1 OVERVIEW

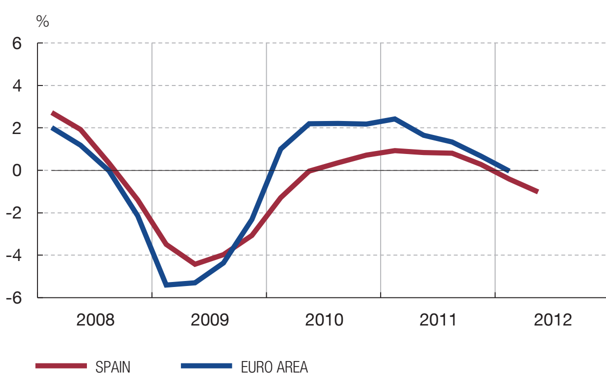
In recent months, and especially since May, the Spanish economy has been strongly affected by the worsening financial tensions in the euro area. As will be analysed throughout this quarterly report, various differing factors have contributed to compounding the sovereign debt crisis, including the doubts over the Spanish economy, and in particular over the recapitalisation needs for its financial system and its ability to see through the fiscal consolidation process along the lines agreed at the European level. The doubts surrounding the Spanish economy have taken the form of fresh financial outflows, increases in the risk premia on sovereign debt, declines in stock market indices and downgrades in public and private debt credit ratings. In response to the risks posed by this situation, the Spanish authorities took various measures. These included most notably the request to the EU for financial assistance for the purpose of recapitalising the weakest banks, the conditions of which are laid down in the Memorandum of Understanding signed on 20 July, and the approval of an ambitious package of measures to redress the budget deficit, with a view to lowering it to a level under 3% in 2014, following the extension of the term granted by the EU.

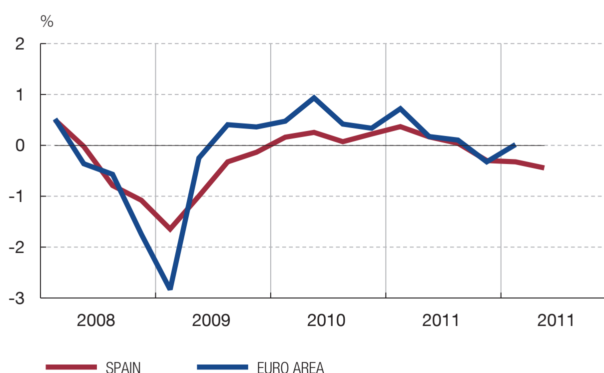
On preliminary estimates, based on still-incomplete information, economic activity in Spain fell again in Q2. The pace of decline was estimated to be sharper than that of the two previous quarters, with a quarter-on-quarter rate of change of -0.4%. National demand fell off more markedly than in the previous quarter (-1.2% against -0.5%), since household spending and general government demand shrank at a quicker pace. As has been the case in recent years, net external demand softened the adverse impact of the decline in national demand on GDP, as it made a positive contribution of 0.8 pp, up on that of the previous quarter, thanks to a moderate pick-up in exports. In year-on-year terms GDP declined by 1%, set against -0.4% in Q1.

Employment is estimated to have fallen in Q2 at a year-on-year rate of 4.6%; as a result, productivity continued to grow at a very high rate (3.8%). In combination with the projected slowdown in the increase in compensation per employee, this allowed unit labour costs to continue falling at a significant pace. Despite the sluggishness of spending, consumer prices held at a year-on-year rate of 1.9% on average in Q2, similar to their level in March, although the CPI excluding energy and unprocessed food prices posted a more moderate rate (1.3% in June). The year-on-year growth in inflation, measured in terms of the HICP, remained below that of the euro area, although this difference narrowed slightly in June to -0.6 pp. Rises in certain prices are projected in the coming months as a result of the agreed hike in VAT, along with other measures that affect administered prices, such as electricity, drugs and university fees, although these effects will be partly offset by the impact of the lower oil prices observed in recent weeks which, as the futures markets appear to anticipate, might continue in the coming months. In any event, in the recessionary environment afflicting the Spanish economy, the pass-through of tax rises to consumer prices will foreseeably be only partial, in line with what happened in 2010, and, moreover, the impact on the inflation rate will be short-lived.

The world economy turned down to some extent in Q2, marked by the heightening instability in the euro area, where the economic situation worsened across the board. As a result, the estimates available point to a decline in euro area GDP in Q2. This fall-off in activity affected the world economy through the trade channel, owing to fewer imports from the

GROSS DOMESTIC PRODUCT (a) CHART 1





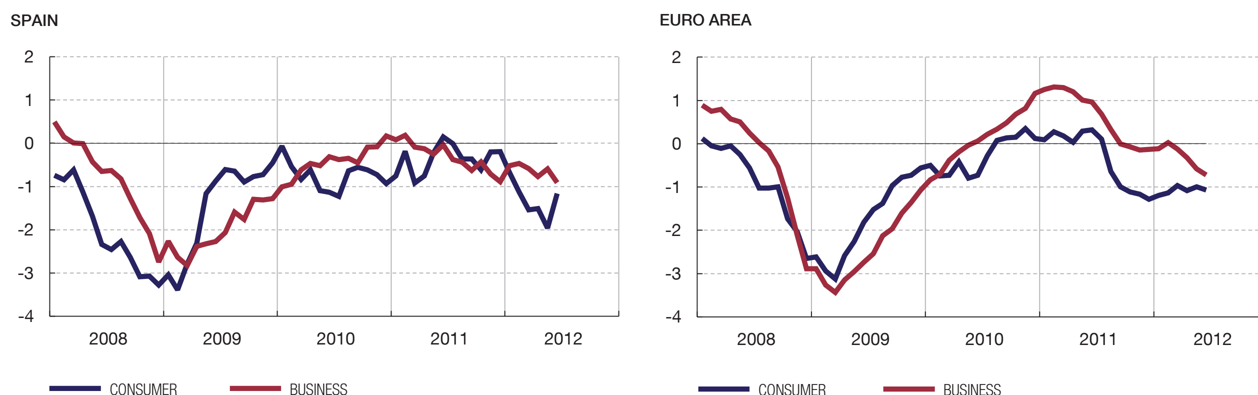
SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

euro area, although the pessimism on European markets also spread, to some extent, to global bourses and bond markets. This, together with certain indicators of domestic weakness in some countries, has generally meant that the global outlook for 2012 has been revised downwards and that the risks of lower growth in the world economy have stepped up. In the United States, the indicators for Q2 reveal a somewhat weaker economy, especially regarding the employment figures. In some emerging economies, too, such as China, India and Brazil, there are signs of a slowdown, although they are on the whole expected to remain far more buoyant than the industrialised countries. On the positive side, the fall in energy and other commodity prices has improved the inflation outlook. Specifically, oil prices dipped below the $100 threshold in June and, although they have risen in recent days, the outlook is that they will remain below that level in the coming months.

The turbulence affecting the euro area in Q2, following the relief that the non-conventional monetary policy measures adopted by the ECB in late 2011 brought, highlighted the complexity of the substantive problems underlying the crisis in the area. The need to adopt far-reaching measures was patent. In the short run, to alleviate the tensions affecting the most vulnerable countries in the area, the linkage between sovereign risk and banking risk must be broken, and the renationalisation of financial markets, which bears so harmfully on the ability to obtain external funding, must be halted. And, from a longer-term perspective, doubts over the institutional framework of monetary union should be dispelled, with measures that enhance its functioning and stabilise expectations about the continuity of the project. In this respect, the meeting of euro area Heads of State or Government and the European Summit of 28 and 29 June were significant landmarks (see Box 2); they addressed the essential elements that should underpin EMU in the future, and headway towards a European banking union was made, in which the ECB will play a central role. Regarding measures with a more immediate impact, it was agreed that, once the single supervisor was in place, the European Stability Mechanism could directly capitalise those credit institutions needing funds, which would help decouple banking risk from sovereign risk. Further, greater flexibility was afforded so that the European Financial Stability Facility and the European Stability Mechanism, which will soon come on stream, may purchase public debt on secondary markets. Of note also was the approval of a programme to boost growth in the EU, through the mobilisation of resources drawn from the European budget and from the European Investment Bank, which places economic recovery among the priorities of the European institutions.

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).

With regard to the Macroeconomic Imbalance Procedure, the European Commission published in May the exhaustive examinations of the 12 countries whose imbalances had been identified as most significant (see Box 3). In no cases were the imbalances deemed to be *excessive,* whereby the corrective procedure envisaged has not been implemented, although it should be said that Spain and Cyprus were the countries where these imbalances were judged to be most acute. These recommendations, along with those relating to the Stability Programmes, were in turn approved by the June European Summit. Subsequently ECOFIN, at its meeting on 10 July, issued a specific recommendation for Spain on the excessive deficit procedure: in light of the adverse economic circumstances, it extended the deadline for placing the budget deficit below 3% of GDP by one year. The new path of reduction should thus place the deficit at 6.3% of GDP in 2012, 4.5% in 2013 and 2.8% in 2014, which entails an annual average fiscal effort in structural terms of over 2 pp of GDP. Spain was also urged to reinforce this path with the announcement of a budget plan for 2013 and 2014, which should be submitted before the end of July.

On the monetary policy front, the slowdown in actual inflation and the projections that this moderation would continue in the future, given the deterioration in the economic outlook, allowed the ECB Governing Council at its meeting on 5 July to cut the interest rate on its main refinancing operations by 25 basis points to 0.75%. At the same time, the interest rate on the marginal lending facility was lowered to 1.5% and the deposit facility rate to 0%, whereby the surplus liquidity held by banks has ceased to be remunerated by the Eurosystem. It was also decided to maintain fixed-rate tenders with full allotment in the main refinancing operations to January 2013, and the eligibility criteria for the acceptance of collateral in monetary policy operations were altered in order to extend the range of financial instruments that may be used as backing for these operations.

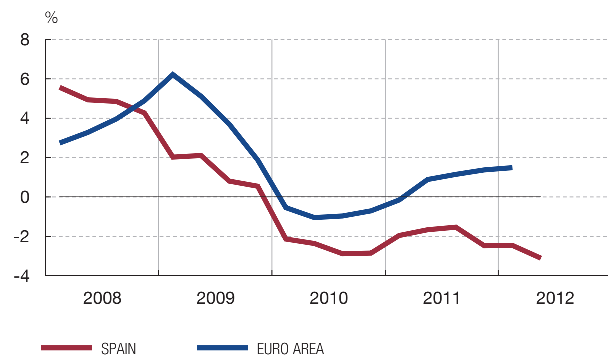
The extraordinary economic and financial instability experienced in recent quarters has necessitated the adoption of ambitious reforms in various areas, especially by the countries most directly affected by the tensions. In Spain's case, very significant progress has been made in two areas where uncertainty was greatest. Regarding the banking system, financial markets' doubts over banks' capital needs led the Spanish authorities to entrust an assessment of the capitalisation needs of credit institutions to two external consultancies. The results of these assessments estimated capital requirements to lie in a range of between €52 billion and €61 billion in the event of a highly adverse macroeconomic sce-

PRICES AND COSTS

CHART 3

HARMONISED INDICES OF CONSUMER PRICES (a)

UNIT LABOUR COSTS (b)



SOURCES: Eurostat, ECB and INE.

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

nario occurring. Furthermore, on 9 June the Spanish government announced its intention to request financial assistance from the European institutions in order to recapitalise the weakest banks. The request for assistance, formally made on 25 June, has the backing of the Eurogroup, which has agreed to extend funds for a maximum amount of €100 billion. In recent weeks a Memorandum of Understanding has been drawn up between the Spanish and the European authorities. This sets the conditions under which banks are to receive these European funds, and other horizontal conditions that are essentially financial in nature (rules governing provisions, supervisory procedures, the segregation of impaired assets, etc.) At the same time, the Memorandum stresses the close link between macroeconomic imbalances and bank solvency, and therefore highlights the importance of Spain meeting the recommendations on public finances under the excessive deficit procedure and on structural reforms.

As regards public finances, the main highlight in recent months in Spain has probably been the approval of the Organic Law on Budgetary Stability and Financial Sustainability. This legislation substantially strengthens the budgetary discipline framework by setting balanced-budget targets for all tiers of government, ceilings on public debt, transparency requirements, automatic correction mechanisms for slippage, procedures for the continuous surveillance of budgetary developments and instruments to enforce the targets, which include sanctions and even the intervention of the government body that has not observed these objectives. In addition, on 11 July the Prime Minister announced an extensive package of measures (subsequently detailed in their attendant Royal Decrees[1]), whose aim is to meet the commitments assumed at the European level. The measures adopted include most notably a significant increase in indirect taxation (with the standard and reduced rates of VAT being raised to 21% and 10%, respectively), a cut in public-sector wages (the elimination of the extra month's pay in December), the abolishing of the tax credit for house purchases as from 2013, cuts to unemployment benefit after six months and a further cut in spending at government ministries. Moreover, a 1 pp cut in employers' social security contributions in 2013 was approved, with a further 1 pp in 2014, a move which, by reducing labour costs, should encourage job creation. Finally, various measures aimed at liberalising certain sectors and promoting competitiveness were adopted.

1 Royal Decree-Laws 20/2012 and 21/2012, both dated 13 July 2012.

As earlier stated, the financial tensions in the euro area affected Spain most substantially. Ten-year government bond yields were at certain times above 7%, and the spread over German debt exceeded 500 bp and was holding above this level as this Report went to press. Stock market indices were highly volatile and losses on the IBEX 35 in 2012 to mid-July stood at around 20%. Interbank market yields fell during Q2, due partly to expectations about the interest rate cut finally made by the Eurosystem. But this was not reflected in the interest rates on bank credit to businesses, since the spreads relative to those market rates have widened. As to real estate markets, the ongoing reduction in house prices has quickened. According to figures from the Ministry of Development, prices fell at a year-on-year rate of 8.3% in Q2, compared with -7.2% in Q1, meaning that the cumulative fall in prices from their 2008 peak stands at 24%.

The heightening of tensions has dented the confidence of agents who, moreover, continue to face very tight financial conditions; accordingly, the decline in private spending steepened in Q2. In the case of households, the quarter-on-quarter rate of consumption is estimated to have fallen by 0.5%, influenced by job destruction, the diminished value of wealth and, generally, the climate of uncertainty that has led to a downgrade in the economic outlook. On information to Q1, the household saving rate continued falling, owing to the weakness of disposable income, which suggests that households are reducing the leeway they have to smooth their pattern of consumption, which points to greater slackness in household spending in the future. Residential investment also fell back owing to the large stock of unsold housing, which discourages new projects from being launched, and to the weakness of demand. Admittedly, lower prices and the temporary reduction in VAT may have improved the affordability of housing, by reducing the financial effort needed; but the absence of clear prospects means that potential demand will be held back, possibly until the prevailing uncertainty clears.

The financing granted to households continued to fall in Q2. On the data available to May, credit to households declined by 2.8% year-on-year, a similar rate to that observed in Q1. In terms of components, there was a somewhat sharper fall in loans for consumer goods purchases, compared with those for house purchase. Despite this lesser resort to borrowed funds in Q2, the ongoing deleveraging in the sector is estimated to have advanced very moderately, owing to the weakness of household disposable income.

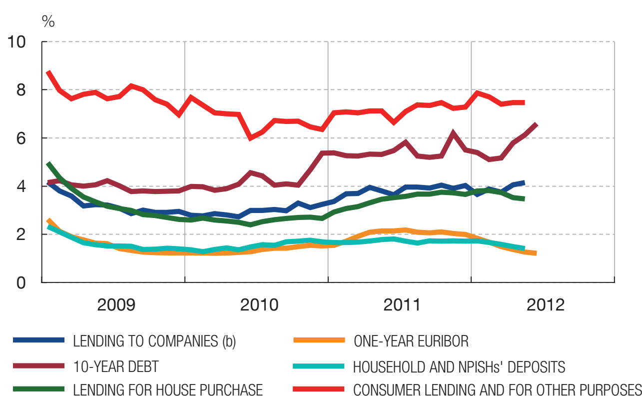
In the case of firms, the climate of uncertainty has been pivotal to their investment decisions, given the long-term horizon investment projects must contemplate. Investment in capital goods is estimated to have fallen by 2.2% quarter-on-quarter in Q2, with declines both in machinery and in means of transport. Investment in non-residential construction likewise fell; along with the foregoing reasons, it was also affected by the impact of the austerity plans on public works, which on many occasions are carried out in collaboration with the private sector. Financing obtained by non-financial corporations fell at a year-on-year rate of 1.5% in May, a similar rate to Q1, with a more substantial decline in bank credit and an increase in bond issues. The business sector's debt ratio is estimated to have continued falling in Q2, moving away from the peak recorded in 2009. Finally, recent weeks have seen the implementation of the plan to pay suppliers, so as to settle the debts that local and regional governments have with companies and the self-employed. This plan, which will involve a total disbursement of €27 billion, should contribute to improving the liquidity position of numerous firms and to easing the financial constraints they may be facing.

General government consumption and investment are also projected to have contracted in Q2, in line with the consolidation process mapped out for this year, with a decline in purchases

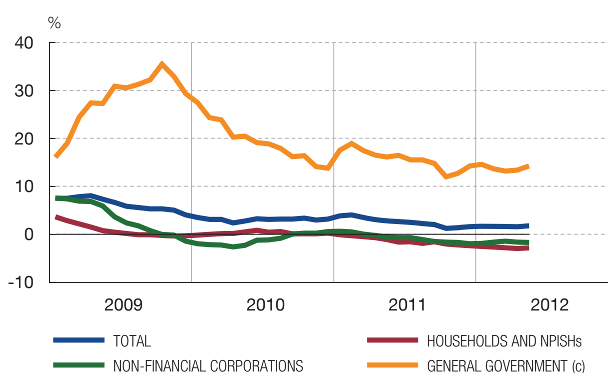
FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4

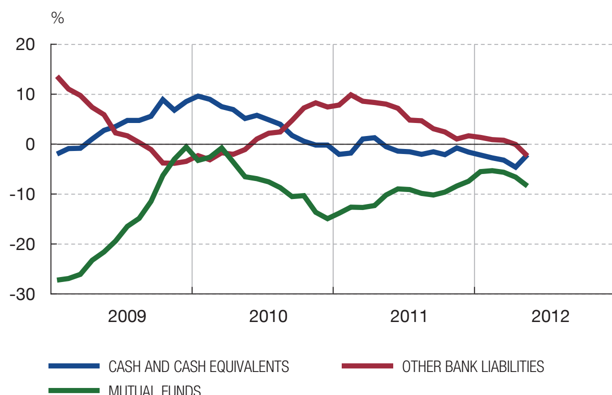
INTEREST RATES (a)



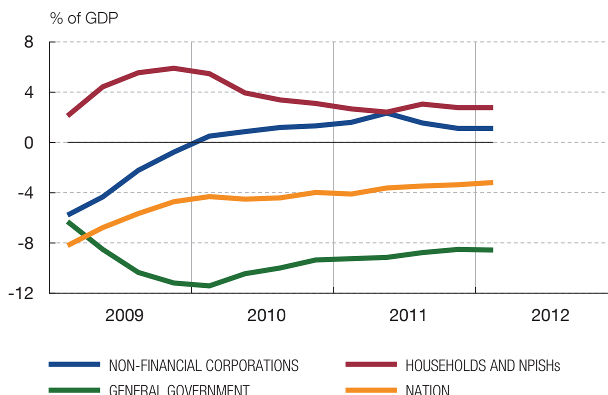
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



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 (Narrowly Defined Effective Rate), which does not include commissions and other expenses, a moving average of such expenses.

c Consolidated financing: net of securities and loans that are general government assets.

d Four-quarter cumulated data.

of goods and services, a fall in public-sector employment and a substantial downward revision in public investment projects. Yet the slippage detected in revenue in recent months has signalled the risk of the budget deficit once again exceeding this year the target set. Drawing on the information for 2012 Q1, the general government deficit, in cumulated four-quarter terms, held at 8.5% of GDP (compared with 8.9% in 2011), and was therefore far off the target of 5.3% set for this year. Foreseeably, the recently approved budgetary measures should allow the fiscal consolidation path to be redressed to meet the new targets.

Foreign trade has once again been affected by the greater slackness in the world economy. Despite this, there was an increase in the positive contribution of net external demand to quarter-on-quarter GDP growth in Q2, to 0.8 pp, thanks to the pick-up in exports, especially of tourist and other services. Goods exports also posted a marginally positive rate. Although exports were harmed by the weakness of demand in some of our main customer countries, such as France, Italy and Portugal, exports to non-EU countries remained considerably buoyant. Imports fell once again, albeit at a less marked rate than in Q1.

The sluggishness of expenditure in Q2 was mirrored by the widespread slackness in activity from the standpoint of the productive sectors. Value added in industry and in construction continued on its declining quarterly trajectory, while value added in market services is estimated to have stagnated, after having posted slightly positive rates for several quarters. Employment fell sharply once more in Q2, more significantly so in construction, in light of the figures on social security registrations. According to this information, the process of job destruction was halted in June, in terms of the related seasonally adjusted rates, but the figures for this month are possibly distorted to some extent by certain factors, such as the regularisation of household employees. Accordingly, analysts must await the information for the coming months to assess whether the trend shown by the labour market in recent quarters has changed.

Finally, labour costs are projected to continue on the gradually slowing trajectory on which they have moved in recent years. However, this is an insufficient adjustment if the significant weakness of demand and the need to increase competitiveness abroad are taken into account. Wage settlements included in collective bargaining agreements recorded to June show a wage increase of 1.7%, although the increases in multi-year agreements signed in previous years (1.9%) are higher than those in newly signed agreements (0.9%); that said, the latter are still few in number. The labour market reform, which has already been passed by Parliament as a law[2], introduces various measures so that wage bargaining reflects more appropriately the particular situation of each company; consequently, it would be desirable for firms to use these possibilities exhaustively as a means of maintaining employment and retaining their competitiveness.

In sum, the process of adjustment has continued in the Spanish economy in 2012 Q2, with a substantial contraction in private and public spending, and an improvement in the external deficit. But these developments have taken place in a very complex environment, characterised by the weakening in the world economy, the instability of financial markets and doubts over the direction and pace of the future reform of institutional arrangements in the euro area. Against this backdrop, the Spanish economy has evidenced two significant sources of vulnerability: the situation of part of the banking system, and the perceived difficulties of the general government sector in effectively bringing public finances back onto a path of stability. Foreseeably, the restructuring, clean-up and recapitalisation plans set in train, with financial assistance from the EU, the strict financial conditionality accompanying them and the conducting of stress and audit tests by external appraisers will allow confidence in the banking system to be restored. If rigorously applied, the Organic Law on Budgetary Stability will no doubt be an essential instrument for attaining budgetary discipline, and in this connection the recently approved fiscal package will also contribute. Finally, progress on structural reforms must accelerate, liberalising sectors where the degree of competition is insufficient, removing administrative obstacles to economic activity and introducing greater transparency in the functioning of the markets for goods and services. Significantly, these measures can soften the adverse short-term effect of greater fiscal tightness and, above all, they will be key to the economy attaining its medium and long-term growth potential and to enhancing productivity.

2 Law 3/2012 of 6 July 2012.

There has been a marked deterioration in international economic and financial developments over the past three months. The financial markets have been characterised by an increase in risk aversion, which has been conducive to some corrections on stock market indices, fresh bouts of flight to quality and a further reduction in long-term interest rates in the main developed economies, which have been accompanied by a depreciating trend of the euro against the main currencies. Along with this, oil and other commodity prices fell notably. These developments have been influenced by the persistence of the euro area's problems and by the slowdown in global activity, also influenced by the downturn in activity in Europe (see Box 1). Indeed, following the economic pick-up in 2012 Q1, subsequent indicators point to a slowdown in the United States and in Japan, and to continuing slackness in the United Kingdom. In the emerging economies a progressive slowdown in activity is likewise perceptible, more so in certain cases (Brazil, China and India) than was to be expected. The economic authorities have reacted with a fresh round of economic stimulus measures, underpinned mainly by monetary policy, observing the fiscal consolidation plans in the main economies. Hence the UK and US central banks have extended their programmes of non-conventional measures, while those of Brazil and China have opted for interest rate cuts which, so far, have not been extensive to the emerging economies.

Financial markets have been marked, among other factors, by the deterioration in the outlook for world growth. At the same time, the continuous tensions linked to the sovereign debt crisis in Europe contributed to an increase in risk aversion during the quarter, with flight to quality assets and rising volatility during April and May. The financial sector posted the biggest declines, especially in the European countries. US, UK and also German 10-year government bonds acted as a safe haven, with their yields falling to historical lows. Stock market indices fell after the announcement of the Federal Reserve's "Operation Twist" (involving the extension of its programme of selling short-term bonds and purchasing longer-dated ones), given that a more ambitious monetary stimulus measure was expected. Market reactions were initially positive, but for only a very short time, in the wake of the agreements reached at the European Summit in late June, the rate cut by the European Central Bank, the extension of the Bank of England's debt purchase programme and the cut in rates in China. Over the quarter as a whole, stock markets posted losses across the board, in the developed and emerging economies alike, with the biggest declines seen in the latter in Eastern Europe and in Latin America. On the foreign exchange markets, the dollar appreciated against the main currencies, with the exception of the yen. Since April, there has been a generalised decline in commodity prices, most markedly so in the case of oil. The price of Brent fell from $120 per barrel early in the quarter to $90 in late June, although it has since risen to around $100. This correction has mainly been driven by demand factors: the worsening global economic outlook, the deepening European crisis and lower-than-expected growth in certain economies, such as China.

In the United States, GDP posted annualised quarterly growth of 1.9% (2% year-on-year) in 2012 Q1, compared with 3% (1.6% year-on-year) the previous quarter. The slowdown was due essentially to the lower contribution of inventory accumulation to quarter-on-quarter growth. The latest data point to less dynamism in Q2. Thus, both the supply-side indicators (industrial production, capacity utilisation, business confidence and PMI) and the consumption indicators (consumer confidence indices and retail sales) shows signs of weakness. In recent months the pace of job creation has fallen back and the unemployment

The heightening of the euro area sovereign and financial crisis since last summer has been evident, as Panel 1 shows, in a fall-off in domestic demand, with repercussions on the rest of the world. The euro area accounts for around 14% of global GDP in terms of purchasing power parities (the world's second-biggest economy) and a somewhat higher percentage of global trade (around 15%, once intra-area trade is excluded). Accordingly, the level of spending in the euro area and changes in its relative prices notably influence exports of goods and services by the rest of the world. This Box analyses the extent to which recent international trade developments have been influenced by the sovereign crisis.

The trade impact of the euro area crisis should be more acute in economies that direct a greater portion of their exports to this area. Panel 2 analyses in greater detail the exposure of the main economic areas to the euro area. The exposure of the United Kingdom and of the Eastern European countries is prominent, since the euro area is the destination for more than 50% of their goods exports and for almost 15% of their respective GDP. Outside the EU, trade links are closest with the Commonwealth of Independent States (CIS), North Africa and sub-Saharan Africa. In the cases of Asia (including China), Latin America and the United States, the euro area accounts for between 5% and 10% of their trade. As to trade in services, the potential impact is softened by the fact that services exports account for a still-low percentage of GDP compared with goods exports. Panel 3 shows that the deterioration in the economic outlook is in fact notably correlated to trade exposure to the euro area.

The overall influence of the euro area crisis through the trade channel is substantial, although probably less than the impact via the financial channels.[1] According to the IMF[2], for each percentage point of contraction in aggregate euro area demand there would be a maximum reduction in GDP of 0.2 pp in the countries most exposed in trade terms. However, this impact may be greater for several reasons: the strong linkages of the euro area via its integration into global production networks might amplify the effect, essentially through trade in durable goods; further, if the crisis were to cause a depreciation of the euro in effective terms, this would further cut back imports from the area;[3] finally, the reduction in commodity prices, if the euro area crisis were prolonged, would reduce exporting regions' revenue and, given the recycling of this revenue, would affect their external demand and trade values and volumes. Countering this, the dynamics in question would be conducive to the adjustment of global imbalances and to the sustainability of world trade patterns.

The impact via the trade channel began to be observed in the second half of 2011 and, as expected, the regions most affected were those most exposed. Euro area goods import volumes began to contract significantly, in year-on-year terms, in 2011 Q4 (see Panel 4). Panel 5 highlights the more marked loss of momentum of nominal exports to the euro area than to the rest of the world for a broad set of economic areas. Specifically, the growth differential of exports to the euro area relative to those to the rest of the world entered negative territory in the second half of 2011 in the United States, Japan and Eastern Europe, and the negative gap widened in China and emerging Asia. The reduction in exports from Asia to the euro area was particularly marked, due also to a sharp depreciation of the euro against the region's currencies.

In sum, as Panel 6 highlights, exports to the euro area have ceased to contribute positively to the annual growth in trade as at the start of 2012 in almost all geographical areas. And it is in Eastern Europe and the United Kingdom – which have closer trade ties – where the impact has been most severe.

Lastly, financial tensions in the euro area and the notable role of European credit institutions in financing international trade might bear negatively on world trade. European banks' funding difficulties and the reinforcement of their capital buffers are giving rise to a reduction in their international activity in certain segments, such as trade credit. Indeed, in the syndicated trade finance segment in Asia, European institutions can be seen to have retreated significantly in 2011, cutting back at least one-third of the activity recorded in 2010. Advantage has been taken of this gap by Asian and US competitors, to gain market share, although they did not make up fully for the reduction in activity.

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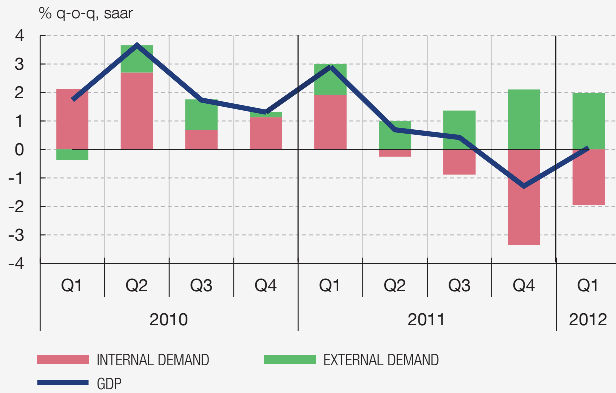
1 See Box 3.1 of the *Annual Report, 2011.*

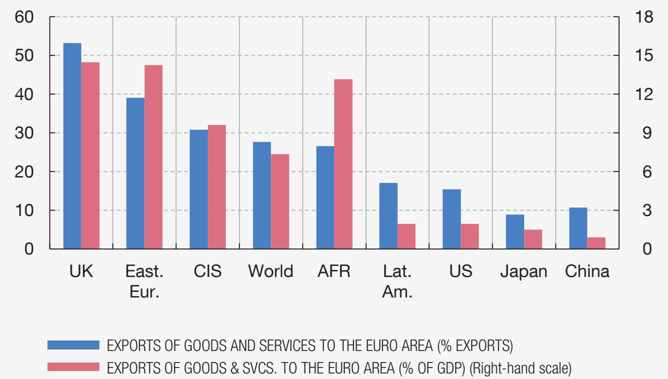
2 Euro Area Policies: Spillover Report for the 2011 Article IV Consultation and Selected Issues, IMF Country Report No.11/185.

3 It is estimated that, for each percentage point of depreciation of the euro, the area's exports increase by 0.3 pp and imports fall by 0.1 pp [A. Dieppe et al. (2011), *The ECB's new multi country model for the euro area. NMCM - with boundedly rational learning expectations,* Working Paper Series, European Central Bank, no. 1316].

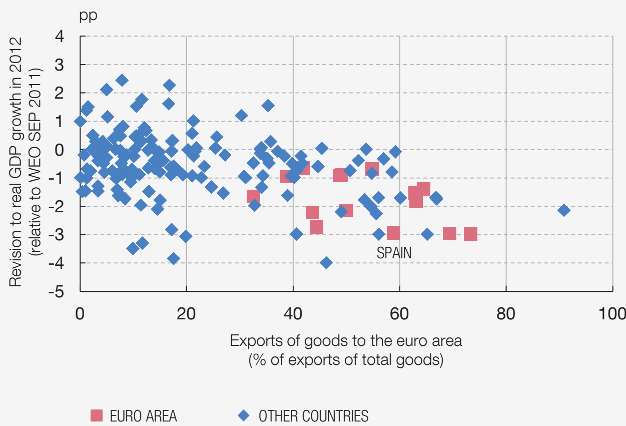
1 EURO AREA: CONTRIBUTION TO ANNUALISED QUARTER-ON-QUARTER GROWTH OF GDP 2010-2011 (a)



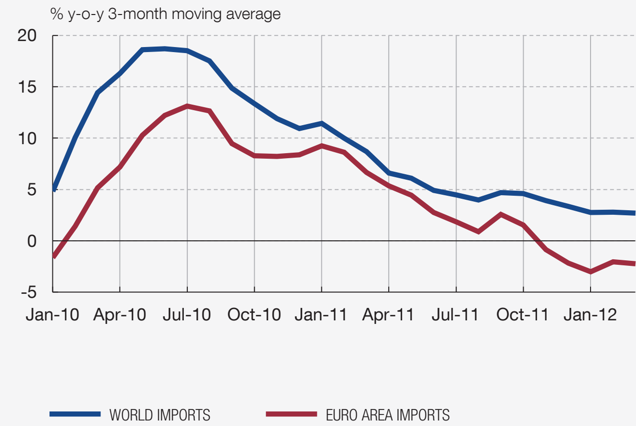
2 EXPOSURE TO THE EURO AREA IN 2010



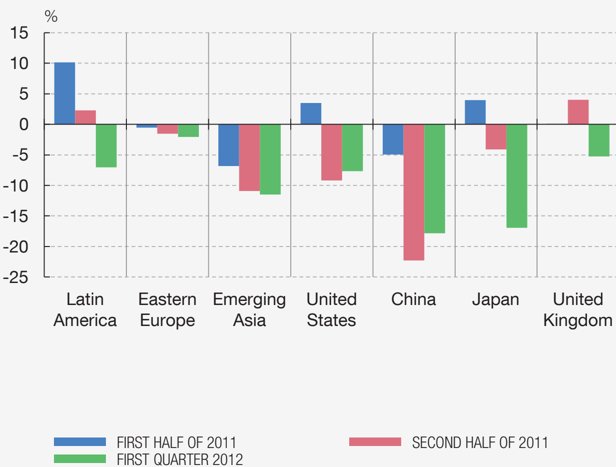
3 TRADE EXPOSURE TO THE EURO AREA AND REVISION TO GROWTH IN 2012



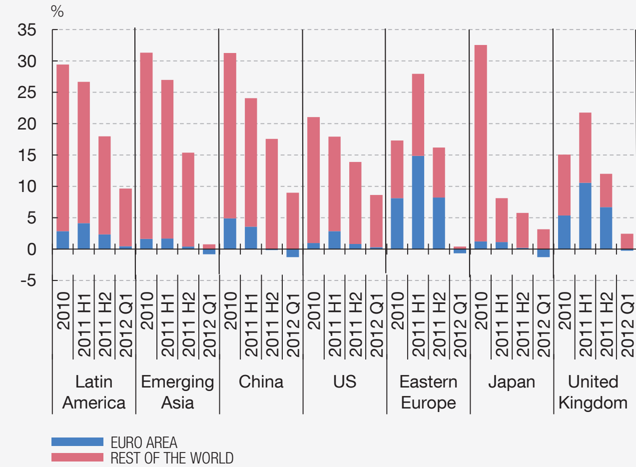
4 REAL IMPORTS. WORLD TOTAL AND EURO AREA



5 GROWTH DIFFERENTIAL OF NOMINAL EXPORTS TO THE EURO AREA VIS-À-VIS THE REST OF THE WORLD



6 CONTRIBUTION TO THE YEAR-ON-YEAR GROWTH OF NOMINAL EXPORTS

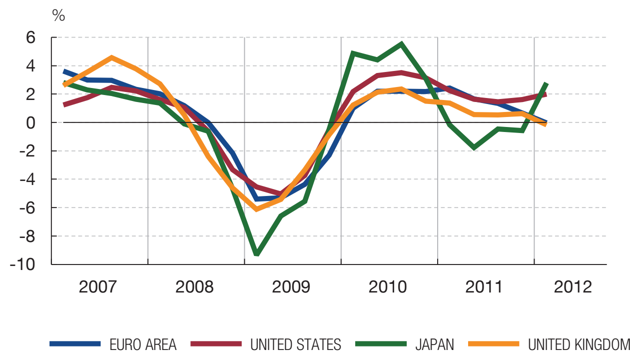


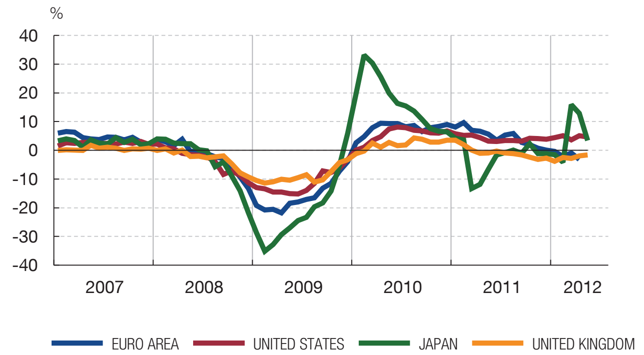
SOURCES: CEIC, CPB, Datastream Euroestat and IMF.

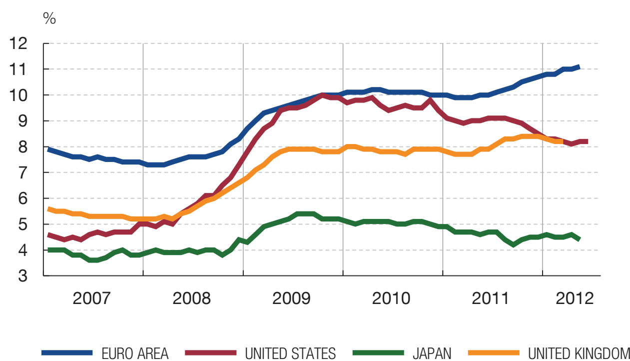
a Contribution, in percentage points, to the annualised quarterly change in GDP.

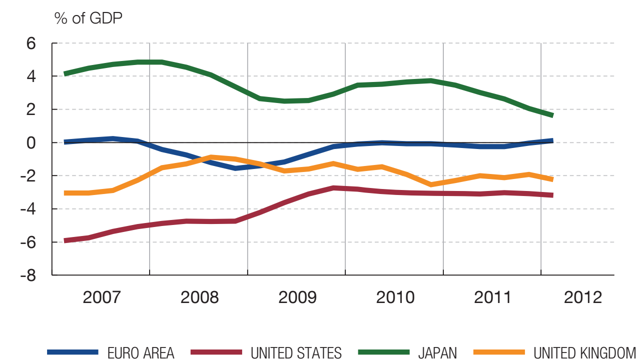
MAIN MACROECONOMIC INDICATORS

CHART 5









SOURCES: Datastream and Banco de España.

a Percentage of labour force.

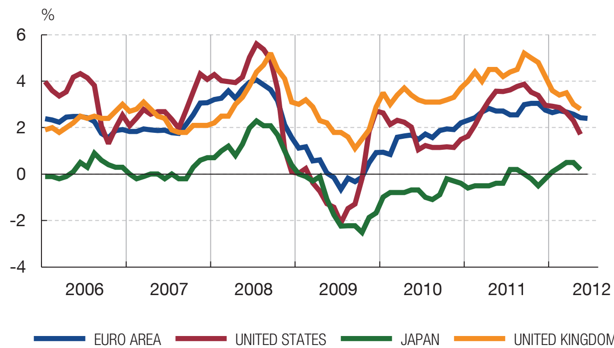
rate has dipped by scarcely 0.1 pp, to 8.2%. Some improvement was visible in the housing market, although housing starts and property sales are holding at low levels. As regards prices, CPI inflation eased during the quarter from 2.7% in March to 1.7% in June, due above all to the fall in energy prices, while core inflation stood at 2.2%. Against this background, the Federal Reserve announced at its June meeting the extension of “Operation Twist” to end-2012 and revised its growth and inflation forecasts downwards. On the fiscal front, the deficit moved on a declining trend during the quarter, though it held at a high level (8% of GDP over the 12 months to June).

In Japan, GDP expanded at a quarter-on-quarter rate of 1.2% (2.8% year-on-year) in Q1, driven by the positive contribution of domestic demand, especially private consumption, which was favoured by tax incentives. The high frequency indicators, such as industrial production and the business confidence surveys, point to a slowdown in activity in Q2. On the external front, the trade balance remained in deficit in April and May and this, combined with the lower surplus on the income balance, translated into a decline in the current account surplus. In the labour market, the unemployment rate held at around 4.5% during the quarter. Inflation stood at 0.2% year-on-year in May (compared with 0.5% in March), while the rate of decline of core inflation steepened to -0.6% year-on-year (-0.4% in March). In July, the Bank of Japan kept its official interest rate unchanged in a range of 0% to 0.1% and made some changes to the design of its asset purchase programme.

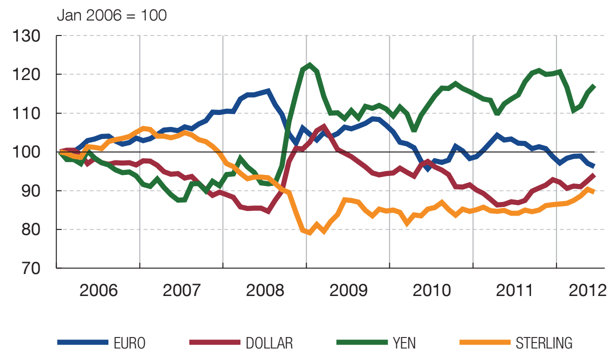
PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6

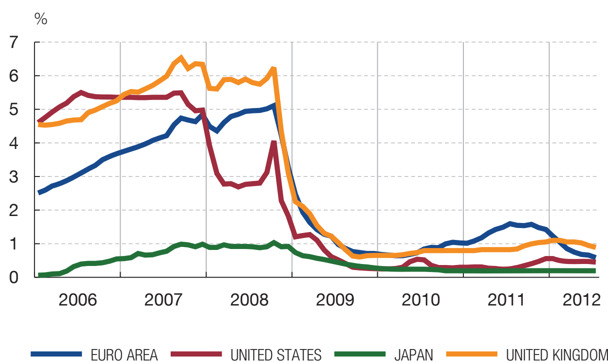
CONSUMER PRICES
Year-on-year rate of change



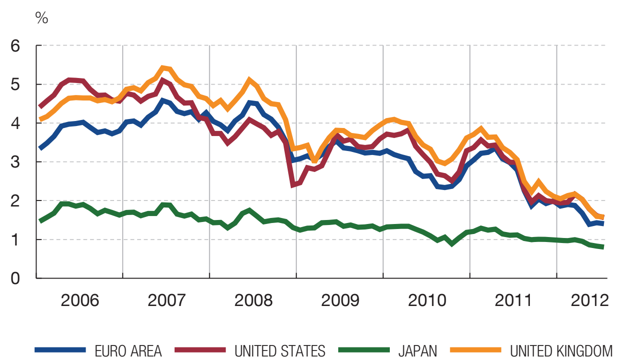
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES



SHORT-TERM INTEREST RATES (a)



LONG-TERM INTEREST RATES (b)



SOURCE: Datastream and Banco de España.

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

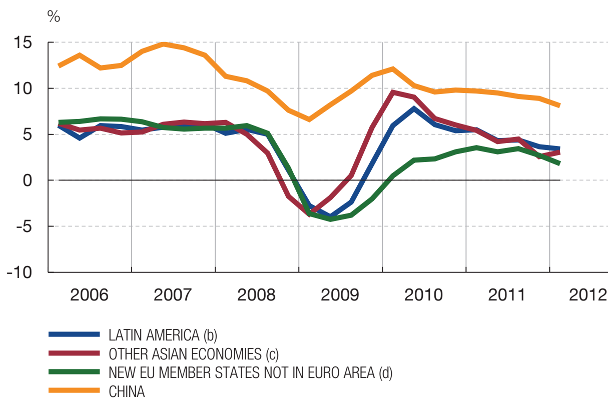
In the United Kingdom, GDP contracted at a quarter-on-quarter rate of -0.3% (-0.2% year-on-year) in Q1, essentially as a result of the negative contributions of stockbuilding and external demand (in particular that from the euro area). Conversely, both private investment and government consumption continue to grow moderately. The indicators for Q2, particularly on the supply side, showed a marked deterioration. On the demand side, however, retail sales continued to expand moderately to June, despite the low level of confidence, tighter financial conditions and marked wage moderation. The labour market showed some improvement in the March-May period as employment creation in the private sector offset the loss of public-sector jobs. Inflation remained on a declining path, standing at 2.4% in June, and the core inflation rate fell to 2.1%. Against this backdrop, the Bank of England held its official rate unchanged (0.5%) at its July meeting and added £50 billion to its asset purchase programme (up to £375 billion), to be implemented in a period of four months as from the announcement. At the same time, in light of the worsening of the euro area crisis and its effects on the British economy, the central bank announced two further measures: the launching of an extraordinary liquidity facility for banks lent against a wide range of collateral and the creation, in collaboration with the Treasury, of a bank financing facility, at a lower-than-market interest rate, conditional upon banks expanding their lending.

In the new EU Member States not belonging to the euro area, GDP grew on average at a year-on-year rate of 1.8% in 2012 Q1, notably down on the figure of 2.8% the previous

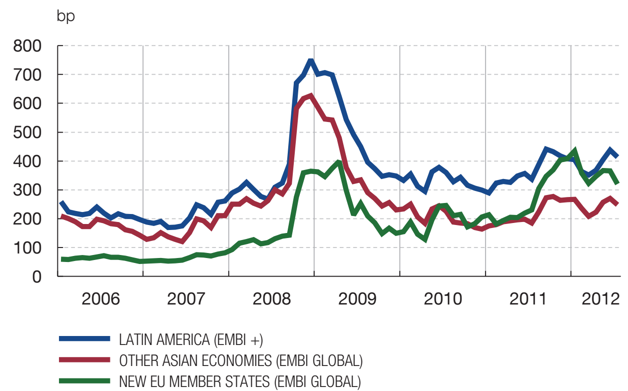
EMERGING ECONOMIES: MAIN MACROECONOMIC INDICATORS (a)

CHART 7

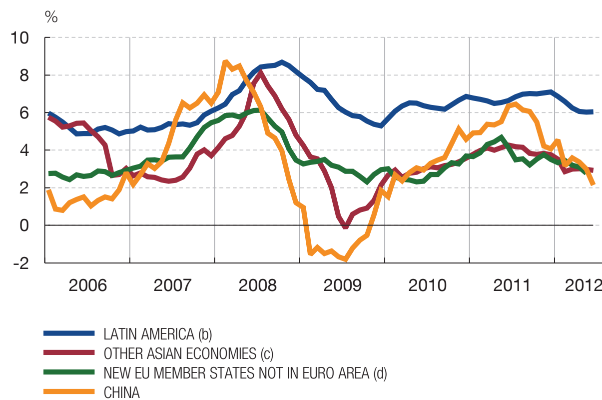
GROSS DOMESTIC PRODUCT
Year-on-year rate



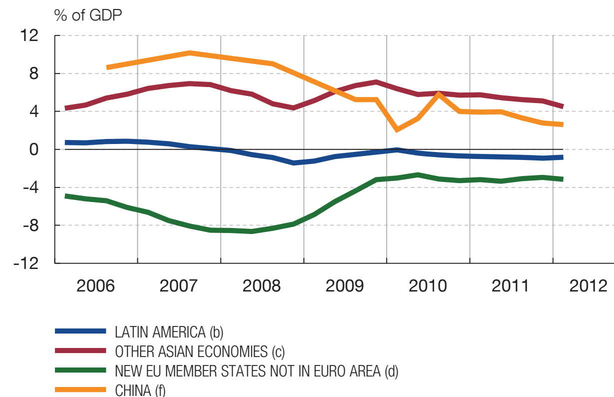
INTEREST RATE SPREADS OVER THE DOLLAR (e)



CONSUMER PRICES
Year-on-year change



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, Slovakia, Latvia, Lithuania, Bulgaria and Romania.
e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Iraq, Kazakhstan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States are for Hungary and Poland.
f Annual data until 2009.

quarter. The slowdown was across the board, although the quarterly contractions in Hungary, the Czech Republic and Romania were notable, while in Poland and the Baltic States, economic performance continued to be more dynamic. The latest data point to a further easing in activity in 2012 Q2, as a result of the sluggishness of external demand, the deterioration in confidence and the slackness of credit to the private sector. Over the course of the quarter inflation eased slightly to 3.7% in June, assisted by lower energy prices, which offset the acceleration in the food component. The central banks kept their official rates unchanged, with the exception of the Czech Republic, which cut its rates by 25 bp to 0.5%, and Poland, where rates were raised by 25 bp to 4.75%. Finally, the European Council decided to unblock cohesion funds for Hungary, given its efforts to cut its budget deficit to below 3% of GDP.

In China, GDP slowed once more in Q2 to a year-on-year rate of 7.6%, down on 8.1% in Q1. The high frequency data for May and June offered signs already of a weakening in

domestic demand. Indeed, business confidence eased further in June, while industrial production and retail sales were markedly moderate in May. The performance of the external sector was more positive. Both exports and imports rose forcefully in May, and there was also an improvement in the trade surplus. Inflation declined sharply to 2.2% in June, down from 3.6% in March. Faced with low inflationary pressures and the weakening of domestic indicators, the Chinese central bank cut its benchmark interest rate on loans and deposits in June and July. The daily fluctuation band for the renminbi was also widened to ±1%. In the remaining emerging Asian economies, GDP grew at a year-on-year rate of 4.3% in 2012 Q1 (unchanged on the previous quarter), with a notable slowdown discernible in India and in the economies more open to trade such as Hong Kong, Singapore and South Korea. The Q2 indicators suggest easing both in economic activity and in exports in several of the main countries. Inflation broadly moved on a downward trend, prompted by the easing in food and energy prices. The exception was India, where prices rose slightly. Against this background, official interest rates held constant, with the exception of South Korea, which cut its rates by 25 bp in July.

In Latin America, GDP growth in Q1 was 0.9% in quarter-on-quarter terms, slightly up on the previous quarter. That placed year-on-year growth at 3.6%. Nonetheless, activity slowed in Chile and Colombia, and the low growth rate discernible since the second half of 2011 in Brazil continued. The high frequency indicators available generally point to an easing in the pace of expansion, due partly to domestic factors, but also to the increase in external risks. Inflation remains relatively high, standing at 6% year-on-year in June, although a moderating trend is discernible. There have been no interest rate movements by the central banks, except in the case of Brazil, which cut its rate by 50 bp, on two occasions, to 8%. Specific government policies were reversed in Brazil, including the reduction in the tax on cross-border financial transactions. Brazil also applied some modest-scale economic stimulus measures. In Argentina, controls on foreign currency purchases are prompting a greater depreciation of the peso against the dollar on the informal market and the outflow of deposits in dollars.

The situation of grave financial instability affecting the euro area continued in 2012 Q2. Following a slight easing in previous months as a result of the unconventional monetary policy measures adopted by the ECB at end-2011, the resurfacing of tensions on this occasion was driven by political uncertainty in Greece, as well as by the complex situation of the Spanish economy and, in particular, the uncertainties surrounding the recapitalisation needs of its financial system and the pace of the fiscal consolidation process. Due to the protracted situation of instability, financial markets in the euro area are being renationalised which is having a very negative impact on the ability of governments and of the banking systems of the most vulnerable economies to borrow abroad (the latter are increasingly reliant on Eurosystem financing).

The worsening of the financial crisis is also severely affecting economic activity in the euro area, at a time when in most countries production has still not recovered the levels of 2008 Q1. The latest information from short-term indicators points to a decline in output in the second quarter of the year, following zero growth posted in 2012 Q1. In the medium term, the continuous tightening of financial conditions, the sharp deterioration of business and household confidence, the short-term effects of fiscal consolidation and the weakening of external demand are further delaying the prospect of a recovery for the area as a whole, prompting downward revisions of growth projections for the second half of this year and for the whole of 2013, as reflected by the most recent analyses of international bodies and private institutions. These new projections remain subject, furthermore, to downside risks stemming in particular from a possible further heightening of financial tensions in the area.

For its part, euro area inflation has been decreasing throughout the year essentially due to the moderation of energy prices and, consequently, it is likely to stand at below 2% at the beginning of 2013. In the medium term the situation of economic weakness does not presage inflationary tensions on the relevant monetary policy horizon. Against this backdrop, the Governing Council of the ECB decided at its July meeting to reduce official interest rates by 25 bp, leaving the rates on the main refinancing operations and on the deposit facility at 0.75% and at 0%, respectively. Additionally, the ECB previously announced that it would continue its refinancing operations using the fixed-rate full allotment procedure until January 2013 and it increased the availability of collateral so as to improve access to Eurosystem operations and to thus strengthen the provision of credit to households and non-financial corporations.

Finally, the European Council meeting and euro area Summit of Heads of State or Government held on 28 and 29 June adopted important measures aimed at alleviating the financial and sovereign debt crisis by taking action on two fronts (see Box 2). The decisions adopted provide, on one hand, a medium to long-term benchmark for the necessary development of the institutional framework of the monetary union over the next decade, helping to firm expectations about the continuity of this project, whose feasibility is questioned by leading analysts. On the other, mechanisms were created to influence more directly certain of the short-term factors generating most tension that are severely affecting the most vulnerable countries in the area. The European Council also completed the 2012 European Semester, taking a positive view of the progress made by EU Member States in relation to fiscal consolidation. However, it demanded that they move further with the

The European Council meeting and euro area Summit of Heads of State or Government of 28 and 29 June 2012 adopted a set of relatively far-reaching decisions in relation to certain factors underpinning the recent renewed tensions on sovereign debt markets and the need to redesign the euro project with a view to the future.

In particular, the Council discussed the report "Towards a Genuine Economic and Monetary Union" prepared by the President of the European Council in cooperation with the Presidents of the Commission, the Eurogroup and the ECB. The report identifies four essential components which should constitute the foundations of a new version of economic and monetary union in the medium and long term:

1 An integrated financial framework or "banking union", which firstly will have a centralised banking supervision system, in which the ECB will play a core role, in combination with national authorities maintaining some supervisory functions, depending on the size and the nature of banks. The Commission has announced that at the beginning of September it will make a proposal to define this new supervision system which must be urgently discussed at the Council meeting at end-2012. In the medium term a European deposit insurance scheme and a European bank resolution scheme should also be set up. The resolution scheme would be financed through contributions from banks to weaken the feedback loop between banking and sovereign risk. However, in order to guarantee their effectiveness, both schemes would have a public financial backstop, which could be provided by the European Stability Mechanism (ESM).

2 Secondly, an integrated budgetary framework would be created, in which discipline in public finances would be strengthened, by envisaging that euro area countries will have to receive prior authorisation for debt issuance above agreed limits and that European institutions may demand a revision of budgets if they do not comply with the commitments undertaken. Subsequently, the possibility of issuing common debt, with joint and several liability, could be explored along with the introduction of other instruments which may make further progress towards a fiscal union (a central budget and a European treasury office, for example).

3 The third factor is achieving an integrated economic policy framework in which the targets, recommendations and actions – currently part of the European Semester and Euro Plus Pact – become more binding.

4 Finally, since all the foregoing entails sharing responsibilities in areas currently under national sovereignty, it will be necessary to strengthen the democratic legitimacy of the process and its transparency with the involvement of the European Parliament and national parliaments.

Among the measures with more immediate effects geared at reducing tensions on debt markets, it was agreed that the ESM can directly recapitalise troubled banks, although in order to do so, the centralised banking supervision system for the euro area, as a whole, will have had to be previously put in place. It was also agreed that financial assistance for the recapitalisation of certain Spanish banks will first be granted by the European Financial Stability Facility (EFSF), then by the ESM, when the latter is in place, without the ESM acquiring preferred creditor status. Lastly, it was announced that both the EFSF and the ESM will be used efficiently and flexibly, opening the way for highly diverse financing alternatives that have yet to be specified. The most immediate of these alternatives could be the activation of bond purchases on secondary markets by the EFSF/ESM, using the ECB as agent and with suitable conditionality. At its meeting on 9 July, the Eurogroup reaffirmed its resolve to implement all these measures and, in fact, the agency agreement has already been entered into by the ECB and the EFSF and in September they will begin the technical discussions so that the EFSF is ready to directly recapitalise financial institutions, once the single supervisor has been created.

Finally, the Council also approved the "Growth and Employment Pact" which reaffirms its commitment to the objectives of the Europe 2020 Strategy and to the recommendations of the European Semester. As a result of the Pact, €120 billion will be mobilised for infrastructure investment through an increase of €10 billion in the paid-in capital of the European Investment Bank (thereby potentially raising its lending capacity to €60 billion) and the pilot phase of EU "project bonds" with almost €5 billion will be launched. €55 billion of structural funds were reallocated to research and innovation, SMEs and youth employment.

Overall, the agreements adopted indicate the governments' unequivocal resolve to move ahead with the financial, fiscal, economic and, possibly, political integration of the euro area. In the current circumstances, providing clarity about the medium and long-term development of the institutional framework of EMU is essential to firm expectations about the continuity of the project. The will for deeper integration has been shown especially by the fact that certain facets of the "banking union" will be pushed through urgently in order to set in train the institutions that must break the perverse feedback loop between bank and sovereign risk which has underpinned recent tensions. Clearly, however, following the initial positive market reaction, the absence of specific details about some of the measures has prevented a greater easing of financial tensions which continue to severely affect the most vulnerable countries. Consequently, swift progress is needed in implementing the agreements, clarifying the details of how they will be applied and establishing, as envisaged, a road map with specific goals and deadlines, while at the same time enhancing the euro area's crisis management mechanisms.

reforms aimed at bringing wages into line with productivity and at increasing competitiveness in the services sector as well as in the reforms intended to improve the long-term sustainability of public finances (see Box 3).

3.1 Economic developments

Euro area National Accounts data confirmed zero activity growth in 2012 Q1, following the decline of 0.3% in the preceding period (see Table 1). The momentum of net external demand, due to the higher increase in exports than imports, and the slight rise in government consumption (0.2%), offset sluggish consumption and the sharp contraction of gross fixed capital formation. The slump in the latter was the result of the fall in capital goods investment (2.3%) and in construction (1.9%). In this setting employment contracted again – by 0.2% – in relation to the previous quarter (see Chart 8). By country, activity rose in Belgium, Austria and Germany, essentially underpinned by net external demand, it remained stable in France and deteriorated further in Italy by -0.8% as a result of the contraction of private consumption and of gross capital formation.

The latest conjunctural information indicates a weakening of activity in 2012 Q2 (see Table 1). On the supply side, according to the business confidence indicators compiled by the European Commission and those based on the PMI survey, the deterioration that began in March has continued throughout the second quarter in both the services and industry sectors. The PMIs have moved increasingly below the theoretical threshold which defines positive growth in economic activity (see Chart 9). Furthermore, industrial production slipped in the April-May period, although it rose slightly in the latter month. On the labour front, the unemployment rate continued to rise, reaching 11.1% and indicators of job creation expectations in industry and in the services sector dropped throughout the quarter.

On the demand side, the fragile labour market and the various tax increases implemented by euro area countries in order to meet fiscal consolidation targets are limiting the possibility of private consumption boosting activity. Thus, the recovery of retail sales came to a halt in Q2 and consumer confidence held at very low levels. On average in the quarter vehicle registrations, which were close to their all-time low, once again declined and the propensity to buy durable goods remained stable. As for private investment indicators, in Q2 the degree of capacity utilisation reversed the progress it had made in Q1 and order books fell back to the levels of spring 2010. Finally, the rate of decrease of goods exports in nominal terms quickened in April and expected exports declined, as did the assessment of foreign orders.

The deepening of the financial crisis and the short-term effects of fiscal consolidation led international organisations and private institutions to revise their growth projections downwards for future quarters, putting back the recovery of activity in the euro area until the closing months of 2012 and, in some cases, the early months of 2013 (see Table 2). Furthermore, downside risks continued to prevail insofar as the heightening of tensions on sovereign debt markets might also feed through to financing conditions and private-sector confidence, resulting in a greater contraction of agents' consumption and investment decisions. Similarly, persistently high unemployment levels with the consequent deterioration in human capital, may hamper the potential recovery.

Euro-area inflation moderated throughout the quarter and stood at 2.4% in June, 0.3 pp lower than in March. This was essentially due to the slowdown in energy prices since core inflation, measured by the CPI excluding unprocessed food and energy, only stalled by 0.1 pp to 1.8% (see Chart 10). Industrial prices continued to slow, posting a growth rate of 2.3% in May, 1.2 pp lower than in March. In the medium term, the inflation rate is expected

The Ecofin Council of 10 July concluded the 2012 European Semester by formally adopting the economic policy recommendations for each EU Member State and for the euro area, as a whole. The European Semester is an essential part of the new governance architecture being developed in the European Union. Its main aim is to create a new cycle for orderly, simultaneous and integrated discussion of Member States' fiscal, macroeconomic and structural policies. The European Semester takes place in the first half of each year in order to facilitate earlier and more stringent cross-country coordination, which permits harnessing synergies in the design and implementation of the various policies. Thus, in the second half of the year countries may incorporate the appropriate economic policy recommendations into their budgets and national reform agendas. In the process progress made by the various countries in meeting their commitments is assessed and areas where efforts must be focused at European and national level are identified.

This is the second year that the European Semester has been in force and the first year that it takes place after the entry into operation of the first phase of the reform of European governance. This reform has introduced new mechanisms for the supervision of macroeconomic and structural policies, such as the Macroeconomic Imbalance Procedure and it has strengthened existing procedures in order to monitor fiscal policy within the framework of the Stability and Growth Pact. The accompanying table summarises the role of all these instruments in the European Semester.

1 THE EUROPEAN SEMESTER. MECHANISMS AND STRATEGIES

	Structural policies	Fiscal policy	Macroeconomic policies
Mechanisms	Europe 2020 (objectives in terms of employment, competition, innovation, education, etc.)	Revised Stability and Growth Pact (deficit and debt commitments)	Macroeconomic Imbalance Procedures (surveillance of imbalances)
	Euro Plus Pact (intergovernmental agreement: fiscal harmonisation, competitiveness, financial restructuring, etc.)		
Instruments	Annual Growth Survey (prepared by the European Commission, it sets out economic policy recommendations for the whole of the EU)		
			Alert Mechanism Report (European Commission)
	National Reform Programmes (national targets)	Stability programme (medium-term budget plans)	
Implementation	Peer pressure	Excessive Deficit Procedure	Excessive Imbalance Procedure

SOURCE: Banco de España.

2 THE EUROPEAN SEMESTER TIMETABLE

Institution	January	February	March	April	May	June	July
European Commission	Annual Growth Survey (AGS) (a)					Presentation of recommendations on National Reform Programmes (NRPs) and Stability and Convergence Programmes (SCPs)	
Council formations		Debate and guidelines					
European Parliament		Debate and guidelines					
European Council			Spring European Council: approval of AGS				Approval of recommendations submitted by the Commission
Member States				Approval of NRPs and SCPs			

SOURCE: European Commission.

a In the 2012 European Semester the presentation of the Annual Growth Survey was brought forward to November 2011.

The Semester began in December 2011 with the presentation by the European Commission of the "Annual Growth Survey", which, after it had been discussed in the Ecofin, established the general guidelines which economic policy in the whole of the EU must follow throughout 2012. These guidelines centred on the need for progress in the fiscal consolidation strategy, by attempting to minimise its negative impact on economic growth and to eliminate the imbalances and divergences built up over the years of growth. In the area of structural reform, greater progress was demanded from the EU as a whole towards setting up the Single European Market with the full implementation of the Services Directive, the Single Market Act and the Single European Agenda. At national level, the priorities focused on restoring economies' financing conditions and, furthermore, specifically for the euro area countries, on the need to increase policy coordination commensurately with the degree of economic and financial integration achieved. The countries have taken into account these guidelines when preparing their respective national reform programmes and stability and convergence programmes, the two documents which include the measures that countries are committed to implementing in the short and medium term.

These programmes also include countries' specific reform commitments within the framework of the Euro Plus Pact, an intergovernmental agreement whereby euro area Member States and other EU countries undertake to introduce specific reforms by a set deadline in four areas: competitiveness, employment, the sustainability of public finances and the stability of the financial system, also emphasising the need for greater coordination of tax policies.

The European Commission which is the body responsible for: the technical assessment of the plans and of the reforms adopted and of making an initial proposal for recommendations, has made a relatively favourable assessment of the progress made in fiscal consolidation, the reform of the pensions systems and national fiscal frameworks. By contrast, it demands more ambitious and more specifically detailed measures which should be implemented forthwith to restore growth and eliminate the fissures which still exist in the single market. In particular, the Commission recommends to various countries that they make progress in the restructuring of their financial systems and in the reform of their wage bargaining systems by eliminating wage indexation arrangements which make it difficult to align wages and productivity. Countries should also concentrate their efforts on increasing competition in the services sector and in network industries. On the fiscal front, the Commission suggests to several countries that they reduce taxes on labour and increase taxes on housing or consumption and, in order to improve the sustainability of public finances, it advises deeper reforms of health and pension systems, bringing the effective retirement age into line with life expectancy. With this goal and in line with the philosophy of the Euro Plus Pact, the Commission demands more clearly defined measures and precise deadlines for implementing the reforms.

In the area of macroeconomic imbalances, the European Commission also presented at the beginning of 2012 the "Alert Mechanism Report", in which, based on a set of predetermined indicators, it attempts to detect early the countries in which imbalances might be building up which may pose a risk to the stability of the euro area. The report identifies Belgium, Spain, France, Italy, Cyprus, Slovenia and Finland (in addition to the United Kingdom, Sweden, Bulgaria, Denmark and Hungary, which are outside the euro area) as economies which could be at risk of an excessive imbalance.[1] In these cases, the European Commission has undertaken a more in-depth and detailed analysis of these countries' competitive situation and possible macroeconomic imbalances.

These reports reveal that in recent years most of the countries substantially corrected trade imbalances and differences built up in relative costs. However, it is too early to determine whether this correction is permanent and the analysis of other aspects of competitiveness show weaknesses in the size of European export firms and in the quality of their products. Also, the debt levels built up in the public and private sector remain high and, furthermore, certain banking systems are fragile. That said, the European Commission has not recommended that an excessive imbalance procedure be initiated against any of the countries analysed.

1 The procedure is not applied to Greece, Portugal and Ireland, since they are already subject to stringent supervision in the framework of the assistance programmes.

EURO AREA ECONOMIC INDICATORS (a) — TABLE 1

	2010	2011				2012		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
National accounts (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.3	0.7	0.2	0.1	-0.3	0.0		
Private consumption	0.4	0.0	-0.6	0.4	-0.5	0.0		
Public consumption	0.1	-0.4	-0.1	-0.1	-0.2	0.4		
GFCF	-0.5	2.0	-0.4	-0.3	-0.6	-1.4		
Imports	1.4	0.8	0.6	0.7	-1.9	-0.2		
Exports	1.6	1.4	1.1	1.5	-0.6	1.0		
Contributions to quarter-on-quarter change in GDP (pp)								
Domestic demand, excluding stocks	0.2	0.3	-0.4	0.1	-0.5	-0.2		
Stockbuilding	0.1	0.2	0.4	-0.3	-0.4	-0.3		
Net foreign demand	0.2	0.3	0.3	0.4	0.6	0.5		
GDP (year-on-year rate of change)	2.2	2.4	1.7	1.3	0.7	0.0		
Activity indicators (quarterly average)								
IPI seasonally and working day adjusted	1.9	1.0	0.2	0.7	-2.1	-0.4	-0.6	
Economic sentiment	105.3	106.9	105.2	98.4	93.6	94.1	91.1	
Composite PMI	54.9	57.6	55.6	50.3	47.2	49.6	46.4	
Employment	0.1	0.1	0.2	-0.2	-0.2	-0.2		
Unemployment rate	10.1	9.9	10.0	10.2	10.6	10.9	11.1	
Price indicators (year-on-year change in end-period data)								
HICP	2.2	2.7	2.7	3.0	2.7	2.7	2.4	
PPI	5.4	6.8	5.9	5.8	4.3	3.5	2.3	
Oil price (USD value)	92.3	115.4	114.9	114.8	108.7	126.8	95.7	101.1
Financial indicators (end-period data)								
Euro area ten-year bond yield	4.1	4.6	4.4	4.0	4.1	3.3	3.4	3.2
US-euro area ten-year bond spread	-0.78	-1.14	-1.30	-2.06	-2.17	-1.12	-1.81	-1.69
Dollar/euro exchange rate	1.336	1.421	1.445	1.350	1.294	1.336	1.259	1.223
Appreciation/ depreciation of the NEER-20 (b)	-8.2	3.4	3.7	0.7	-2.1	0.9	-2.4	-4.6
Dow Jones EURO STOXX 50 index (b)	-5.8	4.2	2.0	-22.0	-17.1	6.9	-2.2	-1.4

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

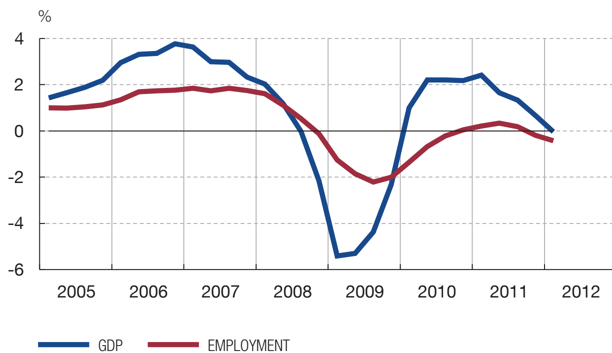
a Information available up to 18 July 2012.
b Percentage change over the year.

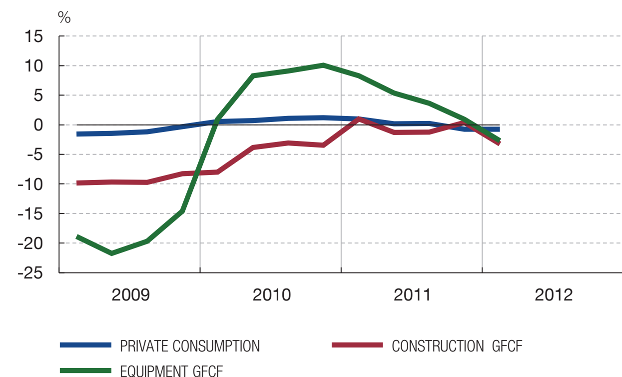
to stand at below 2% at the beginning of 2013, with a central scenario in which risks are balanced since the possible increases in indirect taxes and administered prices, arising from the fiscal adjustment are offset with downside risks stemming from weak activity growth in the euro area. In this context, inflation expectations remain firmly anchored at levels consistent with price stability.

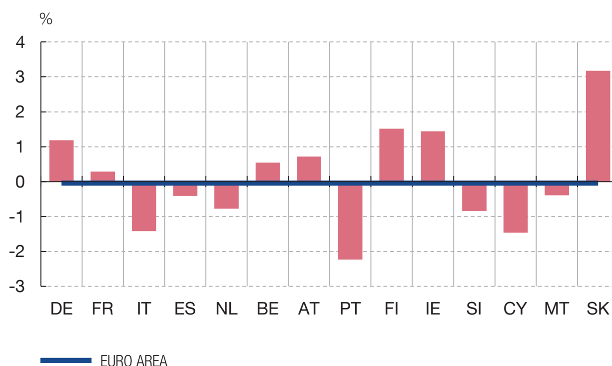
According to estimates published by the ECB, between January and April 2012 the euro area recorded a current account deficit of €5.4 billion (0.2% of GDP), €20 billion down on the same period of the previous year (0.8% of GDP). This improvement occurred because the goods balance turned positive and the surplus on the services balance widened. As for the financial account, net capital outflows in the form of direct investment edged downwards to €34 billion between January and April, compared with €74 billion in the same period of the previous year, while those in the form of portfolio investment amounted to €47.2 billion compared with the net inflow of €141.4 billion in the period from January to April 2011. Consequently, the basic balance, which combines these two types of

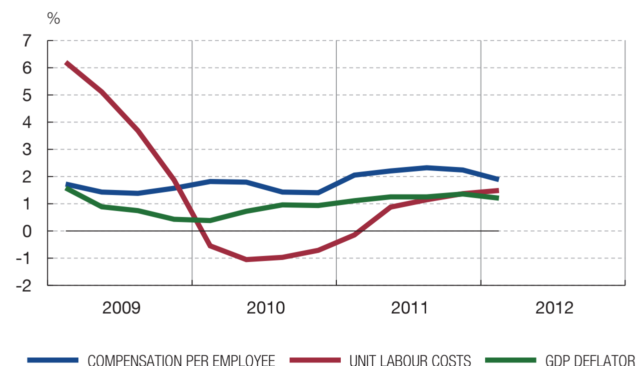
EURO AREA NATIONAL ACCOUNTS

CHART 8









SOURCES: Eurostat and national statistics.

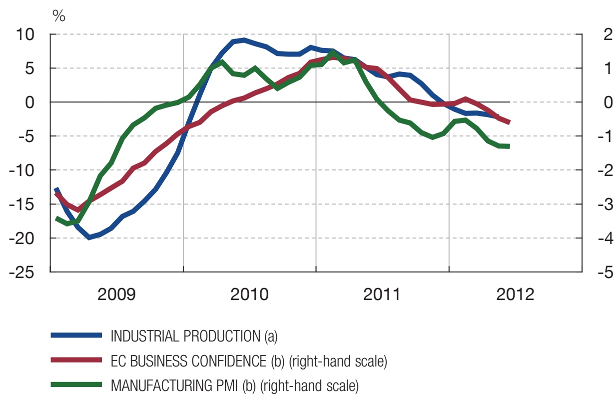
investments with the current account balance, posted a deficit of €86.5 billion between January and April 2012, compared with a surplus of €41.2 billion in the same period of the previous year (see Chart 11).

In the area of public finances, the 2012 budgets and the stability programmes submitted in spring revealed that most countries have stepped up their fiscal consolidation plans to offset the impact of the deterioration of the economic situation on public accounts, with the result that budget targets remain unaltered. According to these plans, the euro area's general government deficit will continue to decline in 2012 to close to 3% of GDP – in keeping with the European Commission's projection of 3.2% (see Table 3). The improvement in the budget balance in 2012 is mainly based on the increase in government receipts (0.9 pp of GDP compared with the previous year) and, especially, on the increase in indirect taxation. It is estimated that government spending, for its part, will remain practically unaltered in terms of GDP, since the moderation in the compensation of public employees will be offset by an increase in transfers and interest payments arising from higher levels of unemployment and debt, respectively. The cyclically-adjusted balance is estimated to decline by slightly more than 1 pp of GDP in 2012, with the result that fiscal policy will remain contractionary despite weak economic activity. By country, the adjustment will be particularly sharp in Spain, Greece, Italy, Cyprus, Portugal and Slovenia, where it is estimated that the balance will decline by more than 2 pp of GDP in structural terms.

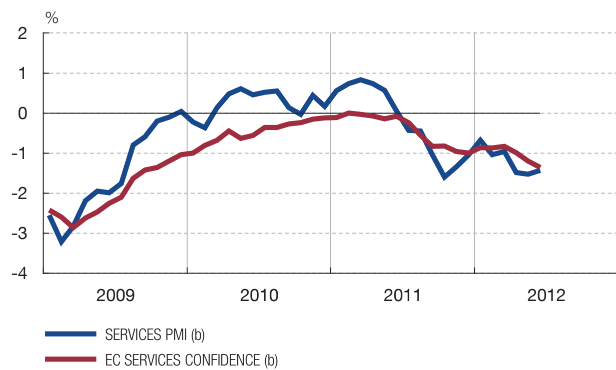
EURO AREA. ACTIVITY, DEMAND AND EMPLOYMENT INDICATORS

CHART 9

INDUSTRIAL ACTIVITY INDICATORS

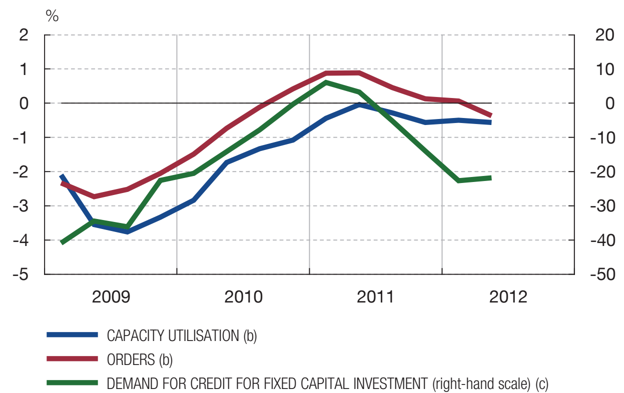


SERVICES SECTOR INDICATORS

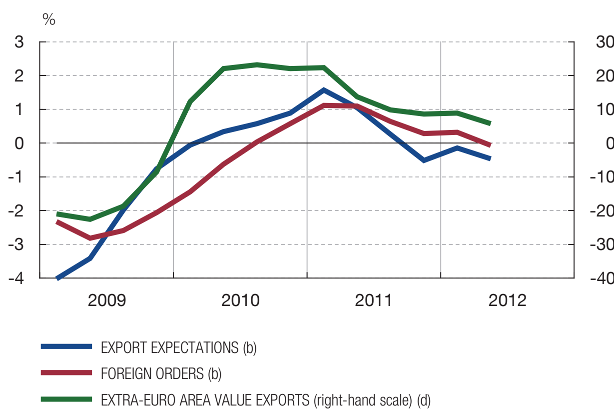


CONSUMPTION INDICATORS

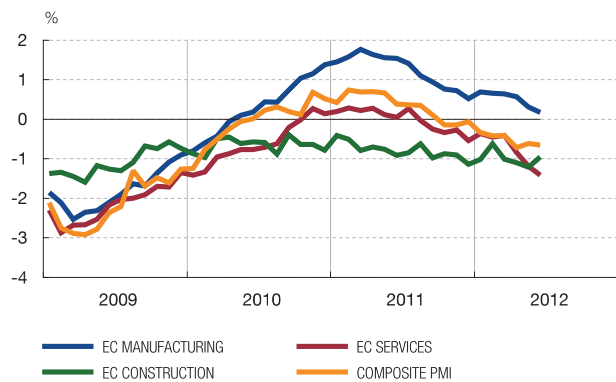
INVESTMENT INDICATORS



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 Survey on bank loans. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase x 0.5 – percentage of banks reporting some decrease x 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.

GDP AND HICP FORECASTS FOR THE EURO AREA (a) — TABLE 2

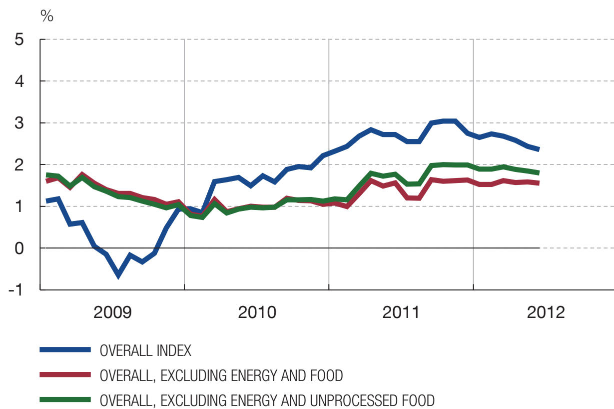
	2012		2013	
	GDP	HICP	GDP	HICP
Eurosystem (June 2012)	-0.5-0.3	2.3-2.5	0.0-2.0	1.0-2.2
European Commission (May 2012)	-0.3	2.4	1.0	1.8
IMF (April 2012)	-0.3	2.0	0.9	1.6
OECD (May 2012)	-0.1	2.4	0.9	1.9
Consensus Forecast (July 2012)	-0.5	2.3	0.5	1.7
Eurobarometer (April 2012)	-0.4	2.3	0.5	1.8

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

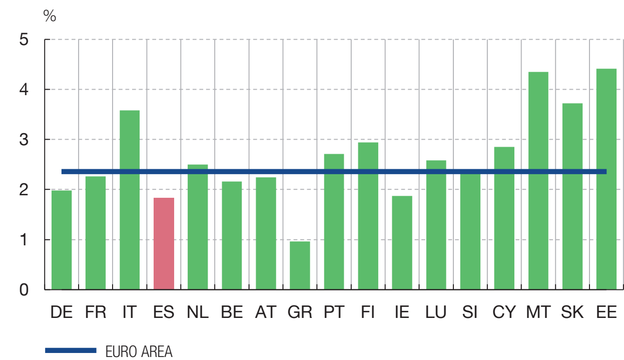
a Year-on-year rate of change.

EURO AREA. PRICE INDICATORS — CHART 10
Year-on-year percentage changes

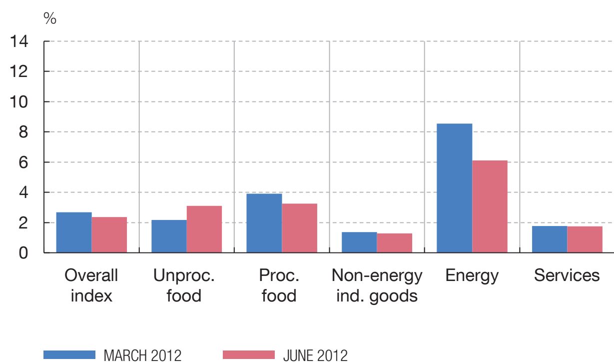
HARMONISED INDICES OF CONSUMER PRICES



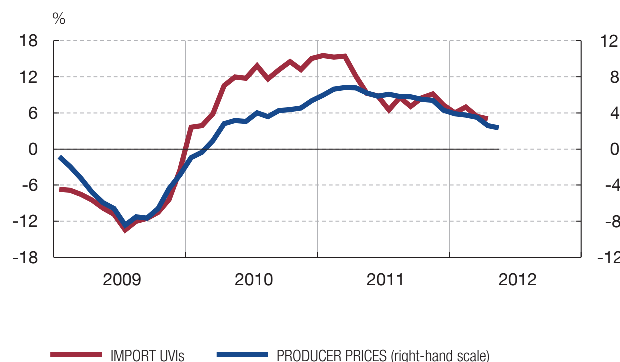
OVERALL HICP
(June 2012)



HICP AND ITS COMPONENTS



OTHER PRICE INDICATORS



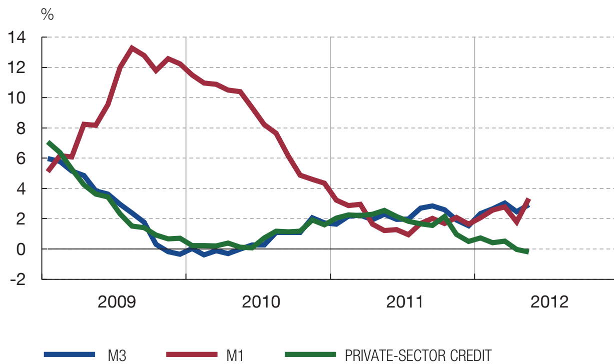
SOURCES: Eurostat and ECB.

The European Commission's review of the stability programmes in the framework of the European Semester concluded that most countries have established ambitious consolidation measures, however, in some cases including France, the Netherlands and Spain, it will be necessary to specify further action in order to comply with the commitments acquired under the Stability and Growth Pact beyond 2012. Except for Estonia, Finland

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS

CHART 11

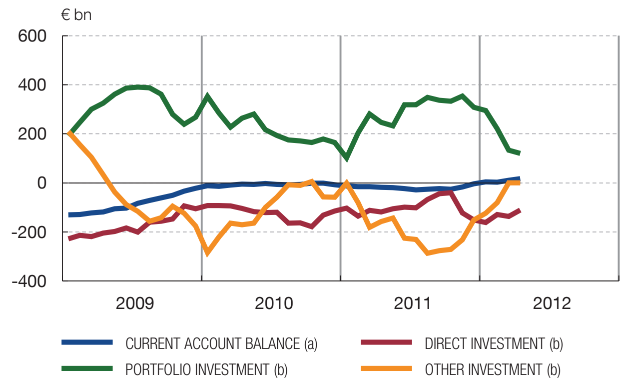
MONETARY AND CREDIT AGGREGATES
Year-on-year growth



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

FINANCING OF HOUSEHOLDS
Year-on-year growth

BALANCE OF PAYMENTS
Cumulative amounts for the last twelve months



SOURCES: ECB and Banco de España.

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

and Luxembourg, all the countries are subject to the Excessive Deficit Procedure (EDP), although the European Commission has proposed that it be suspended for Germany since its deficit already stood well below 3% of GDP in 2011.

Lastly, public debt is expected to exceed 91% of GDP in 2012. Furthermore, there are contingent liabilities linked to the restructuring of certain banks and the expenses related to population ageing are likely to increase. According to the European Commission's 2012 Ageing Report, the latter could have an impact in the time frame until 2060 of more than 4 pp on the public spending/GDP ratio (exceeding 7 pp in Belgium, Cyprus, Luxembourg, Malta, the Netherlands and Slovenia).

The macroeconomic setting shapes a very complex scenario for the fiscal consolidation process under way. For this reason, the European Council's recommendations at end-May on fiscal policy emphasise adjustment measures which diminish the impact on economic activity in the short and medium-term, encouraging a reorientation of tax structures towards taxes which favour growth and employment; in the medium term in most countries it is considered necessary to increase the efficiency of spending on health and to introduce reforms in pension systems to raise the effective retirement age, tying it to the population's life expectancy.

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

% of GDP

	2010	2011	2012			2013	
		EC (b)	EC (b)	IMF (c)	EDP (d)	EC (b)	IMF (c)
Belgium	-3.8	-3.7	-3.0	-2.9	-2.8	-3.3	-2.2
Germany	-4.3	-1.0	-0.9	-0.8	-0.9	-0.7	-0.6
Estonia	0.2	1.0	-2.4	-2.1	-2.2	-1.3	-0.5
Ireland	-31.2	-13.1	-8.3	-8.5	-8.2	-7.5	-7.4
Greece	-10.3	-9.1	-7.3	-7.2	-6.7	-8.4	-4.6
Spain	-9.3	-8.5	-6.4	-6.0	-5.3	-6.3	-5.7
France	-7.1	-5.2	-4.5	-4.6	-4.4	-4.2	-3.9
Italy	-4.6	-3.9	-2.0	-2.4	-1.7	-1.1	-1.5
Cyprus	-5.3	-6.3	-3.4	-3.7	-2.6	-2.5	-1.4
Luxembourg	-0.9	-0.6	-1.8	-1.6	-1.8	-2.2	-2.0
Malta	-3.7	-2.7	-2.6	-2.7	-2.2	-2.9	-2.4
Netherlands	-5.1	-4.7	-4.4	-4.5	-4.6	-4.6	-4.9
Austria	-4.5	-2.6	-3.0	-3.1	-3.0	-1.9	-2.4
Portugal	-9.8	-4.2	-4.7	-4.5	-4.5	-3.1	-3.0
Slovenia	-6.0	-6.4	-4.3	-4.7	-3.5	-3.8	-4.2
Slovakia	-7.7	-4.8	-4.7	-4.2	-4.6	-4.9	-3.7
Finland	-2.5	-0.5	-0.7	-1.4	-1.2	-0.4	-0.8
MEMORANDUM ITEM: euro area							
Primary balance	-3.4	-1.1	0.0	-0.5		0.3	0.1
Total balance	-6.2	-4.1	-3.2	-3.2	-3.0	-2.9	-2.7
Public debt	85.6	88.0	91.8	90.0	91.1	92.6	91.0

SOURCES: European Commission, Eurostat and IMF.

a Deficit (–)/surplus (+). The deficits that exceed 3% of GDP have been shaded.
b European Commission forecasts (spring 2012).
c IMF forecasts (April 2012).
d EDP notification (April 2012).

3.2 Monetary and financial developments

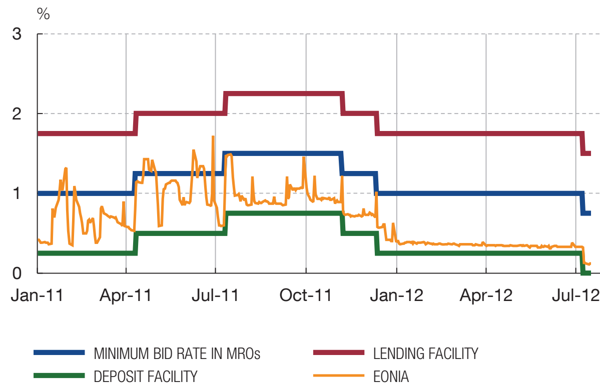
Financial developments in the euro area continued to reflect in 2012 Q2 a highly complicated environment, characterised by market focus on the persisting significant systemic risks and the lack of confidence. The financial situation deteriorated substantially from mid-March, particularly affecting Spain and Italy, which experienced – against a backdrop of high volatility – a sharp tightening of their financing conditions in the public and private sector due to the significant increase in their risk premiums. Thus, ten-year bond yields in the secondary debt market reached 7% for Spain and 6% for Italy and, if they hold at these levels over a protracted period, could question the sustainability of public finances. The increase in risk aversion contributed to the decline in the yields of triple-A rated countries and, in particular, in Germany where the ten-year benchmark (Bund) stood at below 1.5% mid-July.

The resurgence of tensions was related, firstly, to political uncertainty in Greece, which was jeopardising the continuity of the aid programme. Once that scenario had been ruled out with the formation of a coalition government after the June elections, an assessment period began which could result in the new government requesting a revision of the agreements in force. The impact on Cyprus of strong economic and financial exposure to the Greek economy and serious macroeconomic imbalances led it in the last week of June to request financial assistance

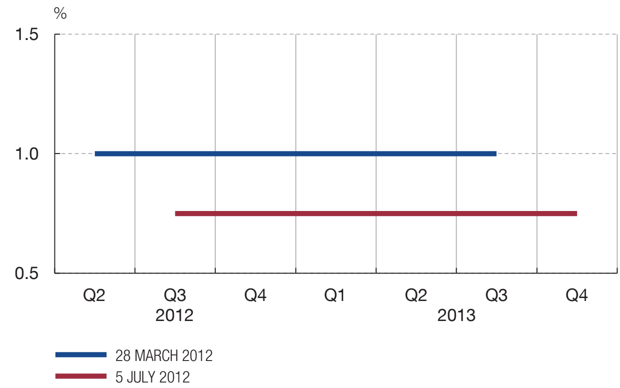
EURO AREA INTEREST RATES

CHART 12

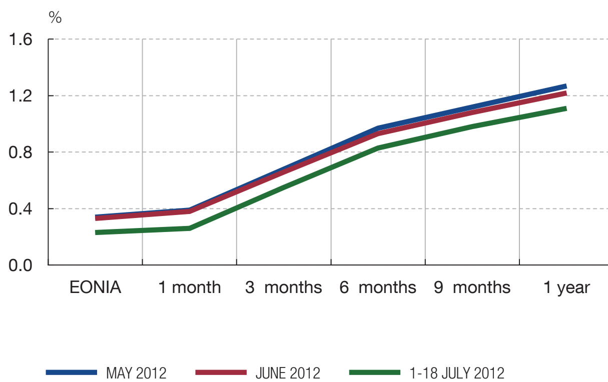
EONIA AND ECB INTEREST RATES



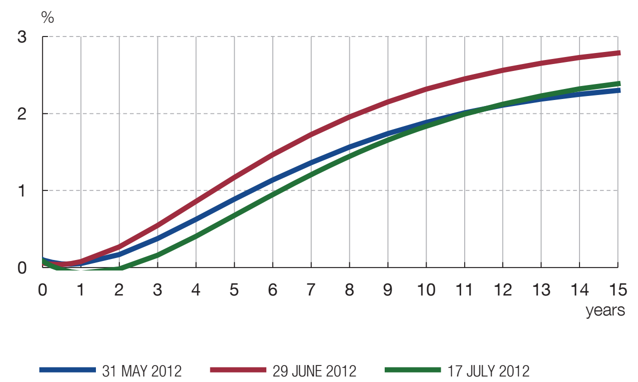
EXPECTED END-QUARTER ECB RATE. REUTERS SURVEYS



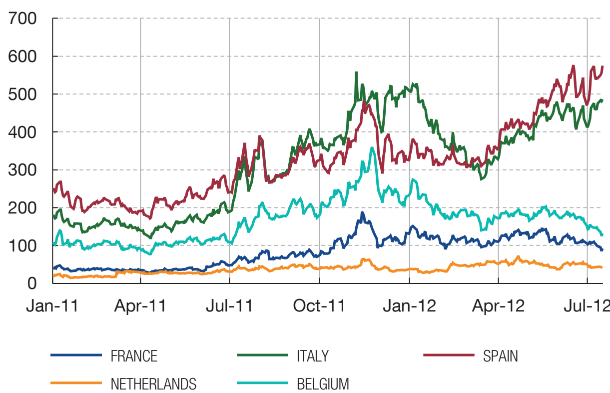
INTERBANK MARKET



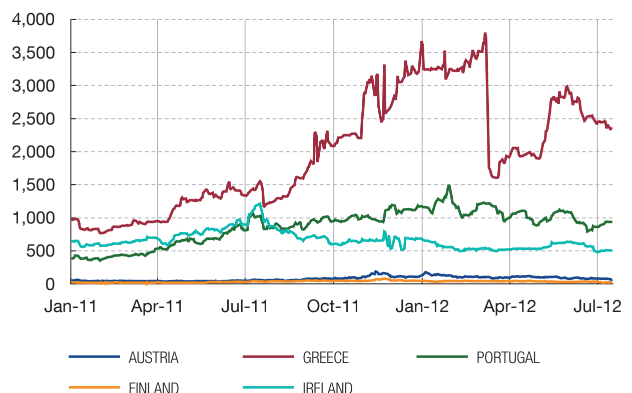
ZERO COUPON CURVE (a)



SOVEREIGN SPREADS OVER GERMANY



SOVEREIGN SPREADS OVER GERMANY



SOURCES: ECB and Banco de España.

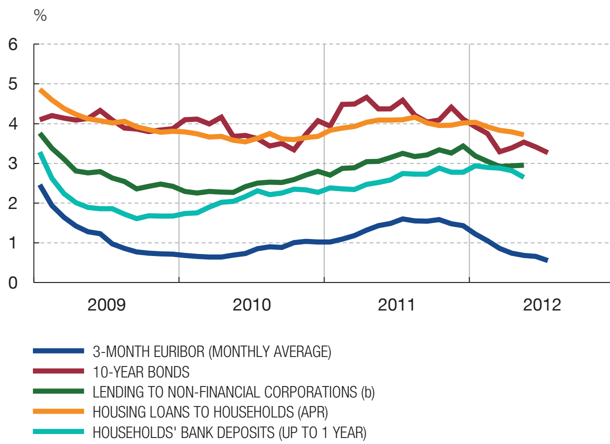
a ECB estimate using swap market data.

from the Eurogroup and the IMF under a general programme which is still to be determined. Doubts about the situation of the Spanish economy and uncertainty surrounding the details and implications of the financial aid requested by Spain in order to recapitalise its banking sector were an additional source of tensions. Finally, financial developments were also conditioned by the potential scope of the measures likely to be adopted at the European Council meeting of 28 and 29 June in order to decouple sovereign and banking risks. Accordingly, as

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

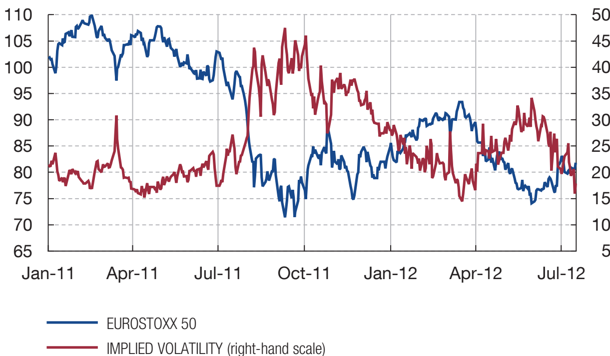
CHART 13

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 one year initial rate fixation.

described in greater detail in Box 2, the agreements of the Council, which were subsequently ratified by the Eurogroup on 9 July, included the possibility of the EFSF and subsequently the ESM being used efficiently and flexibly to buy debt on sovereign markets with suitable conditionality and opened up the possibility for the ESM of directly recapitalising banks, once the single European banking supervisor has been created.

Against this complicated backdrop, the ECB maintained the expansionary stance of monetary policy since it considered that inflation expectations were firmly anchored and that as a result of the situation of economic weakness in the euro area, it was unlikely that inflationary pressure would arise in the medium term. Thus, at its meeting on 5 July, the Governing Council decided to reduce the rate on main refinancing operations by 25 bp to 0.75%, and to cut the rate on the deposit and credit facilities symmetrically to 0% and 1.5%, respectively (see Chart 12). Furthermore, at its May meeting, the ECB announced that it would continue conducting its refinancing operations as fixed rate tender procedures with full allotment until January 2013 and increased the availability of collateral in order to improve the access of banks to Eurosystem operations, with the ultimate aim of supporting the provision of credit to households and non-financial corporations.

Interbank market interest rates tended to moderate, particularly after the easing of official rates. The 3-month and 1-year EURIBOR stood, from the beginning of July, around 0.5% and 1%, respectively, with the result that the spreads in relation to repo operations narrowed slightly, particularly that of the 1-year EURIBOR which stood at below 100 bp.

According to the Bank Lending Survey for 2012 Q1, credit conditions offered by credit institutions remained tight. Thus, the lending standards for new loans to households and firms tightened slightly in Q1, although further tightening was not expected in Q2. The cost of bank loans extended to households and firms in the private sector continued to decline – for loans of less than €1 million – whereas it rose slightly for firms for loans of more than €1 million. These aggregate developments, however, mask uneven credit conditions which are tighter in the economies with greater financial tensions.

The backdrop of high uncertainty and falling economic activity continued to condition private-sector demand for financing which remains weak. Thus, bank loans to the private sector held on a slowing path, showing year-on-year growth of 0.4% in May, in securitisation-adjusted terms. Growth in credit to households stood at 1.3%, with house purchase loans slowing at the same time as consumer credit continued to fall year-on-year by around 2%. The moderation was sharper in corporate loans whose year-on-year rate of increase stood at 0.2%, with wide cross-country divergences. Conversely, the debt issues of non-financial corporations continued to grow at relatively high rates, above 9% year-on-year in May, which may show a certain substitution effect among sources of financing by larger corporations (see Chart 11).

On the stock market the EUROSTOXX 50 index held, albeit with some volatility, on the declining trend it began mid-March, with the result that since the beginning of April it has lost approximately 10% and, in the case of the banking sector, 24%. Declines were widespread across countries although the sharpest were in Spain's IBEX 35 and Italy's FTSE MIB (see Chart 13). The euro-dollar exchange rate depreciated 8% in the same period and at the cut-off date for this bulletin was $1.22 per euro.

On the latest available information, economic activity is estimated to have contracted in 2012 Q2 with slightly greater intensity than in the previous quarter, as a result of which GDP posted a quarter-on-quarter change of -0.4% (see Chart 14). The weakness of national demand became more acute, with a fall of 1.2%, owing to the poorer performance of consumption and of investment in construction. By contrast, the positive contribution of net external demand increased, to 0.8 pp, 0.6 pp up on Q1. This was due to the momentum of exports – of services in particular – and to the continuing slackness of imports. In year-on-year terms, the decline in output steepened by 0.6 pp to -1%.

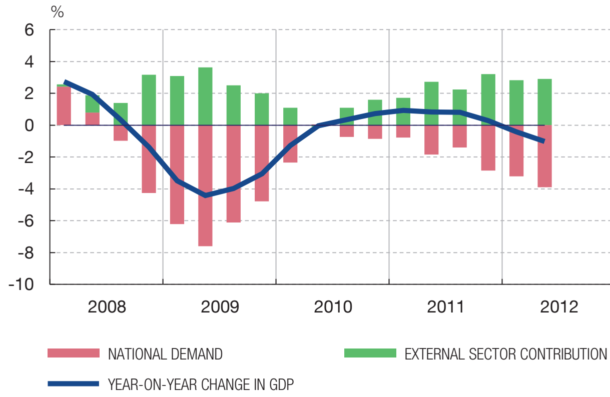
Employment continued falling sharply, with an estimated decline of 4.6% year-on-year, 0.8 pp more than in Q1. The estimated course of output and employment led to a rise in the rate of increase of average labour productivity. In combination with the slowdown in the growth rate of compensation per employee, this behaviour translated into a further decline in unit labour costs economy-wide. Finally, the CPI stood in June at 1.9% year-on-year, unchanged on the March figure. The CPI excluding energy and unprocessed food prices rose from March to June by 0.1 pp to 1.3%. In terms of the HICP, the inflation differential with the euro area as a whole remained negative and stood in June at -0.6 pp. In the coming months, prices in Spain will be affected by the impact of the rise in VAT rates, as well as by increases in other indirect taxes and administered prices, although the marked weakness of demand suggests that the pass-through of these tax increases to final prices will be incomplete.

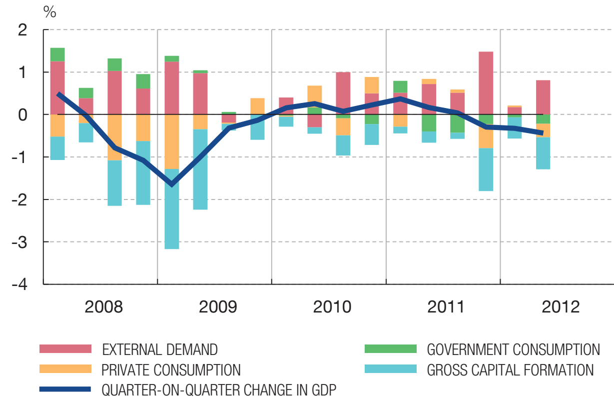
4.1 Demand

The weakness of private consumption increased in Q2 (see Chart 15). This demand component is estimated to have fallen at a quarter-on-quarter rate of 0.5%, compared with 0.1% in Q1. This contraction is consistent with the persistent weakness in the labour market, which continued to erode the main source of household income and fuelled uncertainty over the future course of this variable. Moreover, the bouts of financial stability during the quarter prompted a deterioration in confidence. Household wealth continued falling, in a setting of further declines in house prices and in Spanish stock market prices. Among the quantitative indicators, the quarter-on-quarter decline in new individual car registrations, calculated on the basis of the seasonally and calendar-effect-adjusted series, climbed to 7.3%. The year-on-year decline in large corporations' sales of goods and services (an indicator compiled by the State Tax Revenue Service) and in the retail trade index also quickened over April and May on the whole to a rate of around -7%.

On information to 2012 Q1, the growth of nominal household income slowed for the second quarter running, evidencing a slight decline according to the cumulated four-quarter data from the non-financial accounts of the institutional sectors. The trend in household income is due to the rise in the negative contribution of employee compensation and, to a lesser extent, to the reduction in the positive contribution of the gross surplus of the self-employed. The contribution of general government to household income held stable, since higher direct tax payments following the rise in personal income tax rates were offset by higher benefit income and lower social security contributions payments. The increase in nominal consumption, along with the fall in income, led to a further decline in the household saving rate, on this occasion by 0.8 pp to 10.8% of disposable income, a similar level to that recorded before the start of the crisis.

MAIN DEMAND AGGREGATES. CONTRIBUTION TO GDP GROWTH (a) CHART 14

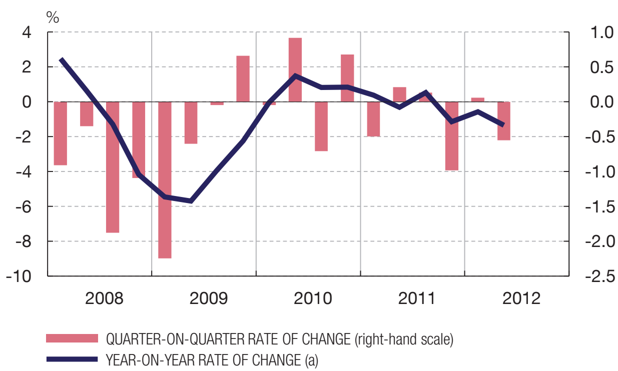




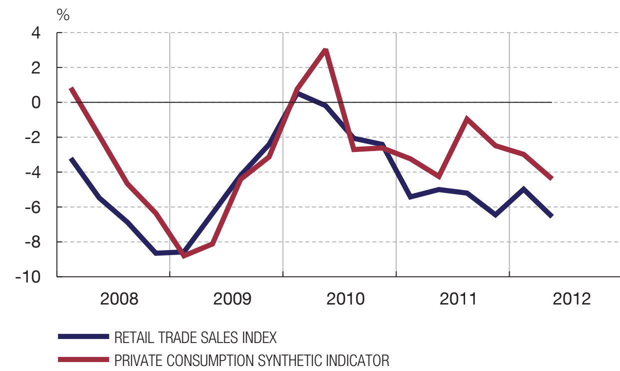
SOURCES: INE and Banco de España.

PRIVATE CONSUMPTION CHART 15

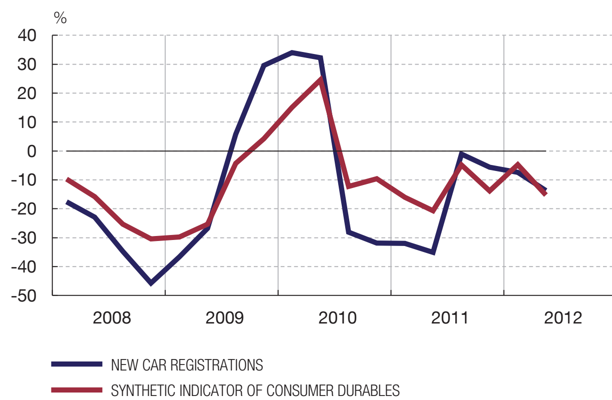
PRIVATE CONSUMPTION (QNA)



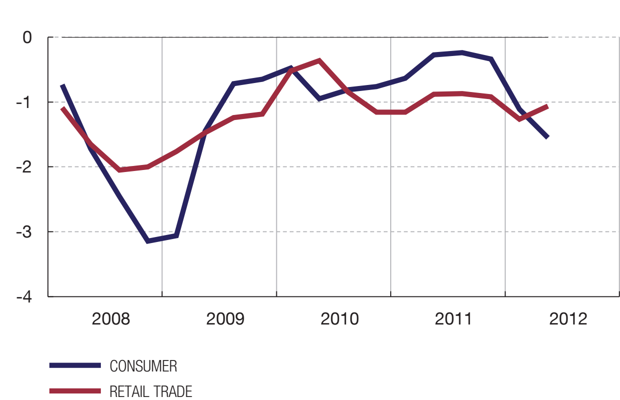
CONSUMPTION INDICATORS (a)



INDICATORS OF CONSUMER DURABLES (a)



CONFIDENCE INDICATORS (b)

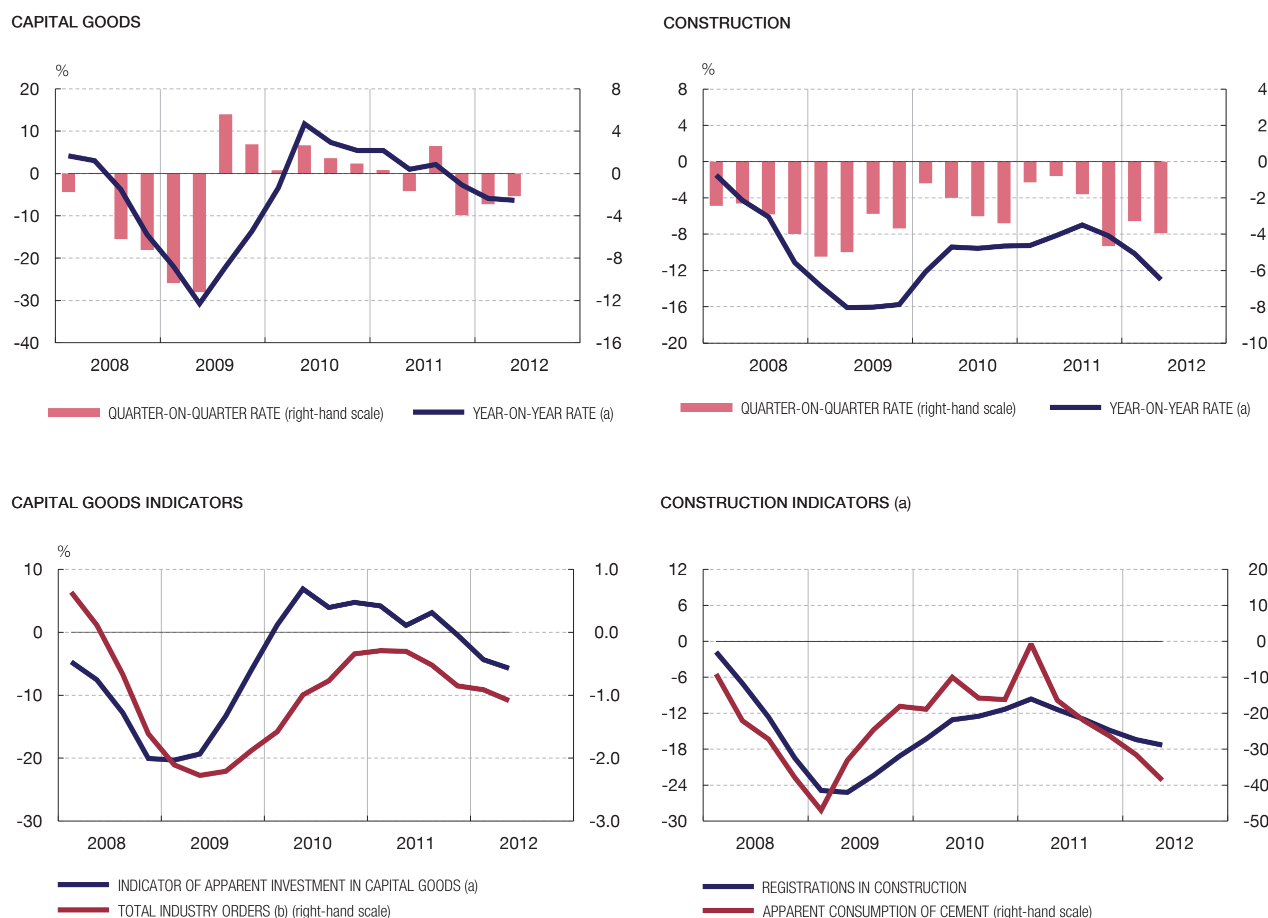


SOURCES: INE, European Commission, ANFAC and Banco de España.

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

GROSS FIXED CAPITAL FORMATION

CHART 16



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, Servicio Público de Empleo Estatal and Banco de España.

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

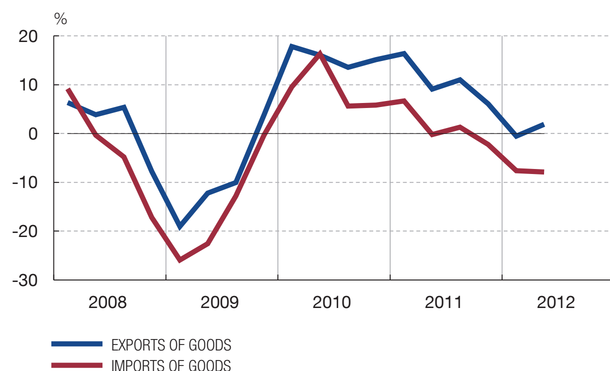
Investment in capital goods continued on a declining trajectory in 2012 Q2, with an estimated fall of 2.2% in quarter-on-quarter terms (see Chart 16). Both the industrial production of this type of good and imports fell sharply in April and May, and new commercial vehicle registrations also fell back significantly in Q2. In the same period, the lack of business confidence increased, both in industry as a whole and in the capital goods segment, potentially reflecting a further downturn in business investment in the coming months.

Drawing on the information from the non-financial accounts of the institutional sectors, the lending capacity of non-financial corporations continued on an improving path in 2012 Q1, standing at 1.9% of GDP with cumulated four-quarter data (0.3 pp up on 2011). Behind this increase lay greater saving by corporations, reflecting their efforts to clean up their balance sheets and strengthen their self-financing capacity in the face of the difficulties of borrowing funds. The increase in saving was essentially underpinned by the business surplus and by lower growth in interest payments.

Investment in construction remained contractionary as in the previous quarters, a trend associated with the ongoing adjustment in the residential segment and with the fiscal consolidation in the area of civil engineering works (see Chart 16). The latest information from the indicators for the sector as a whole in relation to employment and to the use of inputs

FOREIGN TRADE
Percentage change on year ago

CHART 17



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.

shows sharper quarter-on-quarter declines than those at the start of the year. This is the case of residential investment, which has been affected by the gradual reduction in the number of housing starts. As regards housing market transactions, around 70,000 houses were sold in 2012 Q1, a figure somewhat down on that a year earlier. The surface area approved for non-residential building continued to shrink strongly, on data to April, as did government civil engineering procurement.

Along with the contraction in public investment, it is estimated that the decline in government consumption contributed to making the direct contribution of general government to national demand in the April-June period more negative than at the start of the year. Specifically, the partial information available on general government consumption in Q2 points to a substantial fall-off in State purchases of goods and services, while general government employment might have posted a decline in this period, judging by the fall observed in the figures for Social Security registrations in the general government-related sectors.

Turning to the external sector, the contribution of net external demand to quarter-on-quarter GDP growth is estimated to have increased substantially in Q2 to 0.8 pp. This result would mainly be due to the pick-up in exports, whereas imports are expected to have fallen back at a similar rate to that in Q1 (see Chart 17). In year-on-year terms, net external

demand made a contribution of 2.9 pp to the rate of change of GDP. The recovery in exports has been underpinned by the gains in competitiveness (owing to the depreciation of the euro and to the containment of relative labour costs vis-à-vis our competitors), and despite the easing in the demand for imports by the euro area.

On Customs data, real goods exports continue to grow in the first two months of Q2, posting a year-on-year rate of 1.9%, following their 0.3% decline in the previous quarter. By product group, the improvement was fairly generalised, with notable strength in food and non-energy intermediate goods exports. Conversely, sales of non-food consumer goods remained notably sluggish. By geographical area, and in nominal terms, exports to the euro area fell slightly (-1.2% year-on-year) in April and May, while exports to the rest of the world continued to grow at a high rate (10.5%). The decline in exports to the euro area is attributable to the sluggishness of demand in some of our main markets, such as Italy and Portugal, which have witnessed respective falls of 5.3% and 9.7%.

As regards real tourism services exports, the information available suggests that this demand component might once again post a negative year-on-year rate of change in Q2. Although the geopolitical uncertainty persisting in some Arab countries continues to support tourist flows towards Spain, it is doing so with less intensity than in 2011. Indeed, some return by British tourism to eastern Mediterranean destinations has begun to be seen, a trend that is not discernible so far in the case of German tourists. Both incoming foreign tourists and their overnight stays in hotels or their nominal spending performed somewhat less favourably in April on year-on-year terms than in Q1, but greater dynamism was evident in May. Box 4 presents a tool for predicting tourist flows on the basis of Internet searches. Regarding other services, exports remained favourable in Q2 thanks to the sound performance of transport and of services to businesses.

On Customs data, goods imports in real terms fell 7.7% year-on-year in April and May, a somewhat greater decline than that recorded in Q1. In terms of groups of goods, the steeper decline in purchases of capital and consumer goods was notable. By contrast, the rate of decline of real services imports is expected to have eased in Q2, owing both to tourist expenditure and to purchases of other services.

4.2 Output and employment

During 2012 Q2, market-economy gross value added fell once again, placing its quarter-on-quarter rate of change at -0.3%. According to the quantitative indicators available, the rate of decline in the industrial sectors edged up slightly due largely to the progressive loss of momentum in foreign orders. In terms of broad economic category, the production of consumer goods and capital goods performed somewhat more favourably in Q1, while there was some worsening in energy and intermediate goods. Most market services indicators also evidenced a slight worsening relative to the previous quarter. The indicator of services sector activity fell back notably in April and May, largely influenced by developments in retail and wholesale trade. Likewise, opinion-based surveys revealed a downturn in activity over Q2 as a whole.

Turning to the labour market, developments in economic activity in Q2 meant the continuation of the process of net job destruction. The latest EPA data available are for Q1. According to these figures, employment fell in this period at a year-on-year rate of 4%, against -3.3% in 2011 Q4. This decline ran in parallel to that shown by QNA employment figures, as can be seen in Chart 18. By sector of activity, the downturn in employment was across the board, with the exception of industry, where the rate of decline

The popularity of the Internet has changed a large number of our daily activities, spanning a wide range of areas from reading newspapers to buying goods and services and, under this latter heading, the search for information on tourism services, and the booking of such services. Since 2009, the European Commission has annually compiled a survey that draws together detailed information on Europeans' travel habits and customs.[1] According to this survey, Internet has become the second biggest source of information – after recommendations by other people – for organising and booking trips.

The recording of tourism-related Internet searches enables an indicator to be compiled of consumers' interest in travelling to a specific location. This Box constructs a specific indicator of Internet searches by non-residents in relation to the preparation of holidays in Spain. The indicator compiled seeks to proxy the number of tourist inflows into Spain (which, along with the number of overnight stays by each of them, is one of the most significant indicators for estimating real exports of tourism services).

The potential volume of information is huge, meaning an instrument is needed to allow such information to be systematised. Specifically, use is made here of "Google Insight for Search" (GIS), a statistical tool developed by Google which broadly allows searches by consumers in different markets to be analysed. The analysis in this Box is part of the avenue of research initiated by Choi and Varian in 2009[2], who analyse how GIS helps improve the short-term predictions of sales of goods and services in different areas (retail trade, cars, travel and the real estate market). The strategy pursued in each of these applications is as follows:

— Adjust the best possible forecasting model using conventional statistics, including the lagged endogenous variable (hereafter model 0).

— Add the search indices (the so-called "G-indices") as an additional expansion variable (hereafter model 1).

— Assess the improvement in predictions through a standard instrument: the mean absolute error (MAE) or the mean square error (MSE) of the out-of-sample predictions of both models.

The result of the application of this strategy to the case of foreign tourist inflows into Spain is a substantial improvement in the predictive power of the models available when tourist information searches are included, searches which, moreover, are made in many cases several weeks or months prior to the trip being taken.

The indicator constructed only considers tourists from the United Kingdom, Germany and France, the three main clients of the Spanish tourism industry. Overall, these three countries account for 60% of the foreign tourists in Spain, and their tourism pattern is very similar to that of the aggregate of total foreign tourists (see Chart 1).[3] By way of example, Chart 2 compares tourist inflows from the United Kingdom with Internet searches for terms relating to holidays in Spain made from this country.[4] The profile of the series is not very different, partly because of the strong seasonal component of the tourism series, with the biggest inflows of visitors in the summer months. In any event, Internet searches can be seen to lead tourist inflows to some extent.[5]

In step with the broad strategy described above, two models have been estimated for each of the three countries of origin of the tourists: the best ARIMA model estimated by TRAMO (model 0) and a model augmented with the G-index relating to searches made from that country (model 1).[6] In all instances, model 1 appreciably improves the univariate models. The reduction in the MSE of the out-of-sample forecasts in the models relating to British, German and French tourist flows is 12% in the first two cases and 44% in the third, when the G-index is included.

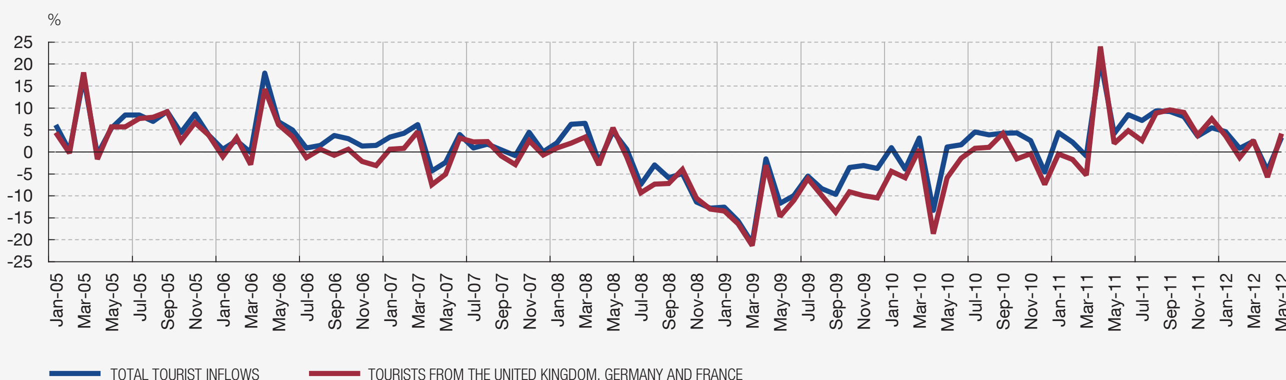
The improvement in the forecast of the total aggregate of tourists when the G-indices are incorporated as a regressor becomes patent in Chart 3, where one-period-ahead forecasting errors are compared. The benchmark model is that used currently to predict the inflow of tourists (model 0). The alternative estimate is obtained from a simple aggregation of the estimates of model 1 for each country of origin of the tourists. The mean absolute error (MAE) for model 0 in the out-of-sample period running from January 2011 to April 2012 is 3.8%, while the MAE for the aggregate of models 1 is 2.2%.

These G-indices are, therefore, useful for making economic forecasts. In the short run, with the model that incorporates the G-indices (model 1), the estimate would be for the figure of tourist inflows in 2012 Q3 to be similar to that of the previous year, a forecast that is somewhat lower than that which would result from a simple univariate model, which would anticipate a slight year-on-year increase.

1 "Survey on the attitudes of Europeans towards tourism".
2 H. Choi and H. Varian (2009), *Predicting the present with global trends* and *Predicting initial claims for unemployment benefits,* Google Research Blog.

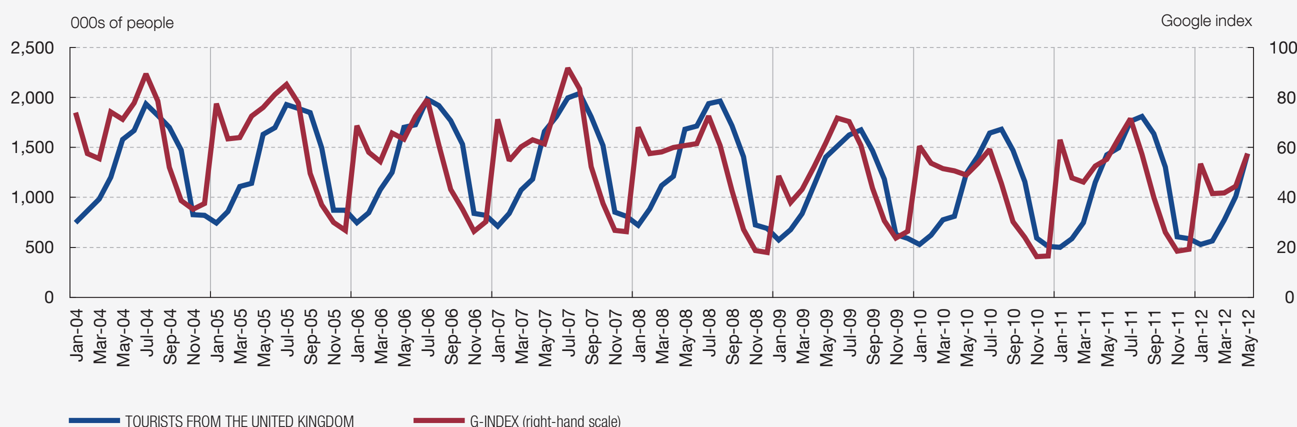
3 Specifically, the correlation between total tourists and tourists from the United Kingdom, Germany and France is very close to unity, without this being merely the reflection of similar seasonal behaviour, since the correlation between year-on-year rates is likewise very high.
4 The search terms used were "Spain holiday", "Spanien Urlaub" and "Vacances Espagne" for searches by residents in the United Kingdom, Germany and France, respectively. Tests have likewise been made with other terms relating to leisure trips to Spain and the results are very similar (see C. Artola and E. Galán, *Tracking the future on the web: construction of leading indicators using Internet searches,* Occasional Papers, no. 1203, Banco de España).
5 In addition to this lead, a rise in searches in January each year can be observed, despite the fact that in that month, and those immediately preceding it, tourist inflows are low. However, searches for holidays are relatively numerous in January, which probably reflects new plans being made as the year begins.
6 In all instances, a model that included as regressors the G-indicator with up to six lags was initially estimated. The final models only included the lags that were significant.

1 TOURIST INFLOWS INTO SPAIN
(year-on-year rates)



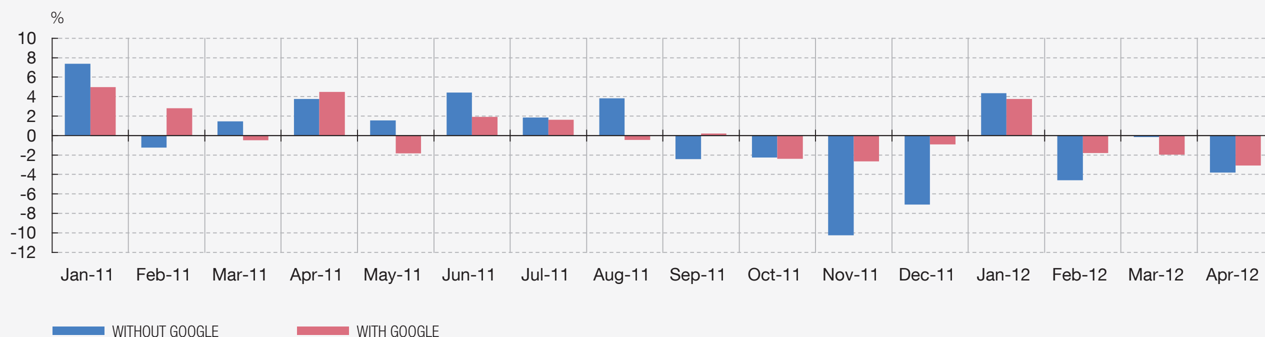
SOURCE: Instituto de Estudios Turísticos.

2 TOURIST INFLOWS INTO SPAIN AND GOOGLE SEARCHES
TOURISTS FROM THE UNITED KINGDOM



SOURCES: Instituto de Estudios Turísticos and Google Insights for Search.

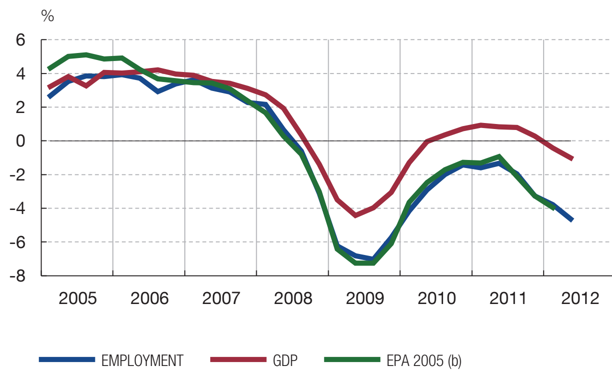
3 ONE-PERIOD-AHEAD FORECASTING ERRORS



SOURCES Instituto de Estudios Turísticos, Google Insights for Search and Banco de España.

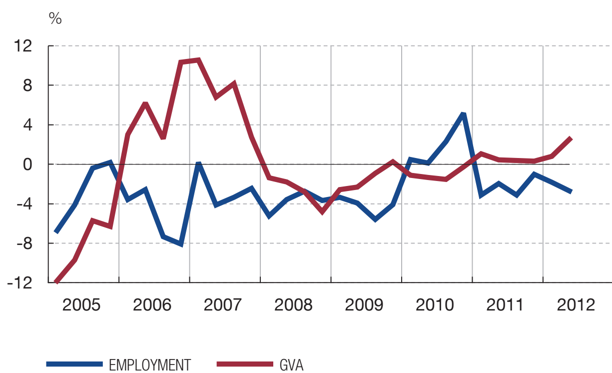
GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 18

WHOLE ECONOMY

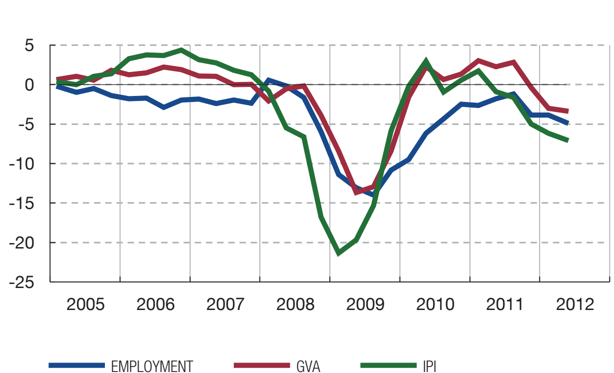


WHOLE ECONOMY (c)

AGRICULTURE



INDUSTRY AND ENERGY



CONSTRUCTION

MARKET SERVICES

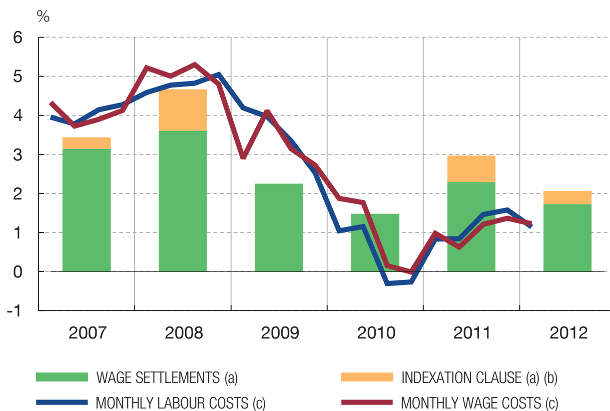
SOURCES: INE and Banco de España.

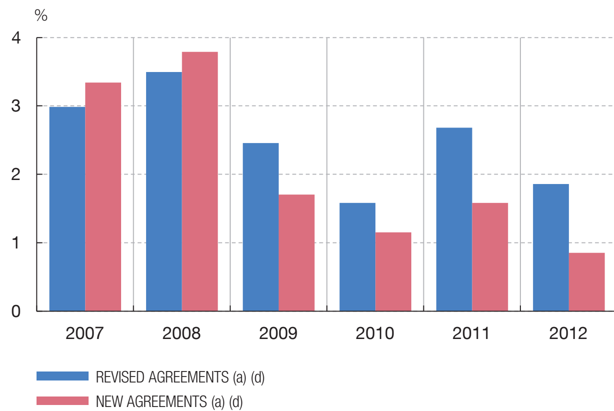
a Year-on-year rates based on seasonally adjusted series, except gross series in EPA. . Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b Series linked by the DG Economics, Statistics and Research on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

eased. Further, there was a notable reduction in employment in non-market services. As the labour force remained stable, the fall in employment passed through in full to an increase in the unemployment rate, which rose to 24.4% in Q1, 1.6 pp up on end-2011. As to labour market developments in Q2, Social Security registrations continued to evidence the decline in employment, posting a year-on-year rate of -3.2%, 0.6 pp high-

WAGE AND LABOUR COSTS INDICATORS

CHART 19





SOURCES: INE and Ministerio de Empleo y Seguridad Social.

a The latest year takes information from collective bargaining agreements to June 2012.
b Previous year's indexation clause.
c Quarterly labour costs survey. Year-on-year rates of change.
d Revised: agreements with economic effects for the current year, but which were entered into in previous years, and are in force for more than one year. New: agreements entered into during the year with economic effects in the same year, this being the same or only year in which they are applicable.

er than in Q1. The quarter-on-quarter decline in seasonally adjusted terms was of the same order as in 2012 Q1 (-0.9%). The steepening of the year-on-year declines in registrations was across the board, this being the first quarter in which registrations in non-market services[3] have posted a negative rate (-1.3%) since homogeneous series have been in place. Construction continued to show the highest rates of decline (-17.3%), followed by industry (-5.2%), with more modest figures in agriculture (-1%) and in total services (-1.6%). Significantly, however, a lower decline was observed in June, owing to favourable developments in the services sector, affected in part by the end of the deadline to comply with the new domestic service regulations. The trend in registrations in Q2 would be consistent with a further weakening in employment in year-on-year terms.

The National Public Employment Service figures on the contraction in employment set the year-on-year fall at -4.8% in Q2, 3 pp milder than the decline in the previous period. On this occasion, the fall in both temporary and permanent contracts eased, albeit somewhat more sharply in the latter case, whereby the weight of this employment modality in total hires stood at 8%. Within this group, the sizeable growth in initial ordinary contracts of employment was notable, including the new small business contract[4], approved in February this year by Royal Decree-Law 3/2012, although itemised information enabling a more detailed assessment of its use by companies is not available.

Lastly, registered unemployment stood at a year-on-year rate of 11.9% in Q2 (more than 2 pp up on Q1), although a significant decline was witnessed in June (of 99,000 people compared with May). These changes in registrations and in registered unemployment appear to indicate that the unemployment rate might stabilise in 2012 Q2.

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3 Aggregation of the sections of General Government and of Defence, Education and Health under the general and self-employed regimes.

4 Aimed at small and medium-sized enterprises, with different tax incentives and rebates. Its sole difference from the ordinary contract of employment is that it has a one-year trial period.

WAGES 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.

4.3 Costs and prices

Against a background of major collective bargaining delays, the agreements registered between January and June 2012 showed a cumulative increase in wage rates of 1.7%, 0.4 pp less than the figure to March. Recent months have seen the first significant progress in newly signed collective bargaining agreements (2012 is the first year these will be in force), for which wage increases of 0.85% have been agreed (see Chart 19). This figure draws closer to the wage recommendations of the II Agreement for Employment and Collective Bargaining 2012-2014 (AENC), signed in January 2012. However, most wage-earners with agreements concluded for this year (86%) are subject to revised agreements, i.e. multi-year agreements entered into in previous years, in which settlements stand at around 1.9%. Given the delicate situation of the labour market, the social partners should step up their efforts so as to strictly fulfil the AENC wage recommendations, which should provide for a more balanced adjustment between wages and employment. In turn, intensely harnessing the greater internal flexibility possibilities contained in the labour reform would allow working conditions to be tailored to a greater extent to the economic situation of each company, thereby contributing to preserving employment and competitiveness.

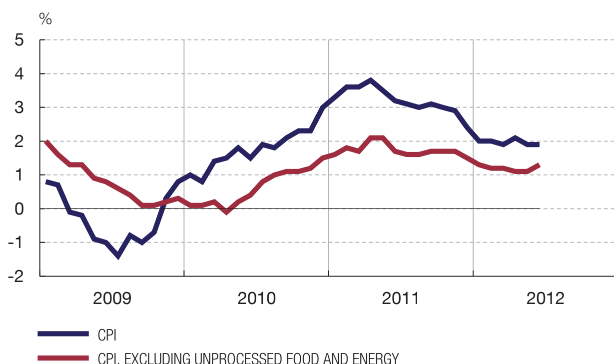
As occurred in the two previous years, both the quarterly labour costs survey and the QNA figures on compensation per employee showed more moderate wage growth rates in 2012 Q1 than those reflected in collective bargaining agreements. Moreover, in the market economy, the slowing in wage rates and the modest increase to May in average gross compensation (according to State Tax Revenue Service data relating to large corporations) suggests a further slowdown in the year-on-year growth of compensation in Q2 (see Chart 20).

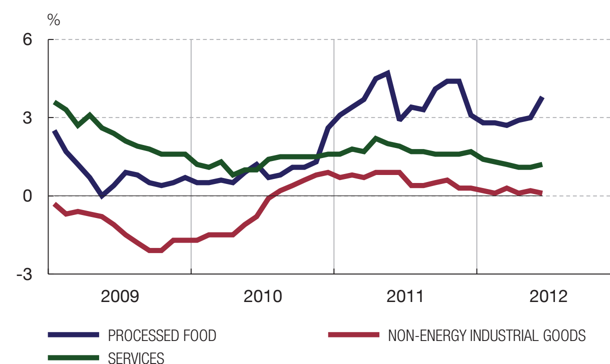
In 2012 Q2, the pace of the deflators of all demand components eased, reflecting both domestic output prices (proxied by the GDP deflator), whose rate of change is expected to have declined by 0.2 pp compared with the previous quarter, and the prices of imported goods and services, whose growth was more moderate.

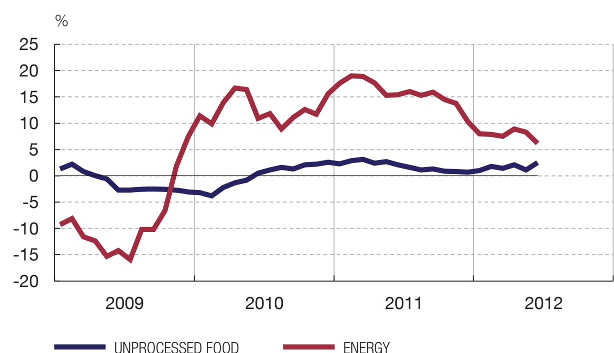
During the second quarter, the main indicators of consumer prices trended stably, in contrast to their declining trajectory in the previous months. The year-on-year rate of the CPI in June was 1.9%, unchanged on March (see Chart 21). This same period, the growth rate

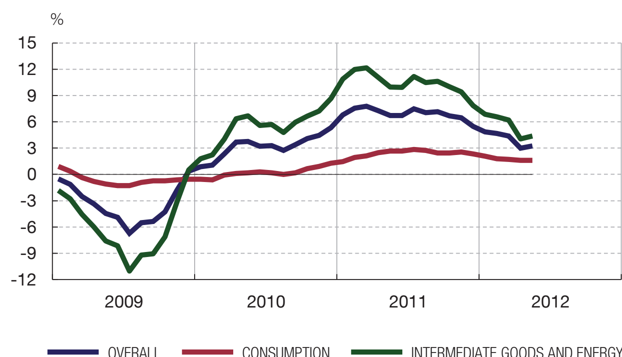
PRICE INDICATORS (a)
Spain

CHART 21









SOURCE: INE.

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

of the CPI excluding energy and unprocessed food prices was 1.3%, 0.1 pp up on the related rate at the end of Q1. Notable among the components of this index is the higher growth rate of processed food prices, which stood at 3.8% in June, 1.1 pp up on March. This is partly due to the increase in the duties on tobacco. The rate of increase of prices of non-energy and industrial goods dipped by 0.2 pp. The year-on-year rate of change in services prices held stable during the quarter at 1.2%, despite the increases in regulated transport prices. The energy component of the CPI slowed somewhat, against the background of lower crude oil prices on international markets, as a result of which its growth rate compared with March fell by 1.3 pp to 6.2%. Finally, the rate of change of unprocessed food prices continued to fluctuate strongly during Q2.

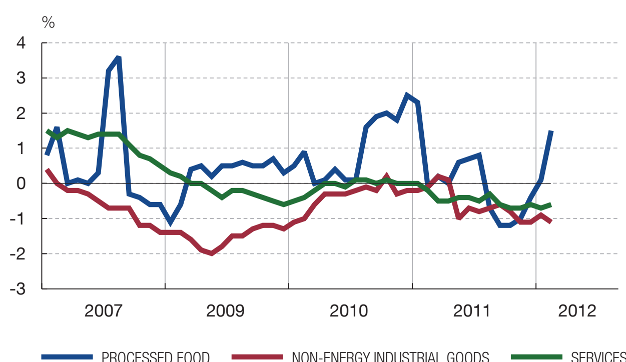
In the first half of 2012, inflation measured by the harmonised index of consumer prices (HICP) continued to be lower in Spain and in the euro area, although the difference narrowed slightly in Q2. Specifically, Spanish inflation in June was 0.6 pp lower than that of the euro area (see Chart 22). The prices of energy products moved from a negative difference of -1 pp in March to 0.9 pp in June, owing to the rise in regulated prices in Spain. The difference in terms of the CPI excluding energy and unprocessed food prices was negative in June (-0.5 pp) as a result of the differences in services (-0.6 pp) and non-energy industrial goods (-1.1 pp), while in the case of processed food prices the difference was positive (1.5 pp).

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

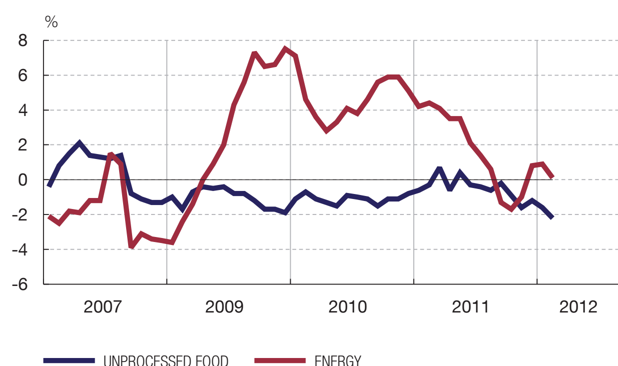
CHART 22

HARMONISED INDEX OF CONSUMER PRICES

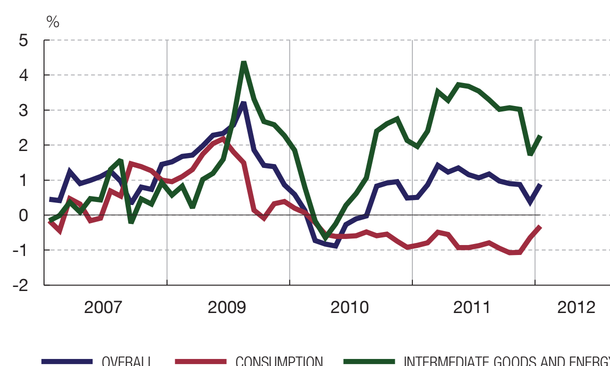
HARMONISED INDEX OF CONSUMER PRICES



HARMONISED INDEX OF CONSUMER PRICES



INDUSTRIAL GOODS INDEX



SOURCES: Eurostat and Banco de España.

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

The producer price index continued to ease in Q2, posting a year-on-year rate of 3.2% in May, 1.2 pp down on March. This slowdown mirrored the deceleration in prices of energy products, since the pace of the non-energy component held stable during the quarter. The growth rate of the price indices of industrial product imports and exports likewise fell, posting respective year-on-year rates of 3.8% and 2.3% in May.

4.4 The State budget

At its meeting on 10 July 2012, the Ecofin analysed Spain's excessive deficit procedure and, having regard to the deterioration of the economic situation, it decided to extend by one year, to 2014, the deadline for the correction of the excessive budget deficit. As a result, the new path of targets for the general government deficit/GDP ratio will be 6.3%, 4.5% and 2.8% in 2012, 2013 and 2014, respectively (compared with the targets of 5.3%, 3% and 2.2% of GDP for these years set under the Stability Programme published in April). In order to strengthen the credibility of these objectives, the EU Council requested that the Spanish government adopt, before the end of July, a budgetary plan spanning 2013 and 2014. In addition, the Council's recommendations include: a structural fiscal drive over the period 2010-2013 amounting to at least 1.5% of GDP in annual average terms; the strict application of the fiscal plans under way at all levels of general government, and of the provisions of the new budgetary stability law relating to data transparency and to the control of the budgets of all tiers of government; the creation of an independent budgetary institution to analyse, advise on and supervise budg-

GENERAL GOVERNMENT. NON-FINANCIAL ACCOUNT IN NATIONAL ACCOUNTS TERMS

TABLE 4

€m and %

	Outturn 2011	Percentage change 2011/2010	Stability Programme 2012	Percentage change 2012/2011	Outturn 2011 Jan-Mar	Outturn 2012 Jan-Mar	Outturn Percentage change 2012/2011
	1	2	3	4=3/1	5	6	7=6/5
1 Total resources	377,085	**-1.1**	386,911	2.6	88,702	85,783	**-3.3**
Current resources	378,391	**-0.8**	--	--	90,829	88,796	**-2.2**
Taxes on output and imports	104,971	**-3.4**	104,455	**-0.5**	28,659	26,863	**-6.3**
Income and wealth taxes	101,610	1.9	112,982	11.2	20,812	21,445	3.0
Social Security contributions	139,868	**-0.2**	140,695	0.6	34,166	33,299	**-2.5**
Other	31,942	**-2.4**	--	--	7,192	7,189	**-0.0**
Capital resources	**-1,306**	—	--	--	**-2,127**	**-3,013**	**-41.7**
2 Total uses	468,505	**-2.3**	443,402	**-5.4**	103,188	100,429	**-2.7**
Current uses	429,216	0.5	--	--	93,830	94,380	0.6
Employee compensation	122,926	**-1.5**	116,180	**-5.5**	26,862	26,617	**-0.9**
Other final consumption spending (a)	88,315	**-3.3**	77,808	**-11.9**	18,329	16,364	**-10.7**
Social benefits (not in kind)	163,486	1.6	169,473	3.7	35,570	37,073	4.2
Actual interest paid	25,867	28.6	33,042	27.7	6,010	7,240	20.5
Subsidies	11,325	**-6.8**	9,593	**-15.3**	2,388	2,247	**-5.9**
Other uses and current transfers	17,297	**-1.8**	--	--	4,671	4,839	3.6
Capital uses	39,289	**-25.4**	--	--	9,358	6,049	**-35.4**
Gross capital formation	28,700	**-30.3**	18,120	**-36.9**	7,824	5,065	**-35.3**
Other capital spending (b)	10,589	**-7.6**	--	--	1,534	984	**-35.9**
3 Net lending (+)/borrowing (–) (3 = 1 – 2)	**-91,420**	6.9	**-56,491**	38.2	**-14,486**	**-14,646**	**-1.1**
(% of nominal GDP)	**-8.5**		**-5.3**		**-5.5**	**-5.6**	
MEMORANDUM ITEM							
Primary balance	**-65,553**	16.1	**-23,449**	64.2	**-8,476**	**-7,406**	12.6
Final consumption spending	217,675	**-1.8**	201,449	**-7.5**	261,657	261,913	0.1

SOURCE: Ministerio de Hacienda y Administraciones Públicas.

a Includes imports, social transfers in kind purchased on the market and other taxes on production. Excludes fixed capital consumption, market production (residual sales) and payments for other market production.
b Includes net acquisition of non-produced non-financial assets (K2).

etary policy; the implementation of measures to enhance the efficiency of public spending; the definition of the sustainability factor envisaged in the latest pension system reform and, finally, the assignment of greater weight to indirect as opposed to direct taxation and the scaling back of the existing favourable tax treatment for house purchases.

Against this background, the Council of Ministers approved on 13 July a new package of adjustment measures. These include the rise from 1 September in the standard and reduced rates for VAT from 18% and 8% to 21% and 10%, respectively; a 1 pp reduction in social security contributions in both 2013 and 2014; a reduction from 60% to 50% in the amount of unemployment benefit as from the sixth month for new recipients; the elimination of the extra monthly payment in December for civil servants at all levels of general government in 2012; the elimination of the tax deduction for house purchase as from 2013; and a further cut to ministerial spending. The Government expects that this set of measures will provide for an improvement of €13.5 billion in the general government balance in 2012.

These measures seek to counter the risks of slippage from the budget target seen in the first half of the year. In this respect, on the latest available National Accounts budg-

SOCIAL SECURITY SYSTEM BUDGET OUTTURN

TABLE 5

€m and %

	Outturn 2011	Percentage change 2011/2010	Initital budget 2012	Percentage change 2011/2010	Outturn		
					2011 Jan-May	2012 Jan-May	Percentage change
	1	2	3	4 = 3 /1	5	6	7 = 6 / 5
1 Non-financial revenue	117,965	-0.4	119,883	1.6	49,398	31,581	-36.1
Social security contributions	106,229	-0.4	107,725	1.4	44,047	26,174	-40.6
Current transfers	8,337	-3.9	8,930	7.1	4,029	4,475	11.1
Other revenue	3,399	8.0	3,228	-5.0	1,322	932	-29.5
2 Non-financial expenditure	118,495	2.2	119,882	1.2	41,850	25,425	-39.2
Wages and salaries	2,357	-2.1	2,358	0.0	916	505	-44.9
Goods and services	1,560	-8.8	1,541	-1.2	602	289	-51.9
Current transfers	114,304	2.5	115,683	1.2	40,281	24,611	-38.9
Contributory pensions	99,528	4.0	101,954	2.4	35,271	22,018	-37.6
Sickness	6,295	-8.0	5,799	-7.9	1,614	593	-63.2
Other	8,481	-5.4	7,930	-6.5	3,396	2,000	-41.1
Other expenditure	274	-24.6	300	9.4	50	20	-60.2
3 Balance (3 = 1 – 2)	-530	—	1	—	7,548	6,156	—

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

et outturn figures, the overall general government sector posted a deficit of €14.6 billion in 2012 Q1, slightly up on the figure recorded in the same period a year earlier (see Table 4). In cumulated four-quarter terms, the budget deficit scarcely improved since it stood at 8.5% of GDP, compared with 8.9% in 2011. Developments in Q1 were particularly conditioned by the sluggishness of revenue: total revenue declined in this period by 3.3% year-on-year, compared with the official growth forecast of 2.6% for the year as a whole set in the Stability Programme. Public spending fell by 2.7%, thanks to the significant declines in capital expenditure and in non-wage final consumption spending.

Regarding 2012 Q2, only partial data for April and May are available. This information includes, for the general government sector as a whole, that relating to taxes shared by the State and the regional governments; and for the State and the Social Security system, the data on the budget outturn (see Tables 5 and 6). Under the shared taxes, there were notably negative rates in revenue for VAT and for excise duties, in cash-basis terms, with cumulative declines from January to May of 10.1% and 2.8%, respectively. The increase in VAT rates, to take effect from 1 September, should allow revenue to pick up to the extent of meeting budgetary targets. In relation to direct taxes, personal income tax revenue continued to quicken in Q2, reflecting the impact of the rise in rates approved in December 2011. Corporate income tax revenue fell by 8% to May; however, once adjusted for certain transitory effects, some recovery should also be seen in the following months. Finally, revenue relating to Social Security contributions remained very slack in cash-basis terms, mirroring wage and employment developments, and posted a year-on-year decline of 1.1% in the January-May period.

Turning to expenditure, the information on public works procurement, to May, reveals a continuation of the substantial adjustment in public investment. Under the current ex-

STATE BUDGET OUTTURN

TABLE 6

EUR m and %

	Outturn 2011	Percentage change 2011/2010	Initial budget 2012	Percentage change 2011/2010	2011 Jan-May	2012 Jan-May	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 Non-financial revenue	104,145	-18.2	119,233	14.5	44,606	45,923	3.0
Direct taxes	53,382	-9.9	54,846	2.7	19,808	20,285	2.4
Personal income tax	33,545	-14.7	29,232	-12.9	14,447	15,597	8.0
Corporate income tax	16,611	2.5	19,564	17.8	3,883	3,572	-8.0
Other (a)	3,227	-13.7	6,050	87.5	1,479	1,116	-24.6
Indirect taxes	34,644	-33.2	21,095	-39.1	18,949	16,707	-11.8
VAT	25,355	-34.1	13,633	-46.2	15,285	13,227	-13.5
Excise duties	6,325	-38.8	4,502	-28.8	2,410	2,221	-7.9
Other indirect (b)	2,965	-1.2	2,960	-0.2	1,254	1,260	0.4
Other revenue (c)	16,118	-0.8	43,292	168.6	5,849	8,930	52.7
2 Non-financial expenditure	151,095	-15.9	152,630	1.0	58,688	65,716	12.0
Wages and salaries	27,420	1.7	27,339	-0.3	9,998	10,139	1.4
Goods and services	4,319	-6.8	3,238	-25.0	1,505	1,044	-30.7
Interest payments	22,204	13.1	28,876	30.0	8,757	11,555	32.0
Current transfers	79,892	-23.7	80,498	0.8	31,109	39,553	27.1
Contingency fund	—	—	2,377	—	—	—	—
Investment	6,895	-21.5	5,280	-23.4	3,028	1,941	-35.9
Capital transfers	10,365	-30.4	5,022	-51.5	4,291	1,485	-65.4
3 Cash-basis balance (3 = 1 – 2)	-46,950	—	-33,397	—	-14,082	-19,793	
MEMORANDUM ITEM: total taxes (State plus share of regional and local governments)							
TOTAL	**138,079**	**1.7**	**139,223**	**-10.0**	**62,898**	**60,372**	**-4.0**
Personal income tax	69,803	4.2	73,106	4.7	29,881	30,124	0.8
VAT	49,302	0.5	47,691	-3.3	25,339	22,782	-10.1
Excise duties	18,974	-4.2	18,426	-2.9	7,678	7,466	-2.8

SOURCE: Ministerio de Hacienda y Administraciones Públicas.

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

penditure heading, National Accounts figures on State spending on goods and services consumption to May indicate that the adjustment had been deepened, which is also apparent in the regional government accounts for Q1 (see Table 7). Under the wage expenditure heading, in contrast, the information for the State in the period to May does not appear to be in line with the contraction budgeted for the year as a whole. As to social benefits, on the latest cash-basis information drawn from the Social Security system and the National Public Employment Service, spending on contributory benefits held in cumulative terms to May at a year-on-year rate of increase close to 4.5%, up on the figure budgeted for 2012 as a whole (2.4%), whereas unemployment benefit payments quickened. Finally, the overall general government debt burden rose in Q2 affected not only by the maintenance of high financing requirements by all agents in the sector, but also by the increase in funding costs. The only information available in National Accounts terms refers to the State, which shows that interest payments grew by 18% to May.

REGIONAL GOVERNMENT BUDGET OUTTURN

TABLE 7

€m and %

	Outturn 2011	Percentage change 2011/2010	Initial budget 2012	Percentage change 2012/2011	Outturn		
					2012 Jan-Mar	2012 Jan-Mar	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	126,110	-6.1	137,004	8.6	29,536	32,517	10.1
Current revenue	120,457	-5.3	129,054	7.1	28,845	31,947	10.8
Direct taxes	39,873	35.3	38,740	-2.8	10,178	9,649	-5.2
Indirect taxes	46,882	39.0	50,765	8.3	11,983	11,080	-7.5
Charges, prices and other revenue	4,769	-14.1	4,578	-4.0	1,087	944	-13.2
Current transfers	28,228	-51.3	34,159	21.0	5,456	10,179	86.6
Interest and dividends	705	70.7	811	15.0	140	95	-32.4
Capital	5,653	-21.3	7,950	40.6	691	570	-17.5
Disposal of investments	178	-38.1	1,546	769.9	52	37	-30.0
Capital transfers	5,475	-20.6	6,404	17.0	639	533	-16.5
2 EXPENDITURE	150,211	-4.4	150,654	0.3	34,531	31,722	-8.1
Current expenditure	132,490	-1.7	131,187	-1.0	31,481	29,582	-6.0
Wages and salaries	57,377	-2.4	56,219	-2.0	12,719	12,583	-1.1
Goods and services	27,344	-2.4	26,931	-1.5	6,867	5,994	-12.7
Interest payments	4,555	51.9	6,381	40.1	932	1,193	28.0
Current transfers	43,213	-4.0	41,287	-4.5	10,962	9,811	-10.5
Contingency fund	—	—	369		—	—	—
Capital	17,721	-20.8	19,466	9.8	3,050	2,141	-29.8
Investment	7,661	-20.9	8,708	13.7	1,524	1,066	-30.0
Capital transfers	10,060	-20.7	10,758	6.9	1,526	1,074	-29.6
3 BALANCE (3 = 1 – 2)	-24,101	—	-13,649	—	-4,995	795	—

SOURCES: Ministerio de Hacienda y Administraciones Públicas, Regional Governments and Banco de España.

In sum, the budget outturn data observed in the year to date pointed to the presence of considerable risks to the budget targets set for 2012 as a whole being met. The risks stemmed, in particular, from the weakness of public revenue, although they have been addressed with the approval in July of the significant measures adopted. In any event, meeting the targets will require a very strict outturn on the part of all levels of government and stringent implementation of adjustment plans.

4.5 Current and capital account balances

The ongoing correction of the Spanish economy's external imbalance has continued in the first half of the year. Specifically, in the first four months of 2012, the overall deficit on current and capital accounts was €15.1 billion, 16% down on the same period a year earlier (see Table 8). This improvement is essentially due to the decline in the trade deficit and the widening of the surplus on services, which offset the deterioration in the income and current transfers balances. The capital account surplus fell over this same period.

The trade deficit decreased by 18.5% in the first four months of 2012 to €11.9 billion. This was due to the improvement in its non-energy component which, on Customs data, posted a surplus, more than offsetting the increase in the energy bill. Further, the surplus on the services balance widened to €8.5 billion, 31% up on the figure for the first four months of 2011, thanks to the improvement in non-tourism services, the balance of which moved into surplus, and to the widening of the surplus on the tourism balance. Conversely, the

BALANCE OF PAYMENTS: CURRENT AND CAPITAL ACCOUNTS (a) TABLE 8

EUR m

		January-April		Rate of change 2012/2011(b)
		2011	2012	
Credits	Current account	116,831	121,208	3.7
	Goods	72,715	74,897	3.0
	Services	28,302	30,047	6.2
	Tourism	10,418	10,340	-0.7
	Other services	17,885	19,707	10.2
	Income	11,324	11,158	-1.5
	Current transfers	4,489	5,106	13.8
	Capital account	2,259	1,391	-38.4
	Current + capital accounts	119,089	122,599	2.9
Debits	Current account	136,661	137,330	0.5
	Goods	87,265	86,757	-0.6
	Services	21,768	21,500	-1.2
	Tourism	3,527	3,389	-3.9
	Other services	18,242	18,111	-0.7
	Income	18,551	19,168	3.3
	Current transfers	9,078	9,906	9.1
	Capital account	412	391	-4.9
	Current + capital accounts	137,073	137,722	0.5
Balances	Current account	-19,831	-16,123	3,708
	Goods	-14,549	-11,860	2,689
	Services	6,534	8,547	2,013
	Tourism	6,891	6,951	60
	Other services	-357	1,596	1,953
	Income	-7,227	-8,010	-783
	Current transfers	-4,589	-4,800	-211
	Capital account	1,847	1,000	-847
	Current + capital accounts	-17,984	-15,123	2,861

SOURCE: Banco de España.

a Provisional data.
b Absolute changes for balances.

income deficit widened to €1 billion, owing to the increase in net interest payments, while the deficit on the balance of current transfers increased slightly to €4.8 billion.

5.1 Highlights

The relatively stable situation on financial markets during 2012 Q1 gave way in Q2, especially from May, to a situation of severe tensions which has been manifest in increases in the risk premia on fixed-income securities issued by resident sectors and in declines in stock market indices. These developments were accompanied, furthermore, by downgrades in the credit ratings of public and private debt (particularly, that of financial institutions). Several factors have contributed to the worsening of the tensions, including most notably political uncertainty in Greece and investors' concern about Spanish public finances and the situation of its financial system. Against this backdrop, on 9 June the Spanish government announced its intention to request financial assistance from the European institutions in order to recapitalise the weakest banks, and on 21 June the reports of two independent consultancies – engaged by the Spanish authorities – were published. In these reports the Spanish banking system's capital requirements in an adverse macroeconomic scenario were estimated to be between €51 billion and €62 billion. The request for aid, which was formalised on 25 June, has the backing of the Eurogroup, which has agreed to grant up to €100 billion of funds. Once the single banking supervisor has been set up, in which connection important steps were taken at the meeting of the European Council on 29 June (see Box 2), the funds may be given directly to the banks that need them without them having to be channelled through the Spanish State. In the meantime, they will be channelled through the FROB. Into July, the Spanish government has adopted a broad set of measures aimed at guaranteeing compliance with its fiscal commitments and the ECB has cut its key interest rate by 25 bp to 0.75%. Despite these developments and the outcome of the Greek elections (in which a majority was obtained by parties in favour of observing the agreements governing Greece's financial assistance programme), tensions continue to mark financial markets' behaviour at the cut-off date for this article.

On the secondary bond markets, the yield on Spanish government bonds and the spread over German bonds increased. Thus, the interest rates on 10-year bonds rose by 113 bp with respect to end-March to 6.55%, and at specific junctures they had reached values of close to 7.2%, the highest recorded since the euro area was created. The spread over the German Bund also rose and even breached 570 bp mid-June, before falling back to 495 bp at the end of that month (see Chart 23). The premia on credit derivatives on securities issued by the private sector, both by financial and non-financial corporations, also rose. On the stock markets, the IBEX 35 dropped 16.4% during the same period, compared with the decline of 11.3% in the EUROSTOXX 50 and that of 3.6% in the S&P 500. On the interbank market, interest rates continued to fall at all terms. The one-year EURIBOR shed 20 bp, while the spread with the EUREPO (the cost of secured transactions) at the same term stood at 110 bp compared with 125 bp at the end of the previous quarter, showing that the tensions have not affected these markets in this quarter.

In July to date the financial tensions have continued, resulting in high volatility in 10-year government bond yields and in their spread over the German Bund, which stood at the cut-off date for this report[5] at levels above those recorded at end-June (around 7% and 575 bp, respectively). On the stock markets, the IBEX 35 posted a decline of 7.2%, while the EUROSTOXX 50 and the S&P 500 rose slightly by 0.9% and 0.8%, respectively.

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5 18 July.

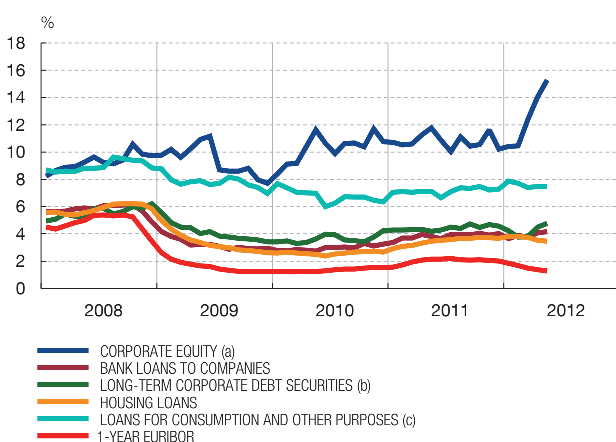
FINANCING CONDITIONS AND ASSET PRICES

CHART 23

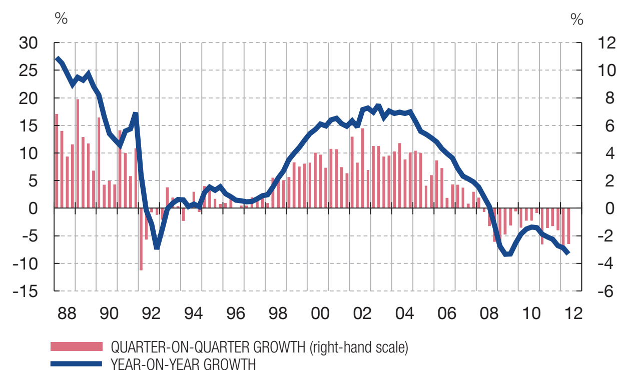
STOCK MARKET INDICES

10-YEAR GOVERNMENT BONDS

COST OF FINANCING



PRICE PER SQUARE METRE OF APPRAISED HOUSING (d)



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

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

In the real estate market, on the latest data published by the Ministry of Infrastructure and Transport, the decline in open-market housing prices continued during 2012 Q2. Thus, the year-on-year rate of decline stood at 8.3% in June, compared with 7.2% in March (see Chart 23). In quarter-on-quarter terms, however, the fall recorded at end-June (2.6%) was slightly lower than in the previous quarter (3.1%).

The latest available information on private-sector financing costs, which relates to May, shows that the recent decrease in interbank market interest rates has still not passed through to the interest rates on household and corporate loans. The latter rose with respect to March, except in the case of house purchase loans, which is reflected in a widening of the spreads over the market rates traditionally used as a benchmark. The evidence available indicates that the financial tensions are likely to have prompted a widening of these spreads in recent quarters, due to the resulting increase in banks' cost of borrowing (see Box 5). The ongoing uncertainty and its negative effects on po-

Since 2010, the cost of financing for credit institutions has risen notably, partly further to the euro area sovereign debt crisis. In line with this rise, financial institutions have increased the interest rates they apply to lending operations with households and firms.

As can be seen in the first four panels of the accompanying graphics, the variable interest rates applied to new lending business with households and non-financial corporations[1] have moved on a rising path since mid-2010. This has been more marked in those lending segments entailing higher risk (consumer loans and loans for other purposes, and, in the case of firms, loans for less than €1 million, no doubt more to small and medium-sized enterprises than to major corporations). It was these segments too which, compared with the euro area, showed the most marked cumulative increase in bank financing costs. Thus the increases in the interest rates on consumer loans and loans for other purposes, and on those extended to firms for up to €1 million, were respectively around 1 pp and 80 bp bigger in Spain. In the other two cases, the increase has also been higher in Spain, but to a lesser degree (33 bp in the case of funds intended for house purchase and 66 bp in that of loans granted to corporations for an amount of more than €1 million). The accompanying panels also show that the spreads over the benchmark market yields in each of the segments analysed have increased since early 2009, against the background of the economic downturn, which raises the risk associated with the extension of loans, and of the tensions on financial markets.

To gauge the impact that the tensions derived from the sovereign debt crisis have had on bank interest rates in Spain, equations have been estimated in which the rates are explained on the basis of their usual determinants. The specification of the equation therefore includes the EURIBOR (3- or 12-month), which is the usual benchmark for lending operations, and to which banks apply a spread which, under normal conditions, varies depending on the end-use and the amount of the loan (and, therefore, on the risk associated with granting it). However, in a setting of growing tensions, which have direct effects on bank financing costs, this spread may respond to other factors linked to the source of these tensions. To capture this impact in the equations, the difference between the Spanish 10-year government bond yield and that of its German counterpart has been added as an explanatory variable. According to the results obtained, this variable has a positive and significant impact on the interest rates applied by banks to new lending business. Specifically, in the case of interest rates associated with loans to households for house purchase and to non-financial corporations, it is estimated that a 1 pp increase in this difference results in the long run in a rise of 23 bp in the former, and of 33 bp in the latter. Part of this impact might, however, be associated with the downturn in the economic situation in this period, which has in turn contributed to the increase in the risk premium on Spanish public debt during this period of tensions on euro area financial markets.[2]

Panels 5 and 6 show the contribution, according to the estimated equations, of the various explanatory variables to the interest rate applied to new loans to households for house purchase and to non-financial corporations. As can be seen, the bulk of the changes in bank rates is attributable to movements in the benchmark market yield (the 1-year EURIBOR in the case of loans for property purchases and the 3-month EURIBOR in that of loans to firms). It can likewise be seen that, since mid-2010, the spread between the respective Spanish and German 10-year government bonds has played an increasingly bigger role in explaining bank lending rates in both instances, somewhat more so in the case of non-financial corporations.

In sum, the evidence available suggests that financial tensions have led banks to increase the interest rates they apply to their loans, in a setting in which such banks have faced higher costs in raising funds. It is estimated these tensions have played an increasing role since mid-2010 in explaining the cost of bank financing, although it is difficult to quantify the scale of this impact, isolating it from that arising from the economic downturn in recent years.

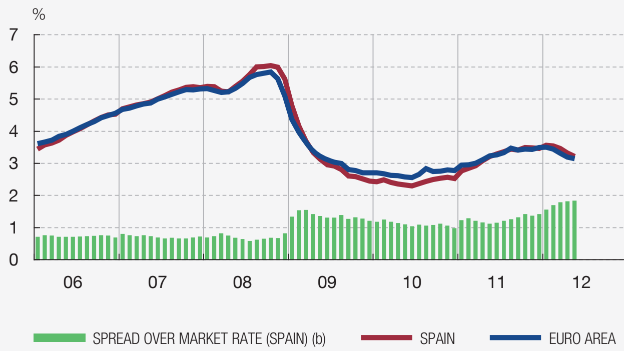
1 Variable-rate loans comprise the bulk of the financing granted to households and firms (on average, since early 2010, 73% of the financing granted to households and 92% of that extended to firms).

2 When, in the specification used to explain the changes in interest rates, the spread between the Spanish and German government debt yields and another variable relating to the business cycle – such as the unemployment rate – are concurrently added, both variables are not simultaneously significant; accordingly, the latter variable has been excluded from the estimated equation. It is likely that part of the impact that is estimated to be associated with the financial tensions is reflecting the impact derived from the downturn in the economic situation.

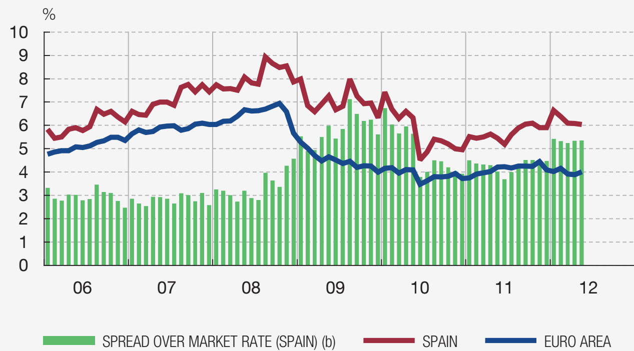
THE IMPACT OF THE TENSIONS ARISING FROM THE SOVEREIGN DEBT CRISIS ON BANK INTEREST RATES (cont'd)

BOX 5

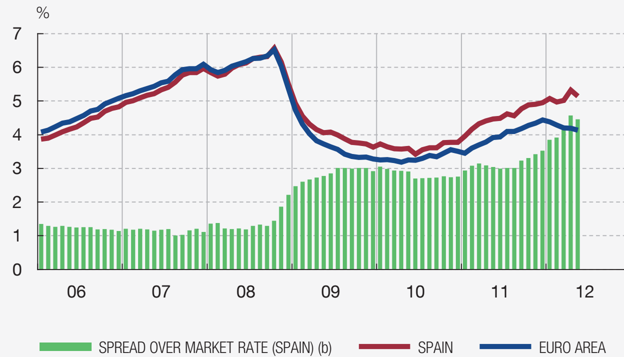
1 LENDING TO HOUSEHOLDS FOR HOUSE PURCHASE (a)



2 LENDING TO HOUSEHOLDS FOR CONSUMPTION AND OTHER PURPOSES (a)

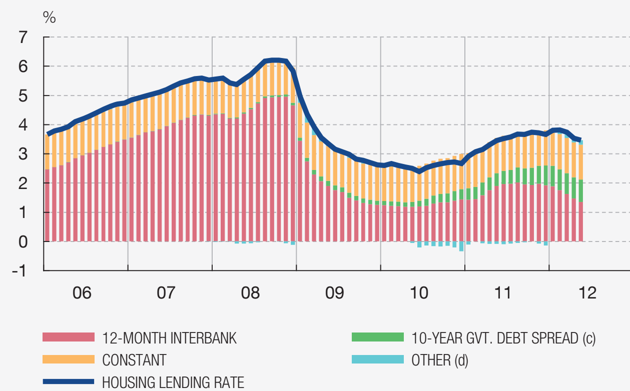


3 LENDING TO NON-FINANCIAL CORPORATIONS FOR AN AMOUNT OF LESS THAN ONE MILLION EUROS (a)

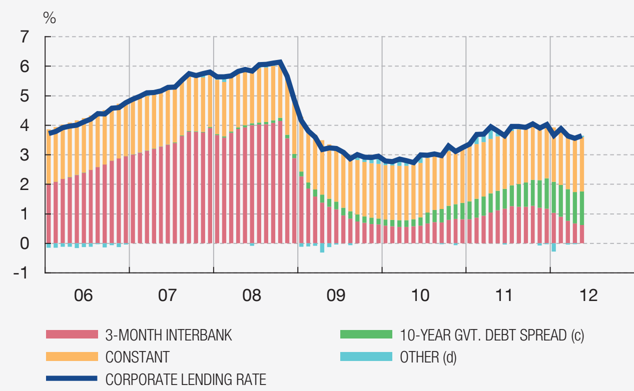


4 LENDING TO NON-FINANCIAL CORPORATIONS FOR AN AMOUNT OF MORE THAN ONE MILLION EUROS (a)

5 LENDING TO HOUSEHOLDS FOR HOUSE PURCHASE. CONTRIBUTIONS OF THE EXPLANATORY VARIABLES



6 LENDING TO NON-FINANCIAL CORPORATIONS. CONTRIBUTIONS OF THE EXPLANATORY VARIABLES



SOURCE: Banco de España.

a Variable-rate loans and up to one year with initial rate fixation.
b Calculated as the difference between the corresponding bank rate and the one-year euribor for loans to households for house purchase, and three-month euribor for the rest.
c Spain/Germany ten-year government bond yield spread.
d Includes seasonal dummies and intervention variables reflecting certain breaks in the series analysed.

tential borrowers' credit quality may also help to explain this behaviour of bank rate spreads.

Against this backdrop, the private sector has continued to reduce its debt. The latest available information for May shows a decline in household liabilities (2.8%) similar to that at the end of Q1, as a result of the larger decrease in house purchase loans and the moderation of the fall in consumer and other purpose loans. In the case of corporations, the rate of decline stepped up slightly compared with March to 1.7%. By instrument, bank loans decreased by 4.2%, whereas the rate of increase in fixed-income securities fell back to 7.2%. In annualised quarter-on-quarter terms, negative growth rates can also be seen in households' and non-financial corporations' liabilities, which are slightly higher in absolute terms than those for March. The latest data on lending by purpose for 2012 Q1 confirms that during this period bank financing in all productive sectors continued to decline.

As a result of the reduction in corporate and household debt, the deleveraging in both sectors continued in 2012 Q1. The decrease in debt ratios was not reflected in a parallel decline in the related interest burden, which hardly changed due to the rise in the average cost of debt for both sectors. In the case of households a fall was also recorded in net assets, essentially resulting from the decline in housing wealth (financial wealth hardly varied). For the sample of corporations reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), among which the biggest have a notable weight, their income is seen to have worsened in the first three months of 2012, stemming in particular from the fall in their activity and financial revenue. Thus, the ordinary net profit of these companies decreased by 41% in this period in comparison with the same months a year earlier.

The volume of doubtful loans has continued to rise since March, and this, along with the decrease in debt, meant that the doubtful assets ratio moved further upwards. Specifically, for total other resident sectors (which includes households and firms), this indicator, at 8.95% in May, was 0.59 pp higher than in Q1.

The year-on-year growth rate of general government debt climbed 1.1 pp between March and May to 14.3%. By instrument, financing obtained through long-term securities and loans remained highly buoyant. In contrast, the fall in financing channelled through short-term securities steepened. The breakdown by holder shows that in May credit institutions reduced their holdings of government debt for the second month running. Conversely, other financial institutions and non-residents made net positive – albeit small – purchases of these assets. The expansion of general government liabilities, along with the weakness shown by GDP, gave rise to further increases in the debt ratio and in the debt burden, which in March 2012 stood at 72.1% and 2.7% of GDP, respectively.

Meanwhile, according to the latest Financial Accounts information, in 2012 Q1 the nation's net borrowing continued on its downward path to stand at 3.2% of GDP in 12-month cumulated terms, down 0.2 pp from December (see Table 9). This behaviour was the result of a slight increase in the credit position of financial institutions, while the net balance of the other sectors' financial transactions held at very similar levels to the previous quarter. The breakdown by instrument shows that in 2012 Q1 the bulk of foreign capital inflows was channelled through increases in the Banco de España's intra-system debtor position, while in contrast, the net debtor position of credit institutions on the interbank market decreased substantially. These developments partly reflect the result of the ECB's second extraordinary three-year LTRO at the end of February, in which resident institutions raised a large volume of funds to bolster their liquid assets. These funds were used, in part, to

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 9

% of GDP

	2007	2008	2009	2010	2011				2012
					Q1	Q2	Q3	Q4	Q1
National economy	-9.6	-9.2	-4.7	-4.0	-4.1	-3.6	-3.5	-3.4	-3.2
Non-financial corporations and households and NPISHs	-13.4	-6.5	5.1	4.4	4.3	4.8	4.6	3.9	3.9
Non-financial corporations	-11.5	-6.7	-0.8	1.3	1.6	2.3	1.6	1.1	1.1
Households and NPISHs	-1.9	0.2	5.9	3.1	2.7	2.4	3.0	2.8	2.8
Financial institutions	1.9	1.8	1.3	1.0	0.9	0.8	0.7	1.3	1.5
General government	1.9	-4.5	-11.2	-9.3	-9.2	-9.2	-8.8	-8.5	-8.6
MEMORANDUM ITEM									
Financing gap of non-financial corporations (a)	-17.9	-11.4	-2.1	-2.9	-2.2	-0.7	0.0	0.8	1.4

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.

replace funding from other sources, in particular that from the interbank market (including that channelled through central counterparty clearing houses). Similarly, during this period there was divestment by non-residents in fixed-income securities issued by financial institutions and general government, which was also offset by the increase in the Banco de España's intra-system debtor position.

To summarise, the Spanish economy is facing a problem of confidence which is reflected in considerable financing difficulties in international financial markets. This tightening is feeding through to the credit conditions applied to loans extended to households and corporations. Against this backdrop, restoring international investors' confidence in our economy is essential so that the necessary aggregate deleveraging of the various institutional sectors is consistent with the availability of funds for solvent projects and does not hinder economic recovery.

5.2 Households

Between March and May, the interest rate on house purchase loans to households fell by 27 bp to 3.5%, while the cost of consumer credit and other lending increased 5 bp to 7.5%.

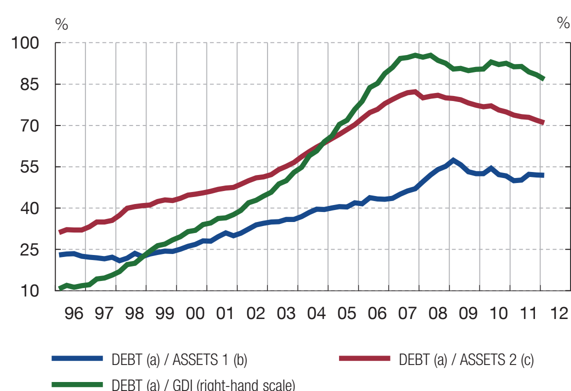
Household debt continued to decline. Thus, the year-on-year rate of contraction stood at 2.8% in May, similar to that recorded at the end of Q1. When analysing developments by loan purpose, it can be seen that whereas the rate of decline in credit to purchase real estate quickened to 2.4%, 0.4 pp higher than in Q1, the decrease in consumer credit and lending for other purposes eased slightly in year-on-year terms from 5.3% to 4.2% over the same period.

The decrease in household liabilities meant that, despite the stagnation of income, the ratio of debt to gross disposable income (GDI) in this sector fell in 2012 Q1 (see Chart 24). Consequently, payments relating to debt principal repayments fell. However, interest payments increased slightly and, accordingly, the total debt burden hardly changed. The gross saving rate and, consequently, the sectors' ability to save, net of debt servicing, continued to decline, thus prolonging the trend seen since the beginning of 2010. Similarly, another factor which contributed to weakening households' financial position in this period was the contraction of their net wealth, which fell back, essentially due to the decline in value

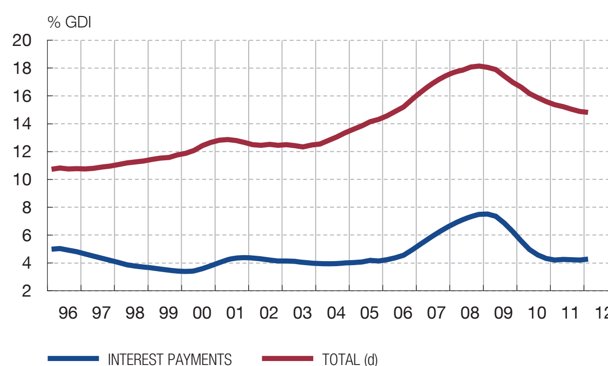
INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 24

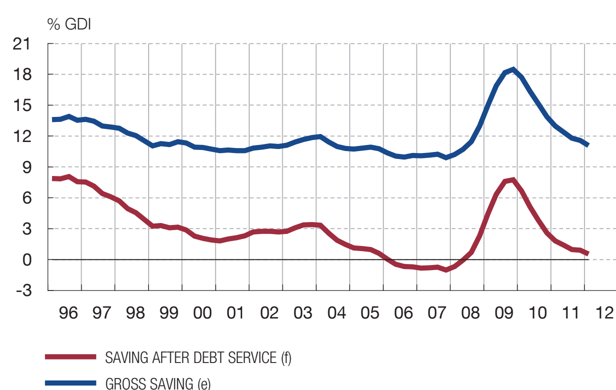
DEBT RATIOS



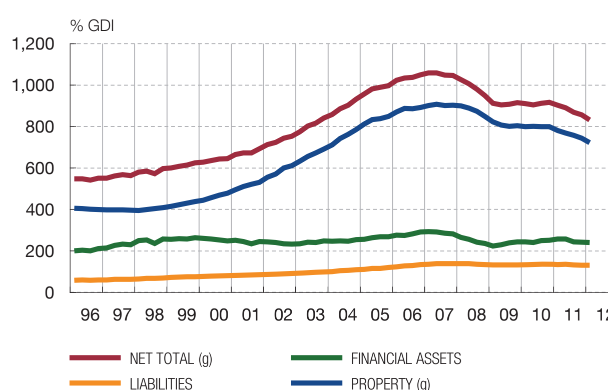
DEBT BURDEN



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 minus «Other».
c Assets 2 = Assets 1 minus shares minus securities fund participations.
d Estimated interest payments plus debt repayments.
e Balance of households' use of disposable income account.
f Gross saving minus 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.

of their real estate assets (the value of their financial instruments remained virtually unchanged). The provisional information available indicates that between March and June the debt and debt burden ratios are likely to have hardly varied, whereas household net wealth is estimated to have declined again.

According to the Financial Accounts, household investment in financial assets decreased 0.4 pp in 2012 Q1, in 12-month cumulated terms, to 1.5% of GDP (see Table 10). Investment in the form of cash and cash equivalents (cash and sight deposits) turned negative again, by an amount equivalent to 0.4% of GDP, 0.3 pp up in absolute terms on that recorded at end-2011. By contrast, in 12-month cumulated terms, investment in term deposits and fixed-income securities, though lower than in previous quarters, remained positive (0.6% of GDP) as did investment in shares and other equity, albeit for a modest amount.

Lastly, the sector's doubtful assets ratio rose again in 2012 to 3.8%. By type, the increase was sharper in consumer loans and lending for other purposes (up 0.5 pp to 7.4%) than in loans for house purchase (up 0.2 pp to 3.1%).

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

TABLE 10

% of GDP

	2008	2009	2010	2011		2012
				Q3	Q4	Q1
Households and NPISHs						
Financial transactions (assets)	2.4	4.6	3.0	1.9	1.9	1.5
Cash and cash equivalents	-0.4	4.2	-0.3	-0.1	-0.1	-0.4
Other deposits and fixed-income securities (a)	6.3	-0.8	2.8	2.0	1.4	0.6
Shares and other equity (b)	0.1	1.1	0.8	0.3	0.2	0.3
Mutual funds	-3.5	-0.1	-1.7	-0.7	-0.4	-0.2
Insurance technical reserves	0.5	0.8	0.5	0.3	0.4	0.4
Of which:						
Life assurance	*0.3*	*0.6*	*0.1*	*0.3*	*0.5*	*0.4*
Retirement	*0.1*	*0.2*	*0.3*	*0.0*	*-0.1*	*0.0*
Other	-0.6	-0.6	1.0	0.1	0.3	0.8
Financial transactions (liabilities)	2.1	-1.3	-0.1	-1.2	-0.9	-1.2
Credit from resident financial institutions (c)	3.4	-0.5	0.0	-1.4	-2.0	-2.3
House purchase credit (c)	2.7	0.1	0.5	-0.5	-1.1	-1.2
Consumer and other credit (c)	0.8	-0.4	-0.3	-0.8	-0.9	-1.0
Other	-1.3	-0.8	-0.1	0.2	1.1	1.0
Non-financial corporations						
Financial transactions (assets)	-1.2	-9.8	6.8	2.0	-0.5	-0.8
Cash and cash equivalents	-1.1	-0.4	0.1	-0.7	-0.7	-1.2
Other deposits and fixed-income securities (a)	2.2	-0.8	2.0	1.6	0.9	1.4
Shares and other equity	3.7	0.5	3.7	0.9	0.0	-0.3
Of which:						
Vis-à-vis the rest of the world	*3.5*	*0.2*	*3.0*	*0.6*	*-0.2*	*-0.7*
Trade and intercompany credit	-6.6	-9.4	0.8	-0.4	-1.6	-1.8
Other	0.6	0.3	0.2	0.5	0.9	1.1
Financial transactions (liabilities)	5.5	-9.0	5.5	0.4	-1.6	-1.9
Credit from resident financial institutions (c)	5.5	-3.0	-1.0	-3.1	-3.5	-3.3
Foreign loans	3.0	-0.1	1.0	0.9	0.5	0.7
Fixed-income securities (d)	0.3	1.3	0.5	0.5	0.5	0.7
Shares and other equity	2.4	2.5	3.3	3.5	3.0	2.3
Trade and intercompany credit	-6.4	-9.3	1.2	-0.7	-1.7	-1.9
Other	0.7	-0.4	0.4	-0.7	-0.4	-0.4
MEMORANDUM ITEM: year-on-year growth rates (%)						
Financing (e)	6.6	-0.9	0.4	-1.5	-2.1	-2.0
Households and NPISHs	4.4	-0.3	0.2	-1.5	-2.4	-2.7
Non-financial corporations	8.2	-1.4	0.6	-1.5	-1.9	-1.4

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.

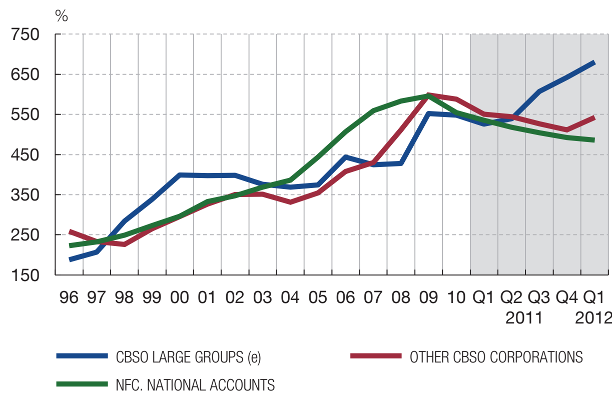
5.3 Non-financial corporations

Developments in interest rates on loans to firms between March and May differed depending on the amount of the operations. The cost of loans for amounts higher than €1 million increased by 64 bp to 3.6%. By contrast, the associated rate on loans for less than this amount, which in prior months had posted more marked increases, rose by only 8 bp to stand at 5.6%. As regards the cost of other sources of business financing, the rate on long-term fixed-income issues increased by almost 1 pp over the same period, while that of securities maturing at up to one year fell slightly (by 6 bp). The cost of equity issuance was also higher (by almost 3 pp), in step with the decline in stock market prices during these months.

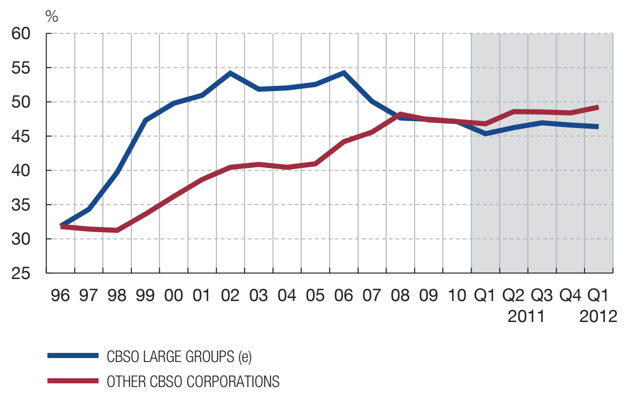
INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS (a)

CHART 25

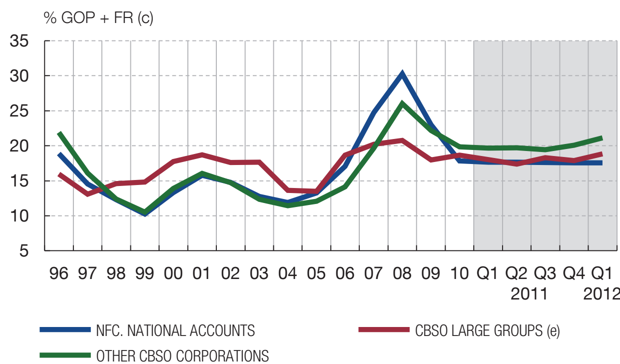
DEBT (b) / GOP + FR (c)



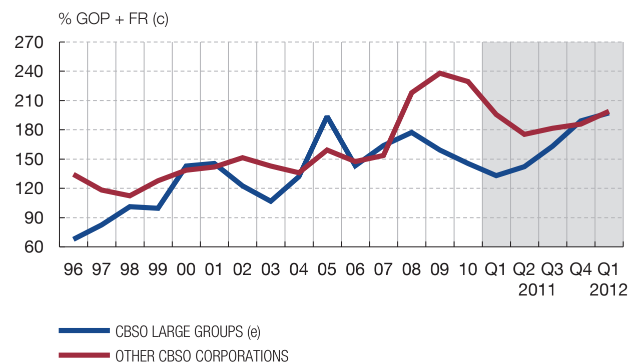
DEBT (b) / ASSETS (d)



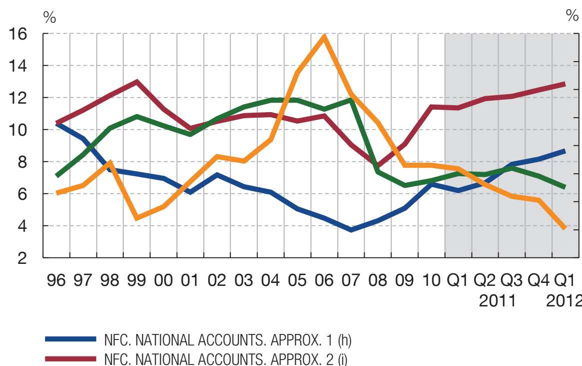
INTEREST DEBT BURDEN



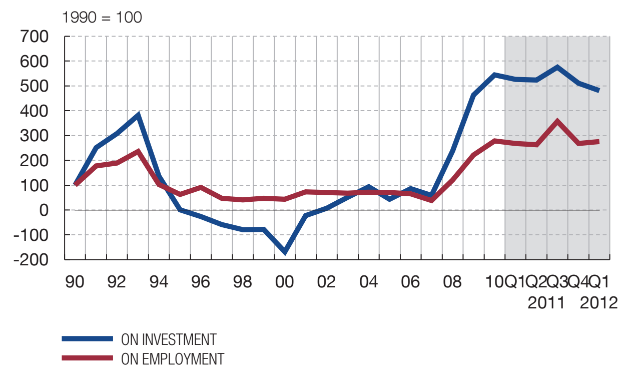
TOTAL DEBT BURDEN (f)



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 Endesa, Iberdrola, Repsol and Telefónica. Adjusted for intra-group financing to avoid double counting.
f Includes interests plus interest-bearing short-term debt.
g NOP, using National Accounts data, is defined as GOS + interest and dividends received – interests paid – fixed capital consumption.
h Own funds valued at market prices.
i Own funds calculated by accumulating flows from the 1996 stock onwards.
j ndicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

The latest available figures on corporate financing, for May, show somewhat higher rates of contraction than those from two months earlier (1.7%, against 1.4% in March). The breakdown by instrument shows a 4.2% fall in bank loans by resident credit institutions, a similar figure to Q1, whereas the rate of increase of fixed-income securities (used by large corporations) eased by 4 pp to 7.2%. The latest information on lending by purpose, relating to 2012 Q1, reveals that the outstanding balance of bank financing in virtually all the productive sectors continued to decline. Once again, the biggest year-on-year fall was in construction (12.2%), although this rate eased somewhat compared with the previous quarters. The rate of decline in industry (4.1%) and in the real estate services branch (5.3%) was also checked, whereas in other services the fall was somewhat more marked (3.2%).

On the latest Financial Accounts information for 2012 Q1, the credit balance of the corporate sector's net financial transactions held at 1% of GDP in 12-month cumulated terms. In combination with the reduction in the sector's purchases in the rest of the world, this led to an increase in the "financing gap" indicator, which approximates – with the sign changed – the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment (a positive figure of 1.4% of GDP, against 0.8% three months earlier).

The quarter-on-quarter stagnation in corporate liabilities, combined with the moderate rise in income on National Accounts figures for 2012 Q1, meant that these sector's debt ratio continued to diminish slowly (see Chart 25). Notwithstanding this development, the slight rise in average financing costs prevented the associated debt burden from declining. The provisional information available suggests these trends have continued in Q2. For the sample of corporations reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), among which the biggest companies have a notable weight, income fell off significantly in the first three months of 2012. Thus, gross operating profit and ordinary net profit respectively shrank by 6.5% and 40.9% compared with the same period in 2011, against a background of deteriorating productive activity and adversely trending financial revenue. The decline in profit was mirrored in firms' related ratios, the ROA and the ROE, both of which stood at 3.6%, 0.6 pp and 1.3 pp down, respectively, on March 2011. This trajectory of corporate income translated into a rise in the debt and debt burden ratios. As a result, the indicators of financial pressure on investment and employment held at historically high levels, although they declined somewhat in relation to end-2011. Analysts have scaled back their expectations concerning listed companies' profits in the short run, while over longer horizons these expectations have scarcely changed (see Chart 26).

Finally, the doubtful assets ratio of non-financial corporations continued to grow in 2012 Q1. It did so more sharply in construction and real estate services (increasing by 1.5 pp to 22.1%) than in the other sectors, where the increase was more moderate (0.4 pp to 5.6%).

5.4 General government

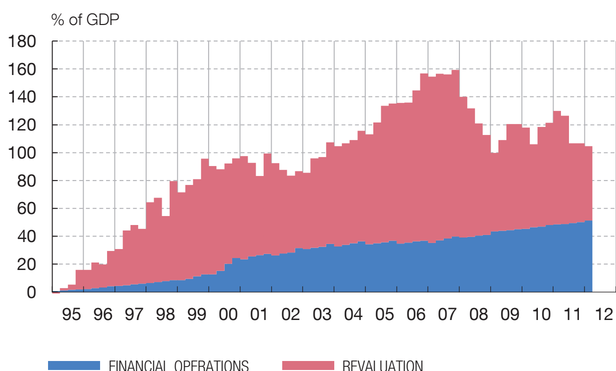
On Financial Accounts figures, general government borrowing needs increased slightly in 2012 Q1 (by 0.1 pp of GDP in 12-month cumulated terms), meaning that they remain at a high level (8.6% of GDP) (see Table 9).

As in previous quarters, the main financing channel used by general government was the issuance of medium and long-term bonds, whereby it raised funds equivalent to 6.9% of GDP, in 12-month cumulated terms, 0.5 pp up on December (see Chart 27). Further, the tapping of funds through short-term securities dipped by 0.6 pp, practically to zero, while funds channelled through loans increased by 0.4 pp to 0.8% of GDP. On the asset side, net

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26

CUMULATIVE CHANGE IN NET WORTH (a)



PROFIT GROWTH EXPECTATIONS OF LISTED FIRMS

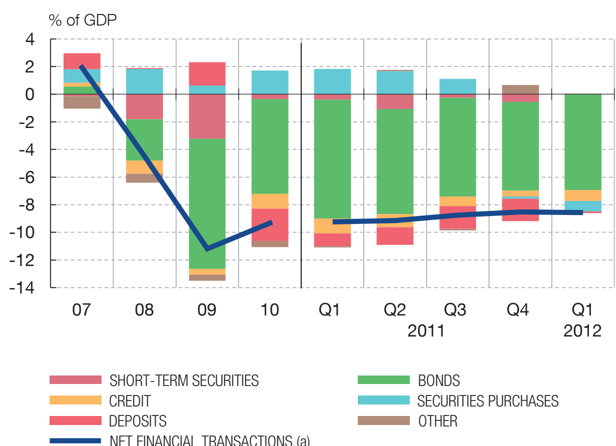
SOURCES: I/B/E/S and Banco de España.

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

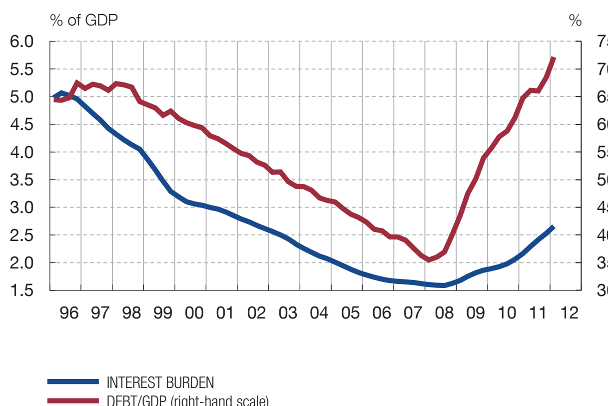
GENERAL GOVERNMENT
Four-quarter data

CHART 27

NET-FINANCIAL TRANSACTIONS. CONTRIBUTIONS BY INSTRUMENT (a)



INTEREST BURDEN AND DEBT RATIO



SOURCE: Banco de España.

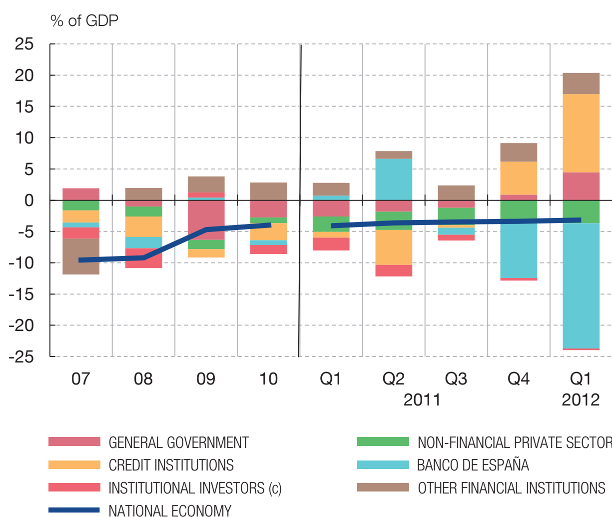
a A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilites.

holdings of securities fell for the third quarter running, in line with the progressive redemption of financial assets in the FAAF portfolio, the winding up of which was approved in March. Divestment in these instruments thus increased by 0.6 pp in four-quarter cumulated terms to 0.8% of GDP. The outstanding balance of general government deposits also dipped slightly, albeit by a very modest amount equivalent to 0.1% of GDP, far below the percentages recorded in previous quarters.

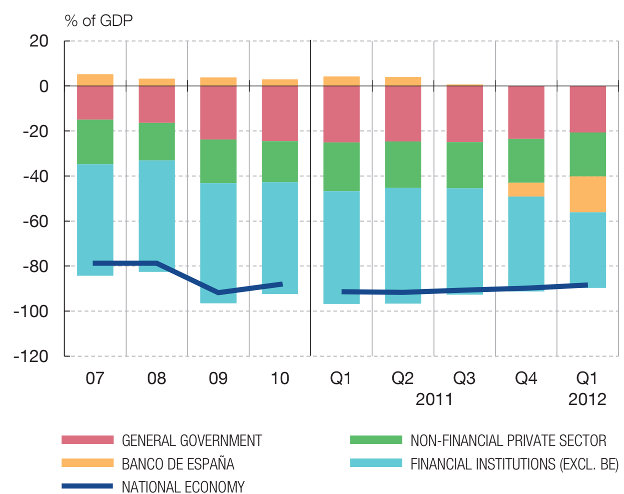
Overall, the growth rate of general government debt increased by 1.1 pp between March and May to 14.3% year-on-year. In terms of instruments, financing obtained through long-term securities remained very buoyant (growing at a year-on-year rate of 15%, virtually identical to that in Q1). There was also an increase in the raising of funds through loans, the bulk of which have been used to cover outlays associated with the programme of pay-

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 portfolio investment institutions.

ments to suppliers, involving unsettled public-sector invoices. Set against this, the decline in financing routed through short-term securities steepened to 15.2%. The expansion of general government liabilities, along with the weakness of GDP, has made for further increases in the sector's debt ratio and debt burden, which stood in March at 72.1% and 2.7% of GDP, respectively.

5.5 The rest of the world

On the latest Financial Accounts information, 2012 Q1 saw a continuation of the downward path of the nation's net borrowing, which stood at 3.2% of GDP in 12-month cumulated terms, 0.2 pp less than in December (see Table 9). This performance was the result of a slight increase in the credit balance of financial institutions, the maintenance of non-financial corporations' and households' net lending capacity, and the general government debtor position.

In 2012 Q1 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 and its excess of expenditure over income. As a result, the Banco de España's net financial transactions with the rest of the world once again showed a debit balance, and for a very high amount: €104 billion, up to 20.1% of GDP in 12-month cumulated terms (see Chart 28). As earlier mentioned, this development is partly influenced by the result of the ECB's extraordinary three-year LTRO in March, in which resident institutions raised a sizable volume of funds. The latest balance of payments information for April reflects, however, a continuation of these trends.

The breakdown by instrument shows, in line with the foregoing, that most external financing in 2012 Q1 was channelled through the Banco de España intra-system position. The funds obtained by this means amounted to €100 billion which, in 12-month cumulated terms, took them to 21% of GDP, double their proportion in December (see Table 11). Conversely, funding flows obtained on interbank markets (through bilateral operations

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 11

% of GDP

	2008	2009	2010	2011		2012
				Q3	Q4	Q1
Net financial transactions	-9.2	-4.7	-4.0	-3.5	-3.4	-3.2
Financial transactions (assets)	1.8	-1.1	-2.4	2.7	2.0	2.4
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-1.3	-3.3	-1.4	1.5	0.3	0.9
Of which:						
Interbank, credit institutions	*-0.5*	*-1.7*	*-1.3*	*0.9*	*0.0*	*0.9*
Securities other than shares	1.3	0.0	-7.1	-2.5	-1.2	-0.6
Of which:						
Credit institutions	*1.5*	*1.2*	*-3.1*	*-0.1*	*0.1*	*0.3*
Institutional investros	*-0.5*	*-1.0*	*-2.6*	*-1.5*	*-1.0*	*-0.6*
Shares and other equity	1.7	1.6	3.2	1.5	1.0	0.0
Of which:						
Non-financial corporations	3.5	0.2	3.0	0.6	-0.2	-0.7
Institutional investros	-2.3	0.6	1.0	0.6	0.5	0.3
Loans	0.8	0.3	1.0	1.5	1.3	1.6
Financial transactions (liabilities)	10.9	3.7	1.6	6.2	5.3	5.6
Deposits	8.0	-0.5	-0.5	4.9	8.7	14.4
Of which:						
Interbank, credit institutions (a)	*6.2*	*0.7*	*-7.4*	*-5.4*	*-3.6*	*-4.6*
Repos, credit institutions (b)	*0.2*	*0.1*	*5.8*	*8.4*	*2.7*	*-1.0*
Interbank, BE (intra-system position)	*1.9*	*-0.8*	*0.2*	*1.7*	*10.5*	*21.0*
Securities other than shares	-2.7	3.5	-2.0	-2.9	-6.6	-11.9
Of which:						
General government	*1.1*	*5.2*	*2.0*	*1.1*	*-0.8*	*-4.6*
Credit institutions	*-1.9*	*1.0*	*-1.3*	*-1.6*	*-2.8*	*-3.9*
Other non-monetary financial institutions	*-1.9*	*-2.7*	*-2.6*	*-2.5*	*-3.1*	*-3.4*
Shares and other equity	3.2	1.0	2.3	2.8	2.3	1.7
Of which:						
Non-financial corporations	*2.4*	*0.4*	*2.3*	*2.6*	*2.3*	*1.8*
Loans	2.9	0.1	1.3	1.2	0.8	1.4
Other, net (c)	0.2	-0.7	-1.5	-0.5	-0.4	-0.5
MEMORANDUM ITEMS						
Spanish direct investment abroad	4.7	0.9	2.8	2.3	2.5	1.4
Foreign direct investment in Spain	4.8	0.7	2.9	2.2	2.0	1.8

SOURCE: Banco de España.

a Including bilateral repos operations.
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.

and, to a lesser extent, via the central counterparty clearing houses) were once again negative, for an amount equivalent to 25% of 2012 Q1 GDP. There was once again divestment by non-residents in fixed-income securities issued by financial institutions and general government. By contrast, the raising of funds through shares and other equity continued to be positive, accounting for an amount equivalent to 5.3% of GDP (the bulk of which related to instruments issued by non-financial corporations), although in 12-month cumulated terms this amount declined. Foreign direct investment in Spain continued to move on a slightly but progressively declining trend, to 1.8% of GDP in annual terms, 0.2 pp less than at end-2011.

Residents' investment abroad increased in 2012 Q1 to 6.8% of GDP, and also grew in 12-month cumulated terms to 2.4% of GDP (0.4 pp up on end-2011). The bulk of this amount was routed through interbank operations. Net purchases of fixed-income securities were negative for the second quarter running as a result of disinvestment by institutional investors exceeding acquisitions by the other sectors. Set against this, investment in shares and other equity increased slightly, continuing on the trend exhibited the previous quarter. However, Spanish foreign direct investment fell, dipping to 1.4% of GDP in annual terms, 1.1 pp down on December.

As a result of cross-border flows and changes in asset prices and in the exchange rate, the Spanish economy's net liabilities to the rest of the world was equivalent to 91.1% of GDP in March 2012, 0.5 pp down on December. This slight decrease was due to a reduction in the financial sector's (excluding the Banco de España) and general government sector's debit balance vis-à-vis the rest of the world, which was almost offset by the increase in the Banco de España's position, while the net external debt of the non-financial private sector showed no significant changes.

18.7.2012.