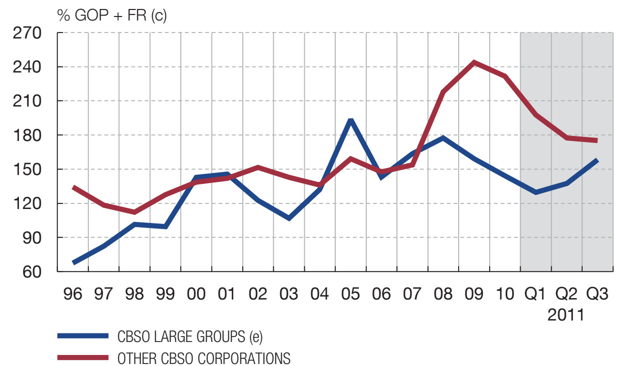
DEBT (b) / ASSETS (d)



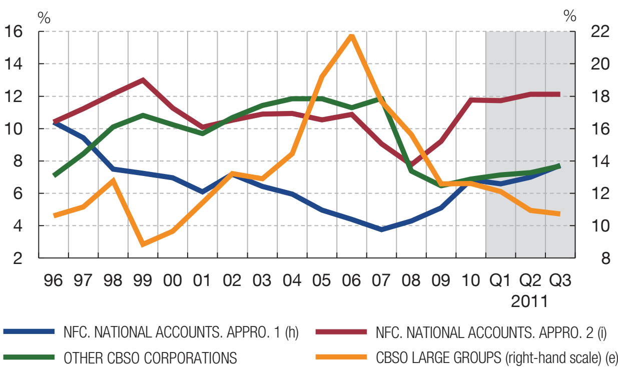
INTEREST DEBT BURDEN



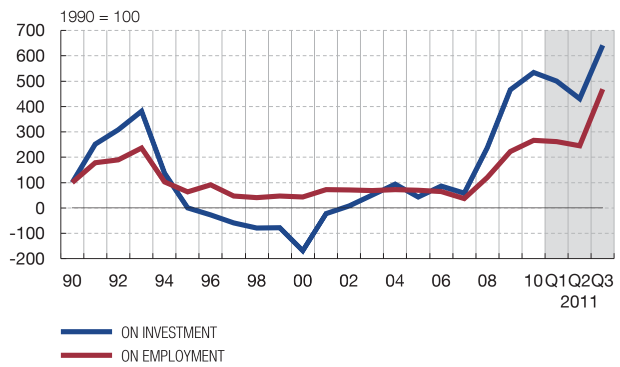
TOTAL DEBT BURDEN (f)



NET ORDINARY PROFIT / OWN FUNDS (g)



SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (j)



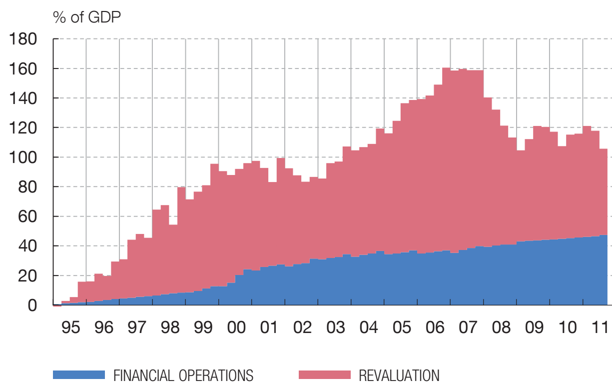
SOURCES: INE and Banco de España.

- **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.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26

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.

In annualised quarter-on-quarter terms, the debt growth rate of the sector was also negative (-1.7%), being, in absolute terms, somewhat higher than in September. The latest information on lending by loan type, relating to Q3, reflects decreases in the outstanding balance of bank financing in all sectors, these declines being sharper than in June. Once again, the fall-off was particularly sharp in construction (15.8% year-on-year) and in real estate services (5.2%), and comparatively more moderate in other services (1.4%). In industry it was 4.3%, against 3.9% in June.

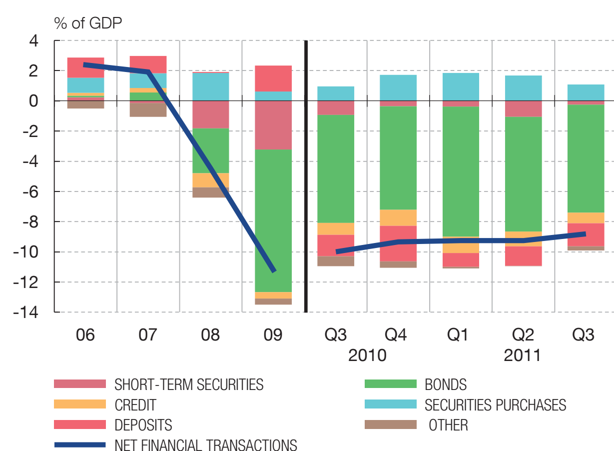
On Financial Accounts information, the credit balance of the corporate sector's net financial transactions decreased in 2011 Q3 to 1.1% of GDP in twelve-month cumulated terms, down 0.6 pp on June. Despite this, the drop in purchases in the rest of the world brought a narrowing of the financing gap, the 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 0.2% of GDP, compared with -0.8% at mid-year.

The stagnation of firms' liabilities, along with the moderate rise in their income shown by the National Accounts for 2011 Q3, meant that the debt ratio continued to decrease slowly, extending the trend initiated in 2009 (see Chart 25). As a result, despite the higher average cost of financing, the debt burden also declined slightly in this period. For the sample of CBQ reporting firms, among which the biggest have a notable weight, corporate activity and income fell in the first three quarters of 2011 with respect to the same months of 2010. Thus, after the recovery seen in 2010, the ordinary net profit of these firms decreased by 2.9%, resulting in a drop of more than 1 pp in return on equity to 6.5%. This fall, which was apparent in all sectors and particularly marked in information and communication, was compatible with a rise in average profitability, suggesting that the course of the aggregate indicator reflects the performance of the larger firms, the results of which were comparatively less favourable. Meanwhile, the debt-to-assets and debt-to-income ratios of these firms scarcely changed, against a backdrop in which their debt showed little variation, while the associated debt burden increased slightly. The overall result of these developments was the interruption of the downward path of the indicators of financial pressure on investment and employment, which rose, most markedly in the case of the

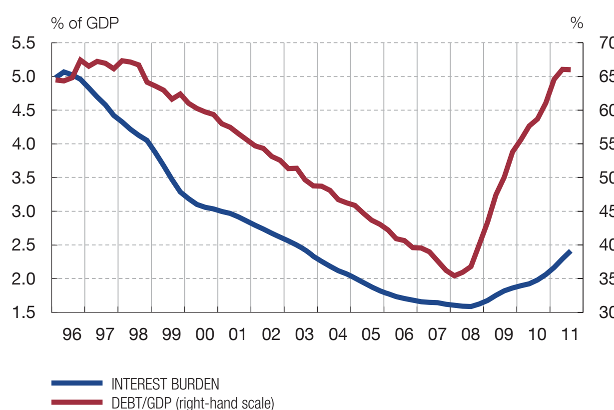
GENERAL GOVERNMENT
Four-quarter data

CHART 27

NET FINANCIAL TRANSACTIONS. CONTRIBUTIONS BY INSTRUMENT (a)



INTEREST BURDEN AND DEBT RATIO



SOURCE: Banco de España.

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

latter. As far as the coming quarters are concerned, analysts revised downward the long-term growth expectations for the profits of listed companies and the same applies even more so to short-term expectations, which moved into negative territory for the first time since the beginning of 2010 (see Chart 26).

The doubtful assets ratio of non-financial corporations grew again in 2011 Q3, more sharply in lending to construction and real estate services firms (the ratio of which increased by 1.23 pp) than in other companies, the ratio of which was up by 0.33 pp. Consequently, the difference between the indicators of these two groups widened again, and in September stood at 18.2% and 4.7%, respectively.

5.4 General government

The Financial Accounts show that in 2011 Q3 general government borrowing decreased by the equivalent of 0.4 pp of GDP in cumulated annual terms, although it continues to be high (8.8% of GDP) (see Table 8).

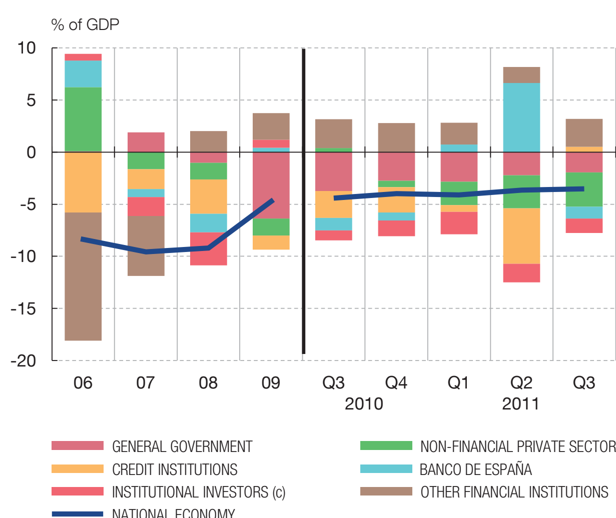
Once again, the main method of financing used by general government was bond issuance, through which funds equivalent to 7.4% of GDP were obtained, down 0.5 pp from June (see Chart 27). Also down were the funds raised through loans and short-term debt securities, which represented, respectively, 0.3% and 0.7% of GDP (0.8 pp and 0.3 pp less than at the end of H1). On the asset side, net acquisitions of securities decreased by 0.6 pp to 1.1% of GDP and the stock of deposits dropped again, this time by the equivalent of 1.5% of GDP, 0.2 pp more than in Q2.

The growth rate of general government debt decreased again between September and November. In year-on-year terms, it stood at 12.6% in November, 2.3 pp less than in Q3. The quarter-on-quarter stagnation of general government liabilities and of GDP between June and September meant that, for the first time since the beginning of 2008, the sector's debt ratio did not increase in 2011 Q3, remaining at 66% of GDP. However, the debt burden grew further to 2.4% of GDP, a development which contributed to the rise in the average cost of funds.

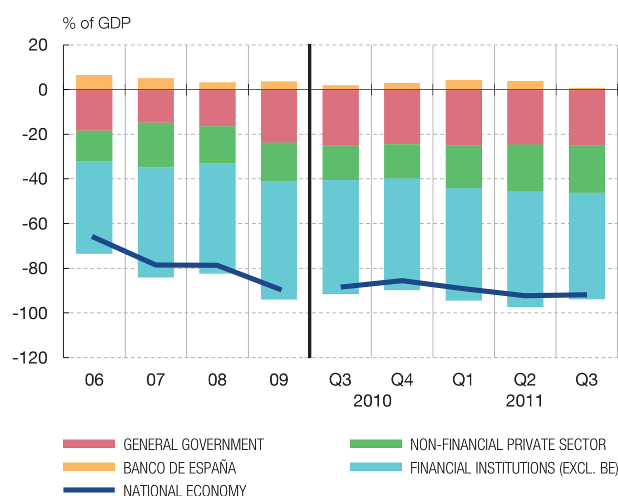
NET FINANCIAL TRANSACTIONS AND NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)

CHART 28

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.

5.5 The rest of the world

On the latest Financial Accounts information, 2011 Q3 saw a continuation of the downward path of the nation's net borrowing, which stood at 3.5% of GDP in 12-month cumulated terms, down 0.1 pp from June (see Table 8). This behaviour was the result of a decrease in the debtor position of general government, higher net lending of households, lower net borrowing of non-financial corporations and scant changes in the credit balance of financial institutions.

Sectoral analysis shows that, in net terms, households and non-financial corporations received external financing equivalent to 4% of GDP in Q3 (1.6 pp more than in the previous quarter). General government also received funds from non-residents, albeit to a lesser extent (1.1% of GDP and 1.9% of GDP, in twelve-month cumulated terms) (see Chart 28). By contrast, credit institutions switched to granting, in net terms, financing to the rest of the world, for a considerable amount, equivalent to 8.7% of GDP (0.5% in the past twelve months. There was also a rise in the capital inflows associated with the activity of institutional investors, which continued to reduce their holdings of foreign assets. 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 net borrowing. As a result, the balance of the Banco de España's net financial transactions with the rest of the world again showed a debit balance, for a considerable amount, equivalent to 13% of quarterly GDP (1.1% of GDP in twelve-month cumulated terms). The October balance of payments information shows that the financing of the Spanish economy in that month was covered by this latter means, while the net flow of funds raised by the other institutional sectors was negative.

The breakdown by instrument shows that the bulk of capital inflows in 2011 Q3 was channelled through the Banco de España intra-system position and, to a lesser extent, though collateralised transactions settled in central counterparty clearing houses. The funds raised in this way represented, in net terms, 14.4% and 7.6% of GDP, respectively

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 10

% of GDP

	2008	2009	2010	2011		
				Q1	Q2	Q3
NET FINANCIAL TRANSACTIONS	-9.2	-4.7	-4.0	-4.1	-3.6	-3.5
Financial transactions (assets)	0.6	-0.5	-3.8	-1.5	1.1	2.6
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-1.3	-3.2	-1.4	0.7	0.4	1.6
Of which:						
Interbank - credit institutions	-0.5	-1.7	-1.3	0.5	0.2	0.9
Securities other than shares	1.3	0.0	-7.0	-7.2	-4.8	-2.7
Of which:						
Credit institutions	1.5	1.2	-3.1	-2.5	-0.4	0.7
Institutional investors	-0.5	-1.0	-2.9	-3.7	-2.8	-2.2
Shares and other equity	1.7	1.6	2.5	3.0	3.1	1.0
Of which:						
Non-financial corporations	3.5	0.0	2.6	2.3	1.8	0.2
Institutional investors	-2.3	0.5	1.0	1.1	1.0	0.6
Loans	0.8	0.2	0.3	0.5	1.3	1.3
Financial transactions (liabilities)	9.8	4.1	0.1	2.6	4.8	6.1
Deposits	8.0	-0.5	-0.5	-1.3	0.8	4.9
Of which:						
Interbank - credit institutions (a)	6.2	0.7	-7.4	-7.8	-1.8	-5.4
Repos - credit institutions (b)	0.2	0.1	5.8	6.2	8.3	8.4
Interbank - BE (intra-system position)	1.9	-0.8	0.2	-1.1	-6.5	1.7
Securities other than shares	-2.7	3.4	-2.0	-0.6	-0.5	-2.6
Of which:						
General government	1.1	5.1	1.9	2.3	2.0	1.7
Credit institutions	-1.9	1.0	-1.4	-0.9	-0.9	-1.6
Other non-monetary financial institutions	-1.9	-2.6	-2.6	-2.0	-1.5	-2.7
Shares and other equity	3.2	1.1	0.9	2.5	2.4	2.3
Of which:						
Non-financial corporations	2.4	0.3	1.3	2.5	2.3	2.2
Loans	2.9	0.2	1.0	1.5	1.6	1.2
Other, net (c)	0.3	-1.0	-1.2	-1.0	-0.7	-1.1
MEMORANDUM ITEMS:						
Spanish direct investment abroad	4.7	0.7	1.6	3.0	3.5	1.8
Foreign direct investment in Spain	4.8	0.6	1.8	2.2	2.4	1.9

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.

(1.7% and 8.4% of GDP in twelve-month cumulated terms) (see Table 10). By contrast, there was a significant fall in the balance of net interbank financing raised through bilateral transactions between credit institutions, amounting to 10.5% of GDP (6.3% in the past twelve months). Also seen was, for the fourth quarter running, a disinvestment by non-residents in debt securities issued by credit institutions, whereas those issued by general government switched to a positive flow. Also up were the funds raised through shares and other equity, although they fell slightly in twelve-month cumulated terms. Foreign direct investment in Spain fell by 0.5 pp to 1.9% of GDP in annual terms (0.9% of GDP in Q3).

Capital outflows decreased between June and September to 2.7% of GDP, although in twelve-month cumulated terms they increased to 2.6%. Analysis by instrument shows that net investment by residents in debt securities issued by the rest of the world turned positive again, following negative figures in the previous quarters, while there was a swing to disinvestment in shares and other equity.

Also down was Spanish foreign direct investment, which was practically zero and thus came to stand at 1.8% of GDP in the period between October 2010 and September 2011.

As a result of the developments in capital inflows and outflows 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 were equivalent to 91.9% of GDP in September 2011, down 0.4 pp from June (see Chart 28). This decrease was due to the reduction in the net external debt of the financial sector (excluding the Banco de España) and of firms to non-residents, which offset the decline in the credit balance of households and the rise in the debit balance of general government. For its part, the Banco de España's credit balance vis-à-vis the rest of the world decreased by 3.2 pp to become practically zero.

17.1.2012.