QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

On QNA estimates, Spanish GDP stood at 3.5% year-on-year in 2007 Q4, with the gradually slowing profile it had shown throughout the year becoming more accentuated. As in previous quarters, the slowdown in spending was due to the lesser dynamism of national demand, which was partly offset by a less negative contribution by the external sector. However, the closing months of 2007 revealed the first signs that the bout of financial stability dating back to the summer could be intensifying the adjustment that the Spanish economy had already embarked upon. And this has been confirmed in the opening months of 2008.

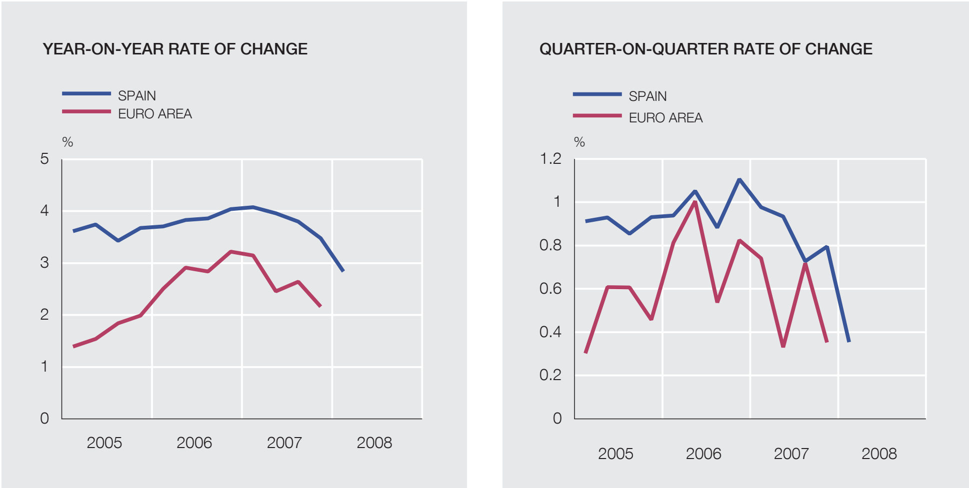
Indeed, drawing on the as yet incomplete conjunctural data available, estimates point to a more pronounced deceleration in activity in 2008 Q1 and to a sharper adjustment in the real estate sector, in a setting in which the prolongation of the financial turbulence has contributed to heightening uncertainty over the economic picture. According to these estimates, the year-on-year growth rate of GDP in 2008 Q1 is expected to have risen to 2.8% (0.4% in quarter-on-quarter terms). This is as a result of a significant cut in the rate of increase of the various national demand components – which are estimated on the whole to have increased at a rate of 3% (3.6% in the previous quarter) – and of a 0.1 pp improvement (to –0.3 pp) in the contribution of net external demand. On the supply side, activity and employment remained on a slowing course, which was also more marked than in the second half of the year. That reflected above all the greater intensity of the adjustment in the construction sector and in related activities. EPA (Labour Force Survey) data for 2008 Q1 show the dynamism of employment to have eased from 2.4% in 2007 Q4 to 1.7% in the current quarter. The unemployment rate rose to 9.6%, against the background of the higher growth in the labour force. Turning to prices, inflation rose once again in the opening months of 2008, driven by fresh increases in oil and food prices. As a result, the March CPI posted a year-on-year growth rate of 4.5%, while the inflation differential with the euro area held stable at 1 pp, the level prevailing in late 2007.

As to the international economic outlook, 2008 Q1 was marked by the intensification of the financial turbulence, continuing strong price rises in energy and, to a lesser extent, in other commodities, and the sharp deterioration in the US economic situation. Despite the resilience other regions have continued to show, the growth outlook for the world economy has been revised downwards again and remains shrouded in considerable uncertainty owing to doubts over the ultimate scope of the above-mentioned developments.

On the international financial markets, the strains on money markets continued throughout the quarter. In this setting, the difficulties beleaguering certain financial institutions exacerbated the prevailing climate of lack of confidence, prolonging liquidity problems. Strains became sharper in the opening weeks of March, when the financial difficulties of the fifth biggest US investment bank became known. In these circumstances, the main central banks conducted exceptional liquidity-providing operations, accompanied in some cases by changes in implementation procedures and even cuts to intervention rates. The Federal Reserve cut its federal funds target rate on three occasions during the quarter, taking it to 2.25% in March, a reduction of 300 bp since August 2007. At the same time, the US monetary authorities laid down new measures for the provision of liquidity, broadening the range of counterparties and accepted collateral, and they took an active role in bailing out the aforementioned investment bank. Elsewhere, the Bank of England cut its official rate on two occasions, the last of which (in April) lowered it to 5%, and more recently it has introduced exceptional facilities for increasing liquidity on bank balance sheets.

GROSS DOMESTIC PRODUCT (a)

CHART 1



SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

The upward revision of credit risk premia continued throughout the quarter and there were declines in stock market prices, which were sharper than in the initial stages of the financial turbulence. Overall, this made for a complicated financial environment in which the weakness of the dollar increased, reaching new lows against the euro (exceeding $1.60 per euro at the end of April), and signs of a credit squeeze began to be discernible in the US economy. Although some improvement can be seen in certain markets, sufficiently clear signs of an ebbing of the international financial strains of recent months are still not visible.

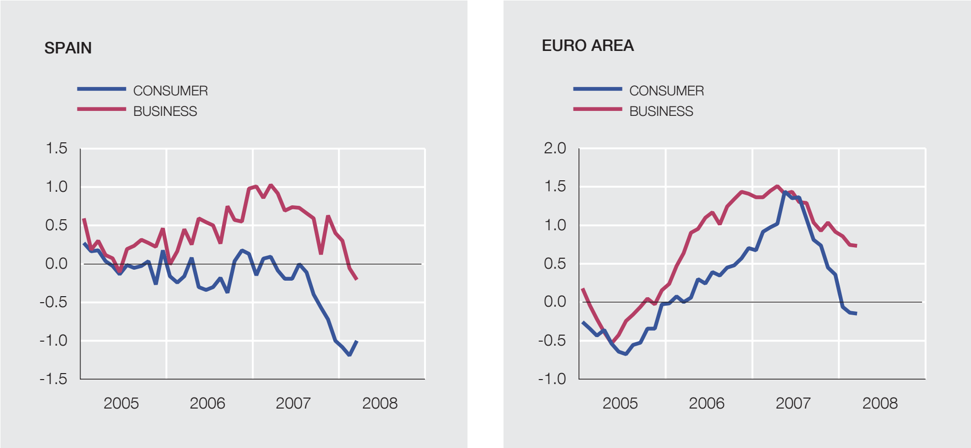
Oil prices remained on a prolonged rising course throughout Q1, standing in the last week of April at a level close to their all-time high ($110 per barrel of Brent) owing to the continuing pressures exerted by the emerging countries, the weakness of the dollar and OPEC's refusal to increase output at its last meeting. This was accompanied by rises in the prices of other commodities, in particular foodstuffs, which prompted a further deterioration in inflation globally and influenced economic policy measures in a good number of countries.

Activity in the world economy throughout the quarter was highly influenced by the marked deterioration in the US economy, where the year-end figures showed its slowing trajectory to be steepening. The information available for the opening months of 2008 points to further weakening, since the adjustment in the real estate sector has deepened, consumption continues to slow and employment has fallen. The economic outlook has likewise worsened in Japan and in the United Kingdom, while in the emerging economies activity generally remained notably buoyant, although there was an across-the-board rise in inflation that prompted the tightening of the monetary policy stance in most of these countries.

The euro area showed some momentum in 2008 Q1, with GDP growth expected to stand at a similar level to the end-2007 figure, or even somewhat higher. Both the dynamism of the emerging economies, which is driving exports and industrial activity, and the strength of the labour market, which is underpinning domestic spending, are expected to have alleviated the effect of other contractionary forces, such as the appreciation of the euro, price increases and the tightening of financial conditions. So far, then, the impact of the financial turbulence on activity in the euro area is proving limited, although here, too, projected growth has been re-

CONFIDENCE INDICATORS (a)

CHART 2



SOURCE: European Commission.

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

vised downwards and considerable uncertainty persists over the effect of the slowdown in the US economy on activity in the area.

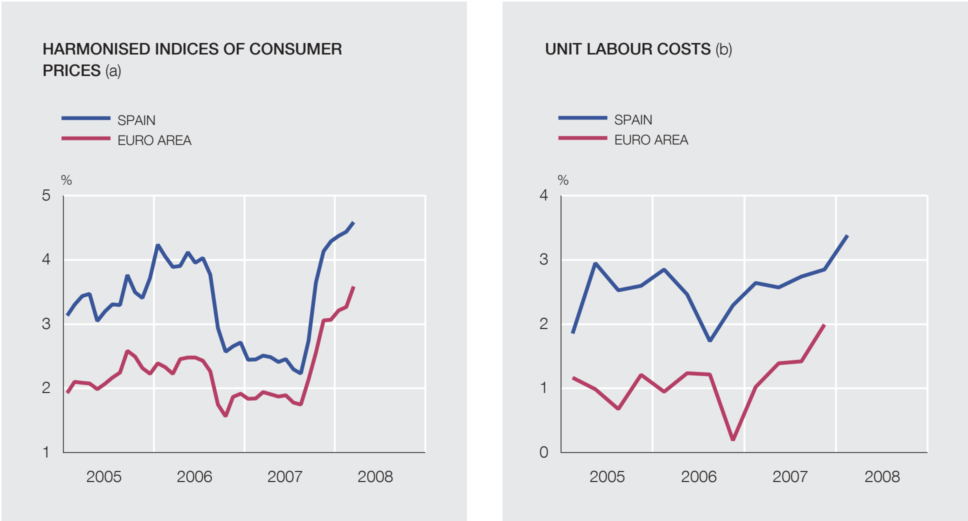
Higher oil and food prices on international markets and certain seasonal effects bore on inflation in the euro area, which continued to quicken in the opening months of the year. As a result, the HICP posted a 12-month growth rate of 3.6% in March, and core inflation rose to 2.7% (against rates of 3.1% and 2.3% at end-2007, respectively). The outlook for the second half of the year is somewhat more favourable, though conditional upon there being no further increases in oil and commodities prices. That said, the inflation rate will hold at a high level, most likely above the medium-term price stability target (2%).

Amid the strong upward pressures on prices in the short term and the risks to medium-term price stability, the ECB Governing Council kept its official interest rates unchanged throughout the quarter at 4% for the main refinancing operations, and at 3% and 5% for the deposit and marginal lending facilities, respectively, indicating that the decisions taken would contribute to achieving its medium-term price stability goal. The ECB acknowledged the high level of uncertainty over the effects and duration of the financial turbulence, and over its impact on activity in the euro area. But it stressed its commitment to pre-empting second-round effects on wages and prices and to keeping inflation expectations anchored in the long run.

In the opening months of 2008, developments in the Spanish economy have thus unfolded in a weaker external environment in which the deterioration in the international financial climate has passed through to domestic financial markets, where there have been fresh rises in money market rates, further increases in credit spreads and declines in the main stock market indices, although a slight improvement has been discernible since mid-March. The prolongation of this episode is contributing to spreading uncertainty over the economic picture, with clear effects on confidence and spending decisions; however, its impact on the cost and availability of private-sector financing is still relatively limited. The gradual slowdown in house prices continued in the opening months of 2008, posting a year-on-year growth rate of 3.8% in Q1 (4.8% in 2007 Q4). There are growing signs in the recent period that the deceleration in the real estate sector might prove sharper than had been forecast some months back. Nonetheless, the course residential prices have taken appears to denote the presence of certain factors that may shore up property values in this sluggish phase of the residential cycle.

PRICES AND COSTS

CHART 3



SOURCES: Eurostat, ECB and INE.

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

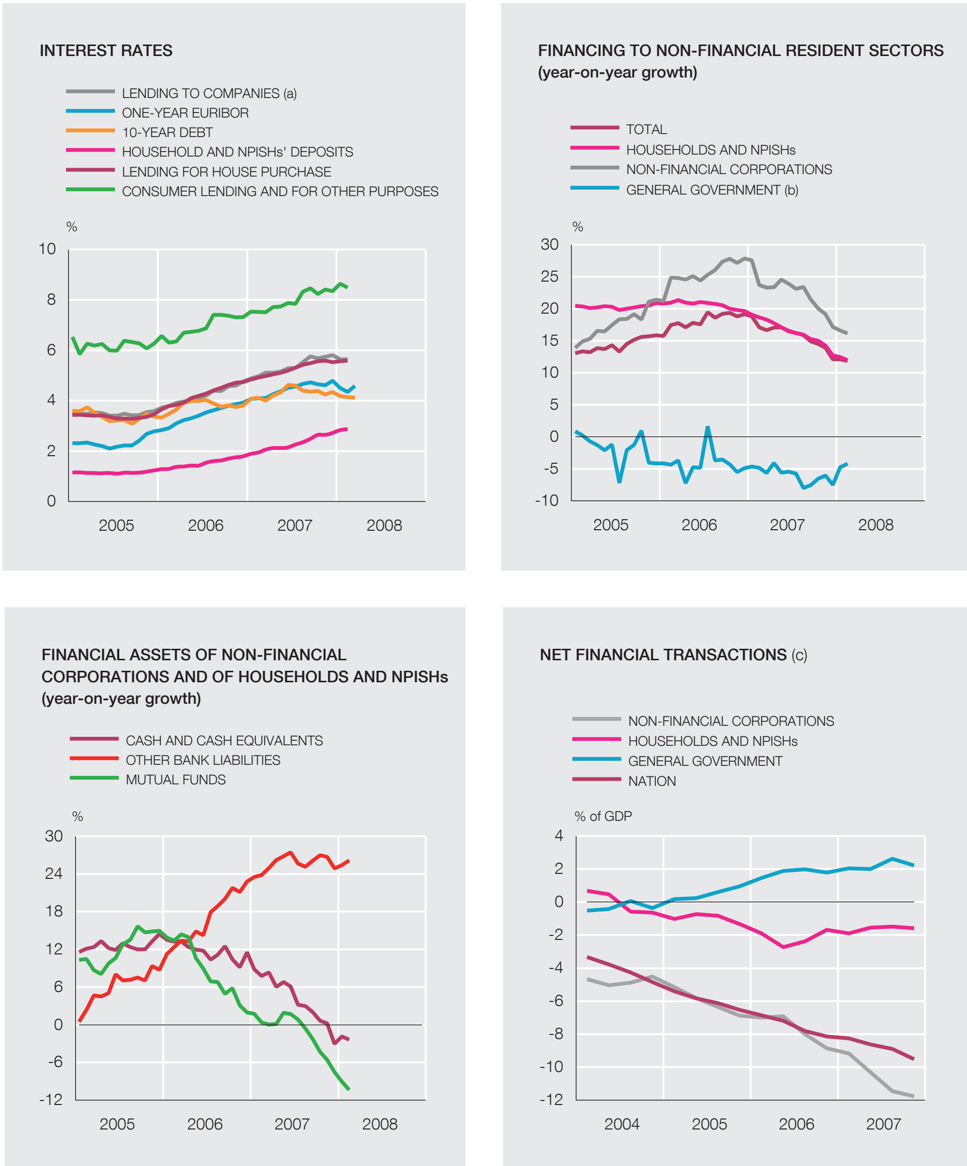
Amid the heightening uncertainty and agents' deteriorating confidence, household spending slowed in the opening months of 2008. This affected both household consumption, the rate of change of which is expected to stand at around 2.2%, and, above all, residential investment, which scarcely increased during the quarter. Several factors lie behind the weakening in consumption. First, disposable income may have been impacted, to some extent, by the loss of momentum in employment, although this was countered by the rise in wages and certain public-sector measures, following the entry into force of those approved in the last Budget (essentially the partial elimination of fiscal drag under personal income tax and the tax credit in support of the birth rate). Next, wealth moderated further as a result of the fall in stock market values and of the slowdown in house prices. And finally, there was a significant deterioration in consumer confidence, given the uncertain economic climate and the marked worsening in the inflationary situation, which may have adversely affected household spending plans.

This climate is also influencing the demand for housing, deepening the slowdown in the real estate sector which had begun some quarters back. Following the strong previous expansion, the slowdown has been in response, among other factors, to the rise in borrowing costs and diminished real estate appreciation expectations. The fall-off in the demand for housing may be increasing the current excess supply and accelerating the adjustment in the sector, through the scaling down of new housing construction projects.

Household demand for financing continued to reflect the lesser momentum of spending, along with the moderate rise in borrowing costs. Accordingly, the growth of credit to households continued to slow gradually, with its year-on-year rate standing at 12% in February. The easing off of the increase in household debt was seen both in credit for house purchases and in consumer credit (with respective growth rates of 12% and 10%).

As has been the case in recent quarters, the behaviour of business investment was more expansionary, albeit moving on a slowing trajectory which, in the case of investment in capital goods, led it to post a rate close to 6%, compared with around 9% at end-2007. No significant changes were perceptible here either in financial determinants, compared with the previous

FINANCIAL INDICATORS OF THE SPANISH ECONOMY CHART 4



SOURCE: Banco de España.

a. 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 NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
b. Consolidated financing: net of securities and loans that are general government assets.
c. Cumulative four-quarter data.

quarter, as corporate earnings held on a similar path to the closing months of 2007 and the cost of borrowed funds scarcely underwent any change in early 2008; however, banks are estimated to have applied more restrictive conditions in their lending (in keeping with their expectations at the start of the year), thereby contributing to further tightening the business financing conditions observed over the past year. As well as to this effect, the slowdown in business investment plans should be attributed to the deterioration in business confidence and to the downward revision of demand growth expectations. Business investment in other construction projects might also have been prone to this climate of uncertainty. Against this backdrop, the pace of corporate debt continued to fall, reaching a year-on-year rate of 16% in February. That is expected to have prompted a fresh increase in the sector's debt ratio, albeit at a lesser pace than that of the previous quarters, and in the debt service burden.

In the opening months of 2007 there was a 0.1 pp improvement – to –0.3 pp – in the contribution of net external demand to GDP growth. This was the consequence of some quickening in the growth of goods and services exports, despite the appreciation of the euro, and of the stabilising of imports at a somewhat lower level than in the second half of 2007, in response to the slowdown in final demand. Drawing on Customs information, the EU countries were the main export markets, with bigger increases in intermediate and consumer products. As to imports, purchases of intermediate goods were notably robust. Finally, the available indicators of tourism showed a continuing and moderately favourable performance in the opening months of the year.

On the supply side, the growth rates of activity and employment continued to decline in 2008 Q1, chiefly reflecting the adjustment in the construction sector and in related activities. In the construction branch, the biggest slowdown in activity was in the residential segment. That made for a rapid adjustment in the sector's employment-generating capacity, and the employment figures were moderately negative over the quarter as a whole. In industry, the slacker growth seen in the second half of 2007 continued, largely influenced by the close connection between certain manufacturing activities and construction activities. Set against these developments was the resilience of the market services branch, with increases in value added of over 3% and increases in employment close to this level; however, a mild slowdown was also observable in activity in this sector. Overall, the pace of employment generation in the market branches progressively adapted to the slowing profile of activity, whereby apparent productivity held at similar figures to those in the second half of 2007, as was the case for the whole economy, where apparent productivity gains remained at around 1%.

The collective bargaining results available for 2008 confirm the rise in labour costs which began to be discernible over the course of last year. Wage settlements, which are standing at 3.4% to March, exceeded average wage growth in 2007 by somewhat more than 0.4 pp, possibly reflecting some deterioration in the inflation outlook in the face of the price rises in the final months of last year. But, moreover, it is estimated that the impact of the activation of the indexation clauses (for the deviation by inflation in 2007 from its official target) will also be sharper, potentially adding 1.1 pp to wage increases (0.3 pp in 2007). It is therefore highly likely that labour costs will continue to quicken during the current year, as will unit labour costs, for which an increase of somewhat over 0.5 pp is estimated in 2008 Q1, reaching a rate of change of 2.9% for the overall market branches.

Prices also continued on the upward trajectory they had initiated in the second half of 2007 against a background of substantial rises in energy and food commodities prices, tightening labour costs and barely any easing in margins. Inflation rose in 2008 Q1, with an increase of 4.4% in the CPI, compared with 4.0% the previous quarter, while the CPI excluding unprocessed food and energy held steady at the level of the previous quarter (3.3%). This latter figure means, in any event, that the prices of processed food and, to a lesser extent, of services are highly dynamic. In this setting, the favourable behaviour of non-energy industrial goods, whose prices have held virtually stable, posting lower growth than those in the euro area (with a year-on-year rate of 0.2% for the quarter as a whole), represents some measure of relief.

The doubts over the course of oil and food prices mean that the performance of inflation globally in the coming quarters is shrouded in considerable uncertainty. In the case of the Spanish economy, the wage rises seen in recent months and the wage indexation mechanisms in place accentuate the risk that price pressures, which are still relatively confined to specific product groups, may ultimately generate second-round effects and spread to the rest of the economy.

On 18 April the government approved an economic stimulus plan consisting of a set of fiscal, financial and unemployment assistance measures with which to help households and firms adapt to the change in the business cycle, to lower the costs tied to changing mortgages, to boost the financing of government-subsidised housing and to bolster activity in the construction industry through stricter compliance with public-works lead times. Some of these measures entail a cost in public revenue terms, the permanent portion of which is difficult to estimate accurately at present. Moreover, the effect they seek to exert on sustaining activity is not free from some uncertainty. This may be the case of the tax reduction to be applied from 2008 to wage-earners, pensioners and the self-employed (to be implemented through a deduction in personal income tax of €400 per annum), for which the government estimates a cost of almost 0.5 pp of GDP. Indeed, the scope of this measure when it comes to boosting household consumption may be lessened by the fact that, in the current circumstances, the portion of the increase in disposable income that is diverted towards saving may be greater than usual.

The general government surplus in 2007 is a favourable starting point to bear up against the cyclical slowdown by means of giving free rein to the budget's automatic stabilisers (unemployment spending and tax revenue, essentially). These should provide valuable support during the slowdown. However, it should be borne in mind that the impact of less dynamic activity on public finances may be high, as shown by the sluggishness of tax revenue in recent months. Accordingly, fiscal policy must be handled with extreme caution, in particular restricting the application of additional measures that might generate a permanent deterioration in the budget balance. Maintaining the counter-cyclical room for manoeuvre that the healthy position of public finances provides is an asset of prime importance for tackling the challenges facing the economy in the downturn and the international financial turbulence. The emphasis of economic policy conduct should be placed, above all, on promptly regaining a path of moderation in price, wage and income formation, and in laying the foundations for a sustainable recovery in activity. In this connection, the main role will fall to those eminently structural measures that smooth the adjustment of the economy and the prompt return to a dynamic path based on a more balanced growth pattern.

2 The external environment of the euro area

In 2008 Q1 there was renewed tension in the international financial environment, which peaked in mid-March when the financing difficulties of a large US investment bank came to light, against a backdrop of credit spreads at historical highs and strains on money markets. This led the Federal Reserve to take decisive action on three fronts: it supported the acquisition of the ailing bank by JP Morgan so as to preserve the stability of the financial system; it established new measures to ease the supply of liquidity (see Box 1) by extending the term of financing transactions, enabling more institutions to have access to these funds and widening the range of assets which can be used as collateral; and finally, at its meeting in March it cut the federal funds target rate by 75 bp to 2.25%, making for a reduction of 300 bp since the beginning of the turbulence and of 200 bp since the start of 2008. The market reaction was favourable, and credit spreads fell and stock markets rallied; however, the dollar's weakness was accentuated and it reached new lows against the euro. In any event, the negative news in financial circles about banks' high losses, the rise in the mortgage default rate, institutional investors' exposure and the steep downward revision of global and US growth projections, in particular, fuelled ongoing uncertainty about the scale of the turbulence.

Emerging markets continued to show some resilience in the face of the financial turbulence over the last quarter and stock markets recovered from the losses recorded at the beginning of the year, with the notable exception of China. Exchange rate movements in the emerging economies were mixed, although most appreciated against the dollar. It was precisely in this context of a weak dollar that the price of Brent oil soared to a record high of approximately $114 per barrel. Prices of other commodities also rose substantially and were highly volatile, partly due to uncertainty about their fundamentals.

In the US, the final estimate for GDP in 2007 Q4 confirmed annualised quarterly growth of 0.6%, which was notably down on Q3 (4.9%). Thus, GDP growth for the whole of 2007 stood at 2.2%, 0.7 pp less than in 2006. The higher frequency indicators have shown signs of a notable slowdown in recent months. On the demand side, consumer confidence indices fell sharply and consumer spending indicators were somewhat slack during the quarter. Housing market indicators reflected the depth of the adjustment in the residential sector: housing starts and construction permits fell to levels not seen since the early nineties and confidence in the construction industry remained very close to its all-time low. There were signs of weakness in activity since, during the first quarter, the manufacturing and services ISM index contracted and industrial production dropped slightly. After notably withstanding the slowdown until end-2007, the labour market weakened rapidly. For the first time since 2003, there was net job destruction, amounting to 77,000 jobs per month in the first quarter, and the unemployment rate climbed to 5.1%. As for prices, inflation rose in Q1 and stood at 4.1% year-on-year, in comparison with 4% in 2007 Q4, due to higher energy and food prices. Likewise, the core rate rose to 2.4% from 2.3% in the previous quarter.

In Japan, GDP grew 3.5% year-on-year in 2007 Q4, up 1.2% on the previous quarter. For 2007 as a whole, GDP grew 2.1%, 0.3 pp less than in 2006. The latest indicators point to a loss of buoyancy in industrial activity in recent months, judging by the worsening of the business confidence indices in the Tankan survey for Q1 and the drop in industrial production in January and February. On the demand side, consumer spending continued to progress favourably, in contrast with the negative performance of consumer confidence. The pace of job creation slowed on the labour market, resulting in a further decline in the

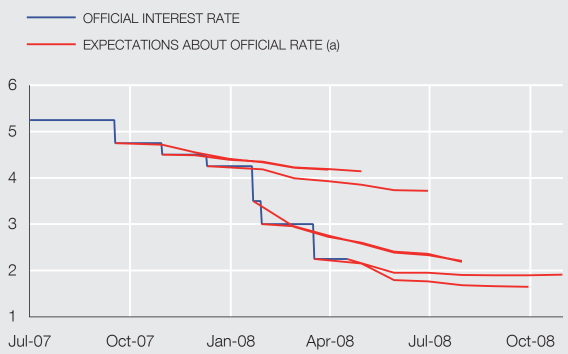
Further to the financial turbulence which began in summer 2007, and in order to mitigate its adverse effects on economic activity and financial stability, the US economic authorities have reacted swiftly and increasingly more decisively on four main fronts: the traditional fronts (monetary and fiscal policy) and others more directly aimed at countering the impact of the turbulence on the financial system (the provision of liquidity to banks and financial policy).

As regards monetary policy, the Federal Reserve (Fed) substantially cut official interest rates, especially in the period between January and March (by 100 bp between August and end-2007, and by 200 bp in 2008 Q1). However, the traditional channels for passing through these cuts to activity seem to be partially blocked by the persisting financial uncertainty, in particular that operating through the property market. In fact, these cuts have not managed significantly to reduce long-term borrowing costs either on the mortgage market or in the corporate sector. As can be seen in panel 1, each reduction in official interest rates in the US seems to have fuelled expectations of further cuts, although such expectations fell at the end of April.

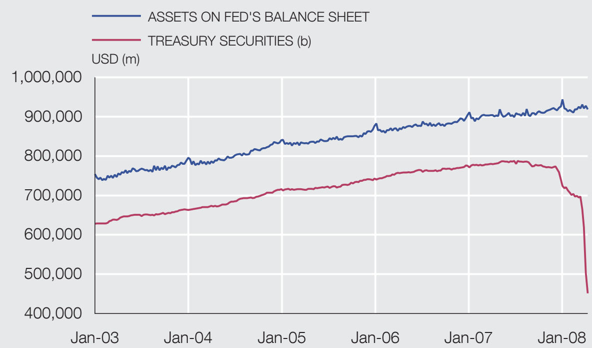
In the fiscal policy area, the need for a stimulus was raised shortly after the turbulence began, although this was not approved by Congress until January this year. The tax package, costing approximately 1.2% of GDP, is designed to increase household disposable income so as to lend some support to consumption, and would begin to have an effect on demand from the end of Q2 and, in particular, in 2008 Q3. However, there is uncertainty over whether the positive temporary effect on the growth of activity in those quarters will have been practically countered in full during 2009.

In response to continuing problems on the interbank market and to ongoing financial instability, the Fed made important changes to the provision of liquidity to markets (partly due to the relatively rigid existing framework for operations - in contrast to that of the Eurosystem). It set in place new procedures for lending funds through the Term Auction Facility (TAF) in December and the Primary Dealer Credit Facility (PDCF) in March. Also, from March it supplemented its Treasury securities lending programme through the creation of the Term Securities Lending Facility (TSLF). The TAF offers funds to commercial banks through an anonymous auction aimed at eliminating the stigma usually attached to the use of the central bank's discount facilities. The PDCF extends access to Federal Reserve funds via the discount window to the financial institutions with which the Fed conducts open market operations (20 primary dealers in total) and, for the first time, it includes the main investment banks not directly supervised by the Fed, which marks a significant change in thinking. Lastly, TSLF permits these 20 institutions to have access to loans of Treasury securities by pledging mortgage securities as collateral. All

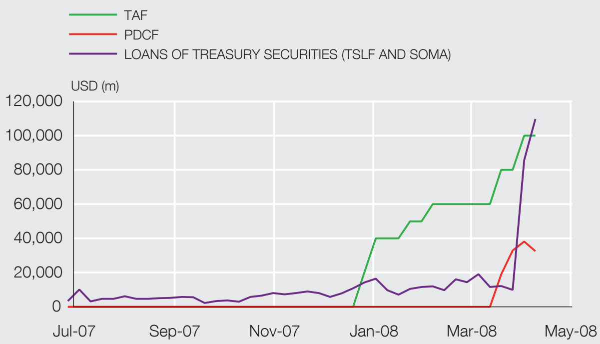
1 UNITED STATES: OFFICIAL INTEREST RATE AND EXPECTATIONS



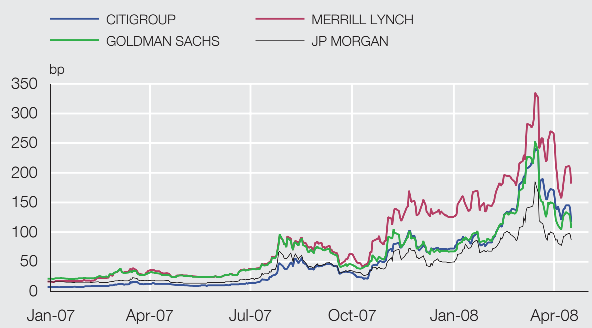
2 FEDERAL RESERVE ASSETS AND TREASURY SECURITIES HELD



3 NEW FEDERAL RESERVE LIQUIDITY FACILITIES



4 CDS 5-YEAR SPREADS FOR THE MAIN BANKS IN THE US



SOURCES: Datastream and Federal Reserve.

a. Expected interest rate following each cut in official rate and on latest available date.
b. Excluding Treasury securities on loan to financial institutions.

these new facilities offer financing for approximately one month, with a relatively low penalty. In addition to these new lines to provide liquidity, the Fed has also relaxed the conditions on the existing lines by reducing the spread between the discount rate and the official rate (from 100 bp to 25 bp), by lengthening the maximum term of these loans (from 30 to 90 days) and by extending the range of financial assets which can be used as collateral. Similarly, the Fed expanded the swap agreements with the European Central Bank and the Swiss National Bank, which enabled them to satisfy the demand by commercial banks for dollars in their respective spheres of influence.

Significantly, this extraordinary provision of liquidity has not altered the total size of the Fed's balance sheet since it has entailed, in parallel, a reduction of its holdings of Treasury securities so as not to compromise the official interest rate target (see panels 2 and 3).

In the financial policy area, the Fed itself and other US authorities have promoted measures to support the property market and the financial markets in general through agreements with and commitments to the private sector. In the first case the effects to date have been very limited (due to the voluntary nature of the mortgage renegotiation plans under the Paulson Plan), or there is uncertainty about how effective they will be (as in the moratorium envisaged in the Lifeline Project). Regarding support for the functioning of the financial markets, following some more limited measures, JP Morgan's bail-out of Bear Stearns in March marked a sea-change since it was an operation brought about and backed financially by the Fed. This action, which coincided with the PDCF, has sent out a clear message of support to the markets, helping dissipate tension and uncertainty about the sustainability of certain banks in the US, whose credit risks reached highs in mid-March, shortly before the Bear Stearns bail-out (see panel 4). However, despite the implementation of these measures and the provision of liquidity, money market tensions continued to run high in relation to the situation prior to summer 2007.

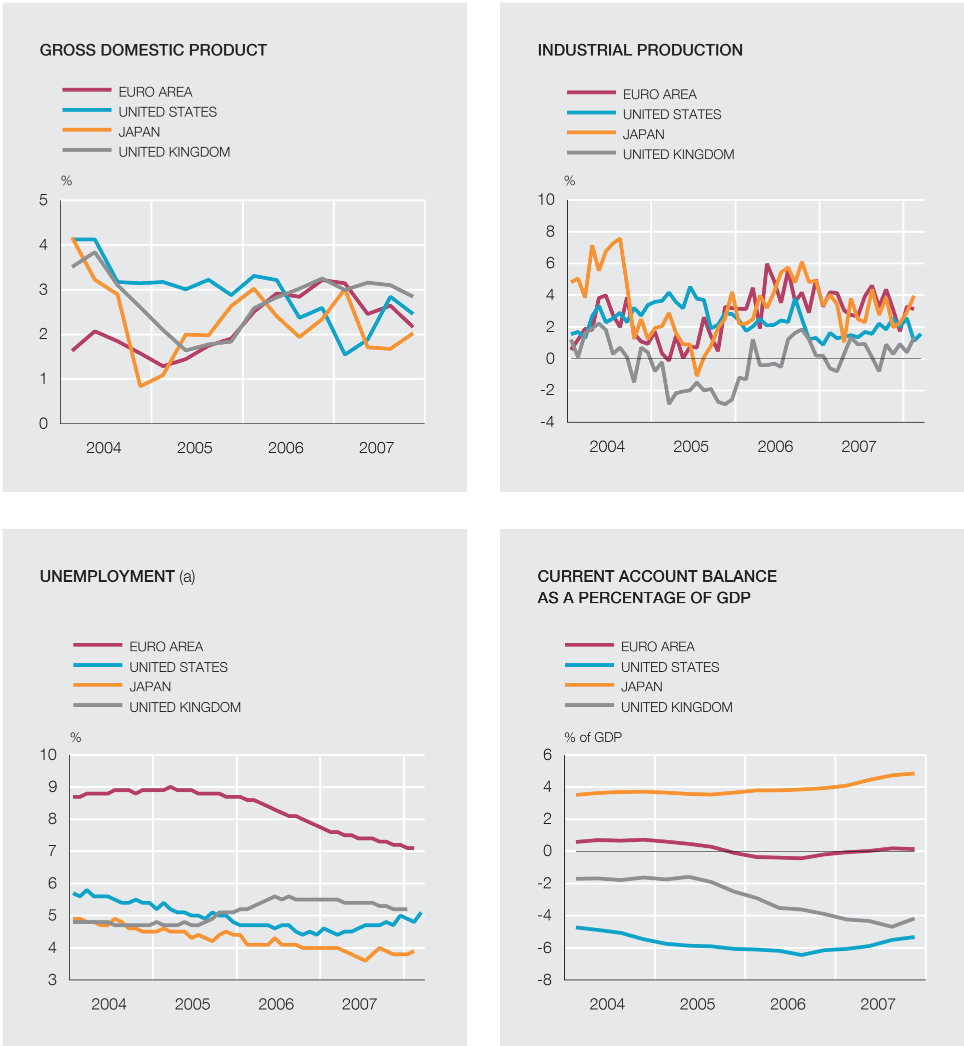
In short, in an initial phase (until December 2008) the authorities reacted essentially by using traditional instruments: moderate interest rate cuts, implementation of a tax package and the provision of liquidity. The second phase between January and March was dominated by monetary policy and interest rate cuts were stepped up. Lastly, the third phase, which began mid-March, was noteworthy due to the rescue of a bank with the backing of the Federal Reserve and the provision of liquidity to investment banks. And here, two key aspects should be highlighted: the preference for measures specifically targeting problem areas as opposed to general ones, and the patent readiness of the economic authorities to become directly involved, and not just as mediators, in resolving institutions' financial problems. At the same time, monetary policy (further decreases in official interest rates) seems to have been sidelined to some extent, which was also reflected in market expectations. Of note in this significant qualitative change is the central role assigned to the Federal Reserve (with the support of the Treasury Department) in leading and implementing economic policy responses, although the use of fiscal resources to alleviate the difficulties of the property sector in the next few quarters too cannot be ruled out.

ratio of vacancies to job-seekers and a slight rise in unemployment. Nevertheless, there are signs of an improvement in wages, which posted increases of more than 1% year-on-year in January and February. The construction sector began to recover in December following the adverse impact of the implementation of new building regulations in mid-2007. On the external front, the current account balance fell in February due to the worsening of the trade surplus. This, in turn, is linked to rising energy costs and it offset the slight rise in the income balance surplus. Inflation continued to grow over the quarter in step with rising oil and food prices, and both the overall and core rate stood at 1% in February. In this setting, at its April meeting the Bank of Japan once again held official interest rates unchanged at 0.50%.

In the United Kingdom, GDP for 2007 Q4 increased by 0.6% (2.8% in year-on-year terms), resulting in an increase for the year as a whole of 3% in comparison with 2.9% for 2006. However, the higher frequency indicators in 2008 Q1 seemed to indicate a slowdown. The services and manufacturing PMI shrank notably in March and the conditions for household access to credit continued to tighten, especially for mortgages. House prices continued to slow and increased by 1.1% year-on-year in March, the lowest rate since 1996. Although inflation increased slightly over the quarter to 2.5% year-on-year in March, the Bank of England revised inflation risks downwards and at its meeting on 10 April cut the official interest rate by 25 bp to 5%.

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

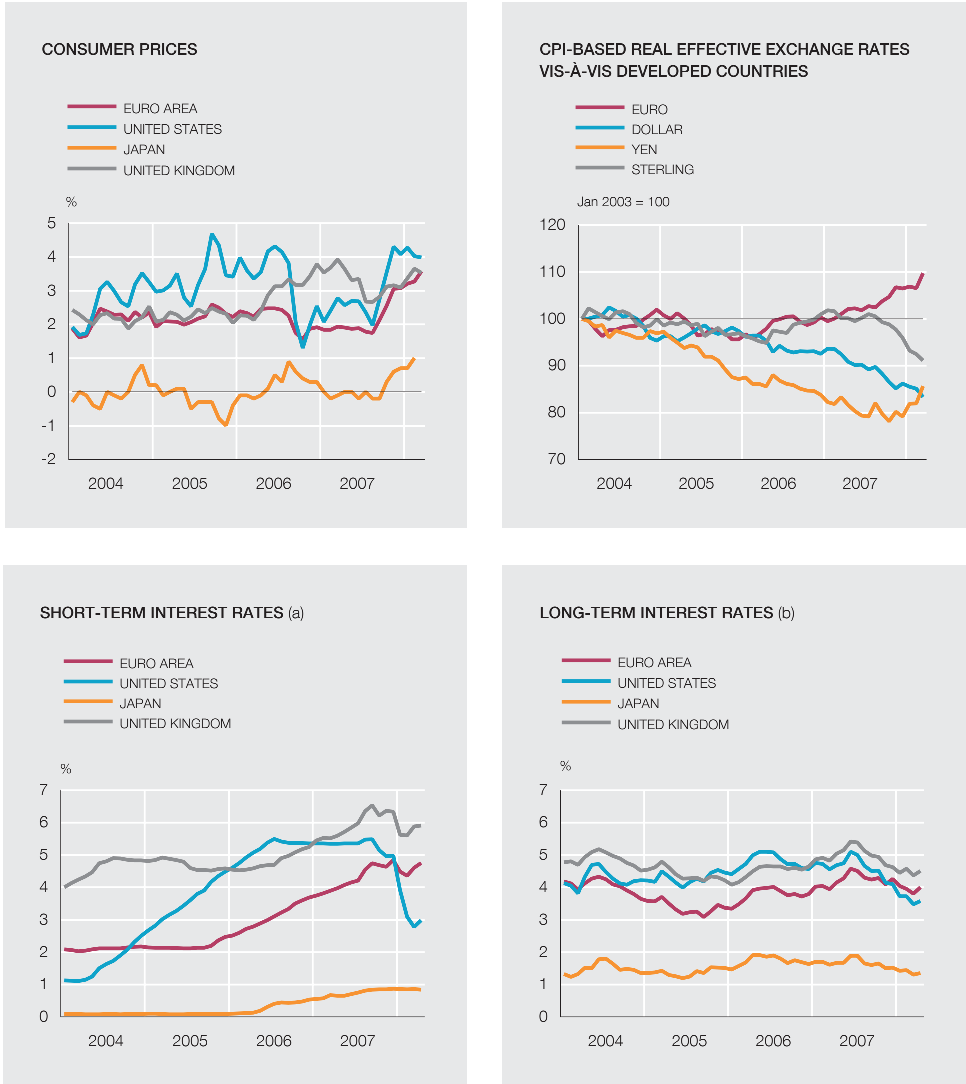
a. Percentage of labour force.

In the new EU Member States, GDP grew 6.3% in Q4, 0.3 pp up on the previous quarter and, consequently, the region's GDP increased 6.2% for the year as a whole, slowing by 0.4 pp with respect to 2006. Industrial production and retail sales indicators for Q1 show the continuing growth of activity. Inflation increased again in March (except in Hungary, Poland and Estonia) to a rate of over 10% year-on-year in the Baltic countries and in Bulgaria. Inflationary pressures led certain countries to tighten their monetary policy stance. In the fiscal realm, the major economies narrowed their public deficit in 2007 (only Hungary's exceeded 3% of GDP), due to the favourable performance of revenue against a backdrop of notable economic growth. The currencies participating in the Exchange Rate Mechanism (ERM II) did not record any sizeable fluctuations. In the institutional arena, the Slovak authorities made a formal request to join the euro area in January 2009.

In China, GDP growth for the whole of 2006 and 2007 was revised upwards to 11.6% and 11.9%, respectively, and growth in 2008 Q1 stood at 10.6% year-on-year. In the first three months of 2008, industrial production eased somewhat, affected by the bad weather. However, in that period the strength of investment in fixed assets in urban areas, retail sales and

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

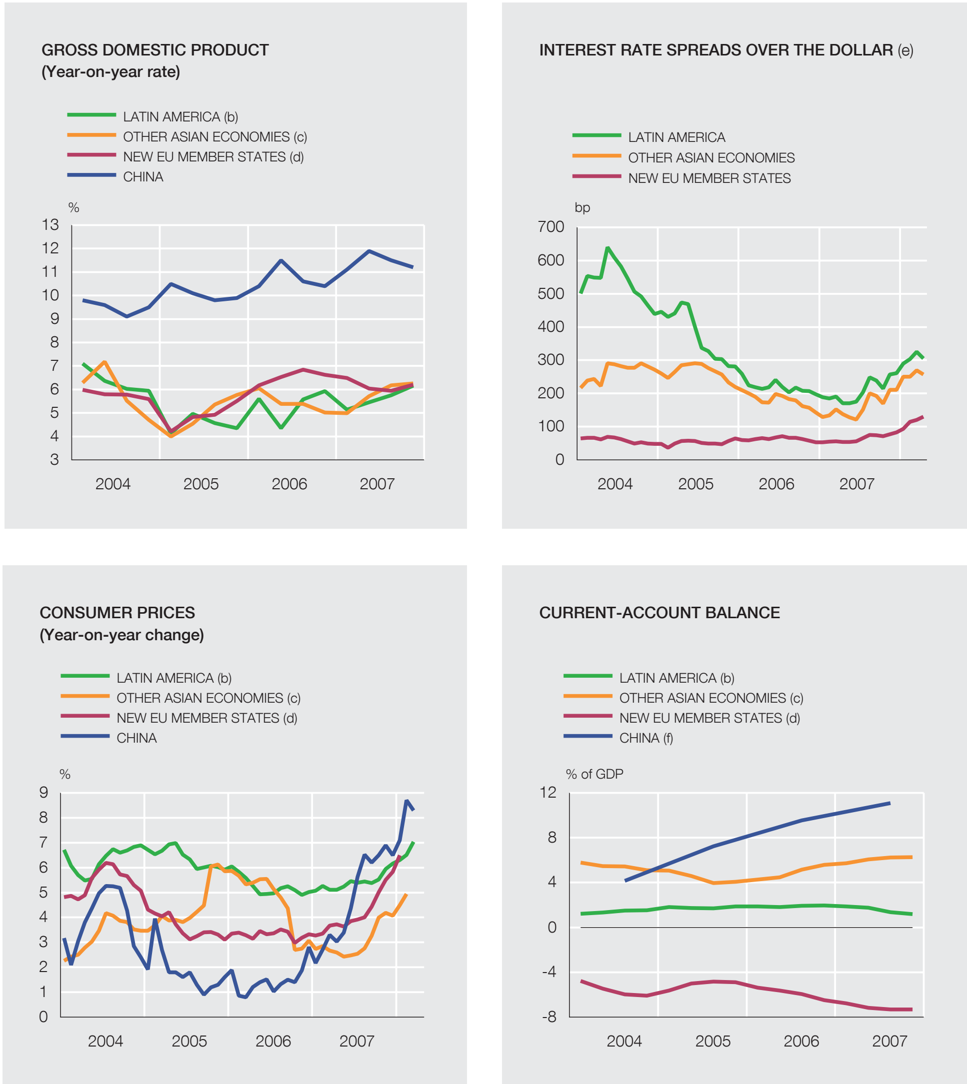
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

imports was reaffirmed. Exports continued to show some weakness, in line with 2007 Q4. Thus, in 2008 Q1, the trade surplus fell by 10.5% in year-on-year terms. Although the renminbi appreciated at a higher rate in recent months, foreign reserves continued to rise at a high rate, up to USD 1.68 million. During the quarter, the authorities raised the bank reserve requirement on three occasions from 14.5% to 16%, and the growth of the money supply and credit eased, despite which inflation reached a historical high in the quarter. Elsewhere in Asia, there was also a widespread increase in inflation, while industrial production moved on a quickening trend with respect to 2007 Q4, with the notable exception of India.

In 2007 Q4, GDP growth in Latin America as a whole accelerated moderately to 6.2% in year-on-year terms, up 0.4 pp on the previous quarter. In this period the positive contribution of domestic demand increased, amply offsetting the slight deterioration in external demand. The countries posting the highest growth rates were Argentina, Brazil, Colombia and Peru, while growth held steady in other countries. For the whole of 2007, the region's GDP expanded by 5.7%, up from 5.4% the previous year, with the acceleration discernible in all countries apart from Mexico and Venezuela. In line with the global trend, inflation increased over the

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

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

quarter from 5.8% in December to 6.4% in March, a rise on a similar scale to that recorded by the core inflation rate. Turning to monetary policy, interest rates moved higher in Colombia and Peru, but the 50 bp rise in Brazil, the first in three years, was especially prominent. Also, exchange rates against the dollar tended to appreciate in this period. That may have contributed to the deterioration over the quarter of trade balances, which felt the effects of higher imports, in particular in Brazil. Against this backdrop, the authorities tried out restrictive monetary measures other than interest rate rises, so as not to contribute to a greater appreciation of their currencies. Likewise, the central banks of Peru, Argentina and Brazil bought dollars to avoid the appreciation of their currencies, and the central banks of Chile and Colombia announced that they would begin to intervene on currency markets.

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

The available information on 2008 Q1 points to a euro area GDP growth rate similar to or somewhat higher than in 2007 Q4. Underpinning this resilience of euro area activity was the strength of the emerging economies on the external side and the vigour of the labour market on the domestic side. This behaviour was particularly notable because it took place against a background of increasing financial turbulence, rising commodity prices and appreciation of the euro exchange rate. Nonetheless, in the more medium term, the economic outlook continues to be surrounded by extraordinary uncertainty brought about by the prolongation of the global financial instability and by the slowdown of the US economy and its impact on the rest of the world. Foreseeably, the confluence of these factors will bring growth at below potential in the coming quarters. In fact, in recent months private institutions and international organisations have revised downwards their growth forecasts for the euro area in 2008 to rates of around 1.5%.

In 2008 Q1, the surge in oil and food prices on international markets resulted in a notable jump in HICP growth, which amounted to 3.6% in March. At the same time, the upward trend of core inflation steepened to a rate of 2.7%. For the rest of 2008, inflation is expected to remain above the price stability objective, although it will progressively moderate towards the end of the year as the prices of the energy and food components slow. In annual average terms, the inflation forecasts of public and private agencies stand at nearly 3%, after having been revised successively upward in recent months. More in the medium term, risks concerning the achievement of the price stability target persist, mainly due to the possible appearance of second-round effects on prices and wages, against a background of relatively tight labour market conditions, and to possible additional increases in commodity prices and in indirect taxes and administered prices (see Box 2). Against this, the expected lower dynamism of the euro area mitigates, at least in part, such upside risks.

Against this backdrop, in its latest meetings the Governing Council of the ECB decided to hold official interest rates unchanged at 4%, although it stressed the existence of strong upward pressures on inflation in the short term. Further, the ECB emphasised that its primary objective is price stability in the medium run and that the decisions taken contribute to achieving this goal. At the same time, it underlined its strong commitment to prevent the emergence of second-round effects on prices and to keep long-term inflation expectations anchored (see Box 3). The ECB acknowledged the high level of uncertainty about the effects and duration of the financial turbulence. Regarding fiscal policy, the aggregation of the data from the latest notifications submitted by the Member States of the euro area to the European Commission in spring indicates that the area's overall budget deficit in 2007 decreased by 0.7 percentage points with respect to the previous year, to 0.6% of GDP. This improvement was shared by a large number of countries, including Italy and Portugal, currently subject to an excessive deficit procedure. However, the new information suggests that the euro area's budget deficit in 2008 will deteriorate to approximately 1% of GDP, mainly due to the worse growth outlook and to tax rebates in some countries.

3.1 Economic developments

According to the second National Accounts estimate, euro area GDP expanded by 0.4% in 2007 Q4, 0.3 pp less than in the preceding quarter (see Chart 8). This slowdown was due to the lesser momentum of domestic demand and to the lower contribution from inventories,

EURO AREA ECONOMIC INDICATORS (a) TABLE 1

	2006		2007				2008	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1 (a)	Q2 (b)
GDP								
Year-on-year growth	2.9	3.2	3.2	2.5	2.7	2.2		
Quarter-on-quarter growth	0.5	0.8	0.7	0.3	0.7	0.4		
IPI (c)	4.2	4.0	3.9	2.9	4.0	3.1	*3.2*	
Economic sentiment	107.6	109.3	109.4	111.0	108.7	104.3	100.5	
Industrial confidence	3.3	5.7	5.3	6.3	4.3	2.3	0.3	
Manufacturing PMI	56.9	56.7	55.5	55.3	54.2	52.3	52.4	
Services confidence	19.0	19.7	20.7	22.0	20.0	15.0	10.7	
Services PMI	57.3	57.1	57.6	57.5	56.9	54.4	51.5	
Unemployment rate	8.1	7.9	7.6	7.5	7.3	7.2	*7.1*	
Consumer confidence	-8.7	-7.0	-5.7	-2.7	-4.0	-7.7	-12.0	
HICP (year-on-year growth) (d)	1.7	1.9	1.9	1.9	2.1	3.1	3.6	
PPI (year-on-year growth) (d)	4.6	4.1	2.8	2.3	2.7	4.4	*5.4*	
Oil price in USD (d)	61.2	62.8	62.3	71.8	78.2	91.2	104.3	*105.8*
Loans to the private sector (year-on-year growth) (d)	11.4	10.8	10.6	10.8	11.0	11.2	10.9	
Euro area ten-year bond yield	4.0	3.9	4.1	4.4	4.5	4.3	4.1	*4.2*
US-euro area ten-year bond spread	1.00	0.82	0.67	0.47	0.32	-0.03	-0.46	*-0.64*
Dollar/euro exchange rate (d)	1.266	1.317	1.332	1.351	1.418	1.472	1.581	*1.587*
Appreciation/ depreciation of the EER-22 (d)	3.3	4.5	0.9	1.5	3.7	6.3	3.6	*4.0*
Dow Jones EURO STOXX broad index (d)	11.9	20.3	3.4	9.9	6.1	4.9	-16.4	*-14.3*

SOURCES: Eurostat, ECB and Banco de España.

a. Quarterly average. The information in italics does not cover a full quarter.
b. Information available up to 17 April 2008.
c. Year-on-year growth rates of working days adjusted data.
d. End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

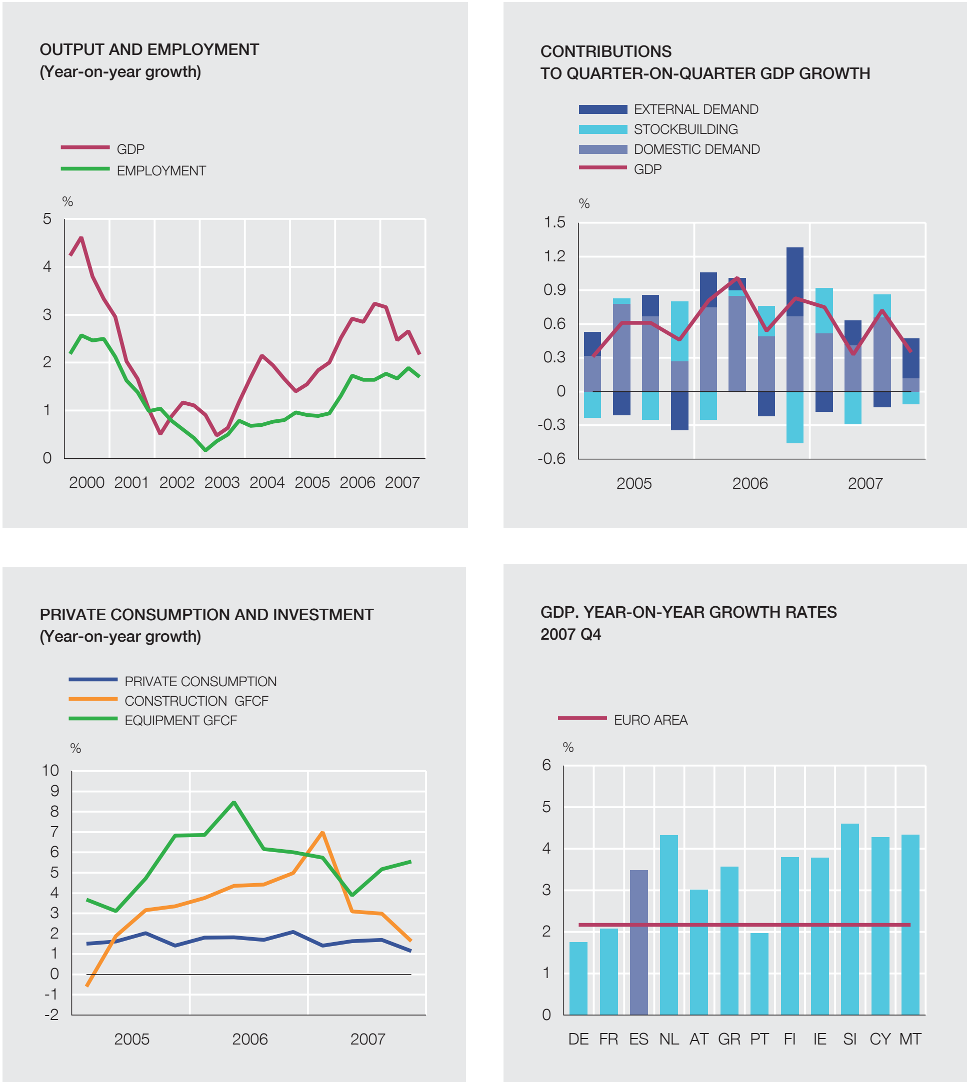
since the contribution of net exports to output growth widened. The deceleration of domestic demand came about from the falls in private and public consumption and from the stagnation of construction investment, which were only partly counterbalanced by the more vigorous capital goods investment. The fall-off in imports in 2007 Q4 offset the lower pace of export growth, and, as a result, the contribution of the net external balance to output growth widened by 0.4 pp to 0.3 pp. In year-on-year terms, output slowed from 2.7% in the period July-September to 2.2% in 2007 Q4. In 2007 as a whole, GDP was up by 2.6% (0.3 pp less than in 2006), driven by domestic demand and, to a lesser extent, by net exports. The breakdown by branch of activity in 2007 Q4 showed a significant quarter-on-quarter slowdown in industry and in market services, and to a lesser degree, in construction, while the value added of agriculture recovered.

The loss of dynamism of economic activity in 2007 Q4 was a feature shared by most countries. Thus, in Germany and France output decelerated by 0.4 pp to 0.3% and 0.4%, respectively, although the sectoral composition differed in the two countries. In particular, consumption and construction investment declined in Germany, while capital goods investment remained vigorous, and the contribution of net external demand stayed positive. French GDP growth was driven by consumption, construction investment and net exports, while inventories contributed negatively to the rise of output.

In the last quarter of 2007, employment continued to expand, although at a slightly lower pace than in the previous quarter. Thus, its quarter-on-quarter growth rate stood at 0.2% and the resulting year-on-year rise of 1.7% was 0.2 pp lower than that of Q3

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

(see Chart 9). Taking into account that the slowdown in output with respect to the previous year was sharper, labour productivity increased by 0.5%. The rise in compensation per employee implied a pick-up in unit labour costs, which showed an increase of 2%. This was in any event less than the rise in the GDP deflator, so unit margins again widened in the last part of the year, although at a notably slower pace than in the previous quarter.

The most recent economic information indicates that in the first part of the year the euro area's real activity may have grown at a pace similar to or somewhat faster than in 2007 Q4. From the standpoint of supply, the production of the industrial and construction branches showed notable dynamism in the first two months of the year (see Chart 10). Although the confidence of the manufacturing sector deteriorated in Q1 according to the European Commission surveys, it stands above its historical average. Also, the purchasing managers' surveys point to greater optimism in this sector in 2008 Q1. By contrast, confidence in the service sector decreased in Q1 according to both surveys, although its level is still consistent with expansion of the activity in the sector. The sentiment indicators relating to employment expectations held at high levels, although in the service sector they kept on their

EURO AREA. WAGE AND EMPLOYMENT INDICATORS
Year-on-year percentage changes

CHART 9

SOURCES: Eurostat and ECB.

a. Expectations based on European Commission sentiment indicators and Reuters PMI survey. Normalised data.

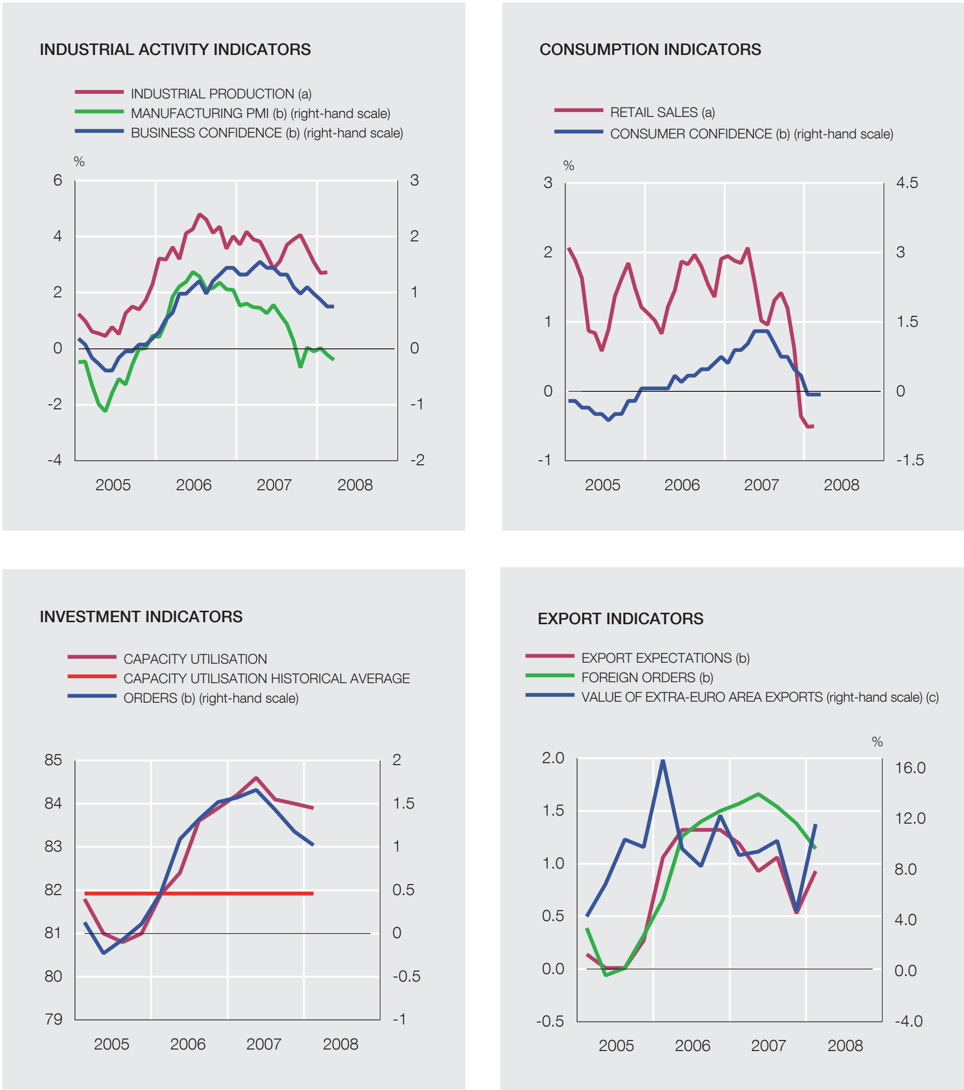
downward path. The unemployment rate decreased further to 7.1% in the first two months of 2008.

On the demand side, the spending-related indicators augured only moderate private consumption growth in 2008 Q1. To start with, the deterioration in retail sales to February was slight and milder than in the previous quarter. Car registrations showed high volatility and, on average, fell in the period January-March. Retail sector and consumer confidence again decreased in the first three months of the year and, in all likelihood, the tightening of credit standards and the extraordinary uncertainty associated with the financial turmoil further reduced consumers’ propensity to buy durable consumer goods. With regard to investment in capital goods, the indicators signal good prospects for this GDP component, given the high levels of capacity utilisation according to the Commission’s quarterly survey and the assessment of order books, despite its downward trend. However, the data published in January in the Commission’s half-yearly investment survey show a deceleration in the capital expenditure expected for 2008 as a whole. Finally, the indicators of external demand signal an expansion of sales to the rest of the world in the first quarter of the year. Indeed, although on average export order books fell in 2008 Q1, export expectations improved in that period and the nominal export data from the trade balance rose in January and February.

In short, the most recent information does not point to an additional deterioration in euro area activity in 2008 Q1, against a background in which, for the time being, the impact of the financial turbulence on the real economy seems to be limited. Thus, GDP will foreseeably continue to grow at similar rates to those in the last part of 2007, in line with the most recent forecasts of international organisations, supported by external demand and gross fixed capital formation. Thereafter, the performance will be closely determined by how strongly real activity is affected by the prolonged situation of financial market instability which, were it to last, could significantly stunt euro area growth, and by the extent of the deterioration in the international environment. In any event, the

EURO AREA. REAL INDICATORS

CHART 10



SOURCES: Eurostat and European Commission.

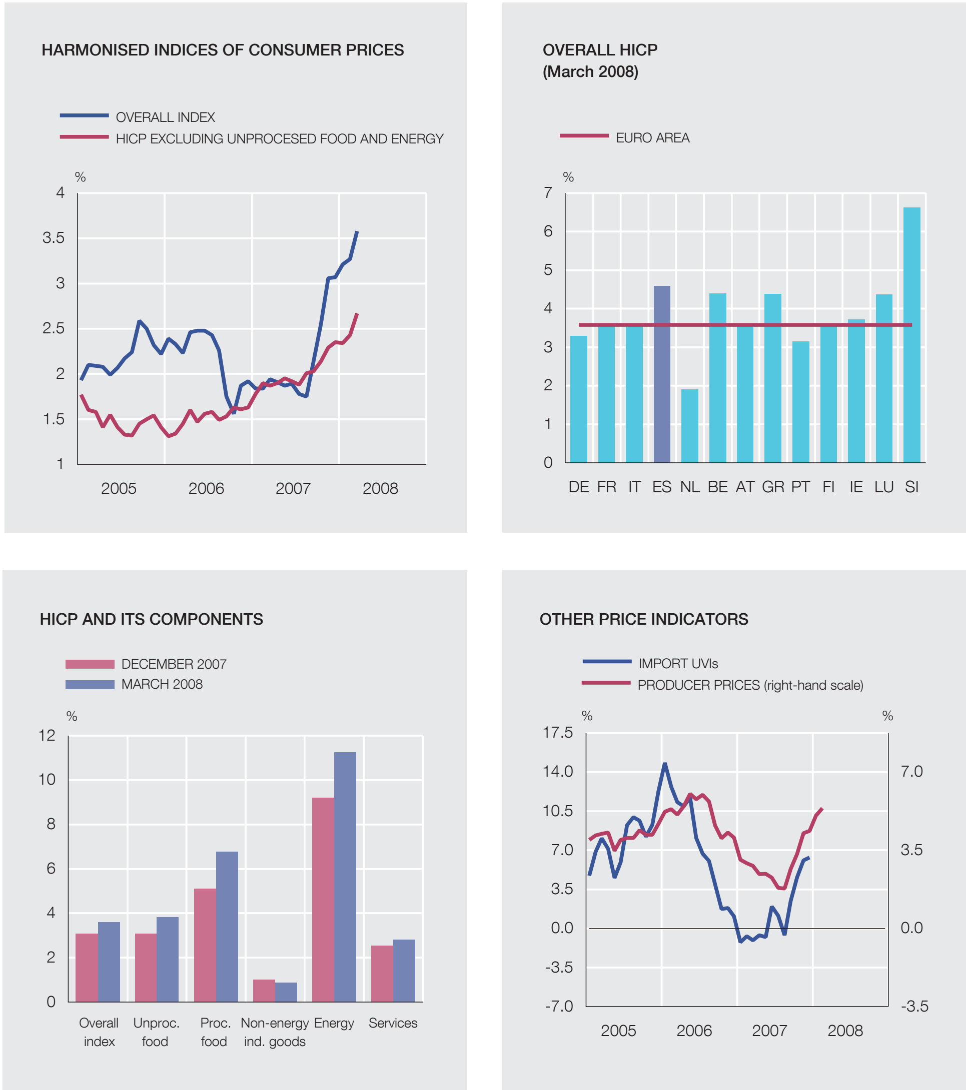
a. Non-centred year-on-year percentage changes, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.
c. Year-on-year rates of the original series. Quarterly average.

most recent forecasts already suggest that GDP will decelerate in 2008 to a rate below potential.

During 2008 Q1, HICP inflation picked up by 0.5 pp to a rate of change of 3.6% in March (see Chart 11). The performance of the overall index continued to be strongly shaped by the behaviour of the energy and food components. In particular, the soaring oil prices, which reached US$ 107 per barrel of Brent oil by mid-March, drove the energy price growth rate upwards from 9.2% in December to 11.2% in March. Meanwhile, the increase in food commodity prices on international markets has spread to the processed food component, which since December has accelerated by 1.7 pp to 6.8% in March. The price growth of these two components, together with the notable rise in service prices in March, resulted in an increase in core inflation of 0.4 pp to 2.7% between December and March. Also, the producer price index (PPI) continued its upward trend and reached a year-on-year rate of 5.3% in February. The energy price surge led the rise in the PPI in the first two months of 2008 and, to a lesser extent, the

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

CHART 11



SOURCES: Eurostat and ECB.

behaviour of durable and non-durable consumer goods and intermediate goods prices also drove the overall index.

Inflation is expected to decrease in the coming months as energy and food commodity prices decelerate. However, if these prices behave as the futures markets anticipate, their contribution to the inflation rate will continue to be high and inflation will remain above the price stability target until end-2008. More in the medium term, the continued easing of inflation will depend crucially on the absence of second-round effects on prices and wages. Against the current background of relatively tight labour market conditions, there is, however, a risk that these effects will be triggered (see Box 2). Conversely, the lesser world economic dynamism, particularly in the euro area, could help to mitigate the negative factors mentioned above.

According to the information published by the ECB, the current account deficit reached €19.2 billion in January 2008, well above the also-negative balance of €3.7 billion in the same month of the previous year. This deterioration was due to the higher deficits on current transfers and

Since the closing months of 2007, the ECB Governing Council has been warning of clear upside risks to price stability, mainly relating to the possibility of second-round effects on wage and price setting stemming from past oil price increases and, more recently, also from food price rises.

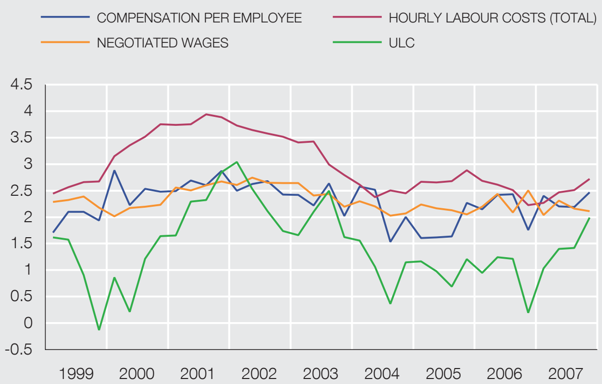
Second-round effects occur when a rise in inflation due to a temporary shock leads to higher wage demands by workers or directly to higher wage settlements due to automatic mechanisms that index wages to a certain price indicator[1]. If these wage increases end up passing through to prices, the impact of the original shock on inflation will be greater and longer lasting (than that which would result from its first-round effects[2]). Second-round effects can also be generated as a result of firms' price-setting mechanisms, particularly if they attempt to preserve their profit margins, or even to take advantage of inflationary periods (and probably of an insufficient level of competition) to increase those margins. This Box focuses, however, on the wage channel.

The recent behaviour of labour cost indicators shows that, overall, the euro area is still in a situation of wage moderation (see Chart 1). Wage costs have accelerated since 2005 in line with the improved

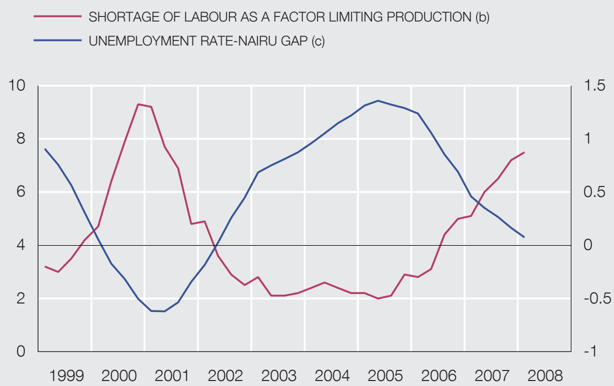
1. It is important to clarify that an increase in the wage growth rate, if it occurs, should not necessarily be attributed to second-round effects, since it may be due to greater buoyancy of activity, particularly of the labour market, or to other exogenous factors, such as labour supply or productivity.

2. First-round effects of a price shock are defined as the sum of the direct effect of that shock on specific items of the price index and the indirect effect that takes place when the shock bears on intermediate goods and is transmitted to the final good or service through the production chain.

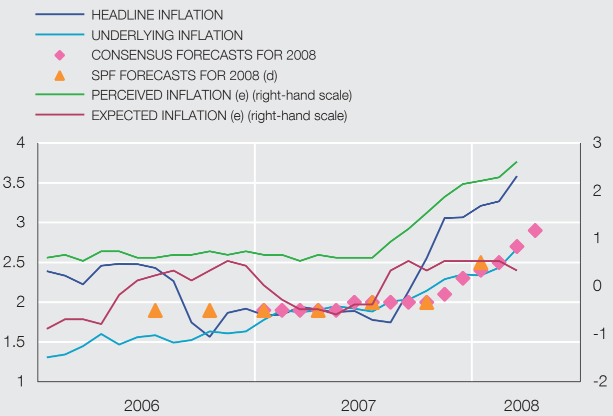
1 LABOUR COSTS (a)



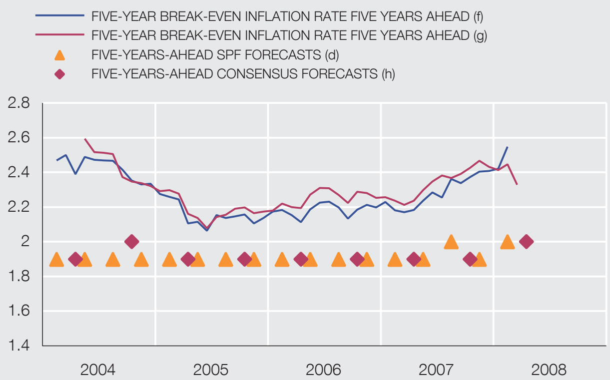
2 LABOUR MARKET SLACK



3 SHORT-TERM INFLATION EXPECTATIONS



4 INDICATORS OF LONG-TERM INFLATION EXPECTATIONS



SOURCES: ECB, European Commission, Consensus Forecasts, Eurostat and OECD.

a. Year-on-year growth rates.
b. Percentage of firms reporting a shortage of labour as a constraint to production, in response to a question posed quarterly in the EC Industrial Survey.
c. OECD NAIRU estimate.
d. The SPF (Survey of Professional Forecasters) is a quarterly survey prepared by the ECB which collects the forecasts of a broad range of analysts from financial and non-financial institutions for inflation, the GDP growth rate and unemployment rates in the euro area.
e. Price trends in the last (next) twelve months, based on the EC Consumer Survey. Normalised data.
f. Implicit in inflation-indexed bonds (seasonally adjusted).
g. Implicit in inflation-linked swaps.
h. The long-term Consensus forecasts are published only in April and October.

performance of employment, but have done so moderately, and their current growth is below the historical average and below the level indicated by their fundamental determinants. This is so even though the automatic indexation of wages to current or past inflation affects a portion of euro area employees. As regards the significant acceleration of unit labour costs in 2007, this was mainly due to lower productivity gains, in a context of slowdown in euro area economic growth.

As far as the outlook is concerned, labour costs in the short and medium term will be affected by labour market developments and the amount of slack in it. Both the unemployment gap (measured by the difference between the observed unemployment rate and the non-accelerating inflation rate of unemployment or NAIRU) and the indicator of factors limiting production (taken from the EC industrial survey) show that the slack in the labour market has diminished significantly since the end of 2005 (see Chart 2). For instance, the percentage of employers declaring that shortages of labour are constraining their production has increased continuously and notably since 2005 Q3 and its most recent value (7.5%) is well above the historical average of 3.7%.

These indicators suggest that labour costs may grow in the short and medium term due to the tightening of labour market conditions. In fact, the wage negotiations of recent months evidence workers' greater determination to win larger wage increases after a prolonged period of real wage containment. However, the economic growth outlook for the coming year, revised appreciably downward as a result of the financial market turmoil and the sharp downturn in the US economy, would mitigate this risk, since large wage increases are harder to achieve in an economic slowdown.

Another significant factor in the possible emergence of second-round effects on wages is the impact of price behaviour on inflation expectations. As seen in Chart 3, inflation (particularly headline inflation, but also underlying inflation) has risen a good deal since September 2007. This notably raised the short-term inflation forecasts of private analysts and public organisations, as well as the perceived and expected inflation reported by consumers. Also, even though long-term expectations based on surveys do not seem to have been significantly affected, those derived from financial indicators do show a clear upward trend, although it is difficult, particularly in the current financial turbulence, to distinguish what part of this increase is due to an actual rise in inflation expectations and what part is due to a rise in risk premiums (see Chart 4). These developments confirm that there are reasons for being on the alert, since if the inflation expectations depart from the ECB's inflation target, there may be higher wage demands that would trigger second-round effects.

In short, although wage moderation still prevails in the euro area, the amount of slack in the labour market has shrunk significantly and the recent rise in inflation has notably raised short-term inflation expectations. Thus the risk of second-round effects has heightened and this scenario is only relieved by the prospect of slower growth in activity in 2008.

goods (the latter because imports increased more than exports) and to the decline in the incomes balance, which turned negative after the positive value a year earlier. For its part, the surplus on the services balance increased slightly. Meanwhile, January saw a significant net outflow of capital in the form of direct investment (€32.2 billion) exceeding that seen in the same month of 2007, while net inflows of portfolio investments increased to €54.3 billion. The surplus of the resulting basic balance, which aggregates these two sub-balances and the current account balance, decreased significantly to €2.9 billion from €25.2 billion in January of the previous year (see Chart 14).

According to the aggregation of the latest data notified by the euro area Member States to the European Commission in spring, the budget deficit of the euro area as a whole in 2007 decreased by 0.7 pp with respect to the previous year to 0.6% of GDP (see Table 2). The lower deficit seems to be due to the decrease in expenses and to the disappearance of the impact of the temporary factors that had raised the deficit in 2006, particularly in Italy, while the notable dynamism of activity in euro area boosted tax takings. The deficit therefore behaved more favourably than expected by the European Commission in autumn and than the aggregation of the stability programmes submitted between the end of 2007 and the beginning of 2008, which envisaged a negative balance of 0.8% of output. According to the most recent notifications, the debt ratio decreased to 66.3% in 2007 from 68.4% a year earlier.

GENERAL GOVERNMENT BUDGET BALANCES AND PUBLIC DEBT OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	BUDGET BALANCES (a)						
	2006	2007 (b)	2007 (c)	2007 (d)	2008 (c)	2008 (d)	2009 (c)
Belgium	0.3	-0.3	0.3	-0.2	0.5	0.0	0.7
Germany	-1.6	0.1	0.0	0.0	-0.5	-0.5	0.0
Greece	-2.6	-2.9	-2.7	-2.8	-1.6	-1.6	-0.8
Spain	1.8	1.8	1.8	2.2	1.2	1.2	1.2
France	-2.4	-2.6	-2.4	-2.7	-2.3		-1.7
Ireland	3.0	0.9	0.5	0.3	-0.9	-0.9	-1.1
Italy	-3.4	-2.3	-2.4	-1.9	-2.2	-2.4	-1.5
Luxembourg	1.3	1.2	1.0	3.0	0.8	1.3	1.0
Netherlands	0.5	-0.4	-0.2	0.4	0.5	1.1	0.6
Austria	-1.5	-0.8	-0.7	-0.5	-0.6	-0.6	-0.2
Portugal	-3.9	-3.0	-3.0	-2.6	-2.4	-2.4	-1.5
Slovenia	-1.2	-0.7	-0.6	-0.1	-0.9	-0.9	-0.6
Finland	4.1	4.6	4.5	5.3	3.7	4.6	3.6
Malta	-2.6	-1.8	-1.6	-1.8	-1.2	-1.2	-0.1
Cyprus	-1.2	-1.0	1.5	3.3	0.5	1.1	0.5
PRO MEMORIA: Euro area (including Malta and Cyprus)							
Primary balance	1.5	2.1	2.2		2.1		
Total balance	-1.3	-0.8	-0.8	-0.6	-0.9	-1.0	-0.4
Public debt	68.4	66.5	66.6	66.3	64.8	65.0	62.8

SOURCES: European Commission and national stability programmes.

a. Deficit (–) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. European Commission forecasts (autumn 2007).
c. Stability programme objectives submitted between the end of 2007 and the beginning of 2008. As Belgium has not yet submitted its objective, the stability programme forecasts for end-2006 have been used.
d. EDP notification (spring 2008)

As anticipated in the stability programmes submitted at end-2007, in that year no Member State exceeded the 3% deficit limit set in the Stability and Growth Pact. In addition, the improvement in budget figures was shared by a large number of countries, including the two Member States subject to excessive deficit procedures (Portugal and Italy), where the correction was significant (by 1.3 pp and 1.5 pp to 2.6% and 1.9%, respectively). In the second case, this improvement was due to the disappearance of some temporary measures taken in 2006 and to increased direct tax takings. Nevertheless, some countries, such as France, where taxes were cut following the May 2007 elections, saw heightened budgetary imbalances, and others, such as Ireland, aggravated their fiscal surplus by conducting procyclical fiscal policies against the recommendations made in the European fiscal framework.

Although for the time being the Commission has not published the structural balance based on the new information from the notifications, the estimates published in its autumn report suggest that the fiscal policy stance in 2007 was contractionary. The latest information from the notifications suggests that the euro area's budget deficit will increase in 2008 to approximately 1% of GDP, mainly due to the deterioration in the growth outlook and to certain tax cuts in some countries, including most notably those relating to corporate income tax in Germany and to social security contributions in Germany and France. However, a higher deficit cannot

One of the channels through which monetary policy can influence prices is by its effect on long-term inflation expectations. If economic agents believe in the commitment of central banks to maintain price stability , the wage and price setting mechanisms will contribute to the achievement of inflation targets. For this reason, the Governing Council of the European Central Bank regularly emphasises the importance of long-term inflation expectations remaining firmly anchored and of the need to monitor them very closely.

In the euro area there are two main sources of indicators of long-term inflation expectations: opinion surveys, such as, for example, the ECB's survey of professional forecasters, and the indicators of break-even inflation calculated from financial instruments, particularly inflation-linked bonds and inflation swaps. The main advantage of the latter is their higher frequency, which enables a knowledge to be had at all times of the market's opinion and of its response to the economic situation and to economic policy actions.

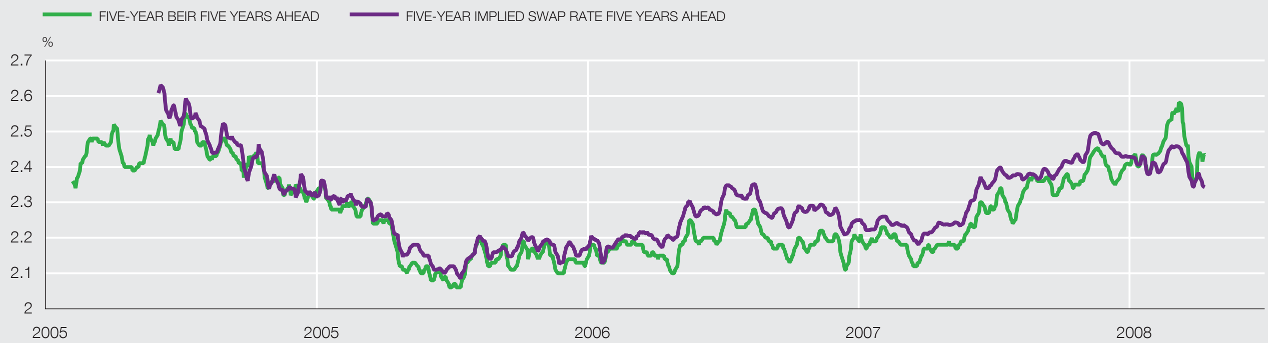
The break-even inflation rate (BEIR) estimated from inflation-linked bonds in the euro area is calculated as the difference between the yield on a nominal bond and that on a bond indexed to the HICP (excluding tobacco) with the same characteristics in regard to issuer and maturity. This measure approximates the hypothetical inflation rate at which the expected yield of the two types of bonds is equal. The main advantage of BEIRs, in addition to their high frequency due to continuous trading on the bond and derivatives markets, is the availability of a considerable number of maturity periods which allows measures of break-even inflation to be calculated for different time horizons and, moreover, the term structure of real interest and inflation rates to be estimated.[1] These curves enable, for example, 10-year BEIRs (an indicator of the average break-even inflation required in the markets for the next 10 years) to be decomposed into 5-year BEIRs and implied BEIRs five-to-ten years ahead, which provide more accurate information on the overall expected inflation rate (and associated risk premium) in the medium to long term.

Inflation swaps are contracts for the exchange of two capital flows, one of which depends on the inflation observed over the life of the swap. Break-even inflation is the rate that, ex ante, would equate the nominal rates exchanged. Inflation-indexed swaps offer a wide range of maturities, so, as in the case of BEIRs, a curve of break-even inflation versus contractual maturities can be obtained and the most significant values selected.

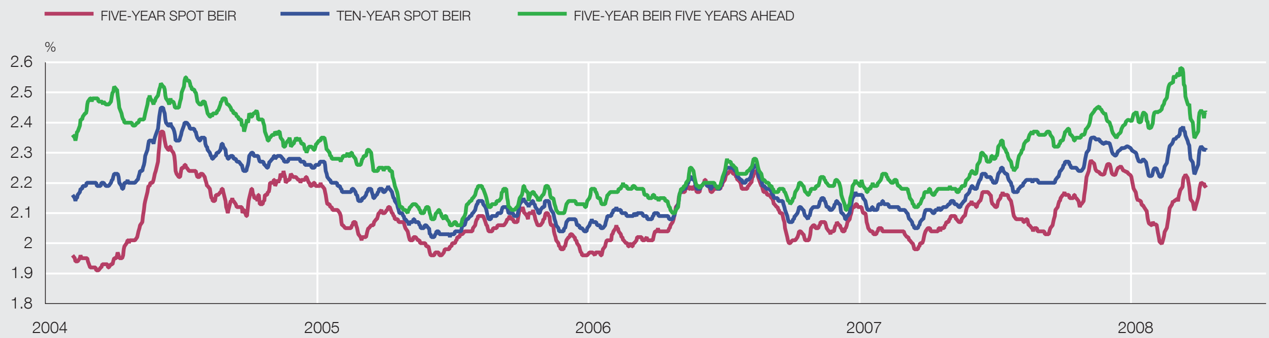
However, both indicators of break-even inflation are imperfect measures of the market's inflation expectations, for a variety of reasons. The main one is that investors are averse to risk and require an ad-

1. See J. Ejsing, J.A. García and T. Werner (2007), Estimating real and inflation term structures using euro area inflation-linked bond data, ECB Working Paper series No. 830, December.

1 MEASURES OF BREAK-EVEN INFLATION:



2 BREAK-EVEN INFLATION RATES:



SOURCES: ECB and Reuters.

ditional remuneration or risk premium when contract terms get longer, because of the uncertainty as to how economic variables will behave in the future. In the case of inflation swaps, furthermore, a premium may be offered to offset counterparty risk and an organised market may be lacking, which makes it difficult to obtain data of relatively uniform quality over time. The lower liquidity of inflation-linked bonds with respect to conventional ones implies the presence of a premium on the yield of the former, which will reduce the BEIR and introduce downward bias in the resulting inflation expectations. Further, inflation-linked bonds are subject to technical or institutional factors which may sometimes reduce temporarily the information content of BEIRs on inflation expectations.

Charts 1 and 2 present some alternative measures of break-even inflation for the euro area. As can be seen, these have followed an upward path since 2007 Q2. This increase might reflect rising inflation expectations. However, given the general reassessment of risks in financial markets in that period, it is also likely to reflect a rise in the associated risk premium. The upward trend intensified notably in early 2008, particularly in BEIRs. The strong demand for short- and medium-term (high grade) sovereign bonds in those months seemed to trigger substantial fluctuations in 5-year BEIRs, which were mechanically translated into sudden movements in long-term implied BEIRs.

These recent events underline the complexity of interpreting movements in indicators of break-even inflation, given that they can be subject to distortions that are difficult to identify and even harder to quantify. For this reason, it is important to analyse these break-even inflation measures together with indicators of inflation expectations drawn from surveys, particularly in the present setting of significant financial market turbulence.

be ruled out, especially in a context of high uncertainty surrounding the economic prospects of the euro area.

3.2 monetary and financial developments

In the first few months of the year, the euro area financial markets became increasingly affected by the financial turbulence initiated last summer in the US subprime mortgage sector. In particular, as well as the liquidity problems in interbank markets, instability worsened in other segments and credit conditions tightened.

The ECB Governing Council decided to hold official interest rates unchanged at 4% for the minimum bid rate on main refinancing operations and at 3% and 5% for marginal deposit and lending facilities, respectively (see Chart 12). However, the ECB confirmed the strong inflationary pressures in the short term, against a background of vigorous money and credit growth and of sound economic fundamentals, while at the same time acknowledging the high level of uncertainty as to the effects and duration of the financial turmoil. In any event, the ECB emphasised that its primary objective is maintaining price stability in the medium term and that the decisions taken contribute to achieving that objective. Lastly the ECB underlined its commitment to preventing second-round affects and the materialisation of upside risks to price stability over the medium term.

The tensions in the interbank markets tended to ease in the first two months of the year. From March, however, they re-emerged, linked both to liquidity problems and to the rise in counterparty risk premiums. Hence the yield spread between unsecured interbank transactions (EURIBOR) and secured ones (EUREPO) widened again and by mid-April stood at around 90 bp on one-year maturity operations. Against this background, the ECB continued to inject liquidity on an extraordinary basis through main refinancing operations, in which volumes above those considered to be neutral were assigned, and, above all, through supplementary longer-term operations. Also, the ECB continued acting in co-ordination with other central banks and in March broadened the agreement with the Federal Reserve to supply dollar-denominated funds.

EURO AREA INTEREST RATES

CHART 12

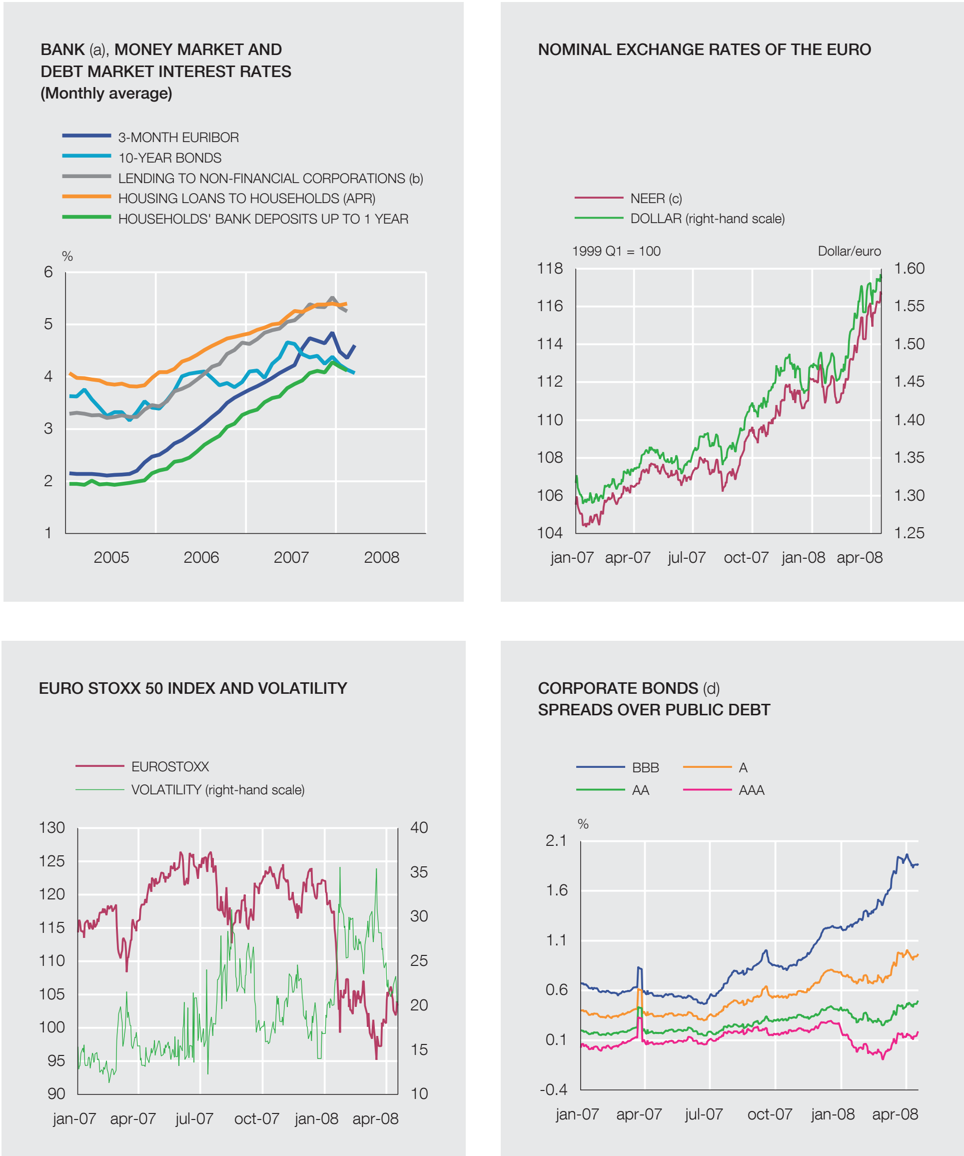
SOURCES: ECB and Banco de España.

a. Estimated using Euribor data.

In the first quarter of the year, 10-year government debt showed a gradually declining yield (albeit with volatile behaviour) as its role as a safe haven became increasingly important. In April, however, the return rose again to 4.2%. In the United States, the monetary policy relaxation and the worsening macroeconomic outlook acted to further reduce long-term interest rates, which in April stood some 60 bp below those in Europe, as compared with a difference of 30 bp in December (see Chart 13). The quest for credit quality and liquidity also led to a widening of spreads between German sovereign bonds and their equivalents in other euro area countries, particularly between end-February and mid-March. Yield spreads on the private bond markets have continued to increase in 2008 to date, most markedly in the bonds of lowest credit quality.

The financial turbulence affected stock market indices more clearly at the beginning of 2008, as economic agents perceived a greater impact on economic activity, particularly in the United States. Thus, following the notable losses in January, share prices continued to fall with a high degree of volatility until about mid-March. Since then, the Federal Reserve's support of JP

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX CHART 13



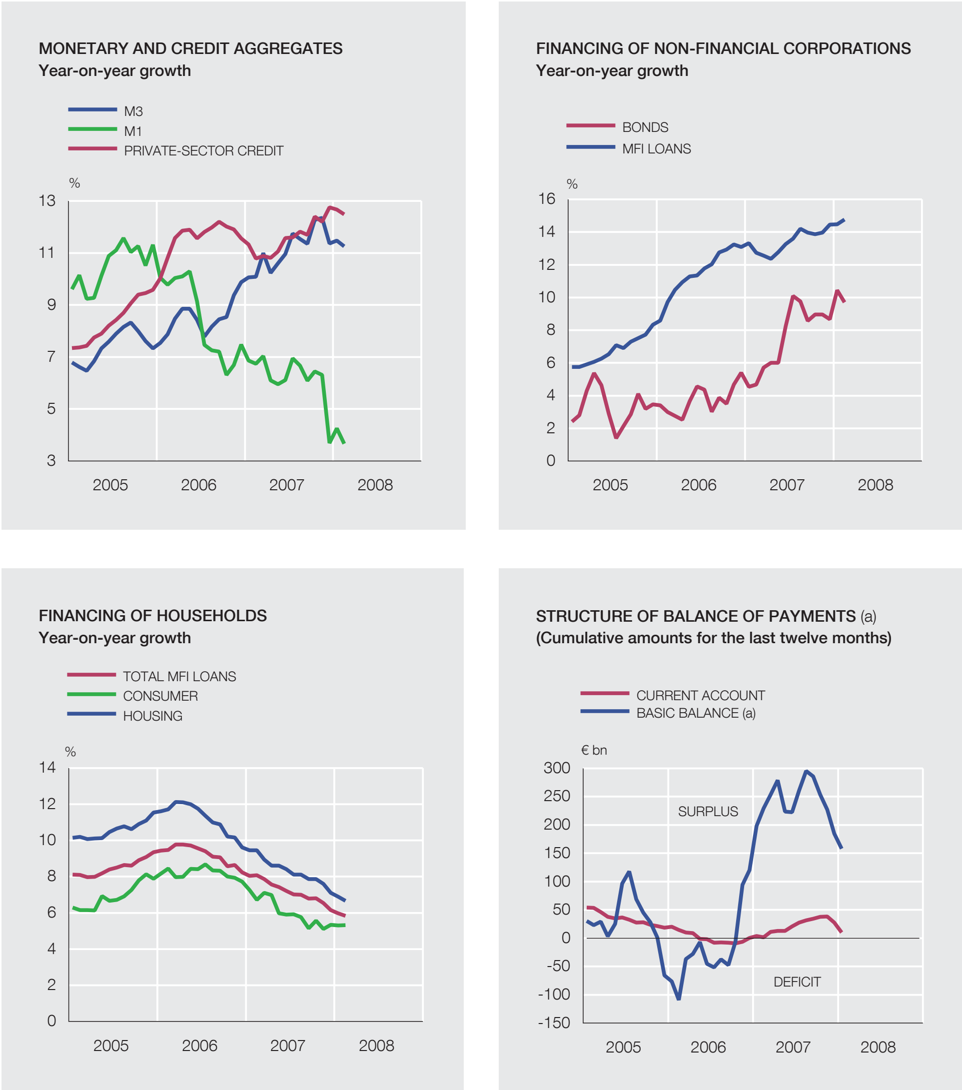
SOURCES: ECB and Banco de España.

a. Statistics on interest rates on new business compiled by the ECB.
b. Floating interest rates and up to 1 year initial rate fixation.
c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
d. Euro-denominated bonds issued by non-financial corporations.

Morgan's acquisition of Bear Stearns and the US official interest rate cuts spurred indices not only in that country, but also in the euro area, where from mid-March to the date this Bulletin went to press, the cumulative gain of the EURO STOXX broad index amounted to approximately 9%. This improvement did not, however, offset the negative performance of the first weeks of January, and the cumulative losses since the beginning of the year exceed 12% in 2008.

In the year to date, the prolongation of the financial instability, the deterioration of the US economic situation and the expectations of widening interest rate spreads between this country and the euro area helped the euro to continue its upward trend, which was particularly sharp from end-February. Hence the nominal effective exchange rate appreciated ap-

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS CHART 14



SOURCES: ECB and Banco de España.

a. The basic balance is approximated by the sum of the balance on current account and direct and portfolio investment.

proximately 3% from December and the exchange rate against the dollar was up by 6% (see Chart 13).

The monetary aggregates continued to expand at high rates in the first few months of 2008, largely reflecting the flattening of the yield curve and the resulting higher demand for safe and liquid assets. Thus, in February the M3 aggregate increased by 11.3%, a slightly lower rate than in the previous month, but very similar to that in December. At the same time, the more liquid M1 monetary aggregate slowed in February as a result of the lower buoyancy of currency in circulation and particularly of overnight deposits, leaving its growth rate below 4%, at the same level as at end-2007 (see Chart 14).

Credit to the private sector continued to show signs of buoyancy in the first two months of the year, underpinned by the vigour of lending to non-financial corporations, which grew at 14.8% year-on-year in February. This behaviour suggests that, for the time being, bank loan supply has not contracted severely as a result of the financial turbulence, despite the tighter credit conditions revealed by the Bank Lending Survey. By contrast, loans to households slowed in the first two months of the year, posting an increase of 5.8%. Within these latter loans, those for house purchase slowed to 6.7% in February, while consumer loans held unchanged at a growth rate of 5.3%. According to the Bank Lending Survey, in this case, the lower growth might be due to tighter credit conditions and to a fall in loan demand by households. Lastly, loans to non-monetary financial institutions again grew briskly, probably in line with the recourse to this type of financing in view of the lack of liquidity in the markets.

4 The Spanish economy

On QNA estimates, GDP growth in 2007 Q4 was 3.5% year-on-year, accentuating the slowing profile it had shown throughout the year. The information available for the opening months of 2008 indicates a steeper slowdown in activity in 2008 Q1. For this quarter the GDP growth estimate is 2.8% year-on-year (0.4% quarter-on-quarter) as a result of slacker national demand, whose growth rate fell to 3%, whereas the contribution from the external sector improved slightly to –0.3 pp (see Chart 15). The loss of momentum in national demand in 2008 Q1 was widespread, with the exception of government consumption, which advanced at a sharper pace.

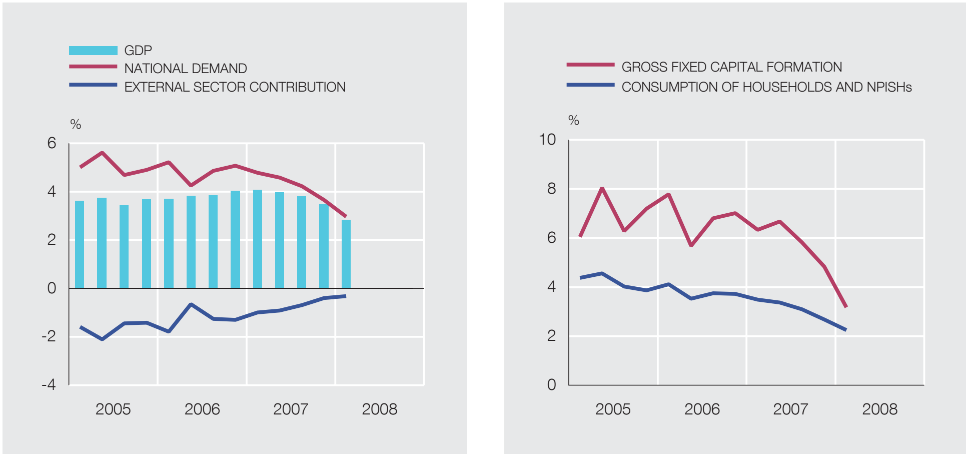
On the supply side, and except for the industry and energy branch, whose pace of growth remained practically unchanged, the slowdown in value added was extensive to all branches of activity, although it was sharper in construction. Services continued to post notable growth, albeit moving on the above-mentioned slowing trajectory. As for employment, the indicators available point to less buoyancy in line with GDP estimates and, consequently, the pace of growth in apparent labour productivity for the whole economy is expected to hold steady at approximately 1%. At the same time, compensation per employee is projected to accelerate significantly due to the higher wage rates under negotiation in collective bargaining agreements and, in particular, to the activation of indexation clauses in the 2007 collective bargaining agreements, as a result of which unit labour costs are estimated to rise in Q1. Turning to consumer prices, the CPI climbed further in the opening months of the year to an average for Q1 of 4.4% year-on-year, up 0.4 pp on 2007 Q4, as a result of rising energy and food prices. Core inflation held at 3.2%, a similar rate to that of 2007 Q4.

4.1 Demand

In 2007 Q4, final consumption expenditure of households and NPISHs grew by 2.7% year-on-year, 0.4 pp down on the previous quarter. According to the latest conjunctural information, this moderating trend in private consumption intensified in the early months of 2008 (see Chart 16) and, as a result, it is estimated that household consumption may have slowed to 2.2%. Against a backdrop of uncertainty over the economic and international financial situation, coupled with relatively high inflation rates, consumer and retail trade confidence slid further in 2008 Q1 to thirteen-year lows. Among the quantitative indicators, the tax authorities' data on large corporations for January and February indicated less dynamism in their domestic sales of consumer goods and services. The real retail trade index fell again in the same period. Lastly, under consumer durables there was a significant drop in new car registrations in 2008 Q1.

It is difficult to determine whether this easing in private consumption is due to the performance of disposable income or, rather, is in response to other conditioning factors. Admittedly, household disposable income is being unfavourably impacted by less dynamic job creation, the heavier financial burden derived from higher interest rates and the rise in inflation (which diminishes household purchasing power); but the wage increases agreed upon in early 2008 and, above all, the activation of indexation clauses for 2007 for a considerable amount, could be countering these adverse effects. As for other determinants of consumption, the pace of growth of household wealth (in the shape of real estate and financial assets) slowed due to lower expectations of property appreciation (house prices rose by 3.8% year-on-year in Q1, down 3.4 pp on 2007 Q1) and lower share prices. These developments in household assets together with the poor performance of the consumer confidence index would suggest that the savings rate had continued to recover in line with data from the non-

MAIN DEMAND AGGREGATES (a) CHART 15



SOURCES: INE and Banco de España.

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

PRIVATE CONSUMPTION INDICATORS CHART 16

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

a. Year-on-year percentage change based on the seasonally adjusted series.
b. Normalised indicators (deviation from the mean, divided by the standard deviation).

GROSS FIXED CAPITAL FORMATION

CHART 17

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

a. Year-on-year percentage change based on the seasonally adjusted series.
b. Normalised indicator (deviation from the mean, divided by the standard deviation).
c. Construction Industry Production Index. Year-on-year percentage change based on the seasonally adjusted series.

financial accounts of institutional sectors in 2007 Q4, which showed a rise in the savings rate to 10.3%.

The strength of general government final consumption slackened in 2007 Q4. It grew by 4.4%, 0.7 pp down on the previous quarter, and is projected to quicken in 2008 Q1, according to information available on net purchases of goods and services.

The buoyancy of gross fixed capital formation moderated at end-2007 for the second consecutive quarter, posting a 4.8% increase year-on-year, 1 pp less than in 2007 Q3 (see Chart 17). This was the outcome of a lower pace of growth in investment in equipment and in construction, while investment in other products performed more favourably. On information for 2008 Q1, this slowing trend is continuing and growth is lower in all components of gross fixed capital formation.

Although investment in capital goods remained the most dynamic component of domestic demand, it continued to lose momentum in 2008 Q1, judging by its main indicators. Thus, apparent investment in capital goods, calculated with incomplete data for 2008 Q1, advanced at a slower pace while confidence indicators fell off in the case of the industrial climate indicator for capital goods and the order book indicator. The recent trend in investment in equipment continued to be underpinned, on non-financial accounts data for institutional sectors to 2007 Q4, on upbeat activity and corporate earnings, although both factors were affected by the deceleration of demand and the increase in the financial burden, respectively. Accordingly, the growing financing requirements of non-financial corporations against a background of higher borrowing costs, financial market instability and a gloomier economic outlook, could hold back corporate investment plans.

The growth rate of construction dropped 0.9 pp in 2007 Q4 to 2.9% year-on-year, the lowest rate since 1998, with lower increases in residential and non-residential building. In 2008 Q1, the slowdown in investment stepped up according to data relating to inputs and employment indicators for the sector. As regards inputs, domestic output of construction materials recorded negative rates in January and February (double those recorded in 2007 Q4) which was also seen in the apparent consumption of cement. As for employment, the number of Social Security registrations in the sector fell in net terms for the whole of January to March for the first time since 1996, while unemployment in construction increased at a rate of more than 30% in that period. Lastly, the production indices for the construction industry began the year lower both in terms of residential construction and civil engineering projects, while business sentiment in the sector deteriorated considerably between January and March to historical lows not recorded since 1997.

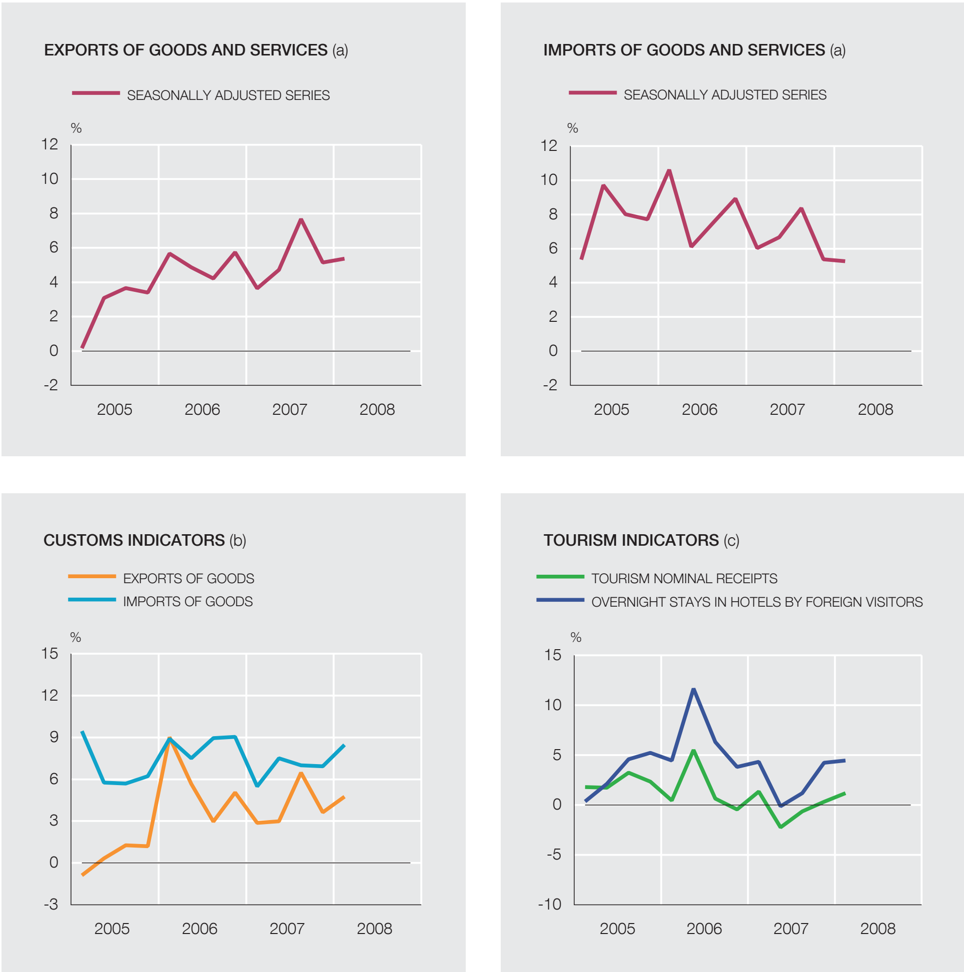
As for the different types of construction work, it is estimated that the rate of increase in residential construction fell due to fewer housing starts during 2007, particularly in the second half of the year. This was the response of the housing supply to the weaker demand observed during 2007. Indeed, the demand for housing has decelerated in recent months, judging by data on transactions from the Association of Registrars and Notaries Public for 2007 Q4, along with the data on new mortgage loans and the new “Statistics on the Transfer of Ownership Rights”, which cover the period to January this year. In all instances, however, new house purchases (which are more significant as an indicator of investment in housing) slipped more than those of used homes. Also, approvals of non-residential building projects and government tenders for civil engineering projects have dropped in recent months. Consequently, the slowdown in non-residential building seen in previous quarters will continue.

2007 Q4 ended with a 0.4 pp negative contribution of net external demand to GDP growth, the best recorded in recent years, since imports eased more sharply than exports, to 5.4% and 5.1%, respectively (see Chart 18). In 2007 as a whole, net external demand subtracted 0.7 pp from GDP growth, 0.5 pp less than in 2006, due to the slight acceleration of real export flows and, to a greater extent, the easing of real imports. These results were against a background of slowing international trade which, following growth of approximately 9% in 2006, eased off to a rate of 6% in 2007. The as yet incomplete information for 2008 Q1 suggests that exports remained sound in this period, despite the possible unfavourable effects of a stronger euro. Imports slowed slightly, in keeping with the easing of final demand, meaning that the contribution of net external demand improved slightly on the previous quarter to –0.3 pp.

On QNA figures, the year-on-year growth in real goods exports slackened to 4.6% in 2007 Q4 (down from 6.2% in 2007 Q3), interrupting the accelerating profile they had shown during the year. On Customs data for January and February, real exports recovered slightly to 5.2%, just over 0.5 pp higher than the figure for 2007 Q4. By product type, in the first two months of 2008 the rise in sales of non-food consumer goods (in particular cars) and the decline in

FOREIGN TRADE
Percentage change on year ago

CHART 18



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

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

capital goods exports were especially noticeable. By geographical area, sales climbed in particular in the euro area and in the United Kingdom, while the growth rate of sales to China, Russia and its associated countries, and the OPEC countries remained high.

On QNA figures, real exports of tourist services rose slightly by 0.3% in 2007 Q4, after falling in the two previous quarters. The indicators available for 2008 seem to confirm this trend, given the significant increases seen in Q1 in inflows of foreign tourists (which climbed by 5.3% year-on-year) and in the number of overnight hotel stays (up 5.6%), although it should be remembered that these rates might be biased upwards, since this is a leap year. Likewise, according to the tourism expenditure survey (EGATUR) both total nominal expenditure (with a rate of change of 9% year-on-year) and average spending per tourist picked up in the first two months of the year.

The rise in real exports of non-tourist services slowed in 2007 Q4, although their growth remains sound at 11.7%. The breakdown of information provided by the Balance of Payments for 2007 Q4 shows that this slowdown occurred in two of its main headings: services provided to companies and transport services, while other headings with less weight in the structure of exports – such as construction services and to a lesser extent financial services, insurance and computer services – remained highly dynamic.

On QNA figures, the year-on-year growth rate of real goods imports slowed to 4.7% in 2007 Q4, down from 7.4% in the previous quarter. More recent data show that the growth rate of purchases abroad, like exports, picked up slightly (by 0.5 pp) throughout January and February to 8.2%. By product group, purchases of both energy and other intermediate goods quickened most noticeably in the first two months of 2008, while imports of capital and consumer goods (especially cars) slowed substantially, in line with the diminished vigour of private consumption and business investment.

Lastly, in QNA terms the year-on-year growth rate of real imports of services decelerated in 2007 Q4 to 8.2%, down from 12.3% in the previous quarter. This was as a result of the slowdown in the year-on-year rate of real imports of non-tourist services by more than 6 pp to 8.5%. Nevertheless, its main categories (transport services and business services) became more buoyant, in tandem with the pick-up in other minor items such as communications and computer services. Royalties also climbed notably for the second consecutive quarter. Conversely, payments for financial services dropped and payments relating to construction and insurance slowed. Real imports of tourist services quickened in 2007 Q4 to a year-on-year growth rate of 6.5%, compared with 5.5% in Q3.

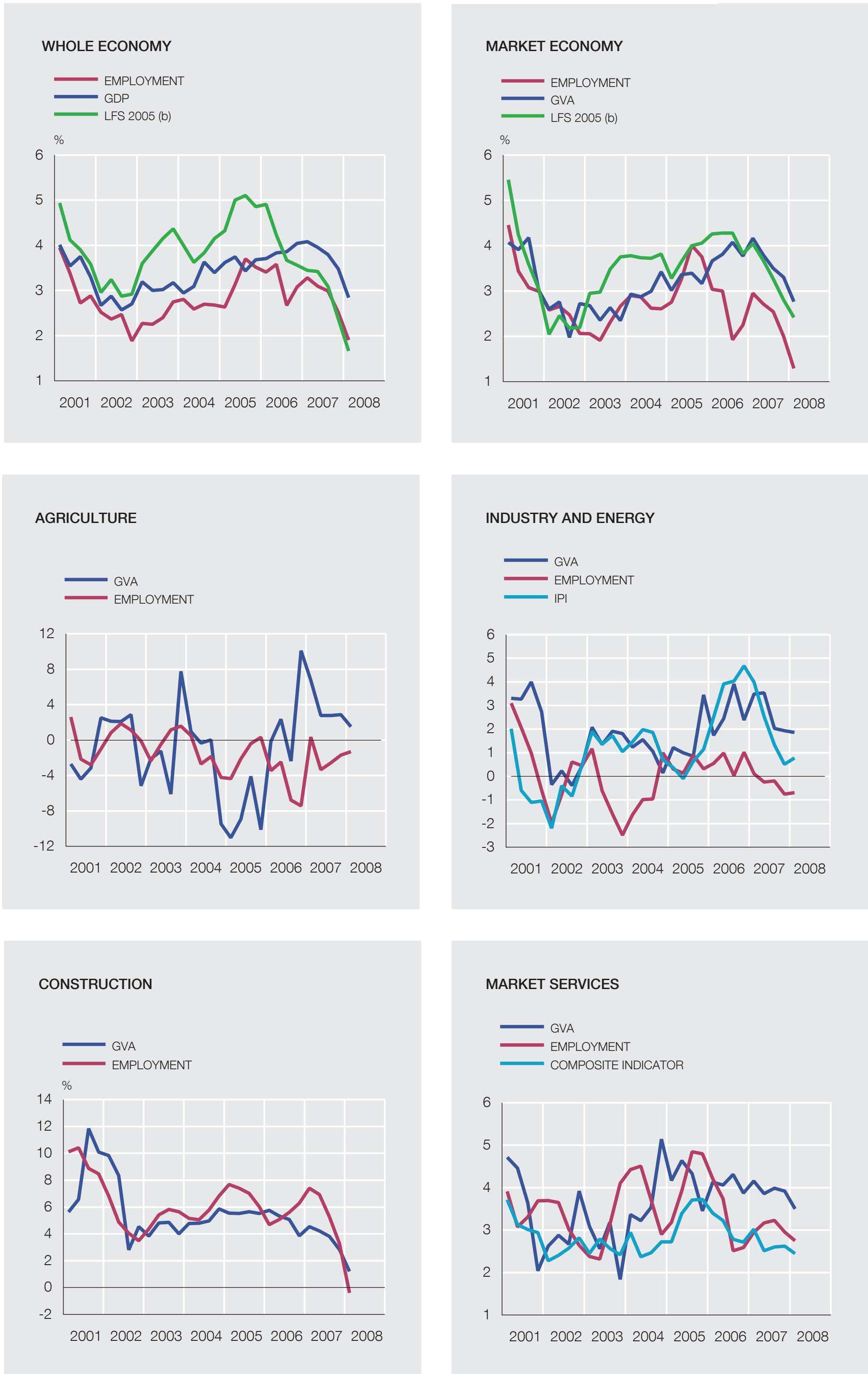
4.2 Output and employment

In 2007 Q4 the slowing profile shown by the market economy throughout the year continued, meaning that gross value added (GVA) expanded at a rate of 3.3%, 0.2 pp less than in the previous quarter (see Chart 19). The various productive branches were less buoyant across the board with the exception of agriculture and energy. This pattern of diminished strength in the market economy is expected to continue in 2008 Q1, with an estimated 0.5 pp fall in its rate of increase.

The activity of the agriculture and fisheries branches posted a slight rise in 2007 Q4 growing by 2.9%. However, the outlook for 2008 indicates that these branches will be less robust. In fact, although the initial available information indicates that the land set aside for crops in sectors such as cereals has increased by around 5% (probably driven by the strong rise in the prices of these products), weather conditions are not favourable due to low rainfall since the hydrological year began.

The GVA of the industrial and energy branch once again lost momentum in 2007 Q4, albeit much more moderately than in the previous three months. On QNA figures, the slowdown only amounted to 0.1 pp and, as a result, its rate of increase stood at 1.9%. Growth in this branch was contained despite the noticeable boost to its energy component, which went from being flat in Q3 to growing by 4.5% in Q4. The industrial branch, by contrast, slowed to a growth rate of 1.4% in the final quarter of the year. Industrial activity in early 2008 was characterised by the ongoing sluggishness seen between October and December last year. Thus, the year-on-year growth rate of the non-energy component of the industrial production index (IPI) was flat in January and February, while sales by large corporations slipped in the same period, albeit slightly less than in 2007 Q4. Other indicators such as social security registrations in industry or several opinion-based surveys in the sector, such as the European Commission's confidence indicator and the PMI manufacturing index, pointed to even more unfavourable developments in 2008 Q1. Based on the classification of product groups by Broad Economic Categories, capital goods are proving resilient despite the slowdown in their production, and food production has recovered in recent months.

GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 19



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

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

In 2007 Q4, GVA in construction slowed by 1 pp to 2.8%, which was lower than the overall growth of the economy for the first time in recent years. As discussed in the previous section, it is estimated that this loss of dynamism, which has continued in 2008 Q1, may have intensified.

The whole of the services branch ended 2007 with a GVA growth rate of 4.1%, representing a loss of dynamism of 0.2 pp with respect to Q3. The slowdown in non-market services was even more marked (0.3 pp), taking its rate of increase to 5% and ending the upward profile seen until Q3. GVA in market services dropped by 0.1 pp to 3.9%. In 2008 Q1, however, the loss of momentum was more marked, according to the conjunctural information available. Thus, the rate of increase in Social Security registrations slowed in comparison with 2007 Q4 by approximately 0.4 pp, while sales by large corporations showed negative rates of change throughout January and February in real and calendar-adjusted terms. Various opinion surveys have also presented a negative picture of 2008 to date. In fact, both the European Commission confidence indicators and the PMI are at an all-time low (although both statistics only present data from 1996 and 1999, respectively), while the retail index is at its lowest value since November 1993.

On QNA information, the slowing path followed by employment throughout the economy in recent months became more marked in 2007 Q4. Specifically, the year-on-year rate of increase in employment stood at 2.5%, half a percentage point lower than in the previous quarter. Employment in the market economy also decelerated by half a point and grew by 2% in year-on-year terms. In both cases, the moderation of the pace of job creation exceeded the loss of momentum of added value and, consequently, apparent labour productivity rose in Q4 to 0.9% in the economy as a whole and 1.3% in the market branches.

On the basis of the indicators available to March, the slowdown in job creation continued and even intensified in 2008 Q1. Thus, growth in the number of Social Security registrations, calculated with average data, dropped to 1.7% in 2008 Q1, 0.8 pp lower than the rise in 2007 Q4. The decline of INEM-registered new hires steepened in 2008 Q1 to –7.2% year-on-year on average, which compares with –2.1% in 2007 Q4. Similarly, the LFS data for 2008 Q1 show a moderation in the buoyancy of employment from 2.4% in 2007 Q4 to 1.7% in 2008 Q1.

By productive branch, there was a sizeable deceleration in Q4 in employment in construction, the year-on-year growth rate of which fell to 3.3%, 2 pp down on the previous quarter. In services, the year-on-year rate of increase in employment remained relatively stable (at approximately 3.5%) due to the buoyancy both of non-market services, where employment rose by 4.7%, and market services, where the related year-on-year increase was 3%. Employment in industry contracted for the third consecutive quarter at a rate of –0.7%, higher than in Q3. Conversely, in agriculture, job destruction eased and fell by approximately 1 pp to –1.7%. The indicators available for Q1 show that job creation was less dynamic in construction and in the agricultural branches, stable in market services and had recovered notably in the industrial branches. Consequently, LFS data for Q1 show that employment in construction dropped by 1.7%, after rising by 2.7% in Q4, whereas it fell by 6.8% in agriculture (-1.7% in the last three months of 2007). In market services, employment retained the buoyancy it showed at end-2007 (5%) and, finally, employment in industry made a strong recovery and grew by 2.2% following the negative increases seen during 2007.

On QNA figures, dependent employment was dynamic in 2007 Q4 and grew by 2.8%, a rate that outpaced that of self-employment (0.6%). However, the pace of growth in dependent employment dipped by 0.5 pp, slightly more than in the case of the self-employed. These developments match those from statistics on Social Security registrations, although they contrast with those shown in the LFS, which indicate that the slowdown in the rate of change in self-employment was sharper.

The LFS data for Q1 infer that the slowdown in employment affected Spanish nationals in particular, whereas growth rates for foreigners remained considerably higher (10.9%) and were similar to those posted at end-2007. As regards contract duration, permanent employment retained substantial momentum during 2008 Q1, with a year-on-year growth rate of 4.5%; that rate was, however, 2.5 pp down on the previous quarter. The year-on-year rate of decline in temporary employees moderated to –3.9% following the decrease of 6.3% posted in the closing months of 2007. As a result, the ratio of temporary to total employees fell significantly during the quarter to 30.1%, 0.9 pp down on that posted a year earlier. Lastly, as regards the duration of the working day, part-time hiring slowed to a greater extent than full-time hires, giving rise to a 0.4 pp decrease in the part-time/full-time employment ratio to 12%.

In 2008 Q1, the labour force grew at a year-on-year rate of 3%, 0.3 pp up on the previous quarter, interrupting the slowing trend seen throughout the previous year. This rise occurred despite the lower growth of the population aged over 16 (1.6%), which was 0.2 pp down on the previous quarter. The participation rate climbed to 59.3%, making for a year-on-year rise of 0.8 pp, following the smaller increases seen in 2007. In terms of the breakdown by gender, the rise in the female labour force was sharper and it continued to grow at a rate (3.9%) which was higher than that of the male labour force (2.3%). The participation rates stood at 49.7% for females and 69.3% for males, 1.1 pp and 0.4 pp higher, respectively, than a year ago. By nationality, the foreign labour force pushed growth of the overall labour force higher in Q1 by 13.5%, more than 0.2 pp up on end-2007, while growth of the Spanish labour force held at 1.3% year-on-year. The reason behind the rise seen in the foreign labour force is the increase in the foreign participation rate (up to 76.6%), following the decreases in 2007, since growth of the foreign population moderated to 13%, 2.5 pp down on the previous year.

Finally, the slowdown in the pace of job creation together with the greater dynamism of the labour force led to sharp growth in unemployment in 2008 Q1, with 318,000 more people jobless in comparison with the same period a year earlier. This resulted in a year-on-year increase in unemployment of 17.1%, with the unemployment rate at 9.6%, 1 pp up on the previous quarter. The data for March show a steep rise in registered unemployment, of 10.6% on average in comparison with 3.9% growth in 2007 Q4.

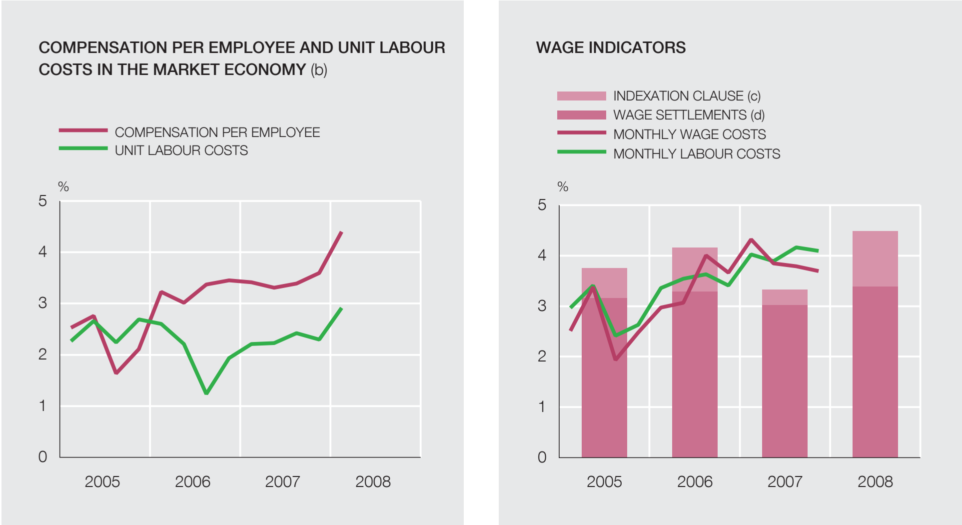
4.3 Costs and prices

On QNA estimates, the year-on-year growth rate in economy-wide compensation per employee climbed 0.3 pp in 2007 Q4 to 3.8% (see Chart 20). This acceleration was extensive to all branches of activity (with the exception of agriculture), although especially noticeable was the sharp rise in the industrial branches. On the information available, the growth rate of compensation per employee continued on this rising trend in 2008 Q1. In particular, the collective bargaining agreements registered in 2008 Q1, which affect 5.6 million employees, include an average increase in agreed wage rates of 3.4% for this year. This figure, which is 0.4 pp up on that for 2007 (excluding the effect of the indexation clause), seems to be slightly higher than the wage rate guidelines agreed under the new Interconfederal Agreement for Collective Bargaining for 2008.[1] As is usual at the beginning of the year, almost all the agreements recorded

1. The extension to 2008 of the Interconfederal Agreement for Collective Bargaining for 2007, which was signed on 18 December 2007 by the main social agents, provides continuity to the various agreements signed since 2002, which include, among others, the following recommendations regarding wages: indexation to projected inflation of 2% in wage negotiations, activation of the indexation clauses if the CPI in December exceeds that projection and tying wage increases in excess of this benchmark to productivity increases in order to favour job creation.

WAGES AND LABOUR COSTS (a)

CHART 20



SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Percentage change on same quarter a year earlier.
b. Rates based on QNA seasonally adjusted series.
c. Information from registered collective bargaining agreements to March 2008.
d. Previous year's indexation clause.
e. ETCL (quarterly labour costs survey).

are the result of the revision of multi-year settlements signed in previous years. In these, the agreed increase was 3.4%, while in the few newly-signed agreements the rise stood at 4.2%. The estimated impact of the 2007 indexation clauses (which affect 74% of employees with an agreement for that year) on wage increases for 2008 is 1.1 pp, some 0.8 pp higher than the estimated impact of the previous year, as a result of the higher deviation of inflation at year-end from the official reference of 2%.

The greater buoyancy of compensation per employee in 2007 Q4 was not offset by the slight rise in apparent labour productivity. That led to a further 0.2 pp quickening in unit labour costs (ULCs), up to a year-on-year growth rate of 2.9%. The situation in the market economy, however, was slightly different, with a moderate slowdown in ULCs due to productivity gains in market services and in industry (see Chart 21). Productivity is also expected to rise a little in the market economy in 2008 Q1, although it will be insufficient to offset the estimated acceleration in labour costs and, as a result, ULCs will probably quicken in that period.

In 2007 Q4, the moderating path on which the final demand and GDP deflators had moved in previous quarters came to a halt or was reversed. The final demand deflator quickened by 0.8 pp to a year-on-year growth rate of 3.3%, as a result, among other factors, of the sharp rise in imports, which stood at 45%, more than 3 pp more than that posted in Q3 due to the higher prices of crude and non-energy commodities on international markets. In turn, the year-on-year growth rate of the GDP deflator held steady at 2.9%. From the expenditure standpoint, the growth in the private consumption deflator rose by 1.8 pp to 3.9%, in line with more expensive imports, while the goods exports deflator dropped slightly to 1.7%.

The year-on-year rate of the CPI continued to rise during 2008 Q1 to 4.4% on average in that period, 0.4 pp more than in 2007 Q4. This acceleration is almost entirely due to the upward trend in energy and processed food prices. The prices of non-energy industrial goods were the only ones whose growth rate, following the performance of recent quarters, eased. Converse-

PRICES AND COSTS BY BRANCH OF ACTIVITY (a)

CHART 21

SOURCES: INE and Banco de España.

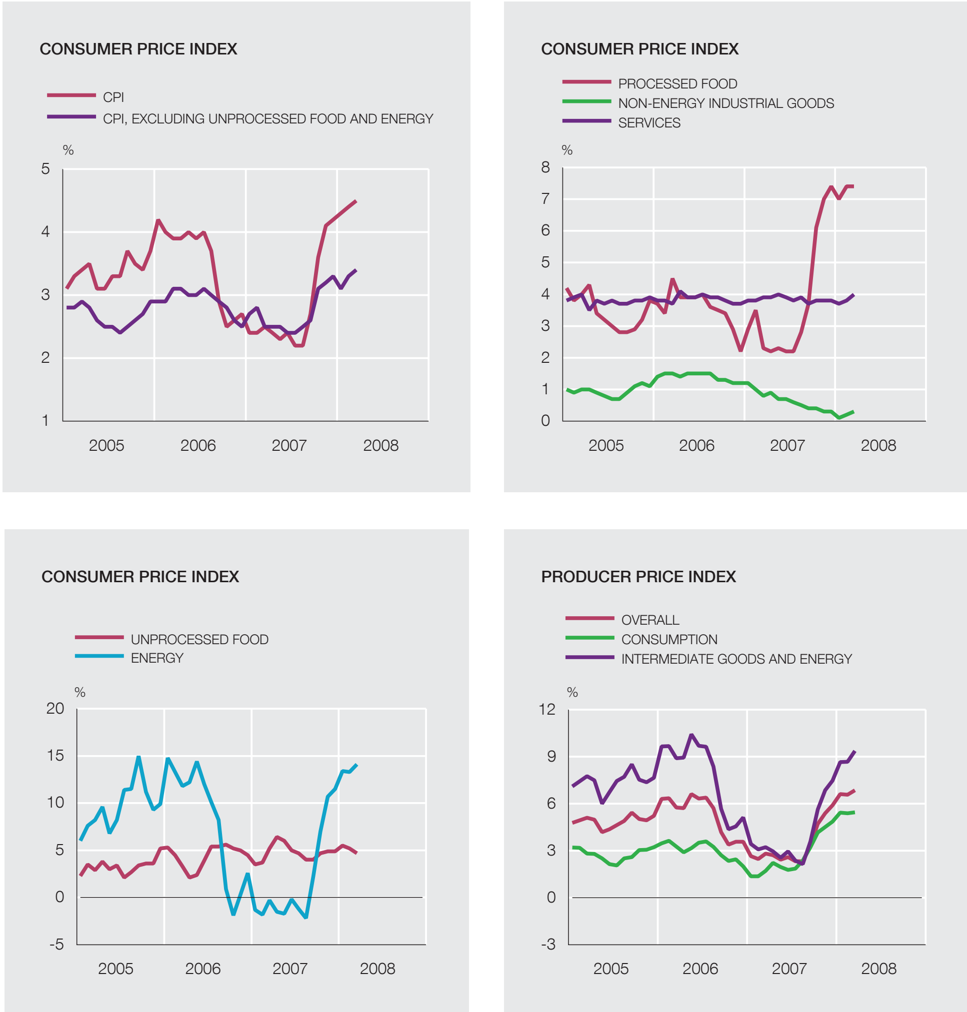
a. Percentage change on a year ago based on QNA seasonally adjusted series.

ly, the prices of processed and unprocessed food went up once again, although less sharply than in the previous quarter. The growth rate of services prices held steady, albeit at very high levels of approximately 4%. Consequently, both the overall index excluding energy and the core CPI (excluding unprocessed food and energy) remained practically stable in Q1 on average at 3.4% and 3.2%, respectively (see Chart 22).

For the second consecutive quarter the prices of energy products once again posted the highest increases. The sizeable appreciation of the euro against the dollar (averaging 14.4% in Q1 and finally standing at approximately $1.55 per euro in March) was not enough to offset the substantial rise in oil and other energy products. The prices of non-energy industrial goods were the only ones to moderate slightly. Year-on-year growth in 2008 Q1 amounted to 0.2%, 0.1 pp less than in the previous quarter, since the slowdown in car prices and electronic and computer equipment stepped up from the beginning of the year. Tourism-related and hotel and restaurant services became slightly more expensive due to the higher prices of package tours following seasonal declines in the previous quarter, while the pace of growth in the prices of restaurants, bars and cafés remained high. Unprocessed food prices continued to increase in the early months of the year, averaging 5.1% in Q1, 0.3 pp more than in the previous quarter due to the higher prices of fish, fruit and eggs. Lastly, processed food increased by 7.3% year-on-year, 0.5 pp above the previous quarter, mainly due to the performance of cheese and certain cereal products such as pasta and flour. Box 4 analyses in greater detail

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

the recent developments in the prices of this component and their impact on the overall index.

Like the CPI, inflation measured by the HICP increased in 2008 Q1 to 4.5% year-on-year on average (4.6% in March). In the same vein, inflation rose to 3.4% on average (it stood at 3.6% in March) in the euro area as a whole. Consequently, for the quarter as a whole the differential held steady at 1.1 pp, matching the average differential recorded since the inception of the euro area (see Chart 23). By component, the inflation differential held steady in services, while in the case of non-energy industrial goods (the only component for which price increases in Spain are lower than in the euro area) the differential was less pronounced. The positive differential narrowed in the unprocessed food component and, especially, in the processed food component, by 1.3 pp. The positive differential for energy products widened with respect to the previous quarter, which was foreseeable given the more variable energy prices in Spain in view of changes in oil prices.

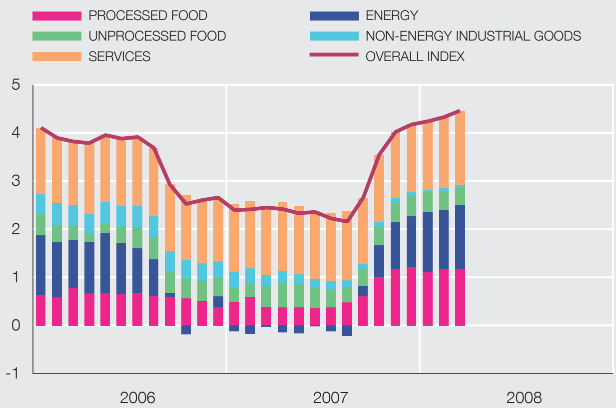
Finally, the producer price index (PPI) rose in 2008 Q1 to a year-on-year rate of 6.7%, 1.4 pp more than in 2007 Q4, as a consequence, especially, of a rise in energy prices (to 13.8%), al-

For much of 2007, Spanish inflation – measured by the growth rate of the consumer price index (CPI) – held at a moderate rate, somewhat below 2.5% in year-on-year terms. However, from the autumn it embarked on an upward trajectory which has continued into the opening months of 2008. Compared with a rate of 2.2% in August 2007, inflation stood at 4.5% in March this year, a figure not reached since July 1995. As panel 1 shows, the marked increase in the CPI in recent months essentially reflects dearer energy and processed food products. Specifically, of the 2.3 pp rise in the rate of increase of the CPI between August 2007 and March 2008, the energy component would account for 1.5 pp and processed food 0.7 pp. The pronounced growth of energy product prices in recent months largely reflects the impact of the increase in crude oil prices on international markets, which has only been partially countered by the appreciation of the euro. As the effect of the changes in oil prices on Spanish inflation was addressed in a recent article in Spanish in the Boletín Económico, the analysis in this box focuses on the effect of developments in processed food prices on inflation.

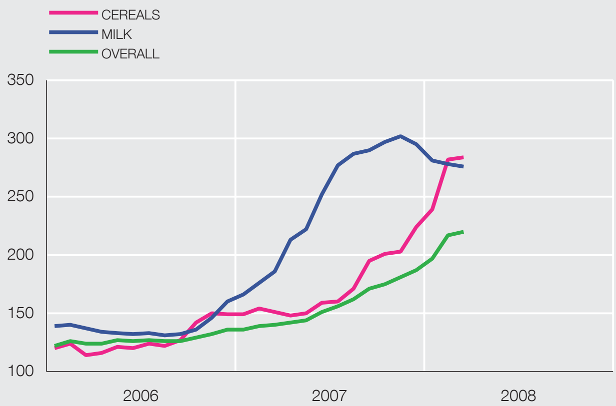
The rise in the consumer prices of specific food products largely reflects price developments on world markets for agricultural commodities. Panel 2, which shows a food price index compiled by the United Nations Food and Agriculture Organisation (FAO) based on the prices of 55 products weighted by their volume in world exports, and the sub-indices of milk and milk products, reveals the sharp rise both in the overall index (57% in March 2008, in year-on-year terms) and in cereals and milk products (88% and 48%, respectively). Other products also showed considerable price increases. The worldwide rise in milk and milk products reflects both supply and demand-side factors. First, there has been a significant contraction in milk production in the main exporting countries, against a background of low inventory levels. Further, there has been a notable increase in the demand for these products, particularly by numerous emerging countries, who are posting high increases in their per capita income. In the case of cereals, the robustness of demand – driven both by household consumption and the manufacture of animal feed and other industrial uses – has compounded the production cuts in some exporting countries and the low levels of stocks.

Along with the strong increase in agricultural commodity prices, higher transport and fertiliser costs have resulted in dearer food prices for final consumers. Prices received by farmers increased in Spain by

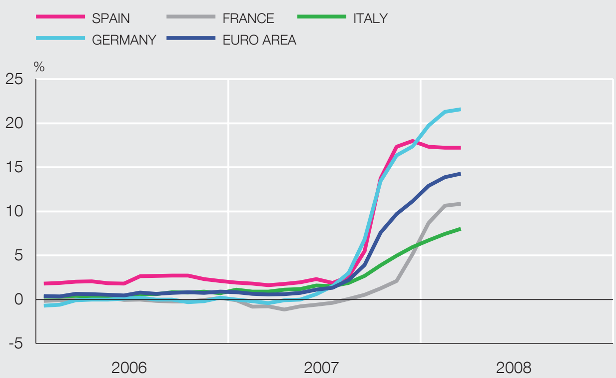
1 CONSUMER PRICE INDEX
Twelve-month percentage change and contributions



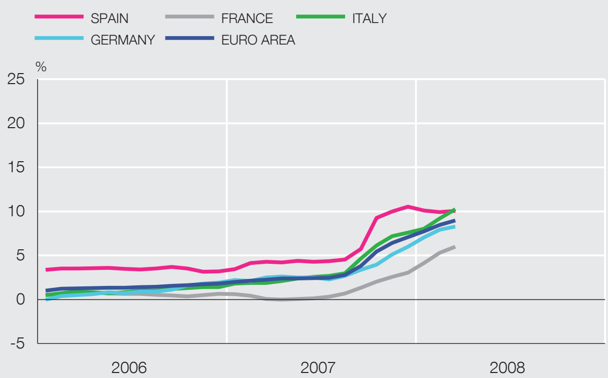
2 COMMODITY PRICE INDICES (a)
1998-2000=100



3 HARMONISED INDEX OF CONSUMER PRICES
Milk, cheese and eggs



4 HARMONISED INDEX OF CONSUMER PRICES
Bread and cereals



SOURCES: United Nations Food and Agriculture Organisation (FAO), Eurostat and Banco de España.

a. Price indices prepared by the FAO. The overall index includes 55 products belonging to various categories and weighted by world export shares in the period 1998 -2000.

almost 18% year-on-year in December 2007 (24% if livestock products are excluded), and the producer prices of food consumer goods, beverages and tobacco rose by practically in 11% in Spain to February 2008, a phenomenon which has also influenced the consumer prices of these goods. Indirect effects are also arising insofar as livestock breeders' production costs increase as the price of cereals for animal food rises. These increases might, therefore, pass through to the prices of meat and other products, such as catering services.

The global phenomenon of dearer food prices is also affecting other European countries, albeit to differing degrees depending on the country and the product. The differences in market structures, the effective level of competition in retail and wholesale distribution, and the cyclical position of the economies are factors bearing on the final pass-through of commodity costs to consumer prices. In Spain, the competition authorities have initiated legal proceedings aimed at determining whether information communicated by certain employers' associations in the food industry to its members may have restricted competition. According to the processed food component of the harmonised index of consumer prices (HICP), the rate for these products in Spain far outgrew that for the euro area as a whole. Specifically, in March 2008 these goods rose by 8.8% year-on-year in Spain, 2 pp above the euro area figure. In the specific case of milk and milk products, prices climbed by 17.2% year-on-year in Spain in March 2008, almost 3 pp more than in the euro area (see panel 3). Bread and cereal prices increased by 10% in Spain, outgrowing the euro area as a whole by 1 pp (see panel 4).

Admittedly, projections of future developments in these markets are shrouded in uncertainty, but the current FAO forecasts for 2008 predict a sizeable rise in world cereal output, especially of wheat, the cultivation area for which has increased considerably. Naturally, however, final output will depend on the weather up to the harvest period. In the EU, measures aimed at expanding cereal supply have been authorised, and will be effective for the 2007-2008 sowings. These include most notably the elimination of the compulsory set-aside of land, under which farmers had to abstain from using 10% of their cultivatable land area for obtaining produce for human consumption. Further, per capita cereal consumption in the developing countries is expected to fall slightly as demand shifts towards higher nutrition value foods in those countries with higher increases in their per capita income. In addition, milk quotas have been raised by 2% in all EU countries. In step with this set of factors, futures markets for the main agricultural commodities point to an easing in growth rates during 2008. As a result, food prices should once again be running at a lower year-on-year rate at the end of the current year, once the baseline effect caused by the higher prices that began to be set in the second half of 2007 is absorbed.

though prices of other intermediate goods and non-durable consumer goods accelerated by 6% and 5.8%, respectively. Conversely, the prices of capital goods moderated to a rate of 2.5% on average in Q1, while those of consumer durables remained practically stable at just above 3%. In the whole of the euro area producer prices increased by 5.3% year-on-year in February, 1.3 pp lower than the rate recorded in Spain in that month.

4.4 The State budget

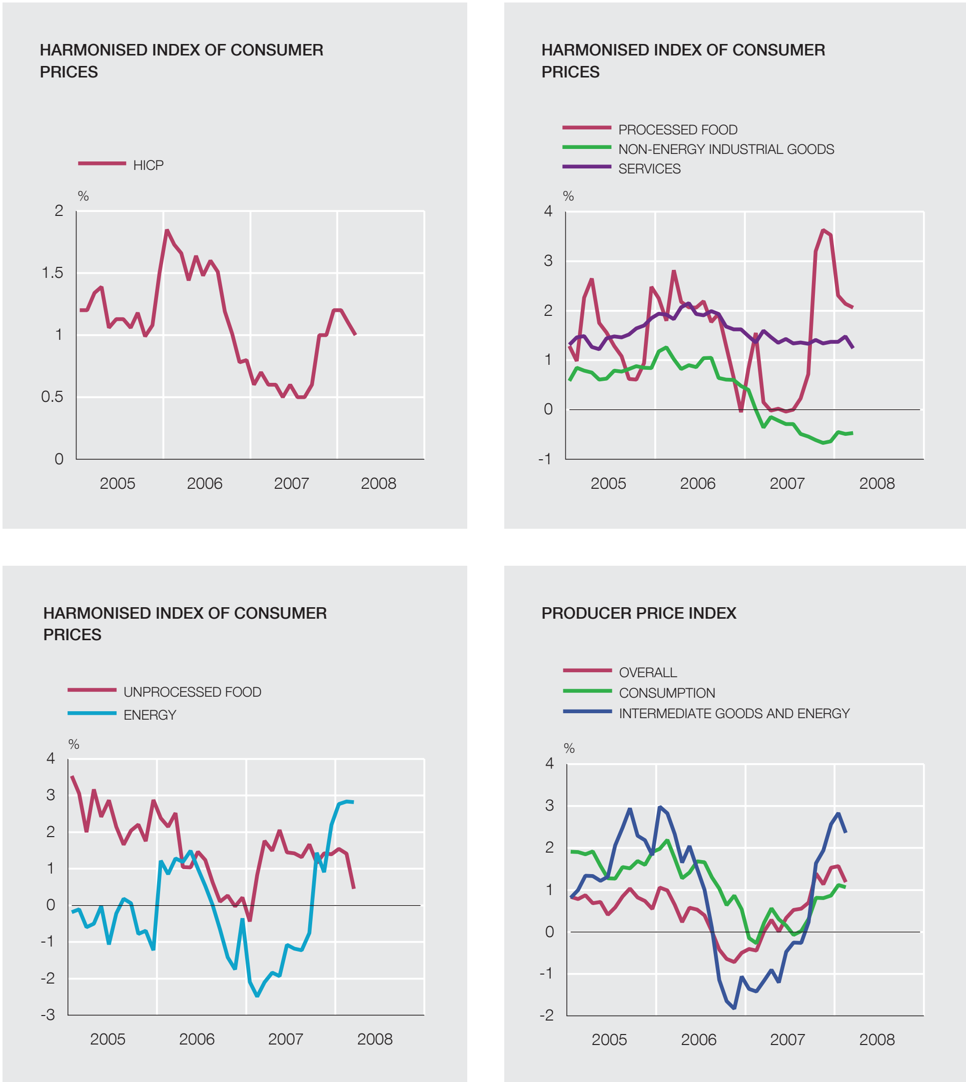
According to the National Accounts methodology, the State budget outturn in Q1, showed a notable reduction in the surplus, which fell from €6,747 million (0.6% of GDP) in the first three months of 2007 to €3,276 million (0.3% of GDP) in 2008 Q1. This result was essentially due to an increase in resources of only 1.3%, compared with the 12.8% rise in uses.

Along these same lines, the cash-basis results showed a reduction in the State surplus to €1,272 million in 2008 Q1, compared with the surplus of €2,316 million recorded in the same period in 2007 (see Table 3). In these opening months, revenue increased by 1.1%, against the 4.1% increase in State expenditure. The differences with the National Accounts figures are largely due to the different criterion for recording interest. It should not be forgotten, however, that the figures for the opening months of the year are highly erratic and not very representative of how the balance will fare in the following months. Nonetheless, the data appear to point to a reduction in the budget balance compared with the previous year, to which the extraordinary personal income tax credit of up to a maximum of €400 per taxpayer will also contribute.

In respect of revenue, information is available on total takings under the main taxes, both for the portion assigned to the State and that relating to the ordinary-regime Territorial Govern-

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

CHART 23



SOURCES: Eurostat and Banco de España.

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

ments. According to this information, revenue increased in Q1 by 3.4% compared with the same period a year earlier, owing to the strength of direct tax takings. Direct taxes were sustained by revenue relating to withholdings on work, and by those on movable capital and gains on mutual funds (which increased by 34.1%). In the coming months, however, the above-mentioned personal income tax credit and the impact of the second phase of the reduction in corporate income tax (the cut in the standard rate from 32.5% to 30%) will foreseeably prompt a slowdown in this revenue. Under indirect tax, there was a notable decline in VAT, which posted a negative rate of –5.7% in relation to 2007 Q1. In this case, developments have been affected by the change in the treatment of corporate groupings, which are allowed to offset balances payable by and refundable to the various group companies (which is tantamount to bringing forward refunds applied for); accordingly, the figures are not homogenous when set against those of the previous year. Excise duties were contained somewhat, owing to the sluggishness of the tax on hydrocarbons. The items aggregated under the “Other State revenue” heading (see Table 3) posted relatively high growth owing to the share in Banco de España profits and to the current transfers received from the Regional (Autonomous) Governments,

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2007	Percentage change 2007/2006	Initial Budget 2008	Percentage change 2008/2007	Outturn 2007 JAN-MAR	Outturn 2008 JAN-MAR	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	159,840	12.7	158,757	-0.7	37,782	38,181	1.1
Direct taxes	96,980	19.5	90,753	-6.4	15,980	17,516	9.6
Personal income tax	*48,626*	*17.3*	*43,260*	*-11.0*	*13,896*	*15,112*	*8.7*
Corporate income tax	*44,823*	*20.5*	*44,420*	*-0.9*	*1,258*	*1,511*	*20.1*
Other (a)	*3,531*	*42.8*	*3,073*	*-13.0*	*826*	*893*	*8.1*
Indirect taxes	48,445	0.2	53,363	10.2	18,725	17,371	-7.2
VAT	*33,752*	*-4.7*	*38,205*	*13.2*	*15,393*	*13,926*	*-9.5*
Excise duties	*11,468*	*15.9*	*11,661*	*1.7*	*2,559*	*2,623*	*2.5*
Other (b)	*3,224*	*7.2*	*3,497*	*8.5*	*773*	*822*	*6.3*
Other net revenue	14,415	16.4	14,641	1.6	3,077	3,294	7.1
2 EXPENDITURE	139,704	7.2	152,331	9.0	35,467	36,909	4.1
Wages and salaries	23,678	6.6	25,378	7.2	5,223	5,363	2.7
Goods and services	4,454	17.2	3,563	-20.0	967	955	-1.2
Interest payments	14,539	-6.9	16,631	14.4	5,701	6,532	14.6
Current transfers	77,680	7.6	83,372	7.3	18,981	19,549	3.0
Contingency fund	…	…	3,100	…	…	…	…
Investment	10,106	11.8	10,588	4.8	2,579	2,580	0.0
Capital transfers	9,248	23.5	9,699	4.9	2,016	1,930	-4.3
3 CASH-BASIS BALANCE (3 = 1 – 2)	20,135	…	6,426	…	2,316	1,272	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Resources	165,171	12.2	157,166	-4.8	37,807	38,298	1.3
Uses	151,877	6.2	153,920	1.3	31,060	35,022	12.8
NET LENDING (+) OR BORROWING (–)							
	13,294	…	3,246	…	6,747	3,276	…
(as a percentage of GDP)	1.3		0.3		0.7	0.3	

SOURCE: Ministerio de Economía y Hacienda.

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

which offset the decline in funds received from the European Union, especially from the ERDF.

State cash-basis expenditure increased by 4.1%, below the budgetary forecast, which points to growth of 9% for the year as a whole. With the exceptions of expenditure on goods and services and of interest payments, the remaining items posted growth rates below those envisaged in the Budget. Wages and salaries and current transfers (mainly to other general government) were particularly contained during these months. However, in view of the figures budgeted, this expenditure may be expected to quicken in the coming months.

4.5 The balance of payments and capital account

The overall balance on current and capital account was a deficit of €10,717 million in January 2008, 46.4% up on the same month a year earlier (see Table 4). The current account deficit widened by 38.6% year-on-year to €11,951 million. In turn, the surplus on capital transactions declined by 5.2% to €1,234 million. The balances of the main current account components worsened in January, with a significant widening of the deficits on the trade and income bal-

BALANCE OF PAYMENTS: SUMMARY (a) TABLE 4

EUR m

		JANUARY	
		2007	2008
CREDITS	Current account	25,436	29,330
	Goods	*14,205*	*15,431*
	Services	*6,434*	*7,355*
	— Tourism	2,673	2,759
	— Other services	3,761	4,596
	Income	*3,808*	*4,949*
	Current transfers	*988*	*1,595*
	Capital account	1,444	1,372
	Current + capital accounts	26,880	30,702
DEBITS	Current account	34,058	41,281
	Goods	*20,657*	*23,806*
	Services	*5,483*	*6,034*
	— Tourism	1,114	1,136
	— Other services	4,369	4,899
	Income	*5,757*	*8,585*
	Current transfers	*2,160*	*2,855*
	Capital account	143	138
	Current + capital accounts	34,201	41,419
BALANCES	Current account	-8,622	-11,951
	Goods	*-6,452*	*-8,375*
	Services	*952*	*1,321*
	— Tourism	1,560	1,623
	— Other services	-608	-302
	Income	*-1,949*	*-3,636*
	Current transfers	*-1,172*	*-1,260*
	Capital account	1,301	1,234
	Current + capital accounts	-7,320	-10,717

SOURCE: Banco de España.

a. Provisional data.

ances, although services were the exception, particularly the reduction in the deficit on non-tourist services.

The deficit on the trade balance increased in January 2008 by €1,924 million in relation to the same month a year earlier, rising to €8,375 million, the result of the substantial increase in the energy bill. Indeed, the non-energy trade deficit declined, with the increase in nominal exports of these goods exceeding imports in January. Turning to the services balance, the slight improvement in its surplus in January 2008 was due to the increase in the tourism surplus and to the decline in the deficit on other services. Nominal tourist revenue rose by 3.2%, down on the previous year's increase on the whole. This development is in keeping with the moderate growth shown in January by the tourism indicators (such as the number of foreign tourists and their overnight stays in hotels); however, these indicators posted more significant increases in February and March, as discussed in section 4.1. Tourist payments slowed appreciably in January, increasing by 2%, in step with the diminished dynamism of private consumption. As to other services, the buoyancy of revenue was more pronounced than that of expenditure (the related growth rates were 22.2% and 12.1%, respectively).

The deficit on the income balance widened notably in January to €3,636 million, up €1,687 million compared with the level observed in the same month of the previous year. Both revenue and, to a greater extent, payments were expansionary, with year-on-year growth rates of 30% and 49%, respectively. This is related to the rise in interest rates on money and securities markets, and to the growing net debit position of the Spanish economy. The current transfers balance posted a deficit of €1,260 million in January 2008, similar to that in the same month a year earlier. Finally, the capital account surplus stood in January 2008 at €1,234 million, somewhat down on January 2007 owing to the decline in revenue received by general government under ERDF structural funds, which countered the rise in Cohesion and EAGGF Guidance Funds.

5 Financial developments

5.1 Highlights

In 2008 Q1, financial developments continued to be shaped by the turbulence on international financial markets that began in summer 2007. Various episodes that highlighted the difficulties being experienced by certain financial institutions exacerbated the existing confidence problems. This was reflected in a further tightening of interbank markets, which also stemmed from liquidity problems. Hence, although one-year EURIBOR fell in the first two months of the year, from 4.8% in December to 4.3% in February, it rose in March to an average level of 4.6%, 90 basis points (bp) above the return on secured transactions (repos) at the same maturity.

Tensions were also observed in other markets. In fixed-income markets, for instance, risk premiums continued to rise strongly in all sectors. At the same time, the preference for liquidity and the safest assets led to a fall in public debt yields. This fall was sharpest in the case of German securities, leading to a widening in the interest rate spread with the other euro area countries. On stock markets price volatility rose, while prices declined markedly (see Chart 24). From the middle of March, there was a certain improvement in some of these markets, although it is too soon to know if it will continue. As the Spanish version of this report went to press, the Madrid Stock Exchange General Index stood 9.8% below its end-2007 level, this loss being somewhat smaller than that suffered over the same period by the EURO STOXX broad index of European stock markets (12.4%), but greater than that of the S&P 500 index of US companies (4.8%).

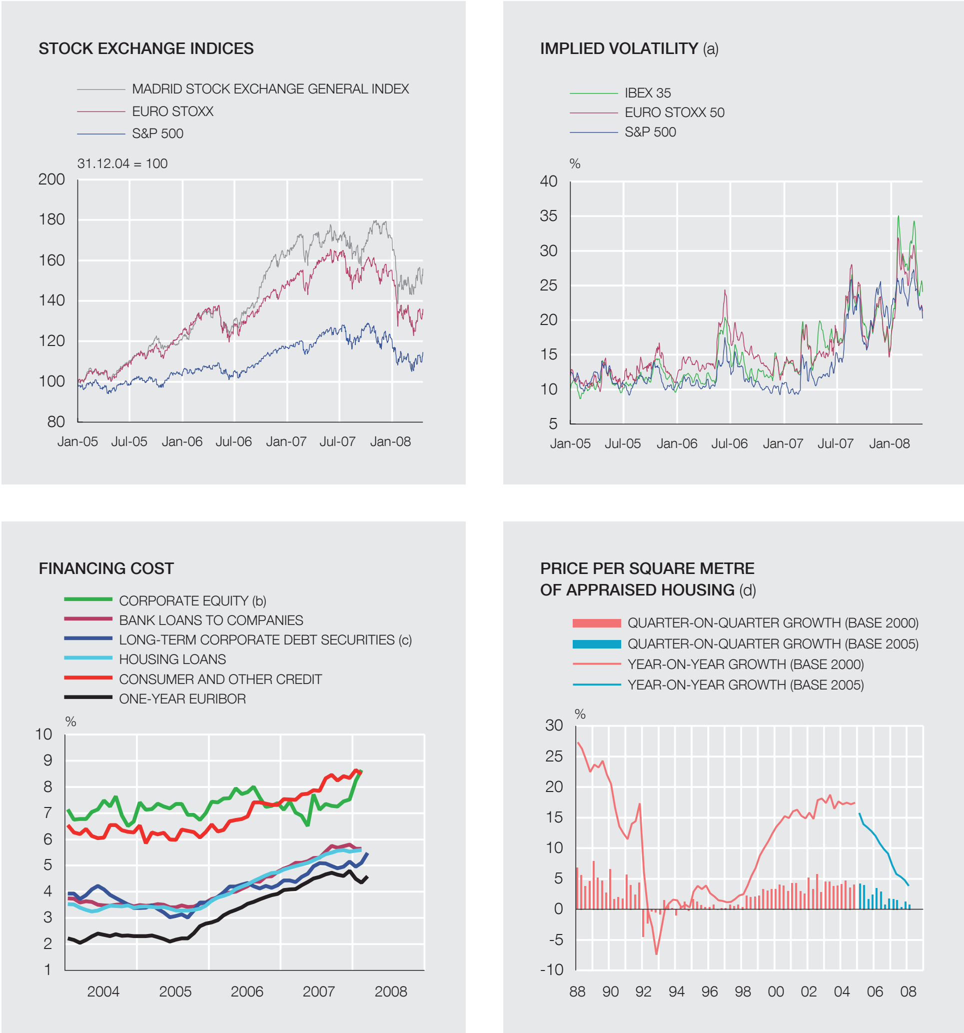
The latest information on the cost of financing for the private sector suggests that developments varied according to the instrument concerned, basically depending on the dynamic relationship of each with market yields, since there were no significant changes in the margins applied. In the case of households, interest rates on loans for house purchase, which reflect interbank rate movements with a certain lag, rose between December and February, as did those on consumer and other loans, which are more variable. By contrast, the cost of corporate bank borrowing and bond issuance fell, although the cost of equity rose notably, so that the synthetic indicator of the cost of financing for firms showed no significant changes during this period. In any event, it should be noted that the above figures do not yet reflect the rise in interbank rates in March. In addition, there has been an increase in the return on long-term debt issued by this sector and, according to the January Bank Lending Survey (BLS), institutions were expecting to tighten their credit standards further in 2008 Q1.

The latest data supplied by the Ministry of Housing show that, the gradual slowdown in the value of appraised unsubsidised housing continued in 2008 Q1. As a result, the year-on-year rate stood at 3.8% in March, down one percentage point from December 2007.

Against this background, in 2008 Q1 the gradual moderation of the expansion of private-sector debt seen in the preceding quarters continued. In the case of households, the year-on-year growth rate of financing stood at 12% in February, down somewhat more than half a percentage point from December. Meanwhile, corporate borrowing rose by around 16% on the same period of the previous year, almost 1 pp less than in 2007 Q4. The latest information on lending by purpose, for December, shows that there was a slowdown in most productive branches. This slowdown was sharper in real estate services and somewhat less pronounced in construction and industry, while other services maintained their buoyancy, in line with the greater relative strength of investment in this sub-sector.

FINANCING CONDITIONS AND ASSET PRICES

CHART 24



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

a. Five-day moving averages.
b. The cost of equity is based on the three-stage Gordon dividend discount model.
c. The interest rate on long-term debt securities is approximated by the sum of the 5-year euro swap rate and a weighted average of the 5-year CDS premiums of Spanish non-financial corporations.
d. New statistic from 2005.

The slowdown in household borrowing is contributing to the moderation in the rate of growth of the debt and debt-burden ratios, albeit less in the latter case owing to the rising cost of financing (see Chart 25). Also, at end-2007, the sector's ability to save, after deducting its debt-repayment obligations, and its net borrowing stood at similar levels to previous quarters, in terms of gross disposable income (GDI) and GDP, respectively. Meanwhile, household net wealth grew at a similar rate to GDI, so that the ratio between these two variables remained, virtually unchanged, at historically high levels.

In the case of corporations, the rate of growth of their aggregate debt ratio also moderated in 2007 Q4, while their debt burden, affected by the rise in the cost of financing, grew at a faster rate, which continued to contribute to curbing earnings growth. According to the available projections, these same trends would have continued during 2008 to date. The data for the sample of firms that respond to the quarterly survey of the Central Balance Sheet Data Office (CBQ), in which large firms predominate, showed less buoyant debt and interest payments in

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 25

SOURCE: Banco de España.

a. From 1999, the sectoral National Accounts data corrrespond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Includes bank credit and off-balance-sheet securitised loans.
c. Assets 1 = total financial assets – "other".
d. Assets 2 = assets 1 – shares (excluding mutual fund shares) – shares in FIM.
e. Estimated interest payments plus debt repayments.
f. Balance of households' use of disposable income account.
g. Gross saving less estimated debt repayments.
h. 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. There is a new house price statistic from 2005.

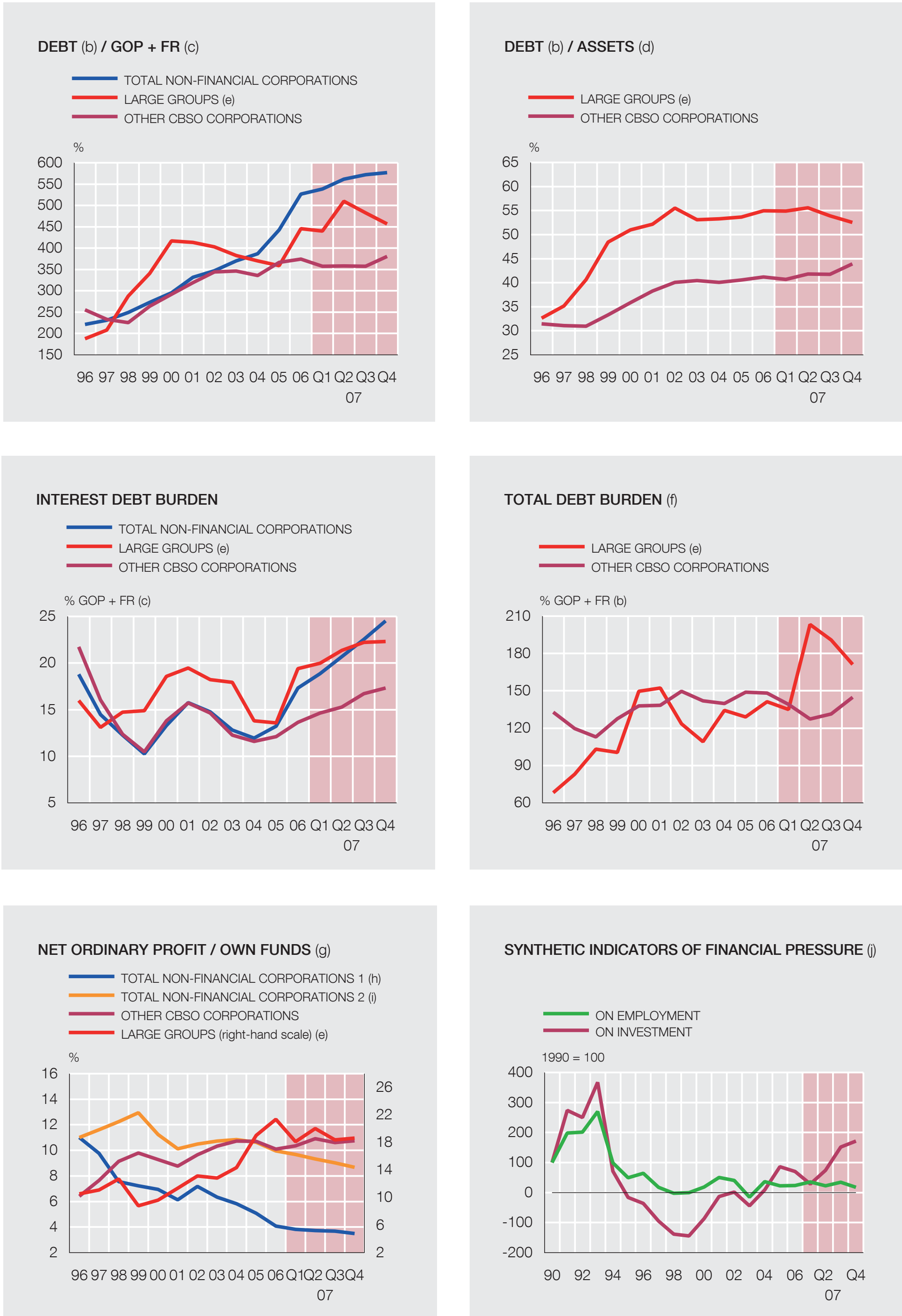
2007 Q4, along with favourable earnings behaviour. As a result of all these developments there was barely any change in the indicators of financial pressure on investment and employment during 2007 Q4 (see Chart 26). Finally, the latest information from the Financial Accounts shows a further increase in the sector's net borrowing in 2007 Q4, to 11.8% of GDP in cumulative 12-month terms, up 0.3 pp from September.

The larger borrowing requirement of non-financial corporations (and, to a lesser extent, of households) and the fall in general government saving were not fully offset by the rise in the surplus of financial institutions, so that the nation's net borrowing rose to 9.5% of GDP in cumulative annual terms (see Table 5).

In 2007 Q4, the funds obtained from the rest of the world by the private financial sector (excluding institutional investors), were again less than on average in recent years. This develop-

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

CHART 26



SOURCE: Banco de España.

a. Based on CBA and CBQ data, except in the case of the "total non-financial corporations" series, which is based on the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is used.
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
e. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
f. Includes interest plus interest-bearing short-term debt.
g. For total non-financial corporations, NOP=GOS + interest and dividends received – interest paid – fixed capital consumption.
h. Own funds valued at market prices.
i. Own funds calculated by accumulating flows from the 1996 stock onwards.
j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 5

% GDP					2006	2007			
	2002	2003	2004	2005	Q4	Q1	Q2	Q3	Q4
National economy	-2.7	-2.9	-4.8	-6.5	-8.1	-8.3	-8.6	-8.9	-9.5
Non-financial corporations and households and NPISHs	-3.3	-3.8	-5.1	-8.2	-10.5	-11.1	-11.9	-12.9	-13.4
Non-financial corporations	*-4.0*	*-3.9*	*-4.5*	*-6.9*	*-8.9*	*-9.2*	*-10.3*	*-11.5*	*-11.8*
Households and NPISHs	*0.7*	*0.1*	*-0.6*	*-1.3*	*-1.7*	*-1.9*	*-1.5*	*-1.5*	*-1.6*
Financial institutions	1.2	1.0	0.6	0.7	0.6	0.8	1.2	1.4	1.6
General government	-0.5	-0.2	-0.4	1.0	1.8	2.0	2.0	2.6	2.2
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.5	-8.2	-8.7	-11.1	-15.8	-13.5	-15.4	-16.3	-17.1

SOURCE: Banco de España.

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

ment is linked to the decrease in the recourse to international financial markets by these intermediaries, against the background of a rise in the cost of long-term bond issuance and scant activity on these markets. At the same time, the net acquisition of external assets by institutional investors and non-financial corporations fell to negative levels, so that the need for foreign funds (to finance the current account deficit and financial investment abroad) was reduced somewhat, although not sufficiently to offset the weakness of funds raised by financial institutions. Hence, the net position of the Banco de España vis-à-vis non-residents declined further, although to a lesser extent than in 2007 Q3 (see Box 5).

In short, the moderation in the growth of household and corporate borrowing is helping to bring the debt of these agents onto a more sustainable path. At the same time, although the financial turbulence worsened and spread, it has so far had only a limited effect on the cost and availability of financing to the private sector. However, given the Spanish economy's high level of net external borrowing, the impact may be greater in future if this episode continues for a lengthy period.

5.2 Households

In 2008 Q1, household financing conditions continued to deteriorate. Between December and February interest rates on new loans for house purchase rose by around 6 bp, while those on consumer and other credit rose by 14 bp (see Chart 24). Also, according to the January BLS, financial institutions were expecting to apply more restrictive credit standards to both types of loans in Q1 than at end-2007.

The tightening of credit standards contributed to the gradual slowdown in the growth of household debt, to a year-on-year rate of 12% in February, somewhat more than half a percentage point down from December 2007. By purpose, the moderation in the growth of liabilities was seen both in lending for house purchase and in consumer and other finance, whose growth rates fell to somewhat more than 12% and 10%, respectively.

According to the Financial Accounts data for 2007 Q4, household acquisition of financial assets moderated and, in cumulative annual terms, represented 7.8% of GDP, almost 2 pp less than in September (see Table 6). The breakdown by instrument shows that the portfolio reallocation seen in the preceding months continued. The notable buoyancy of time deposits, which are included

In recent years, the Spanish economy has needed to raise a large amount of funds from the rest of the world in order to finance its current account deficit and increasing levels of acquisition of foreign assets by the private sector, against a background of internationalisation of Spanish corporations and geographical diversification of institutional investors' portfolios. Financial institutions have played a central role in channelling these flows, primarily through the issuance of fixed-income securities. Thus, as seen in Chart 1, most of the resources from abroad have been obtained through the sale of instruments issued by credit institutions or by other intermediaries, including securitisation special purpose entities.

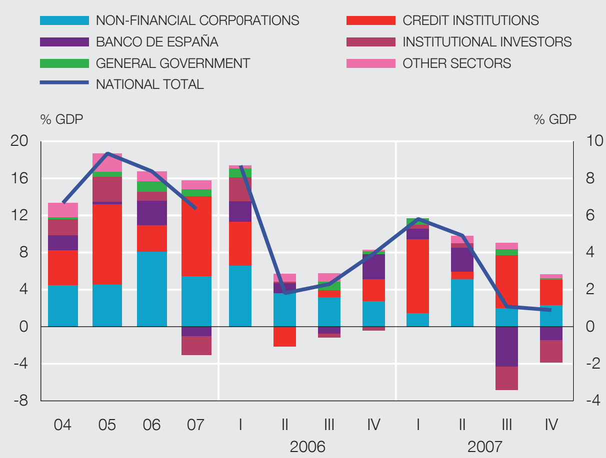
The episode of financial turbulence that began in mid-2007 has given rise to a substantial change in this pattern of cross-border flows. First, there has been a significant fall in funds raised through other financial intermediaries, related to the standstill and notable tightening of financing conditions in asset securitisation markets. However, as can be seen in Chart 2, the new liabilities incurred by credit institutions have not been significantly reduced. In net terms, private financial institutions (excluding institutional investors) continued to receive funds from abroad in the second half of 2007. Second, the inflow of capital channelled through public debt securities turned negative during that period, this being linked to the decline in the stock of securities issued by that sector, against the background of a surplus in public finances.

In addition, there was a decline in the second half of 2007 in the acquisition of foreign assets by the private sector, especially in the case of institutional investors, partly reflecting the net redemption of mutual fund shares against a background of greater uncertainty and rising volatility in market prices. The buoyancy of corporate financial investment abroad also fell. This, along with the unchanged volume of resources raised in the rest of the world, led to Spanish firms becoming, for the first time in recent years, net recipients of capital from the rest of the world.

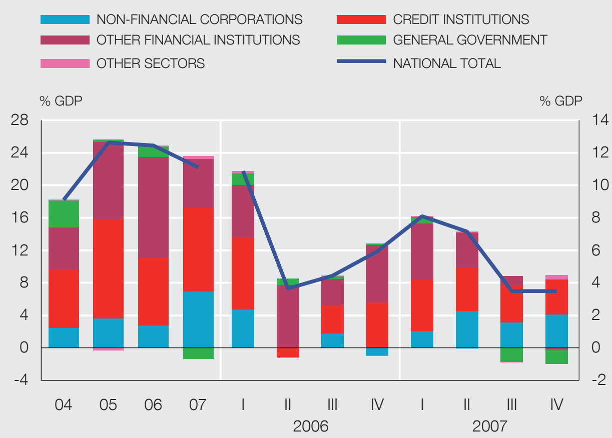
However, the lower rate of accumulation of foreign assets by these sectors was not sufficient to offset the decline in the capital inflows channelled through private financial institutions and general government, so that part of the net borrowing had to be covered by means of a reduction in the Banco de España's net external asset position, although this decline slowed considerably in Q4. This change reflects the greater recourse of Spanish monetary financial institutions to liquidity supplied by the Eurosystem, although the amount thereof remains in line with their weight in the euro area and represents only 1.3% of their balance sheet.

In short, as a result of the tensions on international markets, there have been some important changes in the pattern of financial flows between Spain and the rest of the world. First, the net acquisition of foreign assets by resident sectors has declined, so that the gross volume of external funds required has been reduced. Second, part of this lower requirement has been covered by means of the sale of some of the securities in agents' foreign portfolios. Hence, despite the less favourable environment, it has been possible in recent quarters to continue financing the large current account deficit without any significant impact on domestic spending. However, the room for manoeuvre provided by these two channels is not unlimited. Consequently, the possibility that the turbulence may continue for a lengthy period is an element of risk for the future performance of the Spanish economy.

1 ASSET FINANCIAL TRANSACTIONS VIS-À-VIS THE REST OF THE WORLD (a)



2 LIABILITY FINANCIAL TRANSACTIONS VIS-À-VIS THE REST OF THE WORLD (a)



SOURCE: Banco de España.

a. The quaterly data, which have been divided by annual GDP, refer to the right-hand axis.

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

TABLE 6

% GDP	2004	2005	2006	2007		
				Q2	Q3	Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	9.5	10.4	11.5	10.6	9.6	7.8
Cash and cash equivalents	3.9	4.0	3.1	1.7	0.5	-1.1
Other deposits and fixed-income securities (a)	1.2	1.6	5.8	7.2	7.6	8.1
Shares and other equity (b)	0.3	0.2	-0.7	-0.3	0.0	0.5
Mutual funds	1.5	1.9	0.2	-0.6	-0.6	-1.1
Insurance technical reserves	1.8	2.0	1.7	1.8	1.6	1.0
Of which:						
Life assurance	*0.7*	*0.7*	*0.6*	*0.7*	*0.6*	*0.3*
Retirement	*0.9*	*1.0*	*0.9*	*0.9*	*0.9*	*0.6*
Other	0.7	0.7	1.3	0.8	0.5	0.4
Financial transactions (liabilities)	10.1	11.7	13.2	12.2	11.1	9.4
Credit from resident financial institutions (c)	10.8	12.3	13.0	11.6	10.9	9.4
House purchase credit (c)	*8.7*	*10.2*	*9.9*	*8.9*	*8.5*	*7.2*
Consumer and other credit (c)	*2.1*	*2.2*	*3.1*	*2.7*	*2.5*	*2.2*
Other	-0.7	-0.6	0.2	0.5	0.2	0.0
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.7	18.5	23.0	20.9	17.9	13.7
Cash and cash equivalents	1.0	2.0	2.3	1.2	0.4	-0.4
Other deposits and fixed-income securities (a)	0.3	1.4	2.5	4.0	3.3	2.8
Shares and other equity	6.5	7.4	10.4	9.2	7.8	6.8
Of which:						
Vis-à-vis the rest of the world	*3.8*	*3.9*	*6.8*	*5.5*	*4.5*	*5.1*
Other	6.8	7.7	7.8	6.5	6.5	4.5
Financial transactions (liabilities)	19.2	25.4	31.9	31.2	29.4	25.4
Credit from resident financial institutions (c)	8.3	12.9	17.7	17.9	16.9	13.9
Foreign loans	0.7	2.1	3.3	2.7	2.4	2.4
Fixed-income securities (d)	0.0	0.3	1.8	0.8	0.8	0.5
Shares and other equity	4.4	3.7	2.5	3.5	4.1	5.1
Other	5.8	6.4	6.7	6.3	5.3	3.6
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	16.3	21.2	24.2	20.6	18.8	15.2
Households and NPISHs	20.2	20.9	19.6	16.4	15.3	12.7
Non-financial corporations	13.2	21.4	27.9	23.9	21.5	17.1

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.

under other deposits and fixed-income securities, was maintained (in terms of GDP, they reached 8.1%), while net flows into cash and cash equivalents, which include cash and sight deposits, and into mutual funds turned negative again. Finally, there was a small rise in direct purchases of equities, while the volume of funds in the form of technical insurance reserves declined slightly.

The more moderate buoyancy of financing caused the household debt ratio to grow at a lower rate, and at end-2007 it stood at more than 130% of GDI (see Chart 25). This, along with the rise in interest rates in recent months, led to a further increase in the associated debt burden, to around 18% of GDI, as at the same date. Meanwhile, there were hardly any significant changes in either households' saving, after deducting the expenses associated with their liabilities, or in their net borrowing, while household net wealth, relative to GDI, remained high.

5.3 Non-financial corporations

In the case of corporations, interest rates on new bank loans, in line with the trend in interbank rates, declined between December and February (see Chart 24). The extent of the decline depended on the size of the transaction (19 bp in the case of loans of less than €1 million and 27 bp in the case of larger amounts). Yields on fixed-income securities also fell (by 48 bp in the case of short-term securities and 5 bp in that of long-term ones). However, the return required on equity increased significantly, largely reflecting lower market capitalisations. As a result of these movements, the synthetic indicator of the sector's cost of capital remained practically unchanged. In any event, there has probably been a rise in firms' cost of capital in March, given its dynamic relationship with the EURIBOR indices. There was also a rise in the cost of long-term debt issuance (38 bp) in March and, according to the January BLS, institutions were expecting to apply substantially tighter credit standards in 2008 Q1 than they did in 2007 Q4.

Against this background, corporate debt continued to slow, to a year-on-year growth rate of around 16% in February, down almost 1 pp from end-2007. The shortest rates point to less— albeit still high— buoyancy in annualised terms (around 12%). By instrument, this outturn was basically the result of the moderation in resident institutions' lending, which is the most important item.

The latest data on the breakdown by productive activity of lending to corporations, for December 2007, show that the slowdown in 2007 Q4 extended to practically all sectors, although it was most pronounced in real estate services, whose year-on-year growth rate fell from 35% to 24%. In industry and construction, the rate of growth fell by somewhat more than 3 pp, to 18% and 14%, respectively, while in other services it was very similar to three months previously (22%).

The Financial Accounts information for 2007 Q4 shows a further rise in corporate net borrowing, to 11.8% of GDP in cumulative 12-month terms. For its part, the *financing gap,* an indicator that approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, grew to a greater extent, reaching 17.1% of GDP (see Table 5).

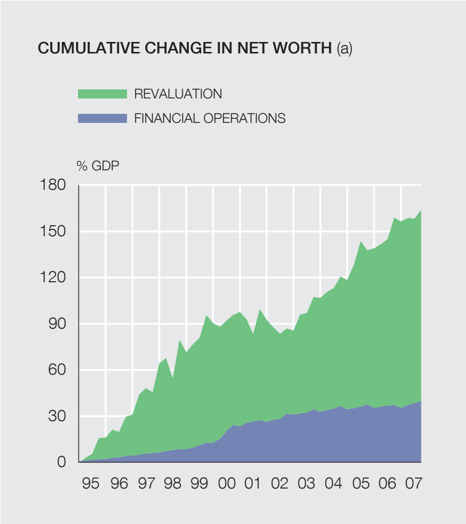
The continued high level of corporate borrowing in 2007 Q4 led to a further rise in the sector's debt-to-earnings ratio, although at a lower rate than in the previous quarters (see Chart 26). This development, along with the increase in the average cost of the outstanding amount of borrowing, meant that interest payments grew again, to represent almost 25% of profits. The increase in financial costs continued to check income growth. Hence, while the gross operating surplus increased by more than 7% in annual terms in December 2007, income after interest payments rose by only 2%.

The latest CBQ information, based on a sample in which large corporations predominate, shows that in December the debt ratio held at similar levels to September 2007, while the debt burden increased, albeit at a slower rate than during the preceding months, and profit developments were favourable. As a result, the synthetic indicators of financial pressure on investment and employment remained at around the same levels as in the preceding quarter. By branch of activity, the favourable performance of profits in industry was especially notable.

Finally, in 2008 Q1, analysts once again revised down profit growth expectations for quoted non-financial corporations for the next 12 months, from 8% to 5%, in step with the anticipated lower economic growth in the coming months (see Chart 27).

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 27

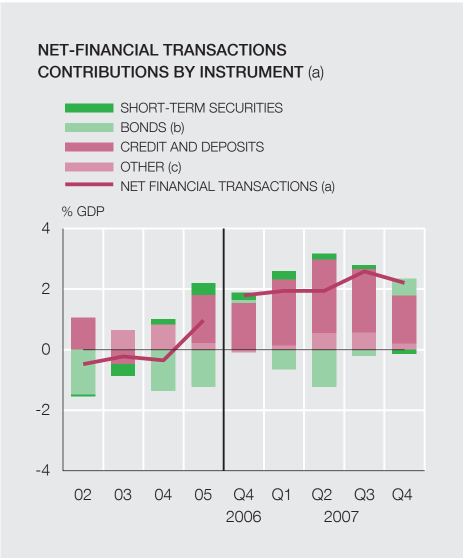


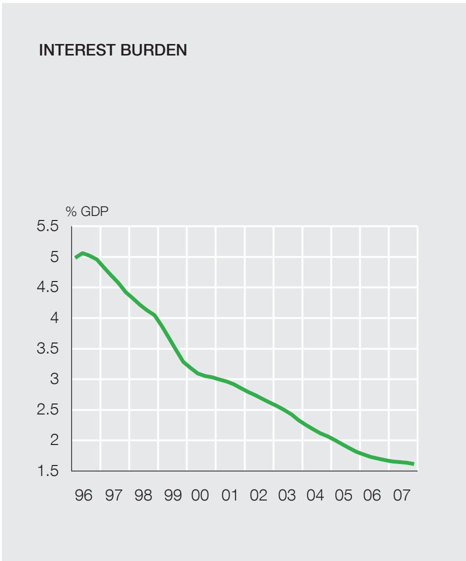
SOURCES: I/B/E/S and Banco de España.

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 28





SOURCE: Banco de España.

a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
b. Includes only liabilities transactions.
c. Unpaid accrued interest on bonds and net investment of Social Security funds in assests issued by the rest of general government.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP

	2004	2005	2006	2007 Q2	2007 Q3	2007 Q4
NET FINANCIAL TRANSACTIONS	-4.8	-6.5	-8.1	-8.6	-8.9	-9.5
FINANCIAL TRANSACTIONS (ASSETS)	13.3	18.7	16.7	17.1	15.8	12.7
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.2	2.2	5.5	6.3	5.6	2.2
Of which:						
Interbank (a)	*0.7*	*3.1*	*3.4*	*4.7*	*5.9*	*4.2*
Securities other than shares	1.8	8.8	-1.2	2.5	2.7	1.6
Of which:						
Credit institutions	*1.0*	*6.6*	*-2.0*	*1.7*	*2.4*	*1.8*
Institutional investors (b)	*0.3*	*2.3*	*0.9*	*0.5*	*0.1*	*-0.3*
Shares and other equity	6.8	5.1	9.2	7.5	6.1	7.3
Of which:						
Non-financial corporations	*3.8*	*3.9*	*6.8*	*5.5*	*4.5*	*5.1*
Institutional investors (b)	*0.8*	*0.9*	*1.2*	*0.5*	*-0.3*	*-1.0*
Loans	0.8	1.1	2.1	0.3	0.9	1.0
FINANCIAL TRANSACTIONS (LIABILITIES)	18.2	25.2	24.9	25.7	24.7	22.2
Deposits	1.7	5.6	0.3	3.6	5.4	7.3
Of which:						
Interbank (a)	*5.0*	*7.2*	*0.6*	*4.1*	*5.3*	*6.7*
Securities other than shares	12.4	15.8	21.3	18.2	14.5	7.8
Of which:						
General government	*2.7*	*0.2*	*1.3*	*0.6*	*-0.4*	*-1.4*
Credit institutions	*4.6*	*6.3*	*7.7*	*6.9*	*5.4*	*3.3*
Other non-monetary financial institutions	*5.1*	*9.3*	*12.3*	*10.6*	*9.4*	*5.9*
Shares and other equity	2.7	0.9	-0.7	0.4	1.7	4.1
Of which:						
Non-financial corporations	*1.7*	*1.0*	*-1.1*	*0.6*	*1.7*	*4.3*
Loans	1.3	2.3	3.5	3.0	2.7	2.6
Other, net (c)	-0.6	-0.9	-0.6	0.0	0.0	-0.2
MEMORAMDUM ITEMS						
Spanish direct investment abroad	5.8	3.7	7.3	5.8	6.1	8.0
Foreign direct investment in Spain	2.4	2.2	1.6	2.1	1.9	4.1

SOURCE: Banco de España.

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

5.4 General government

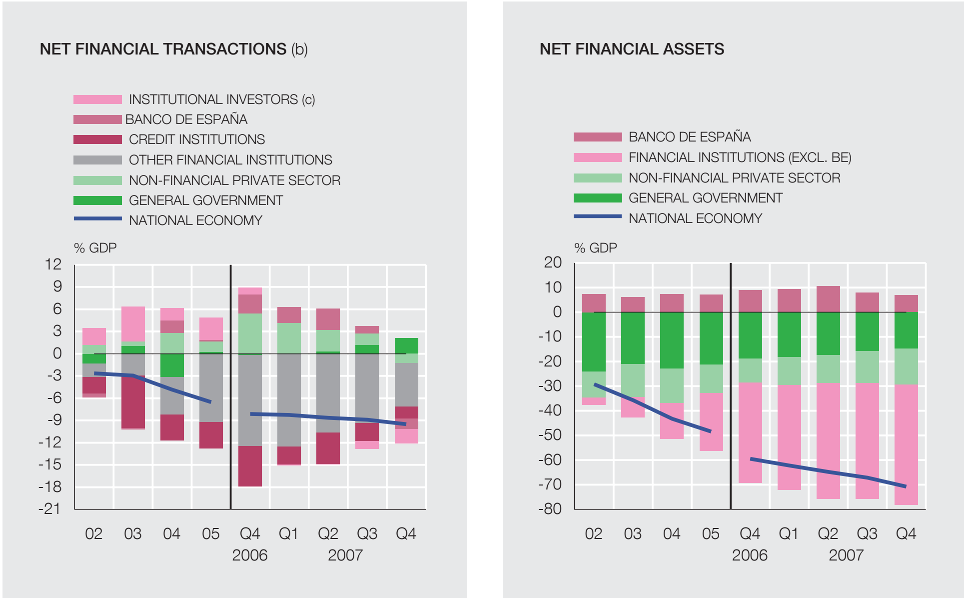
General government net saving stood in December 2007, in cumulative twelve-month terms, at 2.2% of GDP, 0.4 pp less than in Q3 (see Chart 28). By instrument, this development was a consequence of a smaller increase in the balance of deposits net of lending, and of an increase in short-term securities issuance that was not fully offset by the net redemption of medium and long-term securities. At the same time, the reduction in the debt ratio meant that, despite the rise in the average cost of funds, interest payments held at 1.6% of GDP.

5.5 The rest of the world

In 2007 Q4, the debit balance of the nation’s financial transactions continued to rise, to stand, in cumulative twelve-month terms, at 9.5% of GDP, as against 8.9% in September. By sector, this was a consequence of an increase in the net borrowing of firms and, to a lesser extent, of

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

CHART 29



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

households, as well as of the lower general government saving, which was not fully offset by the increase in the surplus of financial institutions (see Table 5).

Capital inflows fell in 2007 Q4, to 22.2% of GDP, in cumulative twelve-month terms, 2.5 pp less than in September (see Table 7). This reduction was primarily a consequence of the reduced buoyancy of the amount in the form of securities other than shares, which fell from 14.5% of GDP in September to 7.8% in December. In particular, there was a decline in the funds obtained through this channel by both credit institutions and other non-monetary financial institutions, including securitisation special purpose entities, a phenomenon linked to the decline in the issuance of these securities, against a background of tightening financing conditions on international debt markets, especially of those linked to mortgage loans. At the same time, net foreign investment in instruments issued by general government was negative, in step with the fall in the outstanding amount thereof. By contrast, there was an increase in the volume of acquisitions of shares and other equity (4.1% of GDP), a development linked to the rise in foreign direct investment in Spain, and in the flows of financing obtained through the interbank market which, in net terms, turned negative.

The acquisition of external assets also fell, to 12.7% of GDP in cumulative twelve-month terms, down 3 pp from September. By instrument, net purchases of fixed-income securities were less buoyant, while investment in shares and other equity recovered from the previous quarter, a development linked to the increase in Spain's direct investment in the rest of the world, which reached 8% of GDP, up almost 2 pp from three months earlier.

As a result of the developments in cross-border financial flows and of the changes in asset prices and in the exchange rate, the value of net liabilities accumulated vis-à-vis the rest of the world continued to rise (see Chart 29). By sector, this development was basically a consequence of the increase in the debit balance of financial institutions (excluding the Banco de España), which was around 50% of GDP, and of the non-financial private sector, which reached a level close to that of general government.

25.4.2008.