BANCO DE ESPAÑA

economic bulletin

January 1999

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Abbreviations and symbols

M1	Money supply = Notes and coins held by the public + sight deposits.
M2	M1 + savings deposits.
M3	M2 + time deposits.
ALP	Liquid assets = M3 + other liquid assets.
ALP2	ALP + Commercial paper held by the public.
ALPF	ALP + fixed-income mutual funds.
EUR	Euro.
ESP	Pesetas.
a	Projection.
p	After a month [January (p)], this means that all the related figures are provisional; after a figure, only said figure is provisional.
	Annual (1970) or quarterly data with this symbol are averages of the monthly data of the year or quarter; series of monthly, ten-day or weekly data are averages of the daily data for such periods.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
»	Less than half the final digit shown in the series.
*	Series of seasonally adjusted data.

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Contents

	Page
Appearance by the Governor of the Banco de España before the Spanish Parliamentary Committee on Economic, Trade and Finance Affairs	7
Quarterly report on the Spanish economy	13
Results of non-financial firms in 1997 and in the first three quarters of 1998	55
Is there scope for inflation differentials in EMU?	69
Financial regulation: fourth quarter 1998	75
Articles in English and publications of the Banco de España	185

Appearance by the Governor of the Banco de España before the Spanish Parliamentary Committee on Economic, Trade and Finance Affairs

Mr Chairman, ladies and gentlemen:

I appear once more before this Economic, Trade and Finance Affairs Committee observing the four-monthly term established by you to monitor the monetary policy implemented by the Banco de España in accordance with the responsibilities and powers attributed to it under the 1994 Law on Autonomy. Under these arrangements, the first two appearances of the year analysed the degree of compliance, in the specific circumstances then prevailing, with the statutory mandate of pursuing price stability, for which the Banco de España had devised a direct inflation targeting strategy. These first two appearances were structured around the half-yearly inflation report that the Banco de España was obliged to publish to make the measures taken in relation to the ends pursued comprehensible and transparent. The last appearance at the end of the year was to take stock of monetary policy conduct and to announce the inflation targets proposed by the Bank for the new year from a medium-term perspective.

On this occasion, the start of Monetary Union in a little over two weeks substantially changes the nature of my appearance. January 1st will see the entry into force of the recently approved reform of the Banco de España Law on Autonomy, which adapts its legislative and statutory framework to the requirements arising from Spanish EMU membership and from the incorporation of the Banco de España into the European System of Central Banks (ESCB). It will then be for this system, steered by the Governing Council of the European Central Bank (ECB), to define the monetary policy strategy and objectives for the euro area as a whole. Further to this significant change, the Banco de España shall cease to announce monetary targets and, consequently, to publish its inflation reports which, as you know, were designed as an instrument to monitor such targets. The last such report was published in September. Nonetheless, the Banco de España will continue to participate actively in the performance of the functions of the ESCB, contributing to shape the opinion of its governing bodies and to decision-making, which shall perforce be centralised. Our central bank will be entrusted with implementing such decisions in national markets, in keeping with the strongly decentralised operational framework that has been adopted.

Under these terms, the Banco de España will be responsible for monitoring the Spanish economy within the framework of the single monetary policy set by the ECB and for its implementation in our money and financial markets. In this regard, the Banco de España will continue to publish, inter alia, the quarterly short-term reports and the monthly notes on the Spanish economic and monetary situation. In my appearances before this Committee, I shall continue to monitor the Spanish economy and our financial system within Monetary Union in the manner and as regularly as you should require. I shall be pleased to attend to your requirements, logically observing the confidentiality to which I am bound as a member of the governing council of the ECB. In this way, and within the specific characteristics of the new framework, we may continue with a tradition which has proven most fruitful as regards understanding and effectiveness of the ends of monetary policy in Spain.

With this in mind, I shall focus today on Spanish monetary policy in 1998. The close of this year marks the discontinuation of a direct inflation targeting strategy and the end of a stage in which the convergence of interest rates with the level to prevail at the start of Monetary Union has been achieved. I shall also tackle certain matters relating to the monetary policy strategy defined by the ECB, the implementation framework that is to be followed and the preparations needed for the organisation of markets and payment systems.

* * *

A year ago, I appeared before you to present the monetary policy objectives for 1998. These specifically involved maintaining the 12-month growth rate of prices, measured by the consumer price index, at close to 2 % over the year. Since then, inflation has declined by over half a point in relation to the level of 2 % as of December 1997, and the inflation targets set for the present year have been comfortably met. Indeed, last spring already we had met the requirements set in this connection for entry into Monetary Union, and our current inflation rate is in step with that of the euro-area members.

The recently released November figure has placed the 12-month growth rate of the CPI at 1.4 %, and the year-end figure may well be the same. Energy prices, which have fallen by close to 6 %, have contributed decisively to this favourable result. And food and non-energy industrial goods have also increased moderately, by around 0.5 % and 1.5 %, respectively. It is thus in services where the greatest price pressures are concentrated, as reflected by the fact that the latest-month rate of 3.6 % is well above the values prevailing in most euro-area countries. These levels testify to the lack of competition still characterising many branches in the services sector.

The sound overall performance of prices during the present year has been enhanced by the conditions prevailing abroad and at home. Abroad, the marked fall in commodity and oil prices and the absence of inflationary pressures in the main economies (particularly in Europe) have, against a background of dimmer prospects due to the disturbances and uncertainty caused by the Asian and Russian crises and their influence in other areas of the world, made import prices dip.

On the domestic front, a sustained pattern of balanced growth in 1998 has allowed a notable expansion in economic activity (GDP increased by around 3.8 % on average during the year) to co-exist with very low inflation rates. As the Spanish economy reached a more advanced position in the cycle, domestic demand progressively replaced the external sector as the driving force, with net external demand contributing slightly negatively to GDP growth. Thus, while the strength of domestic demand has been mainly driven by the momentum of investment and by the pick-up in private consumption, the external sector has flagged increasingly, owing both to the slower pace of exports, against the background of a deceleration in world demand, and to the greater impetus of imports, associated with the strength of national demand. Confidence indicators have confirmed favourable consumer expectations about the economy and only business confidence surveys show any uncertainty over the influence of the international crisis and its impact on foreign markets.

Attaining sound growth without inflationary pressures has proven possible thanks to sustaining an economic policy firmly geared towards stability and wage moderation. In this respect, progress in correcting budgetary imbalances has been noteworthy. The budget deficit has been lowered from 2.6 % of GDP at end-1997 to a forecast level of 1.9 % at end-1998, a substantial improvement on the initial target.

Given the favourable climate prevailing for price developments and inflation prospects throughout 1998, the Banco de España has continued progressively to lower its intervention rate, in line with the inflation target set. It has also sought to draw Spanish monetary conditions closer to those that might prevail at the onset of the euro.

In 1998, the Banco de España cut its intervention rate on five occasions. The last of these, at the start of December, was in concert with the other central banks of the countries that will initially make up the European monetary area. Hence the intervention rate of the Banco de España and that of the rest of these central banks, with the temporary exception of the Bank of Italy, stands at 3 %. In our case, that amounts to a fall of 1.75 percentage points since the beginning of the year.

With this decision, the opening interest rate for Monetary Union that the ECB intends to maintain in the foreseeable future has, de facto, been set. Any continuing uncertainty over this process has thus been dispelled, smoothing the complex transition in store in the opening days of 1999.

Setting the euro-area interest-rate at 3 % responds, logically, to considerations relating to the new monetary area as a whole. In particular, it counters concerns that the climate of moderate recovery might be adversely affected by the factors of uncertainty prevailing in the international environment. Admittedly, such factors appear to have abated in recent weeks. But they continue to entail a risk that growth will weaken, given the slowdown in world growth, the persistence of serious economic problems in Russia and Japan and significant doubts concerning developments in most emerging economies and those in transition. Fortunately, the present situation across the euro area (price growth is running slightly below 1 %) and the favourable monetary and price outlook in the future Monetary Union meant that a preventive interest rate cut could be made, so clearing the horizon and alleviating the potential risks detected.

During the present year, expectations about interest-rate convergence have progressively limited the Banco de España's scope to influence the yield curve in financial markets in its shortest-dated segments.

In the prevailing climate of nominal stability and convergence, the easing of monetary conditions in 1998 has passed through, with more or less intensity, to the term structure of rates on different financial markets, placing such rates at historically low nominal and real levels. In turn, these financial conditions have helped improve both the general government and private-sector balance-sheet and financial positions, with the subsequent beneficial effects for public finances, economic activity and employment.

The reductions in interest rates on all markets and at all terms have drawn rates closer to those in other countries in the area and, in certain cases, this has meant lower interest rates for Spanish borrowers than for those in other European countries. The 10-year government bond spread over Germany is currently very narrow and the convergence of interest rates has been accompanied by the high stability of the peseta in the ERM, where it has constantly traded very close to its central parity.

Turning to the monetary aggregates, ALP (liquid assets held by the public) has slowed during 1998, and currently stands at a growth rate of close to zero. This deceleration cannot be accounted for by the overall performance of nominal expenditure and of interest rates, since it is closely related to the ongoing shifts in the public's holdings towards shares in mutual funds. Hence, on considering the overall course of liquidity, bearing in mind the increase in shares in mutual funds, its year-on-year growth is higher (specifically, ALPF is growing at 6 %) and, consequently, more consistent with the trend of the basic determinants of the demand for liquidity. In contrast to ALP, the narrow monetary aggregates – such as M1, which only includes cash and sight deposits, and M2, which further includes savings deposits – have been on a more expansionary course (of around 10 %), which is logical given the intense growth of economic activity. The growth rate of credit extended to households and firms has accelerated in 1998 in step with the economy's expansion and the decline in the cost of financing. In October, it reached a year-on year rate of almost 15 %, in contrast to the moderate growth of general government net borrowing, which was influenced by the headway made in fiscal consolidation.

The Spanish economy is moving into the euro area with the appropriate levels of stability and the prospect of maintaining high output and employment growth rates. That said, such rates may be tempered as the effects of the international crisis on the euro area and on economic agents' confidence become more tangible. Low interest rates and the rapid growth of lending to the private sector point to certain risks of lax initial monetary conditions. That obliges me to stress what I said on previous appearances about the role in these new circumstances of the economic policy components that remain under national sovereignty.

The loss of autonomy in the management of interest and exchange rates arising from Spanish membership of the euro area means non-monetary policies must be pursued more stringently than in the past so as to ensure the compatibility of Spanish macroeconomic conditions with the rest of the area and with the single monetary policy. It is thus vital that budgetary policy should continue on the path set under the 1999 Budget. Hence, the shortfall in public finances should be reduced, first, via measures that contain and cut expenditure on those items which least contribute to the economy's productive potential or to social well-being; and further, via improving the tax system's efficiency and revenue-raising capacity. Of no less importance is the deepening and widening of the structural reforms undertaken in recent years. These should aim at improving the working of those goods and services markets which have so far been sheltered from competition, and at adding greater efficiency and flexibility to the labour market.

* * *

As I mentioned at the beginning of my address, it is for the ESCB and, in particular, the ECB to formulate the monetary objectives for the euro area as a whole. And these must be fully assumed by the Banco de España as a member of the system. Let me now move on to discuss the elements or basic pillars underpinning the framework which will govern monetary policy decisions in the euro area.

As decided by the governing council of the ECB, the basic elements of the single monetary policy framework are as follows.

First, price stability, which will be pursued over a medium-term horizon, has been quantified as «a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %». In this respect, the current course of inflation in the area may be considered to be in line with this definition.

Second, a notable role is assigned to the money supply in monetary policy decision-making, establishing a reference value for the growth of the relevant monetary aggregate. This ensures that there will be a degree of continuity with the practices successfully pursued by some of the central banks shortly to make up Monetary Union. Nonetheless, so as to avoid a mechanistic reaction to short-term deviations from the reference value, price developments and the associated outlook in the euro area will be assessed on the basis of the information provided by a broad set of economic and financial indicators. Accordingly, single monetary policy decisions will not be tied more or less automatically to how a particular monetary variable fares, but will reside on an overall analysis of the economic situation and the inflation outlook in the euro area as a whole. Under these co-ordinates, the Governing Council of the ECB agreed to establish an initial annual growth reference of 4.5 % for the monetary aggregate M3, leaving itself the possibility of revising this value in December 1999. M3 is defined as the sum of euro-area residents' holdings of cash, deposits and other bank liabilities maturing at less than two years, and money-market fund shares. The reference value, for its part, has been derived in keeping with the definition of price stability and its medium-term horizon, bearing in mind the trend of GDP and the velocity of circulation of money in the euro area as a whole.

* * *

Allow me now to refer to certain matters linked to the implementation of the single monetary policy and the introduction of the euro as from January 1st next year. Here, the most important decision adopted has probably been to establish a minimum reserve system with which credit institutions in the euro area must comply. These institutions will, moreover, act as counterparties to the ESCB in its monetary policy operations, and the fact that the reserve assets required are to be remunerated at market interest rates will mean that the cost arising for them from compliance with this requirement will be very small and, for Spanish banks, considerably less than at present. Recently, the ESCB has also made public the list of financial and monetary institutions which make up the money-creating sector in the euro area, and the statistical information that these institutions must supply to the central banks of their respective countries has been specified.

Also, during the second half of the year, the central banks of the participating countries have undertaken a series of trials to test the working procedures for the decentralised implementation of the single monetary policy. The results have demonstrated the suitability of these procedures for effective monetary policy conduct. The Banco de España, too, has continued the ongoing adaptation of its monetary policy instruments and procedures so as to approximate them progressively to those that will be in place as from January 1999. The transition towards a real-time gross settlement payment system, the extension of the assets that will be accepted as collateral for monetary policy loans and the introduction of new liquidity-regulating instruments are some of the changes which were already begun in 1997. During 1998, this process has been drawing to its culmination. Risk control measures in the taking of guarantees have been harmonised; a deposit facility similar to that which will be in force in 1999 has been introduced; and the frequency with which regular liquidity-injection tenders will be held has been altered from a thrice-monthly to a weekly basis. Furthermore, arrangements for compliance with the minimum reserve requirement were modified in November and December, on the basis of a new harmonised accounting reporting framework, and its maintenance period has been extended to one month.

The introduction of the euro will require a major effort by financial-market agents in terms of learning and adaptation. The first business day of 1999 will see a mass conversion into euros affecting the listing and wholesale trading of securities and the clearing and settlement thereof. Consequently, given that euro notes and coins will not be in circulation until January 2002, the effects of this mass conversion will, first and foremost, fall on financial intermediaries.

I would not wish to conclude here without pointing out that the adaptation of Spanish financial markets to the requirements of the single currency will be smoothed by the entry into force of the legislation covering the introduction of the euro, also known as the «umbrella law», recently approved by this Parliament. This legislation, which provides the legal framework in which the transition shall unfold, establishes a series of clear, accurate operational procedures for conversion to the new currency, along with simple, orderly methods for the redenomination of accounts and securities into euros. These methods and procedures have been designed to prevent the conversion into euros hindering the sound workings of markets, to minimise the costs associated with the process and, ultimately, to secure its rapid acceptance by Spanish society. The Banco de España will ensure that the supply of new euro-denominated financial products and services by credit institutions is conducted with due transparency, avoiding any confusion that might erode the public's confidence in the new currency.

* * *

To conclude I should like to stress, as I have on previous occasions, that, more than an end in itself, Spanish membership of Monetary Union involves new opportunities to improve standards of living and well-being in Spanish society as a whole. However, full benefit may only be had from these opportunities if the fiscal consolidation drive adheres to the balanced-budget rules established in the Stability and Growth Pact; if the markets for goods and services and for labour operate more flexibly and efficiently; and if economic and social agents adopt behaviour in keeping with the Spanish economy's participation in the common area of monetary stability.

17.12.1998.

Quarterly report on the Spanish economy

1. Overview

As a result of the start of Economic and Monetary Union (EMU) on January 1st, the Banco de España is revising its publications to adapt them to the setting of a single currency and a common monetary policy. However, both this Bulletin and the forthcoming January «Statistical Bulletin» are still in the transition stage; although the new analytical and conceptual frameworks are well defined, the time scope of these publications continues to refer essentially to the stage prior to the start of EMU (data to December 1998). The January editions of the two bulletins have various new features (for example, the generalised dissemination of information expressed in euros); but the changes needed for full adaptation to the new situation will be progressively incorporated over the coming months.

Against an uncertain international backdrop, owing to the persistence of destabilising factors in certain financial markets, the Spanish economy has concluded 1998 and moved into the Third Stage of Economic and Monetary Union (EMU) under favourable conditions. Real growth is running at a high rate and the mild deceleration seen in the second half of the year is due to the decline in exports, as a result of the lesser buoyancy of certain industrial countries (see Table 1 and Chart 1). In the fourth quarter, the pace of national demand sustained a high rate and employment growth was notable. Consumer confidence levels remained firm, as in the other EMU countries (see Chart 2). Only industrial activity has shown signs of weakness, and business confidence surveys have reflected this. As a result, the growth of capital investment has slackened. However, the strength of fixed-capital investment has remained considerable, with the construction sector contributing decisively. The continuity of the upswing, the fall in interest rates and the perseverance of the check on spending means that the Spanish economy has reduced its public finances deficit to a greater extent than foreseen. Moreover, the 12-month growth rate of consumer prices at the end of the year was at an all-time low; in terms of the harmonised indices (see Chart 3), the gap with the euro-area countries stands at half a percentage point. The Spanish economy progressively adapted its monetary conditions during the fourth quarter of 1998 to those which would prevail at the outset of EMU. The Banco de España cut its intervention rate by 1.25 percentage points during this period, placing it, in co-ordination with the other central banks of the euro area, at 3 %. This is the rate the European Central Bank (ECB) has adopted at the start of EMU. The monetary policy decisions of the ECB will be aimed at preserving the stability levels achieved, bearing in mind the general macroeconomic context. Against this new back-

TABLE 1

Gross domestic product (a)

	1997	1997				1998		
		Q I	Q II	Q III	Q IV	Q I	Q II	Q III
Private consumption	3.1	2.5	2.9	3.4	3.7	3.8	3.7	3.5
Government consumption	1.4	0.3	1.3	2.0	1.9	1.3	0.8	0.3
Gross fixed capital formation	5.1	3.1	4.0	5.8	7.3	8.4	8.4	8.4
Construction	*1.3*	*–1.1*	*0.4*	*2.6*	*3.5*	*4.9*	*5.7*	*6.1*
Capital goods	*11.0*	*10.2*	*9.7*	*10.7*	*13.1*	*13.7*	*12.5*	*11.8*
National demand	**2.9**	**2.0**	**2.5**	**3.3**	**4.0**	**4.5**	**4.5**	**4.3**
Exports of goods and services	14.8	14.9	15.2	15.0	13.8	11.3	9.3	8.6
Imports of goods and services	12.2	10.1	11.5	13.3	13.8	12.6	10.9	9.9
GDP at market prices	**3.5**	**3.2**	**3.4**	**3.7**	**3.8**	**3.9**	**3.9**	**3.8**

Source: Instituto Nacional de Estadística.
(a) Year-on-year trend rates of change. 1986 constant pesetas. Provisional figures.

ground, the stance of other Spanish national economic policies should be kept tight, so as to improve competitiveness, reduce the price-growth differentials in certain sectors and sustain employment growth.

The instability of the international economic situation appeared to have subsided in the closing months of 1998 as a result, essentially, of the reduced turbulence on international financial markets and signs of recovery in the emerging Asian economies. However, the situation has once more been affected by the fresh crisis in Brazil and unchanged unfavourable prospects in the Latin-American economies and, above all, in Japan, where recession and the fragility of the financial system remain prevalent. In parallel, activity in the developed Western economies appears to be moving into a slowdown which, in principle, will be moderate and, on current forecasts, continue throughout 1999. The determinants of this deceleration were, in general, the sluggishness of merchandise exports (seen in previous quarters), the signs of a loss of momentum of certain domestic demand components and the deterioration of business confidence indicators. In any event, the scale of this deceleration will basically depend on developments in the international financial situation, where factors of risk persist, especially following the recent foreign exchange crisis in Brazil.

In the euro area, economic growth in the third quarter of 1998 (2.4 % in year-on-year terms) stood at appreciably lower rates than in the first two quarters. Further contributing to the slowdown, which was, as stated, largely due to the sluggishness of the foreign sector, was the behaviour of stockbuilding. The related indicators attest to the deterioration in business confidence, although consumer confidence remains at very high levels, whereby the continuing strength of private consumption may, for the moment, be anticipated. Inflation across the euro area, measured by the Harmonised Index of Consumer Prices, has continued over recent months at very low levels (around 1 %) that are consistent with the standard of price stability adopted by the ECB. In addition to other domestic factors, the fall in commodity prices (essentially energy prices) has contributed to this highly favourable performance. Nonetheless, services prices are showing downward stickiness, their related 12-month growth rate standing at over 2 % at the end of 1998. With regard to fiscal policies in the area, although the overall general government deficit has fallen slightly, this appears basically to be due to the decline in the interest burden. Accordingly, the fiscal drive by national authorities, measured by the primary balance, would appear to have weakened in 1998. Against this backdrop of stability and moderate growth, the ECB decided in early December that the interest rate to prevail at the start of EMU should be 3 %. With this it was sought to counter the potential contractionary effects that might arise from the uncertain international situation without jeopardising the degree of stability prevailing.

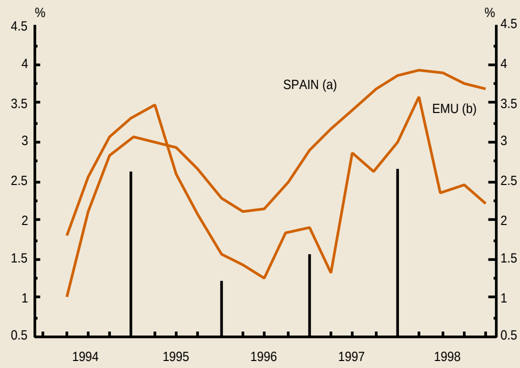
The Spanish economy ended 1998 with a growth rate clearly higher than that recorded on average in EMU (see Chart 1). The negative contribution of real net external demand to GDP growth increased, as exports are being affected by the slowdown on international markets inside and outside the euro area. The growth rate of national demand stabilised, however, after a slight fall the previous quarter. With the data available to date, real GDP is estimated to have increased by around 3.7 %, and national demand by very close to 4.5 %, with the external balance subtracting about eight-tenths of a percentage point. Notable among the main components was the strength of private consumption. Its real year-on-year growth rate is expected to be similar, at least, to that of the preceding period. The behaviour of the two major aggregates of gross fixed capital formation continued to differ. While capital investment slowed moderately, investment in construction continued to rise. There are no relevant changes in stockbuilding or in government consumption, although the rate of increase of the latter variable might have climbed slightly. If these data are confirmed, real GDP growth in 1998 as a whole may have been 3.8 %, national demand 4.4 % and the contribution of net external demand negative by the order of seven-tenths of a percentage point.

The strength of private consumption in 1998 is essentially due to the increase in real household disposable income (of around 3.5 %). This is far higher than in 1997 owing to the lesser growth of consumer prices, as the increase in nominal disposable income was similar in both years. The fluctuations in household wealth, the result of the crisis on financial markets, did not affect consumer confidence. Consumer expectations about economic developments and their spending levels to the end of the year remain highly favourable, in a context of notable employment growth. The tendency of confidence indicators to stabilise seen in the central months of the year appears to be behind, and in the fourth quarter substantial improvements have been recorded, similar to those in the other EMU countries (see Chart 2). The growth of consumption was particularly marked in the non-food component and, hereunder, in consumer durables purchases. The household saving ratio stabilised at a similar level to that of the preceding two years, but the considerable increase in investment in housing has meant a slight cut in households' financing capacity.

The climate of uncertainty and the slowdown in international activity has passed through to exports, affecting industrial firms' expectations and investment decisions. Although the effect on the Spanish economy as of end-1998 has been limited, the loss of momentum in merchandise exports is proving notable. The excellent results in the tourism sector and the performance of sales in European markets contributed to mitigate the heavy declines in other markets. Yet the latest data show that the slowing

GRÁFICO 1

GDP



Sources: EUROSTAT, ECB, Instituto Nacional de Estadística and Banco de España.

(a) Non-centred annual rates of change calculated on the trend.

(b) Non-centred annual rates of change calculated on the seasonally adjusted series.

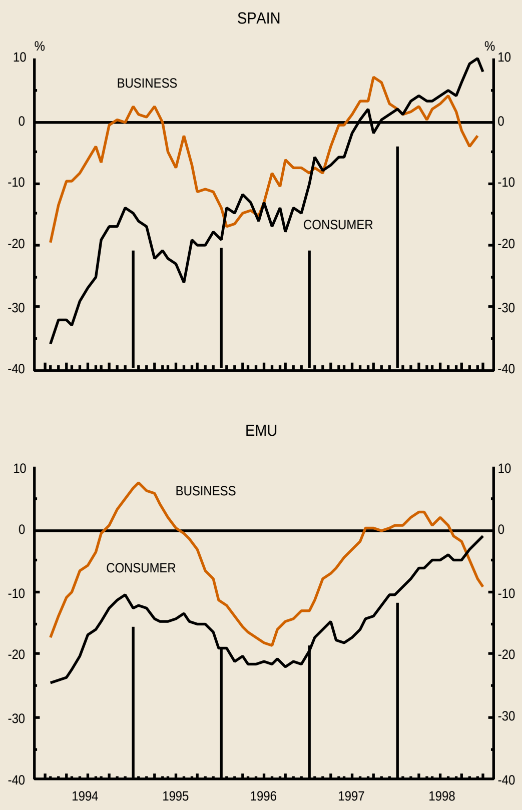
trend of export is spreading to the EU area. On the information available, in which high erraticism is evident, it is estimated that total exports of goods and services in 1998 are running at a real growth rate of around 7 %, over six percentage points below the related rate a year earlier. As to capital investment, its deceleration has been much more limited (less than three percentage points during the year), since the strength of domestic demand and excellent corporate results contributed to offset the effects of the reduction seen in foreign orders.

As earlier stated, the slowdown in capital investment ran parallel to the growing buoyancy of investment in construction, in both its private and public-works components. For the last quarter of the year, a real year-on-year growth rate three percentage points higher than that recorded at the end of 1997 has been estimated. Notable under the remaining demand components is the positive contribution of stockbuilding throughout the year, after the adjustment the previous year, and the moderation in the growth of government consumption, the real growth rate of which may be less than 1 % for the year as a whole.

Although the growth rate of national demand held stable during 1998, that of final demand slowed slightly. In these circumstances and given the continuing fall in their prices, the slowdown in imports of goods and services totalled only four percentage points, approximately, appreciably lower than that in exports. Consequently, the trade deficit has widened notably in the

CHART 2

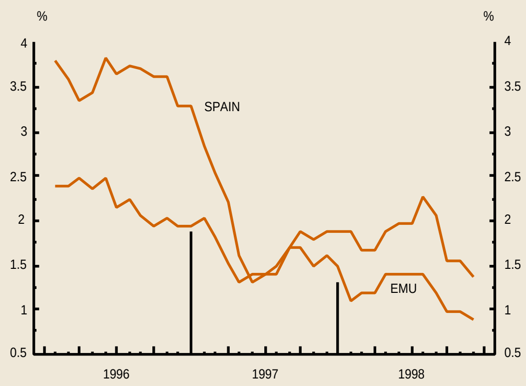
Confidence indicators



Sources: European Commission and Ministerio de Industria y Energía.

CHART 3

Harmonised indices of consumer prices 12-month percentage change



Source: EUROSTAT and Instituto Nacional de Estadística.

first ten months of the year, and is expected to exceed 4 % of nominal GDP for the year as a whole. Nonetheless, the overall current and capital account balance will continued to run a comfortable surplus, given the favourable behaviour of almost all its remaining components.

From the standpoint of the various productive branches, the key recent economic development has undoubtedly been the marked loss of momentum in industrial activity. Meanwhile, construction has become more buoyant and market services have held on a more stable expanding course. The same pattern is likewise visible in the latest data on employment, the growth rate of which appears to have stabilised at around 3.5 % in the closing months of the year according to the information provided by the Labour Force Survey (EPA). It is among dependent employees and, within this category, temporary employees, where the rate of increase has most slackened.

Turning to wages, most of the available indicators show a gradual slowdown in their rate of increase during 1998, tending to stabilise at around 2.5 %, approximately one percentage point above the increase in the CPI in December. This relative containment of labour costs has not fed through in fall to unit labour costs (ULCs) since the strength of job creation in the Spanish economy has meant a reduction in apparent labour productivity. For this reason, the differential between the increase in Spanish ULCs and the euro area as a whole held stable at about one percentage point during 1998.

The 12-month growth rate of the consumer price index (CPI) at the end of 1998(1.4 %) was comfortably below the target formulated the previous year. This was basically due to the behaviour of food and energy prices. The increase in the component that excludes energy and fresh food (IPSEBENE) was 2.2 %. Its main aggregates, non-energy industrial goods and services, were very stable and closed the year with growth rates of 1.6 % and 3.7 %, respectively, not far off the end-1997 levels.

In December, the increase in the Harmonised Index of Consumer Prices (HICP) was 1.4 %, half a percentage point up on prices across EMU. Analysis of the main components with data to November shows that, although growth rates are identical in the goods aggregate (0.3 %, somewhat higher than that of industrial goods in Spain, which is offset by a lower increase in food prices), under services there is a differential of 1.5 percentage points. This gap has held, with slight fluctuations, throughout the year.

The persistence of relatively high growth rates in services prices is matched in turn by a notable moderation of production cost rises. Accordingly, unit margins are widening substantially, unlike in the industrial sectors. It should be borne in mind that in many services branches there has, in addition to the favourable performance of intermediate costs (of domestic and external origin), been a greater moderation in wage costs, as a result of the use of those forms of contract that have most curbed wage increases.

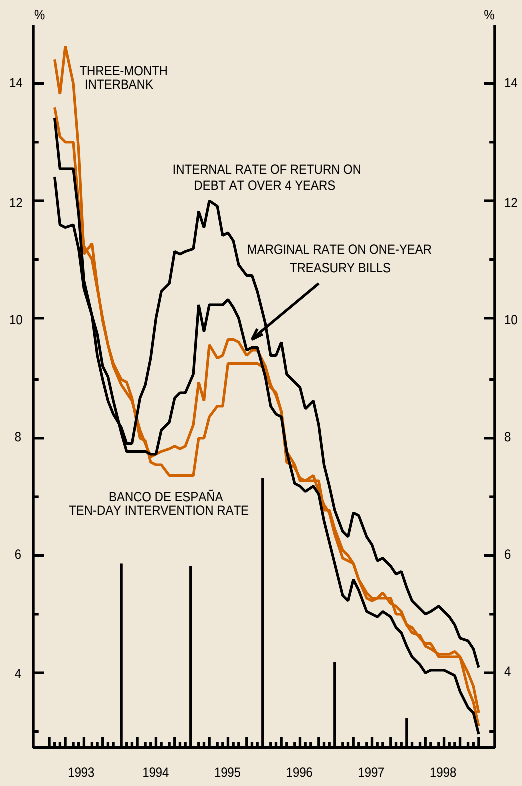
On the data recently released by the Government, the correction in the State cash-basis deficit has substantially exceeded the target forecast, with a reduction in 1998 of 45.6 %. The information available for the closing months of the year shows a sustained growth rate in revenue, while strict control over spending has been maintained. Once the figures for the rest of the general government sector are known, the reduction in the related deficit in National Accounts terms could be greater than forecast.

As mentioned, the ECB set its first main rate for monetary policy operations at 3 %. This decision had been brought forward to the beginning of December, when the central banks that were going to adopt the euro as a single currency lowered their basic interest rates to this level in a co-ordinated move. To some extent, the initial level of interest rates in the Eurosystem was less than the market had discounted; accordingly, there were downward movements in the interbank market yield curve in December. Admittedly, an interest-rate level of 3 % is a historically low one in most European countries. But it is fully compatible with the ECB's goal of maintaining price stability and with the absence of clear inflationary risks in the current economic outlook. In setting this rate, the ECB weighed up the potential recessionary effects that the economic crisis and financial turbulence in other regions could have on the euro area. The markets have reacted to the first decisions of the ECB by maintaining the downward path of long-term interest rates. This could be interpreted as an acknowledgement that these decisions are fully compatible with maintaining price stability and that the framework of macroeconomic stability that the ECB intends to ensure will prove durable.

The ongoing convergence of interest rates has seen the Banco de España cut 1.25 points off its intervention rate in the final quarter of 1998. The effects of this on money and financial markets are equivalent to those recorded in other euro-area countries (see Chart 4). Regarding monetary and credit developments, the pattern in the Spanish economy was also similar to that seen for the euro area as a whole. The broad monetary aggregates ended the year with moderate annual growth rates (6.5 % for ALPF and 1 % for ALP). The narrow aggregates, such as M1 and M2, showed more intense growth rates (around 14-15 %). Financing to households and firms increased at a rate of higher than 16 per cent in 1998, driven by the ongoing process of interest rate cuts, the improved economic outlook and, specifically, favourable employment developments.

CHART 4

Interest rates (a)



Source: Banco de España.
(a) Monthly averages.

Data for November 1998 on the latest monetary and financial developments in the euro area showed that the M3 monetary aggregate, which is the main reference for the ECB, was growing at a 12-month rate of 4.5 %, in step with the quantitative reference set by the ECB for monitoring this aggregate. Meantime, the narrow aggregate M1 posted a growth rate of over 9 % in November. Credit to the private sector also showed a 12-month growth rate of more than 9 % in November.

2. The external environment of the euro area

During the fourth quarter of 1998 the external environment of the euro area was greatly affected by the instability on international financial markets and by the repercussions on global activity of both the crisis in emerging economies and the recession in Japan. As the quarter unfolded, the reduction in interest rates in most industrialised countries and the macroeconomic consolidation plans announced by the authorities of the developing countries most affected by the crisis contributed, along with IMF aid, to a progressive easing of international financial turbulence. Thus, the main global equity markets virtually resumed their pre-August level and there was a certain relaxation of financial conditions in the emerging economies. Nonetheless, in early January, the risk of Brazil not meeting the fiscal adjustment terms required by the IMF to qualify for financial aid coupled with the turbulence of the Brazilian currency on the foreign exchange markets gave rise to a fresh bout of instability on international markets (see Box 1).

Against this background, the behaviour of the real sectors of the main non-euro-area countries varied. Given the generalised reduction in external demand, the Anglo-Saxon economies – the furthest ahead in the cycle – saw their growth rate slow, relatively more markedly so in the United Kingdom than in the United States. Japan remains beleaguered by a strong recession, and it is still not clear when it will resume positive growth rates. In the main south-east Asian economies affected by the crisis some positive signs are beginning to emerge. Should these materialise, they would be auguring a pick-up in productive activity. This does not seem to be the case with the Latin-American economies. There, the persistence of basic imbalances in the large economies (essentially Brazil), along with the tightening of financial conditions brought on by the climate of instability, have prompted a notable reduction in the area's economic growth rate since the second half of 1998.

Turning to prices, the keynote remains the generalised absence of inflationary pressures. Commodity prices on international markets have remained at low levels or have continued falling. Specifically, the oil price was once again at a historical low in December. That said, in the opening weeks of 1999 the oil price has picked up slightly. But there are no signs that, in the short run, commodity prices will rise significantly in such a way as to jeopardise the low inflation rates in the main industrialised countries.

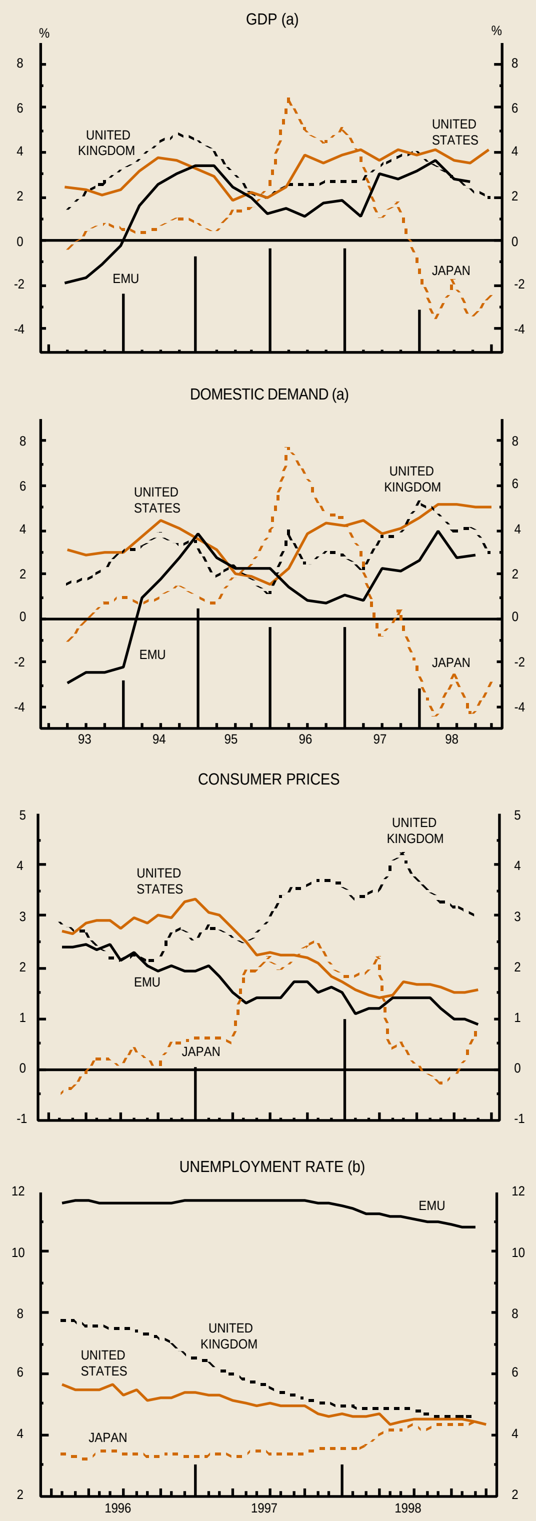
Regarding developments in the US economy in the fourth quarter, the available indicators show very diverse behaviour. Private consumption and investment have continued growing at sustained rates, while industrial production and other supply-side indicators have shown a slowdown in productive activity, in response to the contraction in external demand. On provisional figures, US GDP in the fourth quarter may have grown at a year-on-year rate of 4 %. That would place growth for the year as a whole at 3.9 % (see Chart 5). This result is essentially due to the firmness of private-sector spending, which continues to be underpinned by rises in real disposable income (the result of the increase in employment and in wages) and by the wealth effect generated by the cumulative appreciation of financial assets. Notably, in recent months the US private savings ratio has turned negative. Elsewhere, the reduction in exports has heavily impaired the external balances, whereby both the trade and current-account balances are running growing deficits, which are notably higher than 12 months ago.

In the labour market, net employment creation has placed the unemployment rate at 4.3 % of the labour force in December (4.7 % in December 1997). A further, accompanying development in the same month has been a slight wage slowdown. Consumer prices have continued running at very moderate rates (average year-on-year growth of 1.5 % in the fourth quarter). Despite the depreciation in the dollar since August, import prices have continued to run at negative growth rates.

In Japan, despite the expansionary fiscal and monetary measures and the official plan to shore up the banking system, unequivocal signs of the end of the recession have not been seen. Following the strong contraction in GDP in the third quarter (–3.5 % in year-on-year terms), there would not seem to have been any improvement in the economic situation in the fourth quarter. The recessionary climate and pessimistic expectations are continuing to prompt a strong contraction in private-sector spending. Confidence indicators are thus still portraying a highly unfavourable picture. Industrial production has fallen further and the unemployment rate increased in November to 4.4 % of the labour force. Moreover, the external sector is not contributing to galvanising productive activity in the economy. In recent months, the appreciation of the yen has compounded the slackness of the demand for exports (despite the growth of the US trade deficit), whereby the improvement perceptible in the trade balance is essentially the result of the decline in imports. Consumer prices have, in recent months, once more begun to post positive year-on-year growth rates; however, if fresh food is excluded from the general index, this rate is negative.

CHART 5

Main macroeconomic indicators
Percentage change on previous year

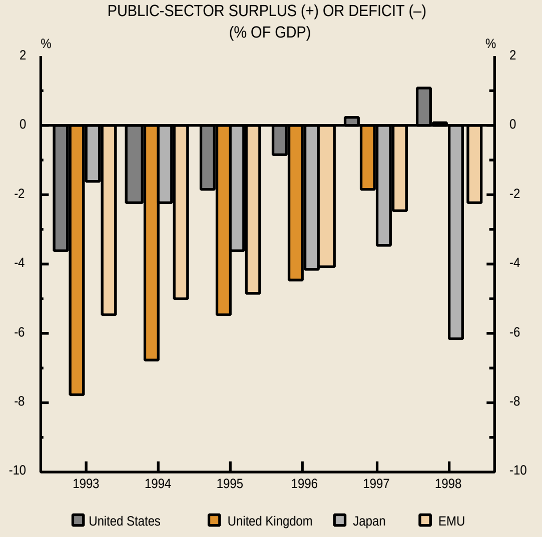


Sources: Banco de España, national statistics and EUROSTAT.

(a) The figure for the last quarter is a forecast.
(b) As a percentage of the labour force.

CHART 6

Public finances in the main economies (a)



Sources: IMF and European Commission.
(a) The 1998 figure is an estimate.

With regard to the European Union countries not belonging to the euro area, there has been a notable slowdown in activity in the United Kingdom. As 1998 advanced, the sluggishness of domestic demand and, in particular, of private investment added to the scant buoyancy of exports, although consumption has been more sustained. Despite the lower growth rates of output, the unemployment rate has held stable at 4.6 % of the labour force since mid-1998. Wage growth has tended to moderate following the heavy increases in the first half of the year. Combined with lower demand pressures, this has provided for a reduction in inflation: consumer prices (excluding mortgage interest payments) grew at a 12-month rate of 2.5 % in the fourth quarter compared with 3 % in the second quarter.

Turning to the economic policies pursued by the main developed countries outside the euro area, the essential change in relation to previous months has been the more expansionary monetary policy adopted in the face of the risk that the recent financial instability might intensify the expected slowdown in output. And this against a background marked by the virtually generalised absence of inflationary pressures. Fiscal policy conduct, for its part, has not varied, and forecasts point to practically across-the-board compliance with the fiscal targets envisaged in 1998 budgets.

In the United States, the budgetary consolidation drive and the favourable contribution of this economy's cyclical conditions mean that fiscal year 1998 has ended with a surplus of $70 billion, a result not achieved for 30 years. The budget outturn has exceeded all forecasts which, during the year, had been formulated in this connection. As regards the outturn of the current budget, the cumulative deficit in the first two months of fiscal 1999 (which began in October) has risen to $49.6 billion, 6.9 % down on the same period a year earlier. In the light of these initial data, and given the favourable course of the US economy, the administration has raised its budget surplus forecast for 1999 from $54 billion to $76 billion.

In Japan, the government announced a new package of fiscal kick-start measures in mid-November. These mainly included tax cuts and new spending on infrastructure for 1999. On the latest forecasts, the budget deficit might exceed 6 % of GDP in 1998, with debt rising to close to 100 % of GDP.

Lastly, in the United Kingdom, it is highly likely that the sound performance of tax revenue, along with the tight control of public spending, in line with the budget for the current fiscal year, will result in the general government balance in 1998 running a slight surplus (see Chart 6).

With respect to monetary policies, the US Federal Reserve has cut its federal funds rate by 75 basis points since the end of September, placing it at 4.75 % in mid-November. Some of the main factors behind the reduction in US interest rates were as follows: the foreseeable economic slowdown; the absence of inflationary pressures; the heavy financial turbulence in early autumn; and the tightening of domestic financial conditions. The Japanese central bank has continued supplying liquidity at very low prices, although to date there has been no perceptible positive response in terms of bank lending activity. Lastly, in the United Kingdom, the Bank of England has cut its base rate by 1.5 percentage points between October and the first half of January, placing it at 6 % as of 7th January. The backdrop to this was the clear slowdown in economic activity and a moderating inflation rate.

On the money markets, short-term interest rates have continued on a downward course, especially so in the United Kingdom (see Chart 7). Long-term rates on debt markets, though also on a declining trend, have been more volatile, particularly in the United States. Japan is an exception in this respect; since November its 10-year yields have increased. The causes for this upward movement are still uncertain, though the strong deterioration in public finances, the announcement by the government of the extraordinary volume of debt issues in 1999 and certain changes in debt mar-

BOX 1

The exchange rate crisis in Brazil

Since 1995, the Brazilian authorities have announced at the beginning of each year the exchange rate policy they would pursue. Its definition would involve setting a broad band fixing the maximum fluctuation limits of the Brazilian real against the dollar and which would seek to include the forecast depreciation over the course of the year. A narrow or mini-band would then be set within this band and used as the shortest-dated reference, and this could be changed within the limits of the broad band. In fact, in recent months this mini-band has been altered on several occasions.

On 13th January this year, the Brazilian central bank announced a new band, with limits of 1.20 and 1.32 reales per dollar, to replace that in force during 1998 (1.12-1.22). This change meant an increase in the width of the band, from the range of 8.9 % in force in 1998 to 10 % in 1999, and a devaluation of the order of 8.3 %. Undoubtedly, however, the most important feature of the exchange rate policy plans for 1999 was the elimination of the narrow band which, since last December, had had a width of 3 %. The immediate consequence of the easing of the exchange rate commitment was that the exchange rate of the real began to trade at levels very close to the maximum limit permitted. That obliged the Brazilian authorities to suspend the announced broad band as well. On Friday 15th January the Brazilian currency had depreciated by 17.4 % in relation to the level prevailing prior to the announcement of the suspension of the exchange rate policy pursued since 1995. Between 14th and 15th January, the loss of reserves amounted to $2,114 billion. It was confirmed on Monday 18th January that the real would continue to float against the dollar, and that the Brazilian central bank would intervene only when volatility was deemed excessive. Between the 12th and 21st January, the cumulative depreciation of the real totalled 29 % against the dollar and capital outflows continued.

During 1998 the Brazilian economy showed signs that the adjustment plan applied since 1994 had run its course. For one thing, this plan had permitted the drastic and rapid reduction of the hyperinflation that had beset Brazil since the end of the eighties. And, for another, it had won the confidence of international investors to the point of making Brazil the biggest Latin-American recipient of capital in recent years.

During the adjustment period, the budget deficit was lowered from 44 % of GDP in 1994 to 6.1 % of GDP in 1997. However, the stagnation of the process of structural reforms, the difficulties in furthering privatisation plans and budgetary confrontations between the central government and the federal states all led to an increase in the budget deficit in 1998 to around 7.5 % of GDP, shaping a bleak outlook for future years.

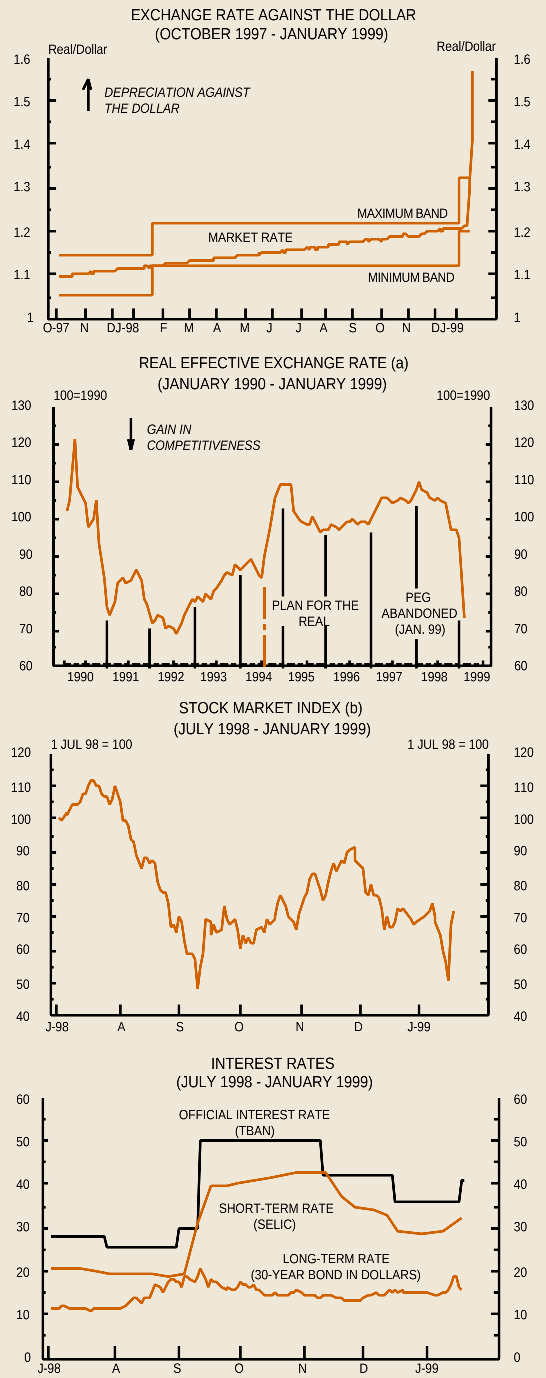
The annual depreciation by the real against the dollar in nominal terms did not suffice to offset the unfavourable price differential for Brazil prevailing in the period from 1994 to 1997, despite the efforts made in this area. As a consequence, the inflation-adjusted exchange rate index of the Brazilian currency, measured by consumer prices, appreciated by around 30 % during this period. The external deficit rose from 0.1 % of GDP in 1994 to 4.1 % of GDP in 1997. The gain in competitiveness achieved in 1998, as a result of price moderation in Brazil and the nominal depreciation, was insufficient to bring about a reduction in the external deficit, which rose to close to 4.2 % of GDP in 1998.

Against this background, selling pressure on the real heightened as from August 1998. These pressures obliged the Brazilian authorities to intervene continuously and substantially on the foreign exchange markets, depleting foreign reserves to levels that scarcely covered one month's imports and prompting a rise in short-term interest rates to 42 % in mid-November.

The economic weight of Brazil and confidence that its authorities could pursue and reinforce the restructuring of the economy led the International Monetary Fund to provide conditional aid estimated at about $41 billion. This aid was conditional upon the reduction of the budget deficit, in which connection a primary surplus target of 2.6 % of GDP was set.

However, as from the end of last year a series of developments ensued which undermined confidence in the agreed aid plan being met and heightened selling pressure on the real. Economic growth estimates for 1999 were thus pared back; rumours emerged that the government wished to amend the agreement with the IMF; and, above all, news was released of the intention of the state of Minas Gerais, the richest in Brazil, to set a moratorium on its debt with the central government. Thereafter, the stock market fell across the board, there were heavy capital outflows and, finally, the exchange rate policy pursued since 1995 was discontinued.

Brazil: main financial indicators

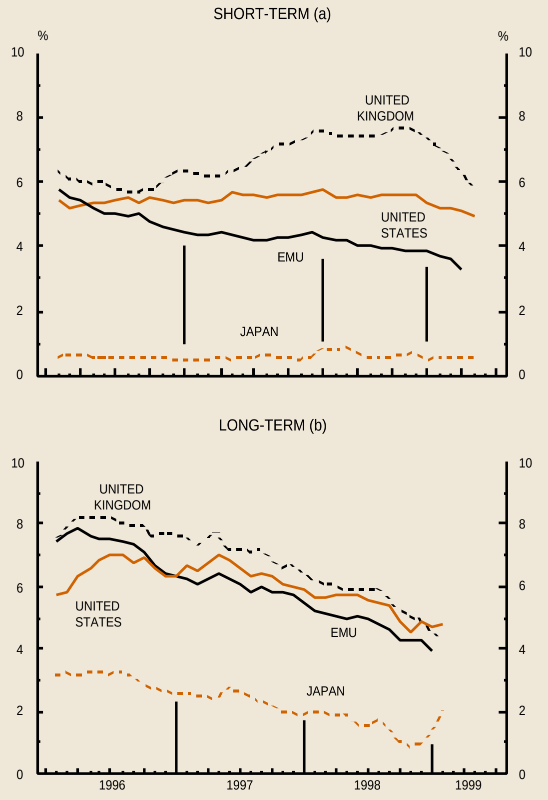


Sources: JP Morgan, Reuters and in-house compilation

(a) The real has been the Brazilian currency since July 1994. January 1999: estimated on the basis of the nominal depreciation of the real.
(b) Sao Paulo Stock Exchange index (BOVESPA).

CHART 7

Interest rates



Source: Banco de España.

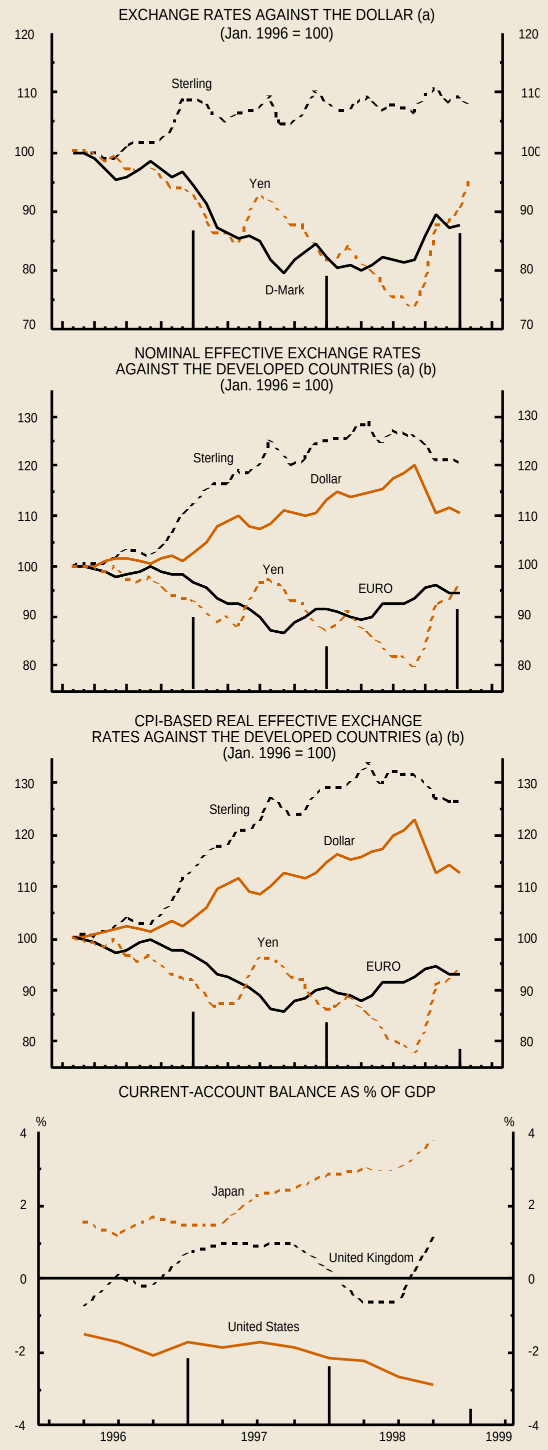
(a) Three-month interbank market interest rates. January 1999: average data to the 15th.
(b) Ten-year government bond yields. January 1999: average data to the 15th.

ket operational procedures are some of the reasons offered by the markets to explain this rise.

The keynote on the foreign exchange markets in recent months has been the depreciation of the dollar and the appreciation of the yen against the main currencies (see Chart 8). Between August and December, the dollar depreciated almost 20 % against the yen, 7 % against the D-Mark and 8 % against the basket of developed countries. In the first half of January 1999, the dollar's loss of value against the yen and the euro has held unchanged. However, in recent days the interventions by the Bank of Japan to curtail the strength of its currency and the foreign exchange turbulence stemming from Brazil appear to have checked the fall of the dollar somewhat. Likewise, the strength of the yen has translated into a significant loss of competitiveness: in nominal and real effective terms, the Japanese currency has appreciated by 20 % and 22 %, respectively, against the basket of developed countries.

CHART 8

Exchange rates and current-account balances



Sources: Banco de España, BIS and national statistics.

(a) A fall in the index denotes a depreciation of the currency against the dollar or the rest of the currencies making up the grouping, and vice-versa.
(b) The "EURO" line is the representation, to 1999, of an approximate indicator devised by the BIS on the basis of the effective exchange rates of the euro-area countries.

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

3.1. Economic conditions in the euro area

In the second half of 1998, and in particular in the fourth quarter, there was something of a slowdown in the rate of economic activity in the euro area (see Chart 5). This was the result of the lesser momentum of both the external sector and, to a lesser extent, of certain investment components. Private consumption has continued to grow at a sustained rate. In any event, growth in the area in 1998 as a whole is estimated to have been higher than that of the seven previous years.

On provisional EUROSTAT estimates, EMU GDP would have grown by 2.7 % year-on-year in the third quarter of 1998 (3.6 % in the first quarter and 2.8 % in the second). These data appear to point to a slowdown in activity as from the second quarter. Nonetheless, if an adjustment were made for the calendar effect arising from the Easter holidays, the distribution of GDP growth between the first two quarters of the year would have been more similar. The economic slowdown may thus be deduced to have come about as from the third quarter.

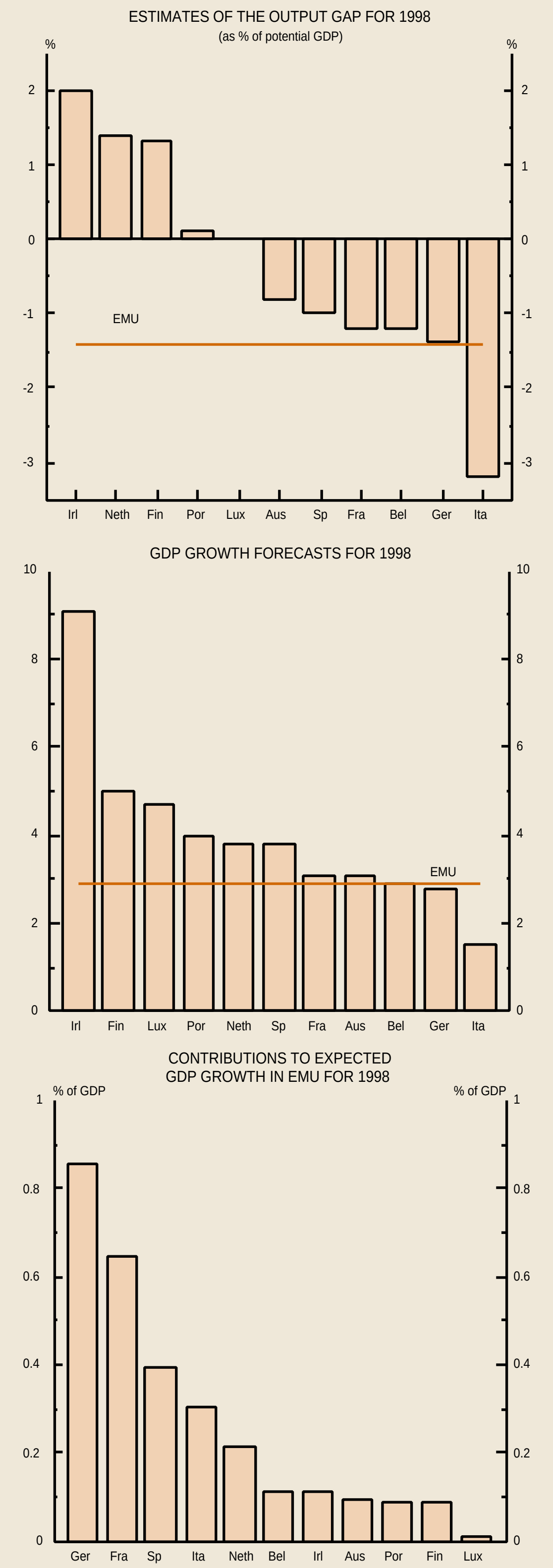
In the first half of 1998, domestic demand was unusually strong. Of particular note was the buoyancy of investment, underpinned by the area's financial stability and low interest rates (see Chart 7). From the third quarter, the negative contribution of the external sector has been accompanied by a reduction in investment in stocks. The international financial crisis and the prospect of a slowdown in the main developed economies may thus have begun to impact economic activity within the euro area.

Nonetheless, some factors have helped lessen the adverse effect of the international crisis on the euro area. Thus, the substantial correction of the macroeconomic imbalances traditionally besetting several of the countries making up the area (notably budget deficits and inflation) and the consolidation of EMU-wide macroeconomic stability have contributed favourably to activity in the area (see Charts 5 and 6).

The latest output indicators and confidence surveys corroborate the impressions arising from analysis of the area's macroeconomic data. According to EUROSTAT, industrial production, after growth of 6.3 % in year-on-year terms in the first quarter, has progressively slowed in the second and third quarters (4.4 % and 4 % year-on-year, respectively). The business confidence indicator, prepared as part of the European Commission's surveys, reflects a gradual deterioration since the summer months. As a result, it is very close to its average over the last 10 years. By contrast, the consumer

CHART 9

Output gaps and GDP in EMU



Source: OECD (December 1998)

confidence indicator has shown sustained improvements since mid-1996, and is close to its peak levels over the last 14 years.

As regards the degree of cyclical synchrony among the euro-area countries, it is expected on the basis of OECD forecasts for 1998 that EMU members (with the exception of Ireland) will have grown at rates in a range from 1.5 % to 5 % (see Chart 9). According to OECD output gap (1) estimates for 1998 as a whole, most countries in the area would have grown below their potential GDP in 1998. Conversely, certain countries (which have been growing above the area average for several years) might have reached a position in 1998 where actual output was above potential.

With regard to the area's competitiveness vis-à-vis its main trading partners, the nominal and real effective appreciation in 1998 of the EMU members' currencies has brought about a partial correction of the depreciation against sterling and the US dollar in 1997(see Chart 8). The effective exchange rate of the euro is thus trending at present towards the average of recent years. According to foreign trade data, the trade surplus declined in September 1998 by e1,600 million (23 %) compared with the same month a year earlier. In the third quarter, the trade deficit fell by 4.6 % in year-on-year terms, reflecting a modest increase in the value of exports (0.9 %) and somewhat higher growth in imports (1.8 %). The cumulative trade surplus in the first three quarters of 1998 was up 0.3 % on the same period in 1997.

Average inflation in the euro area (measured in terms of the Harmonised Index of Consumer Prices [HICP]) remained relatively stable throughout 1998. The temporary rise in the first half of the year raised the inflation rate from 1.1 % in January to 1.4 % in July. Thereafter, inflation fell to 0.9 % in November (see Chart 10).

The slowdown in inflation since the summer has benefited from the favourable performance of goods prices and, in particular, energy prices. Services inflation, however, has shown more downward stickiness. Indeed, goods inflation, which reached 1.1 % in June, fell to 0.3 % in November, while that of services remained flat at around 2 % throughout the year (see Chart 10). Producer prices have been slowing over recent months; from a peak of 1.7 % year-on-year in August 1997 they fell to –1.9 % in October, the sixth consecutive month a negative rate was posted.

(1) Difference between actual and potential output, expressed as a percentage of the latter.

The favourable inflation performance has also benefited from the moderation of unit labour costs. Since the mid-nineties, the growth rate of this variable in the euro area has been falling year after year, from 1.8 % in 1996 to –0.5 % in the second quarter of 1998. The lesser pressure of labour costs on prices has come about mainly from the containment of compensation per employee, the growth of which has moderated steadily from 3.5 % in 1995 to 1.2 % in the second quarter of 1998. Apparent productivity, though it has behaved somewhat more erratically, has also contributed favourably to the decline in unit labour costs, particularly in the first quarter of 1998.

Wage restraint and the effects of the reforms undertaken in national labour markets over recent years have been conducive to net employment creation, though this has been but modest. Despite the recent slowdown in activity, employment has expanded at growing year-on-year rates since the second quarter of 1997, rising to 1.4 % in the third quarter of 1998. The unemployment rate, for its part, has been declining very gradually. Having peaked in early 1997, it fell to 11.5 % in December that same year and stood at 10.8 % in November 1998 (see Chart 5).

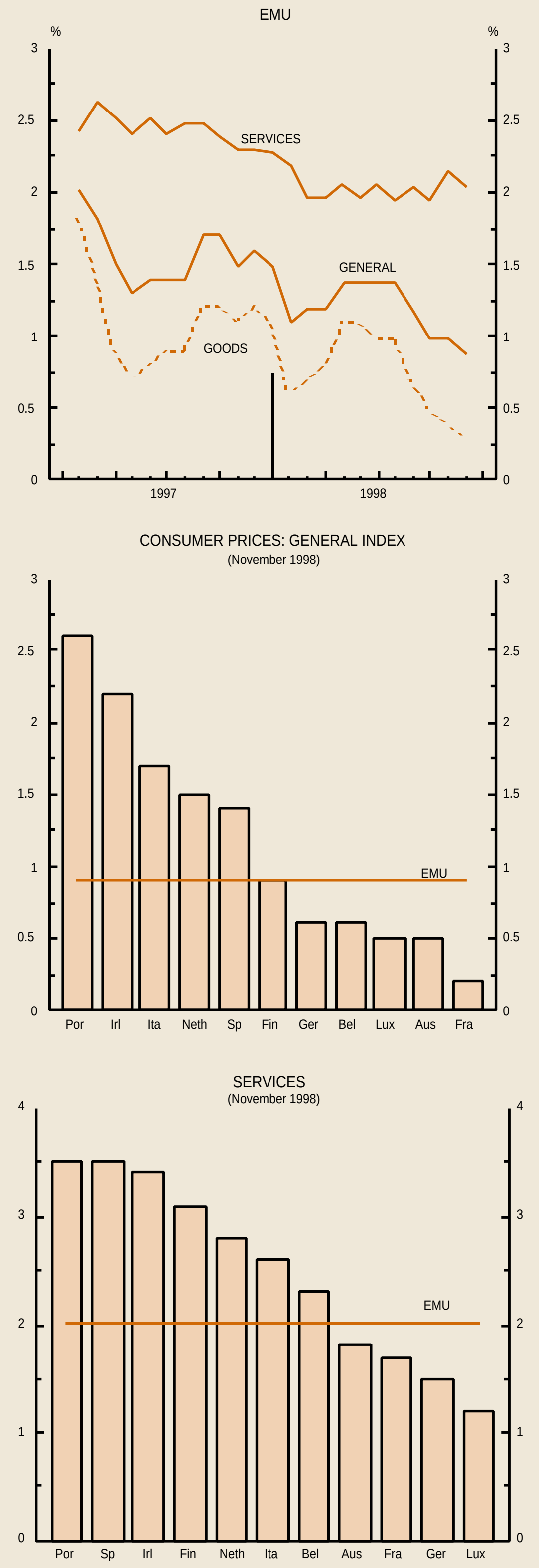
With regard to fiscal policy implementation, and on the provisional information available, the budgetary consolidation drive begun in 1994 in the euro area appears to have flagged somewhat in 1998. Granted, the overall general government deficit for EMU as a whole declined slightly in 1998 to 2.3 % of GDP (compared to 2.5 % in 1997). But the primary surplus worsened for the first time since 1994, falling from 2.6 % to 2.4 % of GDP (see Table 2). The debt-to-GDP ratio declined slightly to around 74 %, essentially as a result of the lesser interest burden.

Set against the targets formulated at the time the budget was prepared, the results obtained in terms of the actual total deficit have, on available estimates, been more favourable in virtually all EMU members. A contributing factor here was the cyclical context, which was moderately more favourable in most countries in the area compared with the macroeconomic forecasts accompanying the presentation of their respective budgets. Likewise, the declining trend of interest rates (which has proven more intense than initially envisaged in budgetary plans) has been conducive to lowering the cost of debt servicing and has therefore contributed to reducing the deficits, particularly in the most indebted countries (see Table 3).

However, the greater scope provided by the trend of the business cycle and of interest rates

CHART 10

Harmonised Indices of Consumer Prices
12-month percentage change



Source: EUROSTAT.

TABLE 2

Fiscal policy in the euro area
(as % of GDP)

	1993	1994	1995	1996	1997	1998 (a)
Primary balance (b)	0.2	0.4	0.8	1.4	2.6	2.4
Total balance (b)	–5.6	–5.1	–5.0	–4.2	–2.5	–2.3
Public debt	68.3	70.7	74.6	76.0	75.3	74.0

Sources: European Commission and ECB.
(a) Estimate.
(b) Deficit (–) / surplus (+).

was partly absorbed, in several cases, by an easing of the fiscal policy stance. Thus, according to European Commission estimates, the cyclically adjusted deficit will have increased slightly in 1998 and worsened in over half the countries of the area.

This situation underscores the unavoidable need for resolute progress in the consolidation of public finances. Broadly, budgetary guidelines for 1999 and the stability programmes drawn up by each country are consistent with this objective. Nonetheless, the degree of ambition regarding attainment of this objective and the margin for manoeuvre with which it is intended to endow fiscal policy in the medium term diverge from country to country. Moreover, the improvement expected for 1999 will continue partly to draw on the favourable effects of the low level of interest rates and the inertia of the business cycle. Along with the improvement in overall balances, budgetary plans in the short and medium term are generally pursuing a reduction in the share of revenue and expenditure in GDP and, in particular, the restructuring of these two categories. A common feature on the revenue side is the proposed tax reforms. These are generally aimed at easing the direct tax burden on companies and households (in particular the lower-income brackets) in order to enhance the efficiency of the labour market. The resulting forgone revenue would be partly offset, in some cases, by higher indirect taxes. On the expenditure side, greater priority is to be given to public investment and to active labour market policies.

3.2. Monetary and financial conditions in the euro area and the monetary policy of the European Central Bank

The monetary and financial conditions prevailing in the euro area at the beginning of 1999

TABLE 3

General government balance of the euro-area countries
(as % of GDP)

	1993	1994	1995	1996	1997	1998 (a)
Belgium	–7.1	–4.9	–3.9	–3.2	–2.0	–1.3
Germany	–3.2	–2.4	–3.3	–3.4	–2.7	–2.6
Spain	–7.0	–6.3	–7.3	–4.7	–2.6	–2.1
France	–5.8	–5.8	–4.9	–4.1	–3.0	–2.9
Ireland	–2.4	–1.7	–2.2	–0.4	0.9	2.1
Italy	–9.5	–9.2	–7.7	–6.7	–2.7	–2.6
Luxembourg	1.7	2.8	1.9	2.9	3.0	2.2
Netherlands	–3.2	–3.8	–4.0	–2.2	–0.9	–1.4
Austria	–4.2	–5.0	–5.1	–3.7	–1.9	–2.2
Portugal	–6.1	–6.0	–5.7	–3.3	–2.5	–2.3
Finland	–8.0	–6.4	–4.7	–3.5	–1.1	0.7

Source: European Commission.
(a) Estimate.

have been determined by the prior convergence of numerous European countries' interest rates towards the levels of the core countries with lower rates. At the end of 1998, the intervention rates of the countries that were to initiate the Third Stage of Economic and Monetary Union (EMU) stood at 3 %, which is the level at which the European Central Bank has begun to conduct its main refinancing operations. These monetary conditions are consistent with the favourable course at present of prices and with the signals from a broad set of inflation leading indicators, which exhibit no risks of inflationary pressures.

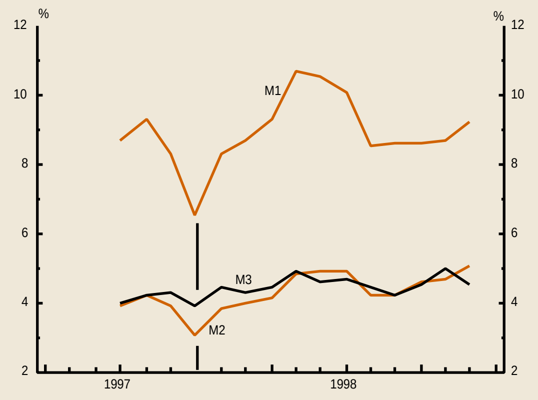
Real interest rates in the euro area are, on available estimates, at a historically low level of around 2.5 %-3 %. The stability of nominal exchange rates and the closeness of national inflation rates mean that, as discussed in section 3.1 of this report, competitiveness has held at the average levels prevailing in recent years. The start of the Third Stage of EMU has not appreciably changed this situation. Following initial fluctuations, the euro is holding relatively stable against the dollar on international foreign exchange markets.

The course of the monetary aggregates is the main indicator that the ECB will analyse when taking monetary policy decisions. It will, however, analyse the information it derives from these aggregates alongside a broad set of monetary and financial indicators, with a view to assessing the price outlook for the area as a whole. The fundamental monetary aggregate the ECB is to evaluate is M3. The ECB has set a quantitative reference of 4.5 % for the annual growth of this broad aggregate. It considers this value compatible with the attainment of price stability in the area as a whole and with its estimates for the area's potential GDP growth and for the trend of the velocity of circulation of money. To obtain a more stable signal of monetary developments, it was established that the growth rate to which most attention would be given would be that of the three-month moving average of the actual year-on-year growth of M3.

On the information available, the recent growth of M3 is compatible with the reference value established. With data to November, the centred three-month moving average of its year-on-year growth stood at a rate of 4.6 % in September and of 4.7 % in October. The growth of the monetary aggregates in the euro area has been essentially driven by the rate of economic expansion and by the opportunity costs of holding assets considered liquid as opposed to other alternative assets. In the area as a whole, the broad monetary aggregates ran, according to the information available to November 1998, at a lower rate of expansion than the narrow aggregates (2). As Chart 11 shows, the year-on-you growth of M1, which includes only cash and overnight deposits, held at levels close to 9 %. M2, which further includes time deposits up to two years and deposits redeemable at notice up to three months, trended more modestly in a very similar fashion to M3.

CHART 11

Monetary aggregates in the euro area (a)



Source: ECB.

(a) 12-month percentage change based on original series.

The higher growth rate of the narrow aggregates compared with the broader ones was due to agents' greater preference for more liquid assets (essentially overnight deposits), since cash held by the public is virtually flat. Such preference is not attributable solely to the heavy reduction in the opportunity costs of holding liquid assets (caused by the fall in interest rates that has taken place at all maturities). It is also due to the high volatility on financial markets as a result of developments in recent months in emerging economies. Since this latter factor has caused portfolio shifts towards assets less exposed to risk, the most liquid instruments have temporarily been able to capture a portion of these financial flows.

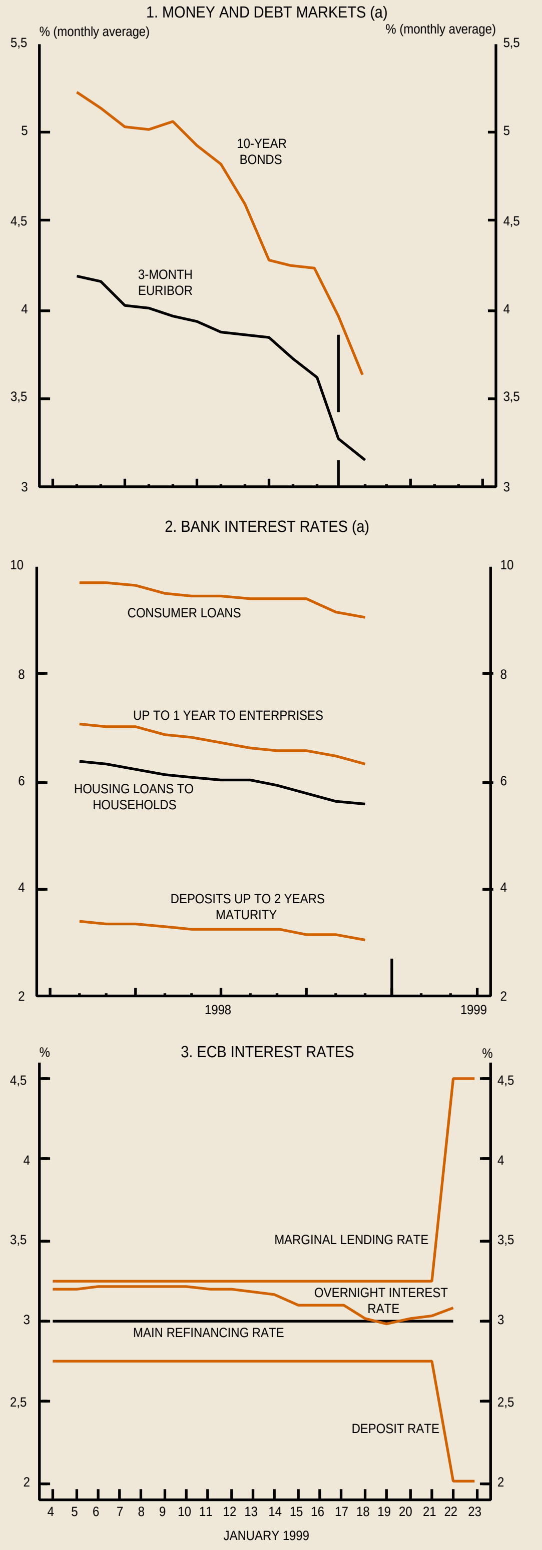
The remaining non-monetary liabilities of monetary financial institutions (MFIs) (3), such as deposits and securities at over two years

(2) For the definition of the monetary aggregates in the euro area, see Box 2 in the ECB January 1999 Monthly Bulletin.

(3) This grouping, which essentially includes credit institutions and money market funds, is the issuing sector of instruments included in the euro-area monetary aggregates.

CHART 12

Interest rates in the euro area



Sources: Banco de España and ECB.

(a) Up to December 1998, average of the euro-area countries' interbank interest rates.

and capital, expanded moderately with year-on-year growth of 3 % in November 1998. These liabilities account for about 30 % of the total liabilities of MFIs, as opposed to 41 % accounted for by the liabilities included in the M3 aggregate.

Turning to the counterparts, financing by MFIs to the private sector has been accelerating during 1998, attaining year-on-year growth of 9.2 % in November. The pace of this financing to households and non-financial firms is partly due to the significant reduction in financing costs (see Chart 12). Furthermore, although there are doubts about the strength of the growth rate of economic activity, consumer confidence is perceptibly high and the rate of job creation has improved, which has also contributed to boosting credit expansion. In any event, credit growth above the increase in nominal GDP is to some extent normal in economic upswings.

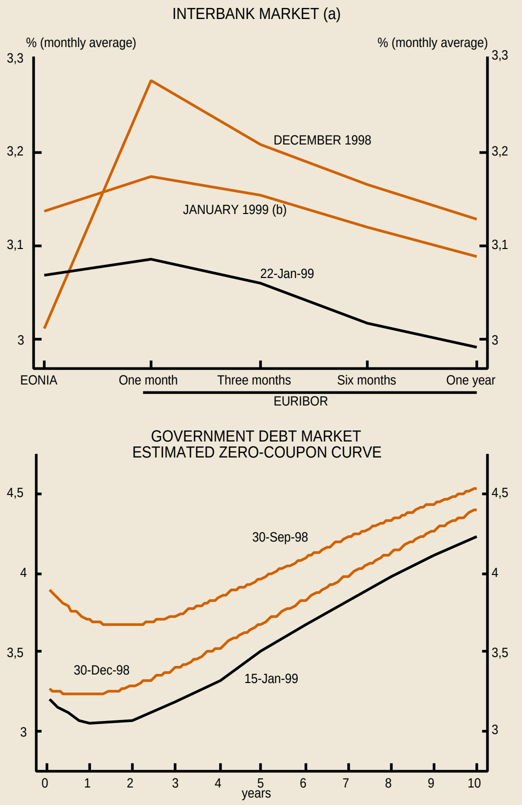
The growth rate of the financing extended by MFIs in the euro area to residents is in contrast to the continuing slowdown in lending by these institutions to general government. In November, loans to general government fell by 1.5 % year-on-year and the outstanding balance of debt issued by the sector and held by MFIs grew by 3.8 %, in a setting of declining budget deficits.

As a result of the forceful pace of financing extended by MFIs in the euro area to the private sector and of the moderate growth of monetary and non-monetary liabilities, the net position of these institutions vis-à-vis the external sector became less of a creditor one in the closing months of 1998. Thus, the year-on-year growth of the liabilities of these institutions vis-à-vis the external sector was 14.9 % in November 1998 compared with growth of 4.6 % for the related assets.

Interest rates on money and financial markets in the area have, as of end-1998 and in 1999 to date, continued on the downward trend begun in 1995. At the time of this report going to press, the average three-month interbank rate in the euro area stood at 3.05 %, 68 basis points below the average level recorded in September 1998 across EMU. The interest rate on 10-year bonds in the euro area, calculated as a weighted average of each country's data, declined by 64 basis points in the same period to 3.65 % (see Chart 12) according to the latest information available. That entails a reduction of 27 basis points compared with the level as of the end of December 1998. However, it should be noted that these rates were subject to temporary bouts of upward movements in January,

CHART 13

Euro-area yield curves



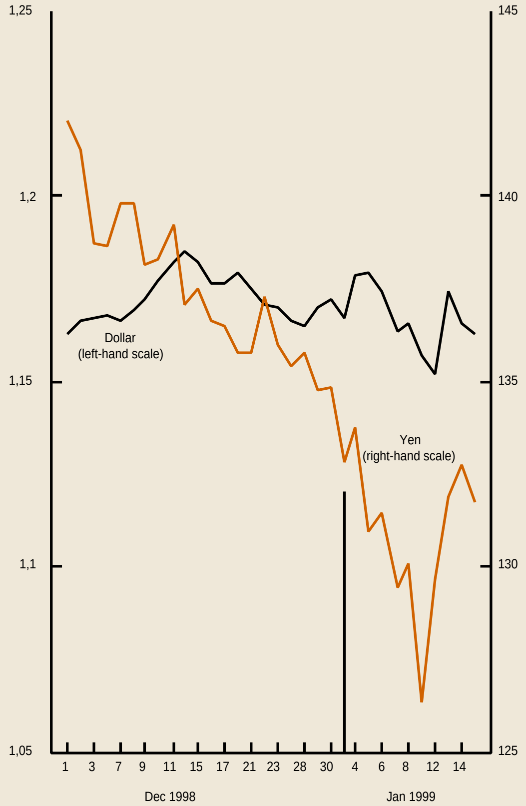
Sources: Banco de España and ECB.

(a) In December 1998, average of the euro-area countries' interbank interest rates.

(b) Average of the month up to latest available information.

CHART 14

Nominal exchange rate of the euro against the dollar and the yen (a)



Source: Banco de España.

(a) National units per ECU (Dec 98) and EURO (Jan 99).

associated with the greater volatility generated by the recent turbulence on international financial markets. In any event, these movements translated into downward shifts of the yield curve in the euro area in January, highlighting the credibility enjoyed by the initial monetary policy measures implemented by the Eurosystem (see Chart 13).

As regards foreign exchange developments, the euro has begun operating on the currency markets without following a clear trend against the dollar. It has moved in different directions, as Chart 14 shows. Up to the close of this Bulletin, the euro had depreciated by scarcely 1 % against the dollar. Against the yen, much sharper fluctuations have been seen in January, although the latest available figure points to a certain depreciation by the euro. To some extent, these foreign exchange movements may have been due to changes in the euro area's interest rate spreads vis-à-vis the United States and Japan, since in recent months short-term interest rates in Europe have fallen more than in these two countries.

Equity markets in the euro area have been influenced by developments on other international markets, although the start of Monetary Union appears to have been favourably welcomed. At the end of December, the Dow Jones Euro Stoxx index stood at about 11 % below the peak reached on 20th July 1998, although this was still 30 % higher than a year earlier. In any event, price developments across sectors differ greatly; those more closely connected to domestic conditions in the euro-area economies are performing much more satisfactorily than those related to foreign activity. To date in January, the Dow Jones Euro Stoxx index has increased slightly.

Monetary and financial conditions at the start of the Third Stage have been largely influenced by the decision adopted on 3rd December by the National Central Banks (NCBs) of the euro area to co-ordinate a reduction in their official intervention rates to 3 %. This contributed to dispelling uncertainty about the intervention rate the ECB would set at the outset of Monetary Union. Along with this decision, the interest rates for the marginal credit and deposit standing facilities were set at 4.5 % and 2 %, respectively, for the start of the Third Stage. That said, given the complexity of the structural change involved, the levels of these rates were temporarily set at 3.25 % and 2.75 % during the transitory period which concluded on 21st January, 1999. In addition, various operational decisions have been adopted regarding the arrangements for the initial main refinancing operations to be executed through tenders. Specifically, it was decided that the initial main refinancing operations (the rates on which are the most important signal of the monetary policy stance) should be executed via fixed-rate tenders. Finally, the Eurosystem's first longer-term refinancing operations were announced, to be conducted via variable-rate tenders, although all bids accepted would be allotted at the marginal rate. The Eurosystem does not seek to emit any monetary policy signal in these operations and acts as a price-taker.

The first four tenders for the main refinancing operations were allotted on 7th, 13th, 20th and 27th January. These tenders were executed at a fixed rate of 3 % and were settled with high rationing levels (16 %, 8.5 %, 10 % and 10 %, respectively). Given that the type of tender and adjudication procedure used (fixed-rate and high rationing) involved a change from previous national practices for the credit institutions of certain countries (Spain among them), there was significant use of both the marginal credit and deposit facilities. This situation has subsequently been corrected, and resort to the standing facilities is proving exceptional.

These liquidity injection operations, along with certain frictions (now overcome) in the workings of payment systems and the logical learning process involved for banks in the new euro money market, led to the emergence of pressures on the shortest-dated interbank rates in the opening days of January. As a result, the overnight interbank rate (EONIA) stood, until mid-January, at between 15 and 20 basis points above the ECB intervention rate (see Chart 12). Subsequently, the adaptation by financial institutions to the new setting and the injection of liquidity further to the long-term refinancing operation on January 14th (4) (resulting in interest rates of around 3.1 %) eased pressure on the shortest-dated interbank rates and resort to the standing facilities tended to diminish. Thus, as can be seen in Chart 13, the interbank rates at the various maturities underwent significant reductions and moved closer to the rate on the main operations (3 %). In sum, the course of euro-area money-market interest rates was dominated in the opening days of 1999 by movements relating essentially to technical aspects connected with monetary policy implementation and with banks' learning process for the new euro money market. Nonetheless, financial conditions in this market have gradually tended to normalise.

(4) This operation involved three simultaneous variable-rate tenders with a Dutch auction-type allotment running until February 25th, March 25th and April 29th. The respective allotment rates were 3.13 %, 3.1 % and 3.08 %.

4. The Spanish economy

4.1. Demand

On provisional QNA figures, national demand held at a high growth rate of 4.3 % during the third quarter of 1998, although this was slightly lower than in the first half of the year. All the national demand components slowed mildly, with the exception of construction spending, which remains on a path of firm recovery. The contribution of external demand to GDP growth was negative of the order of –0.6 percentage points, similar to the first half of year, since the loss of momentum of exports was offset by the moderation of imports.

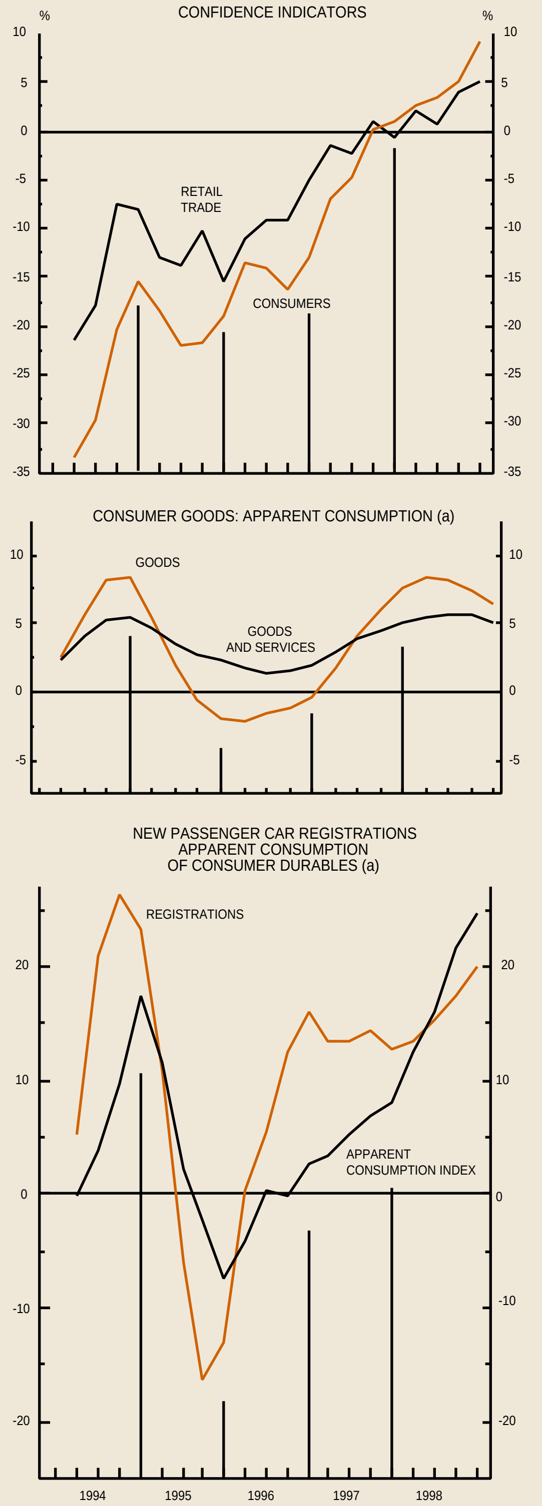
On the economic data available at present, it is estimated that national demand resumed a high real growth rate in the fourth quarter, higher indeed than that of the previous quarter, with growth for the year on average standing at 4.4 %. This performance in the closing months of 1998 is a result of a strengthening of private consumption, which ceased to decelerate as it had to the previous quarter, and of a fresh intensification of construction spending. In parallel, capital investment continued to slow, though maintaining high growth rates. The contractionary nature of the contribution of external demand tended to heighten as a result of the slowdown in exports, which have been marked by the deterioration in the international environment.

Private consumption slowed marginally during the first three quarters of 1998. On the indicators currently available, this does not appear to have continued in the fourth quarter, the year-on-year growth rate being estimated to have stabilised at around 3.5 %. The index of apparent consumption of goods and services, on information to October, has held at growth rates similar to those of the second and third quarters of the year (see Chart 15). At a disaggregated level, the services component (approximated by the course of employment) has moderated slightly, while the consumption of non-food goods has remained very buoyant, particularly in the case of consumer durables. The greater strength of consumer durables is also perceptible in new car registrations, which sustained a strong growth rate in the final quarter of 1998, ending the year with average growth of 17.1 %, far higher than in 1997. Likewise, the general retail trade index, which tended to stabilise in the second and third quarters, regained momentum in October and November. Household equipment sales expanded vigorously, in step with the strength of housing demand.

Various factors help account for the buoyancy of private consumption both in the final quar-

CHART 15

Private consumption indicators



Sources: Instituto Nacional de Estadística, European Commission, Dirección General de Tráfico and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

ter of 1998 and in the year as a whole, for which an average increase of 3.6 % is estimated. Household disposable income in real terms has grown at higher rates than in 1997, assisted by the sustained increase in wage income and by the recovery in non-wage income in comparison with the previous year. In addition, household financial wealth increased during the year, as stock exchange prices moved on to a path of recovery in late autumn, reaching levels by the end of the year close to those seen before the stock market slump during the summer months. Such movements help explain the firmer basis of consumption in recent months. Likewise, the successive cuts in real interest rates have continued driving household spending, especially in the case of consumer durables, as they have substantially lowered the cost of the associated financing conditions. All these developments have occurred in a very favourable climate: the consumer confidence index increased substantially as the year unfolded, exceeding the related peak in the previous upswing at the end of the year. Similarly, retail trade confidence has been on an upward path, certain fluctuations notwithstanding.

On QNA estimates, real general government consumption posted a year-on-year growth rate of 0.3 % in the third quarter of 1998, extending the slowing profile shown since the final quarter of 1997. Nonetheless, the State budget outturn figures for the fourth quarter might warrant a slight rise in this demand component in this period, as a result of the acceleration observed in payments executed by the State under the headings of goods and services and wages and salaries.

Investment in capital goods increased by 11.8 % in the third quarter of 1998, 0.7 percentage points down on the preceding quarter, and this slowing trend appears to have extended into the fourth quarter. Thus, the growth rate of both industrial production and imports of capital goods moderated in October, although the heavy decline in exports of these goods that month slightly checked the ongoing deceleration in the index of apparent investment in capital goods. The cumulative growth rate of this variable in the first ten months of the year stood at 11.5 % (see Chart 16). Component by component, the growth of both the production of transport equipment and that of other capital goods eased in October, as did imports. Surveys gauging confidence in the capital-goods-producing industry, which has been worsening since the start of 1998, confirmed this decline in October and November.

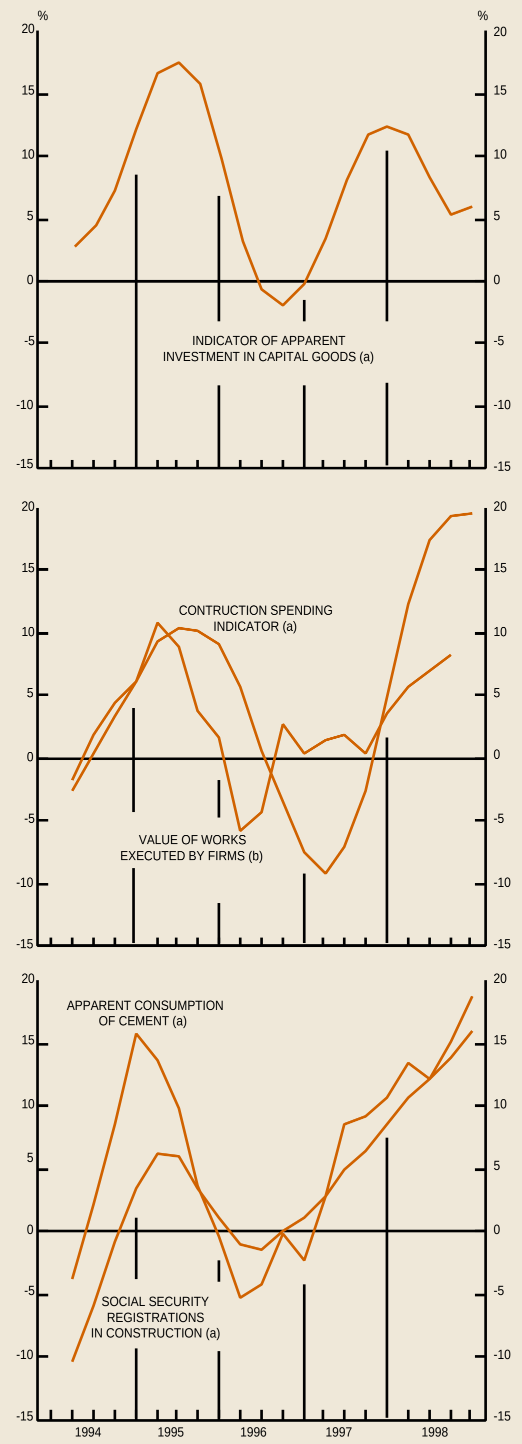
The moderation seen in capital investment during 1998 is closely tied to the containment of the growth rate of final demand, arising from the progressive weakness of exports, which has translated into a sizeable decline in foreign orders. Notwithstanding, capital spending was the most buoyant component of demand on average in 1998, with an estimated growth rate of around 12 %, higher than that seen in 1997. This highlights the intensity of the investment process in the Spanish economy over the last two years. Indeed, the private investment/GDP ratio has been close to the peaks recorded in the mid-eighties. The presence of favourable albeit diminishing demand expectations, and the ongoing improvement in corporate financing conditions, against a background of contained financial charges, are the main factors that account for this result. In this respect, according to the figures provided by the Banco de España Central Balance Sheet Office for the third quarter of 1998, the financial leverage ratio, which reflects the differential between the return on assets and interest-bearing borrowing, has held at very high levels, serving to boost productive investment.

On QNA estimates, investment in construction accelerated substantially in the first nine months of 1998, with year-on-year growth in the third quarter of the year being estimated at 6.1 %. The continuing strength of this expenditure component in the fourth quarter is apparent in all available indicators. Among the indicators of activity, the growth path of apparent consumption of cement steepened in the final quarter of 1998, posting a year-on-year average rate of 20 %. The indicators of employment in the sector likewise confirmed the uptrend in construction activity. Notable in this connection is the progressive improvement in the rate of employment creation reflected in the initial EPA (Labour Force Survey) figures released in September; the rate of decline of registered unemployment in the sector intensified in October and November, while the rate of increase of new Social Security registrations rose in the fourth quarter. In parallel, the business confidence indicator for the construction industry showed a fresh and notable improvement in October and November, which has extended to production and new-hire forecasts.

The course of the leading indicators in 1998, as summarised by the construction spending indicator, is an endorsement of the estimated strength of this spending component at the close of the year (see Chart 16). For one thing, after having held virtually stable in 1997, official tenders grew by 61 % on average between January and September 1998, underpinned to a greater extent by the civil engineering component. For another, the number of square metres to be constructed in private-sector residential

CHART 16

Gross fixed capital formation indicators



Sources: Ministerio de Fomento, Oficemen and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

(b) Obtained from the quarterly construction industry survey and deflated by the construction costs indicator. Four-quarter rate of change based on original series.

CHART 17

Foreign trade in goods (a)

Sources: Ministerio de Economía y Hacienda and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator, in real terms.

buildings, based on the construction licences granted by municipal councils, grew intensely during the first eight months of 1998, rising to a rate of increase of around 40 %. Likewise, private building for non-residential use has also been very expansionary, with the rate of increase of the number of square metres to be built exceeding 60 %.

The acceleration in private residential building is consistent with the increase in household disposable income and with their improved financial position, as it is with the decline in mortgage interest rates. The buoyancy of the non-residential building components is the outcome, as is the case with investment in productive equipment, of the particularly favourable conditions for pursuing investment projects. Lastly, the public-works component has picked up appreciably as a result of the increase in budgetary provisions for infrastructure investment.

The contribution of the change in stockbuilding to the year-on-year growth of output stabilised at around two-tenths of a percentage point in the second and third quarters of 1998 according to QNA figures. Drawing on information from the household expenditure survey for October and November, this contribution might have increased marginally in the closing months of the year, as a slight rise is appreciable in the percentage of businessmen reporting a higher-than-intended level of stocks.

On INE information, the contribution of net external demand to GDP growth held virtually stable in the first three months of 1998, at around –0.6 %, since the diminished momentum of exports was offset by less buoyant imports. On the information available for the final quarter of the year it is difficult to state the exact contribution of net external demand in this period. Nonetheless, the performance of its determinants suggests that the slowdown in exports has intensified as the weakness of certain export markets has heightened, while imports have remained firmer, underpinned by the strength of domestic demand.

The latest figures provided by the Customs authorities showed a very marked deceleration in sales abroad in October and November. Nonetheless, the erraticism of these flows, combined with the prevailing uncertainty as a result of the international financial crisis, which might have caused a deferral of corporate decisions, calls for some caution in assessing this information. In any event, the trend growth rate of goods exports in real terms has weakened substantially since early 1990, and it is estimated this process might have intensified in the last quarter, as a result of flagging economic activity worldwide. The latest results of the export climate survey, in which a deterioration in expectations about foreign orders for the last quarter of 1998 can be seen, confirm this hypothesis; 50 % of respondents declared themselves to have been affected by the international economic crisis.

The breakdown of exports by geographical area reveals a sharp decline in sales to countries directly affected by the crisis. Specifically, exports in recent months to Latin-American and east European countries have been very depressed. And this has compounded the sizeable decline since the start of the year in exports to Japan and other south-east Asian countries. The collapse of the Russian economy and its effects on other economies in the region and the growing instability of the Latin-American economies account for this result. Sales to the United States have flagged substantially in recent months as a result of the downward course of the dollar. Overall, exports to non-EU countries fell by 3.9 % in nominal terms in the first eleven months of the year, in contrast to the 24.2 % increase on average in 1997. As regards exports to the EU, the drastic slowdown in October and November will foreseeably be temporary. That said, the export growth path had already slackened in the preceding months (after gathering notable steam at the start of the year), in step with the prevailing moderation in EU economic activity during the second half of the year. Consequently, the cumulative growth in the first eleven months of 1998 stood at 12.1 %, slightly down on the figure of 14.5 % in 1997. Notable at a more detailed level is the strength of exports to France. Sales to Germany showed similar growth rates to those in 1997, and those to Italy have slowed.

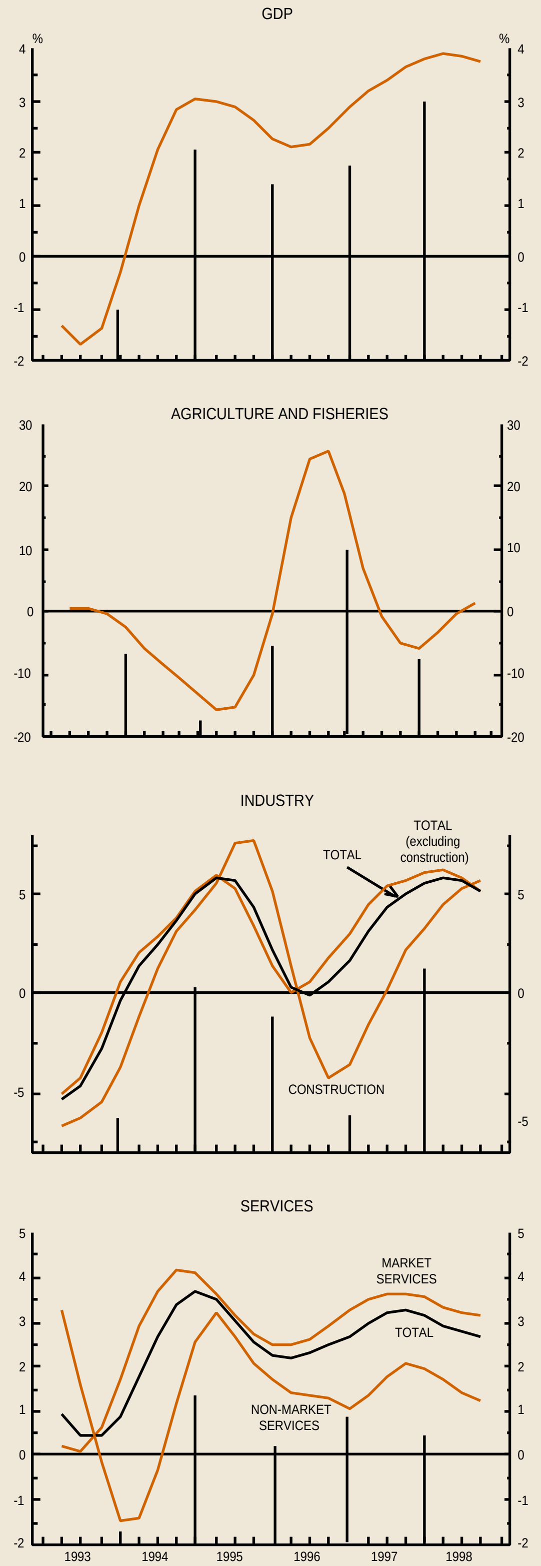
In terms of product groups, the growth rates of all components of exports have slowed as the year has unfolded. The deceleration in sales of non-food consumer goods and, in particular, of cars has been to the fore. However, exports of capital goods continue to show very high real growth rates.

Tourism receipts in real terms remained very expansionary in the closing months of 1998 according to the main indicators available. That said, they did not reach the high rates shown in the opening months of the year. According to balance of payments figures, tourism receipts in nominal terms grew by 13 % in the first eleven months of 1998, a very similar rate to that posted in 1997 on average (12.8 %). The number of tourists entering Spain was up 10.2 % in the period from January to October, while the number of foreign visitors staying in hotels rose 10.8 % over the year as a whole. The improvement in household income in the main European economies, which has translated into greater flows of tourists from France and Germany, and the buoyancy of tourism from the United Kingdom, driven by the appreciation of sterling towards the middle of last year, help explain the favourable performance of this aggregate.

The year-on-year growth rate of goods imports tended to moderate during 1998, standing at 9.4 % in the third quarter according to provisional QNA figures. Granted, it is very difficult at present to assess developments in the final quarter of the year. However, based on the information available, the firm advance of national demand and the absence of significant changes in the competitiveness of imported products allow a growth rate very close to that observed in the previous quarter to be estimated for this aggregate. Component by component, imports of capital goods and consumer goods have contin-

CHART 18

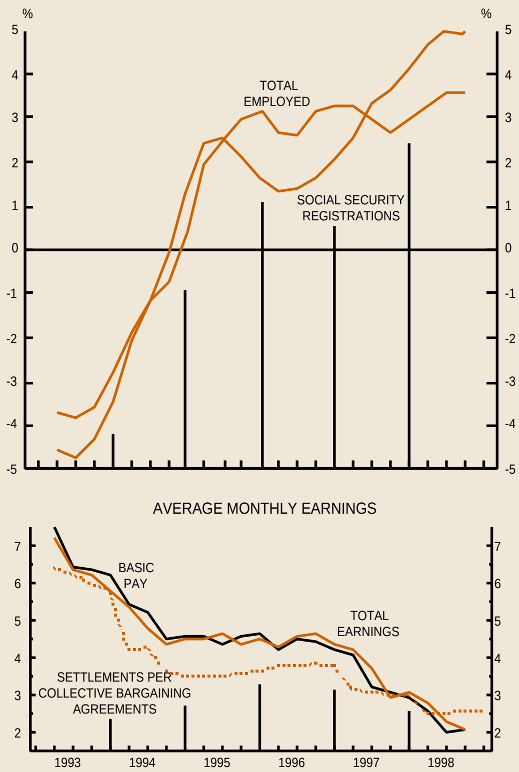
Gross value added by branch of activity
Rate of change



Source: Instituto Nacional de Estadística.

CHART 19

Employment and wages (a)
Percentage change on year ago



Sources: Instituto Nacional de Estadística and Ministerio de Trabajo y Asuntos Sociales.

(a) Non-centred percentage change on same quarter a year earlier.

ued to be buoyant, posting real growth rates of 16.5 % and 15.1 %, respectively, in the first eleven months of last year, in step with the vigour of these demand components. On the contrary, purchases of intermediate goods have been on a slowing path, in keeping with industrial activity.

Lastly, the growth rate of tourism payments tended to increase during 1998, extending the path of recovery begun in mid-1997. This performance is closely connected with the improvement in Spanish household purchasing power.

4.2. Output, employment, costs and prices

During the fourth quarter of 1998, the year-on-year growth of real GDP remained high, though slightly down on the previous quarter, at 3.8 % on QNA estimates. From the standpoint of expenditure, this performance was the outcome of a greater negative contribution of net external demand to GDP growth. From the standpoint of the productive branches, the slight slowdown in output originated mainly in industry. Although growth continued to run at a notable rate in industry, it underwent a deceleration linked to the effects of the international crisis on the external sector. Elsewhere, market services ceased to move on a slowing trend in the second half of the year, while construction remained expansionary. Employment generation continued to show growing impetus in the third quarter, with the number of employed rising by 3.6 % year-on-year. However, the available indicators for the closing months of 1998 appear to signal a tailing off of this acceleration, in step with the trend of activity. Cost developments have been favourable to the process of reduction of the inflation rate. Drawing on collective bargaining results in 1998, nominal wages moved on a decelerating path, although the rise therein exceeded that in consumer prices, and the rate of decline of import prices intensified in the second half of the year. As a result, the 12-month growth rate of consumer prices fell in the final quarter, ending the year at 1.4 %.

As can be seen in Chart 18, primary activity during the third quarter of 1998 continued the gradual process of recovery begun at the start of the year. On provisional QNA estimates, gross value added in the branch increased by 1.3 % on the same period a year earlier (the first positive year-on-year growth since early 1997). The greater buoyancy of the primary sector has come about despite the slight deterioration in agricultural output, the result of scant rainfall in most of Spain in the closing months of 1998. Thus, the yield of most summer and autumn crops fell significantly, with wine, citrus fruit and olive production being most adversely affected by the weather. Conversely, the fisheries and livestock sub-branches were more buoyant than in previous quarters, albeit growing at moderate rates.

Gross value added in industry ran at a year-on-year rate of 5.1 % in the third quarter of 1998, seven-tenths of a percentage point below the rate at the end of the first six months. The marked buoyancy of this variable thus continued, although its growth rate was on a moderating trend, as was the case in the first half of the year. The as yet incomplete data for the fourth quarter show similar behaviour, although the November figures, if confirmed in the coming months, might signify a turnaround. The industrial climate indicator stood in October and November far below the levels of the previous months. This was the result of flagging orders (especially those from abroad) and the increase in stock levels. The industrial production index posted a year-on-year rate of 2.4 % on average in October and November, signifying an increase of 3.6 % when adjustments are made for calendar effects, one percentage point below the related figure in the third quarter of the year. A disaggregated analysis of the industrial production index on the basis of industrial groupings shows that the additional loss of momentum in October spread to all components. Indeed, the production of consumer goods showed a growth rate of 4.6 % on average in October and November, calculated using the series adjusted for calendar effects, compared with 5 % the previous quarter, mainly as a result of the trend of the non-food component. As for the production of capital goods, the sharp loss of momentum between the second and third quarters moderated substantially, even though it continued to slow. Lastly, the production of intermediate goods increased by 3 % on average in the last two months, compared with 4.1 % the previous quarter. Set against the background of this slowdown in industrial activity, production surveys for the following three months showed a substantial improvement in November, and there was also a rise in expected orders. These data have been confirmed by the November industrial production index.

In the second half of 1998, construction activity held firmly on the expansionary course seen since late 1996. In the third quarter of 1998 the growth rate of value added in this branch increased once more to 5.7 % year-on-year, four-tenths of a point up on the previous quarter. The information available for the fourth quarter of the year points to the continuity of this process, since both civil engineering works and building remain very buoyant, as discussed in the previous section.

On QNA figures, value added generated in the services branch increased by 2.7 % in the third quarter of 1998, one-tenth of a point up on the previous quarter. This reduction in the growth rate and the services branch extends the gradual slowdown seen since late 1997, which has been common to its two components. Thus, the year-on-year growth rate of non-market services declined by two-tenths of a point to 1.2 % in the third quarter of 1998, the result of a slowdown in fixed-capital consumption which was not offset by the slight acceleration in public-sector employees' compensation. The ongoing loss of momentum of market services previously perceptible came to a halt in the third quarter of 1998, and a year-on-year growth rate of 3.2 % was posted, similar to that of the second quarter of the year. The scant information available for the fourth quarter, based essentially on employment, trade and tourism indicators, does not seem to point to a further slowdown.

The employment creation process continued forcefully in the third quarter of 1998. On QNA data, the number of employed increased by 3.6 % in relation to the same period a year earlier, up on the figure of 3.4 % for the previous quarter (see Chart 19). Nonetheless, as indicated by the EPA data for this period, the numbers of dependent and self-employed workers trended very differently; there was a slowdown in the former, while the numbers of self-employed increased in year-on-year terms following 18

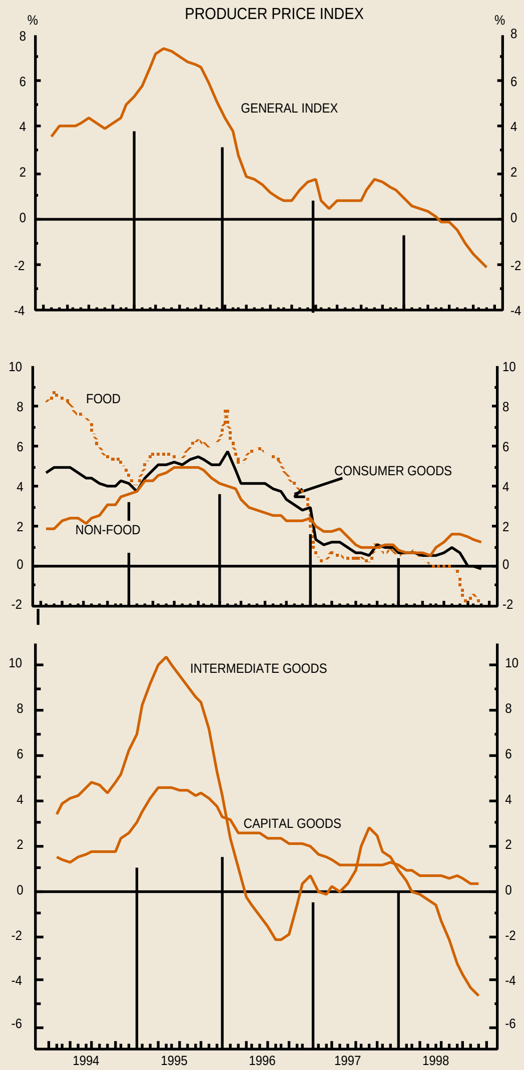
CHART 20

Consumer price index components
12-month percentage change

Source: Instituto Nacional de Estadística.
(a) Index of non-energy processed goods and services prices.

CHART 21

Producer price index components
12-month percentage change



Source: Instituto Nacional de Estadística.

months of decline. This pattern was again apparent in the initial EPA figures for September, including data from August to October, although in a less buoyant context for total employment. This is because the figures appear to indicate that the rate of job creation might have reached a plateau in the second half of 1998, in step with the trend of activity. Specifically, the year-on-change in the labour force totalled 447,000 people in September, which translates into a year-on-year rate of 3.5 %, slightly below that observed in the third quarter (3.6 %). Set against this, Social Security registrations showed greater strength as from September, increasing in the fourth quarter as a whole at rates higher than those seen during the summer. As regards unemployment, and according to EPA figures, the joblessness rate fell by three-tenths of a point in the third quarter of 1998 to 18.6 %, holding at this level in the months covered by the initial EPA figures for September. The reduction in the number of unemployed has worked through to the registered unemployment figure compiled by INEM (the National Employment Office). In the fourth quarter, the rate of decline of registered unemployment intensified, with an average reduction of 283,000 people in the number of jobless: the resulting negative rate of –13.6 % is clearly greater in absolute terms than that seen in previous quarters.

As mentioned, after having decelerated in the third quarter of 1998, the number of dependent employees remained on a slowing trend in the period August-October, running at a growth rate of 4.2 % year-on-year, two-tenths of a point below that of the period July-September. The recovery initiated in the third quarter in the group of self-employed workers was confirmed, with growth of 1 % being posted after more than a year of declining rates. Under the wage-earners category, permanent employment held relatively stable at a growth rate of 5.2 %, which was nonetheless lower than the rate in the second quarter of the year. Meanwhile, the growth rate of temporary employment declined to 2.4 %, lowering the proportion of temporary to total employees to 32.9 %, four-tenths of a point below the related figure for the third quarter. As regards working-day length, data are only available for the third quarter, when the proportion of part-time to full-time workers once more lost momentum, declining to 7.8 %, four-tenths of a point down on the previous quarter. By branch of activity, the September EPA showed the same trends seen in the third quarter. The exception was agriculture, where there was a sharper reduction in the number of employed. The slowdown in employment in industry, which reflects that shown by output in the same branch, continued, though with employment-generation rates that are still high (4 %). Meantime, the number of employed in construction continued on the rising path previously seen (6.9 %), in line with the activity indicators available. Lastly, in the services branches, net jobs increased in the three months covered by the September EPA at the same rate as in the third quarter (3.4 %). Other sources relating to employment developments, such as Social Security registrations and registered unemployment, point to a more favourable performance of the labour market in industry and services in the fourth quarter than that indicated in the initial September EPA figures.

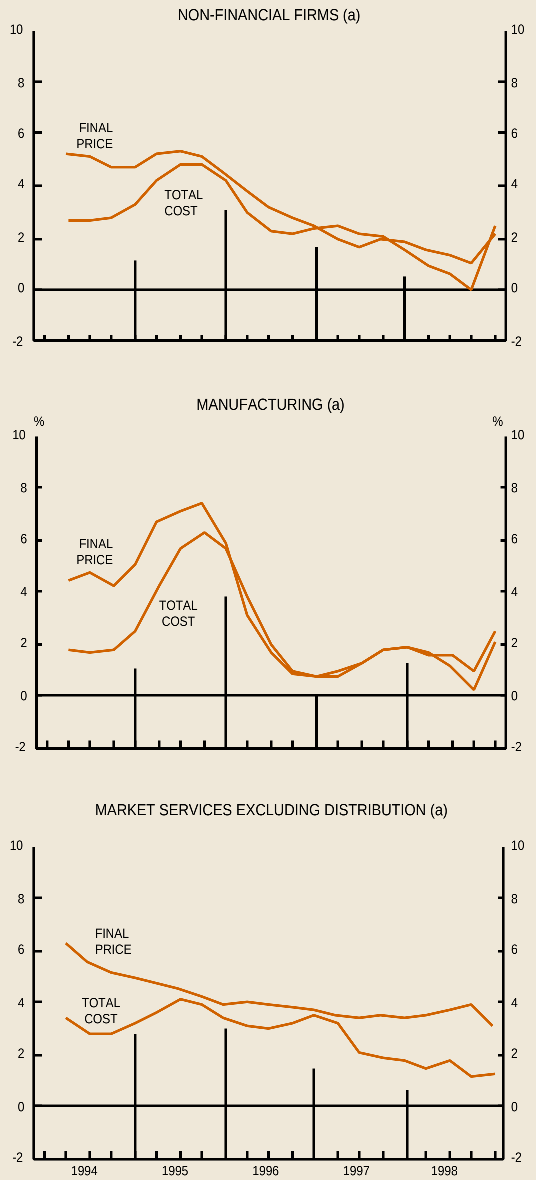
Most of the information relating to the various wage headings has shown a significant deceleration in compensation in 1998, compared with 1997. The most up-to-date information, on collective bargaining agreements entered into until December 15th last year, shows wage settlements for 1998 to be standing at 2.6 %, three-tenths of a point lower than in 1997. The biggest wage settlements were in newly signed agreements; here, wage-rate growth was 2.8 %, above the figure of 2.4 % corresponding to revised agreements. Across the branches of activity, settlements in services (2.7 %) and in agriculture (2.9 %) were notable, while in industry (2.4 %) and construction (2.3 %) the increases were slightly more moderate.

According to the wage survey, average hourly earnings in the third quarter of 1998 (in terms of basic pay) increased by 2.4 %, two-tenths of a point down on the previous quarter. For the first three quarters of the year this increase was 2.7 %, 1.2 percentage points below the average growth recorded in 1997, albeit nine-tenths of a point above the 1998 CPI increase. Workers with shorter working days joining the labour market continued to prompt a situation whereby the increase in monthly earnings per employee was somewhat less than that in hourly earnings in the third quarter (2.1 %). Branch by branch, average hourly wages in terms of basic pay quickened by half a percentage point in industry (to 2.9 %), held at the same rate in construction (3.4 %) and slowed in services (2.2 %). It is in this latter branch that the growth differential between hourly and monthly earnings is widest, although the gap has narrowed by three-tenths of a point in the last quarter.

As Charts 20 and 21 show, the main indicators of prices in the Spanish economy held on a favourable path in the fourth quarter of 1998. There was a fresh cut in the 12-month growth rate of the CPI, which stood at 1.4 % in December. The favourable behaviour of what are traditionally the most volatile CPI components – fresh food, whose 12-month growth rate moderated by almost one percentage point, and energy prices, which fell sharply – was the factor that most contributed to the improved inflationary situation in the period under study. The component of services and non-energy processed goods (IPSEBENE) also slowed slightly, to a 12-month growth rate of 2.2 % in December, one-tenth of a point less than in September. In terms of the harmonised index of consumer prices (HICP), which allows for uniform comparison with the consumer prices of the other EMU countries to November, the inflation gap between Spain and EMU, on one hand, and the EU, on the other, narrowed. Specifically, the 12-month growth rates of the HICPs in November were 1.4 % in Spain, and 1 % and 0.9 % in the EU and EMU, respectively.

CHART 22

Price and cost indicators



Sources: Instituto Nacional de Estadística and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend.

As earlier mentioned, among the factors that have most contributed to the favourable CPI performance in recent months are the traditionally more volatile components, such as energy and unprocessed food. In the closing months of

1998 there was a marked fall in energy prices, led by the fall of energy prices on international markets. As a result, the 12-month rate of the energy component stood at –6.6 % in December. Unprocessed food prices underwent a slowdown which reduced their 12-month rate to 1.1 % in the same month. The behaviour of processed food prices remained moderate, growing at a rate of 0.4 % year-on-year in December, three-tenths of a point below the related September rate. The 12-month growth rate of non-energy industrial goods prices held at 1.6 % during the fourth quarter of the year. Finally, services prices ran at a rate of 3.7 % year-on-year in December, one-tenth of a point less than in September.

The 12-month growth rate of the producer price index underwent fresh cuts in the second half of 1998, standing at –2.1 % in December. Although all its components slowed, the sharpest falls were in the prices of intermediate goods, and more specifically in energy, the year-on-year change in which was –11 % in December. Turning to agricultural prices, and on the latest information to September, these continued to perform favourably overall. However, pork and fresh vegetable prices showed very high growth, which has had a significant bearing on the aggregate.

Import prices, approximated by the unit value index, continued on the moderate trend seen in the summer months and early autumn. Thus, on information to October, the cumulative average rate was –1.7 %. Although this moderation has been common to all the components, it is more intense in the case of intermediate and capital goods. Lastly, export prices also held on a very moderate growth path, showing a cumulative increase to October of 0.7 % in relation to the same period a year earlier.

The information furnished by the cost and price indicators discussed in the previous paragraphs can be combined (as part of a coherent accounting framework) to obtain an overall view of the price formation process (see Chart 22). In the third quarter of 1998 the final prices of the non-financial firms aggregate grew less than in the second quarter. Notwithstanding, the gross operating margin has held on a rising path in relation to the level reached in previous quarters, thanks to greater moderation in the growth of total costs. The latter have been assisted both by the slowdown in unit labour costs and by the low growth of intermediate costs (of both domestic goods and, especially, imported ones). On the contrary, the cost of services used as inputs has held at high rates.

Across the various branches of activity, the performance has continued to be heterogeneous. The progressive narrowing of operating margins has continued in manufacturing, as a result of the greater growth of total costs in relation to prices. The performance of unit labour costs has been especially unfavourable, while the growth of intermediate costs has been very moderate. Conversely, margins have continued on a rising path in services, owing to the persistence of high price increases.

4.3. Balance of payments

The current and capital-account balance amounted to PTA 954 billion during the first eleven months of 1998, down PTA 402 billion on the same period a year earlier. The current-account surplus deteriorated notably in this period, owing largely to the increase in the trade deficit and, to a lesser extent, to the worsening of the investment-income balance. On the contrary, the tourism surplus increased substantially. The capital-account surplus remained virtually stable compared with the previous year.

Merchandise exports lost steam as 1998 unfolded. The intense slide since the beginning of the year in sales to Asian markets was compounded in the final months by progressively weaker exports to east European and Latin-American countries. In addition, the pace of sales to EU countries has also slowed in recent months. Imports remained relatively robust, in step with the thrust of domestic demand. This prompted a growing deterioration in the merchandise balance deficit from the end of the previous year onwards, despite the improvement in the terms of trade in 1998.

The tourism surplus stood at PTA 3,484 billion in the first eleven months of 1998, up PTA 403 billion on the same period the previous year. Tourism receipts expanded strongly in this period (13 %), stabilising after the summer at high growth rates following their notable impetus in the opening months of the year. This result reflects the improved economic situation in Germany and France, which has led to a greater inflow of tourists from both these countries. It also shows the resilience of British tourism, a consequence of the depreciation of the peseta against sterling until mid-1998. Tourism payments grew 12.9 % in the first eleven months of the year, accentuating the path of recovery seen since the second half of 1997. Lastly, receipts and payments for other services sustained very high growth rates, although in the final months there was a perceptible slowdown in revenue arising on transport

TABLE 4

Balance of payments: summary table (a)

PTA bn

	JAN-OCT 1997			JAN-OCT 1998		
	Receipts	Payments	Balance	Receipts	Payments	Balance
Current account	**23,265**	**22,676**	**589**	**25,542**	**25,322**	**220**
Merchandise	13,967	15,726	–1,759	14,983	17,427	–2,443
Services	5,969	3,281	2,688	6,751	3,787	2,964
Tourism	*3,689*	*608*	*3,081*	*4,171*	*687*	*3,484*
Other services	*2,279*	*2,673*	*–393*	*2,580*	*3,100*	*–520*
Income	1,697	2,476	–779	1,992	2,874	–882
Current transfers	1,631	1,193	439	1,816	1,234	582
Capital account	**845**	**78**	**767**	**815**	**81**	**734**
	Change in liabilities	Change in assets	Balance	Change in liabilities	Change in assets	Balance
Financial account	**5,882**	**6,543**	**–661**	**11,942**	**12,158**	**–217**
Spanish investment abroad	—	3,643	–3,643	—	7,427	–7,427
Foreign investment in Spain	2,078	—	2,078	3,791	—	3,791
Spanish loans and deposits abroad	—	1,195	–1,195	—	4,777	–4,777
Foreign loans and deposits in Spain	3,804	—	3,804	8,150	—	8,150
Reserves	—	1,706	–1,706	—	–45	45
Unclassified items, errors and omissions	**—**	**—**	**–695**	**—**	**—**	**–738**

Source: Banco de España.
(a) Provisional.

operations, in step with the lesser momentum of merchandise exports.

The investment-income deficit stood at PTA 882 billion in the period January-November, up PTA 103 billion on the same period the previous year. This result is the outcome of the surge in payments over the same period, where receipts trended more moderately. The performance of receipts largely reflected the slackness of those relating to the credit system, connected with the ongoing cancellation of deposits vis-à-vis the external sector in 1997 and in the opening months of 1998. On the contrary, non-financial private-sector receipts were very buoyant, the result of the expansion in portfolio investment, mainly in mutual funds, and of the increase in direct investment and in short-term lending and deposit operations abroad. There was a notable increase in payments made by the credit system, in line with the performance of its liabilities vis-à-vis the external sector, although there was also a perceptible increase in payments by the non-financial private-sector.

The surplus on the current transfers account increased by PTA 143 billion over the first eleven months of the year in relation to the same period a year earlier. This was due to the increase in transfers received by the private sector, under the European Agricultural Guidance and Guarantee Fund heading, while public-sector transfers relating to the European Social Fund stabilised at the same levels of the previous year. Payments, for their part, increased under all captions, except in that earmarked for the VAT Resource.

Lastly, the capital-account balance ran a surplus of PTA 734 billion in the period January-November, similar to that observed in the same period in 1997, as the increase in structural funds from the EU was offset by the reduction in transfers received by the private sector.

Turning to the financial account, the period January-November 1998 resulted in a net capital outflow totalling PTA 262 billion, in contrast to the net inflow of PTA 1,045 billion recorded in the same period the previous year. Along with the turnaround in the net flow of cross-border capital, a key feature of the 1998 balance of payments financial account is the considerable increase in the volume of financial flows vis-à-vis the external sector. Both the build-up in claims on and liabilities to the external sector is, so far in 1998, twice that of the figure recorded in 1997, with financial movements of around PTA 11 billion in both cases. In an economy such as Spain's, which has traditionally depended on foreign saving, the turnaround in our financial flows with the rest of the world, togeth-

TABLE 5

Balance of payments on financial account

PTA bn

	1997	1997 JAN-OCT	1998 JAN-OCT
1. BALANCE ON FINANCIAL ACCOUNT (2 – 5)	**–442**	**–667**	**–409**
2. CHANGE IN LIABILITIES – CHANGE IN ASSETS	**1,281**	**935**	**–265**
3. CHANGE IN LIABILITIES VIS-À-VIS EXTERNAL SECTOR	**5,466**	**5,067**	**10,965**
Investment	**2,485**	**1,532**	**4,224**
Excluding marketable securities	811	703	1,043
Marketable securities	1,673	830	3,181
Private sector	*63*	*–77*	*1,642*
Public sector	*1,610*	*907*	*1,539*
Other investment	**2,981**	**3,535**	**6,741**
General government and other resident sectors	105	309	864
Credit system	2,876	3,226	5,877
Of which:			
Long-term loans and deposits	*538*	*466*	*1,648*
Repos	*54*	*262*	*488*
Short-term deposits	*2,285*	*2,498*	*3,740*
4. CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR	**4,185**	**4,132**	**11,230**
Investment	**3,961**	**3,279**	**6,189**
Other investment	**225**	**853**	**5,041**
General government	55	53	51
Other resident sectors	2,251	2,432	3,593
Of which:			
Short-term loans and deposits	*1,960*	*2,178*	*3,444*
Credit system	–2,081	–1,632	1,396
Of which:			
Long-term loans and deposits	*328*	*204*	*137*
Repos	*494*	*954*	*–122*
Short-term deposits	*–2,903*	*–2,791*	*1,382*
5. RESERVES	**1,722**	**1,602**	**145**

Source: Balance of Payments. Banco de España.

er with the significant increase in claims on non-residents, is most relevant. This reflects the framework of macroeconomic stability achieved and the country's growing capacity to place its capital abroad, in an environment of financial globalisation.

The net capital outflow recorded was less than the overall surplus on the current and capital accounts. And this, among other factors, translated into a slight increase in reserves (PTA 45 billion).

Among the captions conducive to the increase in liabilities to the external sector are that of foreign investment in marketable securities (both government and private) and that of the credit system's lending and deposit operations with non-residents. The increase in purchases of claims on the external sector has been mainly channelled via investment and private-sector lending and deposit operations, of both a financial and non-financial nature.

According to the disaggregated figures available for the period January-October of the current year, the raising of funds abroad by resident credit institutions via lending and deposit operations almost amounted to PTA 6 trillion, 60 % of which was in the form of short-term operations (see Table 5). However, the key feature is the significant increase in long-term loans and deposits, flows of which have quadrupled in the period January-October 1998, compared with the same period a year earlier.

The considerable increase in foreign investment in Spain has come about mainly thanks to non-resident purchases of marketable securities. The acquisition of paper issued by the private sector (PTA 1,642 billion) exceeded invest-

TABLE 6

Financial account
January-October 1998

PTA bn

	Change in external liabilities	Change in external assets	Net change (liabilities – assets)
1. Total	**10,965**	**11,230**	**–265**
Credit system	6,705	2,812	3,893
Investment	*828*	*1,416*	*–588*
Other investment	*5,877*	*1,396*	*4,481*
General Government	1,514	51	1,463
Investment	*1,539*	—	*1,539*
Other investment	*–25*	*51*	*–76*
Other resident sectors	2,747	8,366	–5,619
Investment	*1,857*	*4,773*	*–2,916*
Other investment	*890*	*3,593*	*–2,703*
2. Reserve assets	**–**	**145**	**–145**
3. Balance on financial account (1 + 2)	**—**	**—**	**–409**

Source: Balance of Payments. Banco de España.

ment in general government securities (PTA 1,539 billion), which is very relevant in the light of the traditionally scant issuance of private securities in the Spanish economy.

The increase in Spanish investment abroad in the period January-October totalled PTA 6,189 billion, clearly up on the figure for the whole of 1997. There has been a significant increase in portfolio investment which, to date in 1998, has exceeded PTA 4 trillion pesetas. The non-credit private sector has accounted for 75 % of this amount, mainly via mutual funds. The reduction in interest rates and the search for greater investment diversification, in a European environment marked by exchange rate stability, have boosted the acquisition of claims on the foreign sector by these funds. Direct investment continues to grow apace.

The increase in non-credit private-sector deposits abroad in the period January-October accounted for PTA 3.6 trillion. These largely related to short-term lending and deposit operations. The credit system increased its claims on the external sector mainly by increasing its short-term deposits, in contrast to the intense process of deposit withdrawal which took place in the same period the previous year (see Table 5).

Lastly, as can be seen in Table 6, the sectoral breakdown of cross-border financial flows shows significant differences in the period elapsed in 1998. The credit system and general government have exerted net demand for foreign financing for large amounts (almost PTA 4 trillion and the case of the credit system and PTA 1.5 trillion in the case of general government). Conversely, the other resident sectors (which include, among others, households, firms and other financial institutions such as mutual and pension funds) continue to finance, in net terms, the rest of the world, both via direct and portfolio investment and through loans and deposits abroad.

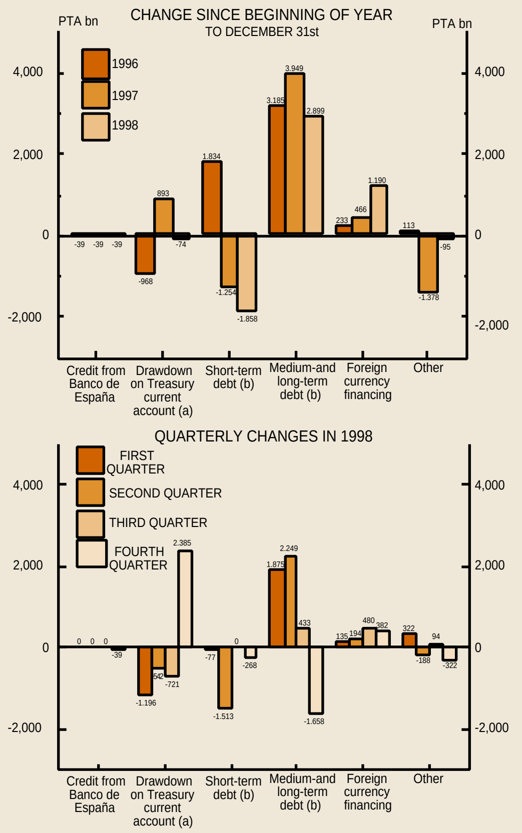
4.4. State Budget outturn and financing (5)

The cumulative State cash-basis deficit to November 1998 stood at PTA 149 billion, 89.7 % lower than the same period the previous year. The resulting percentage decline is greater than that originally budgeted for the year as a whole (–27.6 %), and even higher than that foreseen in the projected outturn for fiscal year 1998 which is included in the draft 1999 Budget (–33.2 %). This reduction in the cash-basis deficit was due both to the fall in expenditure (–0.2 %) and, above all, to the increase in revenue (8.2 %). As indicated in previous reports, comparison of the State budget and its outturn during 1998 with the previous year should be made bearing in mind, firstly, the entry into force of the Regional (Autonomous) Community financing arrangements for the period 1997-2001. Among other measures, this establishes, first, the transfer of 15 % of the rate structure of personal income

(5) According to recent Government figures, the State cash-basis deficit for 1998 totalled PTA 1,144 billion, 45.6 % less than in 1997. This considerable decline has widely exceeded the original budgetary forecasts for this year, as it has the projected budget outturn accompanying the 1999 Budget.

CHART 23

**State financing:
Breakdown by instrument**



Source: Banco de España.

(a) (–) increase in credit balance; (+) decrease in credit balance.

(b) Effective values.

tax to the ordinary-regime Regional (Autonomous) Communities party to the agreement (all except Andalusia, Extremadura and Castilla-La Mancha); and second, the expenditure incurred during the first few months of 1997 in connection with Royal Legislative Decree 12/1996, of 26th July, which affected, above all, purchases of goods and services and investment by the State.

Using the National Accounts framework, the cumulative deficit to November fell by a slightly lesser degree than the cash-basis deficit (–76.5 %), placing it at PTA 249 billion. However, the breakdown of the data hereafter will be in cash-basis terms, this being the information available.

In the period January-November, the rate of increase of revenue accelerated in relation to the first nine months of the year. This was due to the pick-up in direct tax revenue, the rate of decline of which eased to –1.5 %, and, to a lesser extent, to the favourable performance of indirect tax (13.1 %). However, other net revenue underwent a slowdown, although continuing to grow at high rates (27.7 %). Thus, the increase in tax takings and in other net revenue stood, in November, above the level envisaged in the projected outturn for the year as a whole.

The recovery in direct tax was due above all to a better performance both by personal income tax (–7.9 %) and by corporate income tax (22.7 %). Personal income tax continues to be affected by the transfer of 15 % of the rate structure of this tax to the ordinary-regime Regional (Autonomous) Communities, by the bringing forward of refunds in relation to the previous year (PTA 997 billion was refunded between June and November this year compared with PTA 739 billion in the same period last year) and by the fall in revenue relating to capital withholdings. In fact, if the first two effects are eliminated, personal income tax receipts show a growth rate of 6.7 %. The percentage decline in this tax to November is below the projected outturn (–8.7 %). The acceleration in corporate income tax receipts is warranted by the strong increase in partial tax payments made in October compared with the previous year, as a result of sound corporate profits and the revenue arising from capital gains realised on privatisations. In this respect, if an adjustment were made for the year-to-year differences attributable to privatisation proceeds, the growth rate of this tax would fall to 14.2 %. The increase in corporate income tax to November continues, however, to contrast with the budgeted reduction for the year as a whole (–10.5 %), and even with the growth rate included in the projected budget (1.2 %). Lastly, the heavy decline in takings relating to other direct taxes (–44.7 %) is due to the extraordinary revenue arising in 1997 in connection with the asset restatement levy.

Indirect tax revenue accelerated slightly in relation to the first nine months of the year. It was driven by the sound performance of both VAT and excise duties, which are holding at growth rates (10.7 % and 16 %, respectively) above those initially budgeted and higher than in the projected outturn. That reflects the favourable behaviour of consumption and the buoyancy of imports from non-EU countries. This latter aspect also affects customs duties (17.2 %), arising above all from the Common External Tariff. The trend of other indirect taxes (which rose at a rate of 60.8 %) reflects the increase in the tax rate on insurance premiums, which went up from 4 % to 6 % at the beginning of the year.

TABLE 7

Budget: outturn and financing

PTA bn and %

	Outturn	Initial projection		Outturn			Outturn		
	1997	1998	Percentage change	1997 JAN-SEP	1998 JAN-SEP	Percentage change	1997 JAN-NOV	1998 JAN-NOV	Percentage change
	1	2	3 = 2/1	4	5	6 = 5/4	7	8	9 = 8/7
1. Revenue	**16,640**	**17,449**	**4.9**	**12,096**	**12,753**	**5.4**	**15,300**	**16,562**	**8.2**
Direct taxes	7,882	7,320	–7.1	5,874	5,359	–8.8	7,246	7,139	–1.5
Personal income tax	*5,540*	*5,058*	*–8.7*	*4,403*	*3,889*	*–11.7*	*5,217*	*4,804*	*–7.9*
Corporate income tax	*2,095*	*2,119*	*1.2*	*1,261*	*1,362*	*8.0*	*1,801*	*2,209*	*22.7*
Other	*247*	*143*	*–42.1*	*210*	*108*	*–48.5*	*228*	*–126*	*–44.7*
Indirect taxes	6,253	6,982	11.7	4,668	5,241	12.3	5,903	6,675	13.1
VAT	*4,004*	*4,388*	*9.6*	*2,974*	*3,281*	*10.3*	*3,840*	*4,249*	*10.7*
Excise duties	*2,065*	*2,344*	*13.5*	*1,555*	*1,776*	*14.2*	*1,893*	*2,197*	*16.0*
Tariffs	*111*	*131*	*18.0*	*81*	*95*	*17.3*	*102*	*119*	*17.2*
Other	*73*	*119*	*64.3*	*58*	*89*	*54.3*	*68*	*110*	*60.8*
Other net revenue	2,505	3,147	25.6	1,554	2,153	38.6	2,151	2,748	27.7
2. Expenditure	**18,688**	**18,817**	**0.7**	**13,625**	**13,598**	**–0.2**	**16,747**	**16,712**	**–0.2**
Wages and salaries	2,992	3,042	1.7	2,156	2,187	1.4	2,605	2,662	2.2
Goods and services	390	391	0.2	285	275	–3.2	344	348	1.3
Interest payments	3,596	3,367	–6.4	2,593	2,442	–5.8	3,317	3,091	–6.8
Current transfers	10,018	9,826	–1.9	7,362	7,308	–0.7	8,987	8,910	–0.9
Investment	847	1,079	27.5	611	638	4.4	732	762	4.2
Capital transfers	846	1,112	31.5	619	749	21.0	763	937	22.8
3. Deficit (3 = 1 – 2) (a)	**–2,049**	**–1,369**	**–33.2**	**–1,529**	**–845**	**–44.7**	**–1,447**	**–149**	**–89.7**
4. Other expenses	**16**	**—**	**—**	**159**	**–8**	**—**	**–59**	**20**	**—**
Interest payments	15	—	—	158	–18	—	–55	3	—
Other payments	1	—	—	1	10	—	–4	17	—
5. Total expenditure (2 + 4)	**18,704**	**—**	**—**	**13,783**	**13,591**	**–1.4**	**16,689**	**16,732**	**0.3**
6. Net financing (6 = 1 – 5 = 7 – 8)	**–2,065**	**—**	**—**	**–1,687**	**–837**	**–50.4**	**–1,389**	**–170**	**–87.8**
7. Net change in financial assets	**–322**	**—**	**—**	**139**	**2,974**	**—**	**303**	**2,621**	**—**
Deposits at Banco de España	–893	—	—	–361	2,459	—	–281	1,942	—
Claims on Official Credit Institutions	22	—	—	16	9	–44.2	18	10	–44.7
Other net assets	549	—	—	483	506	4.6	567	669	18.0
8, Net change in financial liabilities	**1,743**	**—**	**—**	**1,826**	**3,811**	**108.7**	**1,692**	**2,790**	**64.9**
Borrowing from Banco de España	–39	—	—	0	0	—	0	0	—
Net issues of securities (c)	2,695	—	—	2,241	2,967	32.4	2,302	1,668	–27.5
Treasury notes	*0*	—	—	*0*	*0*	—	*0*	*0*	—
Treasury bills	*–1,254*	—	—	*–45*	*–1,590*	—	*–1,115*	*–1,800*	*61.4*
Medium- and long-term debt	*3,949*	—	—	*2,286*	*4,557*	*99.3*	*3,417*	*3,467*	*1.5*
Debt assumed	–21	—	—	–6	–29	—	–6	–49	—
Non-marketable debt	–850	—	—	–850	0	–100.0	–850	0	—
Foreign-currency loans	466	—	—	516	863	67.1	490	1,156	135.7
Loans in pesetas	–195	—	—	–195	0	–100.0	–195	0	—
Other (c)	–312	—	—	121	10	–91.7	–48	16	—

Sources: Ministerio de Economía y Hacienda and Banco de España.

(a) This is the cash-basis deficit as defined by IGAE (National Audit Office).
(b) Effective values.
(c) Includes coined money, deposits and lags, and peseta- and foreign-currency-denominated loans assumed.

Other revenue, which advanced at a rate of 27.7 %, showed a slowdown in relation to the growth rate recorded to September. Nonetheless, the increase in revenue under this heading was greater than foreseen in the projected outturn (25.6 %) and contrasts with the decline budgeted for the year as a whole (–3.1 %). Notable under this revenue heading are the following items. First, the increase to November in rates and other income (53.2 %), due to the revenue arising on the differences between government debt redemption and issuance prices (which are growing at over 200 % with respect to the same period a year earlier). Second, the rise in profits and dividends (16 %), as a result of the increase in profits paid in by the Banco de España (13.2 %) and of the greater revenue arising on disposals of public-sector firms and in relation to the regulation of mobile telephony (this latter item was recorded in July under the heading of rates and other income). Current transfers show a high rate of growth (47.6 %) owing basically to the increase in revenue from the State National Lottery and Gaming Agency (ONLAE) and to the increase in transfers from the Regional (Autonomous) Governments of the Basque Country, Navarra and Madrid, after the changes made to their financing arrangements. Lastly, capital transfers, which include revenue received from the EU Structural and Cohesion Funds, grew by 20.5 %.

Turning to expenditure, its cumulative rate of change to September was –0.2 %, below the projected outturn (0.7 %), but far removed from the initially budgeted figure (–2.9 %). In fact, all items under expenditure, except that relating to wages and salaries, showed higher rates of change to November than those budgeted for the year as a whole. The differences between the growth rates of expenditure to November and those included in the projected outturn for the year as a whole are essentially due to capital expenditure (real investment and capital transfers) which has, to November, advanced well below budget. As to current expenditure, both wages and salaries and goods and services stood below the projected outturn. In the case of wages and salaries, payments to current employees grew by only 1.1 %, while pension and social security payments ran at 3.2 % and 7.9 %, respectively. Goods and services increased by 1.3 % (rising to over 8 % if the effects of Royal Legislative Decree 12/1996 are removed), above the figure initially budgeted for the year as a whole. Interest payments fell by –6.8 %, in which connection it should be borne in mind that this year a credit extension for PTA 210 billion has been authorised for the purposes of early redemption and debt conversion. Finally, expenditure on current transfers fell by 0.9 %, which becomes an increase of 5.5 % once the effects of the transfer of the personal income tax rate structure to the Regional (Autonomous) Governments are eliminated. It should be remembered that one of the biggest volumes of transfers is to Social Security Funds to finance INSALUD (the Spanish health service). This item showed an increase of close to 10 % to November, the result of the ongoing assumption by the State of health care expenses, to be culminated in 1999.

As regards Social Security Funds, full information on the outturn to September – referring exclusively to the Social Security System – is available. These data show a System surplus of PTA 352 billion, in contrast to the deficit for the same period last year (PTA –75 billion) and to that foreseen for the year as a whole (PTA –119 billion). Revenue showed a growth rate of 10.9 %, which, though it continued falling gradually as from the end of first quarter (19.5 %), remains far above budget (5.8 %) due mainly to the favourable trend of current transfers from the State (21.5 %). Social security contributions, meanwhile, grew by 5.6 %, seven-tenths of a point higher than budgeted. As for expenditure, its growth rate (6 %) held at slightly above budget (5.2 %), due above all to the strong growth in purchases and pharmaceutical expenses (10.7 % and 12.5 %, respectively, against the initially budgeted figures of 6.1 % and 0.1 %). Temporary disability benefits also showed a far higher than expected rate of change (–0.4 %).

National Employment Office (INEM) data are available on social security contributions received to June, which grew by 8.2 % compared with the same period a year earlier, and on unemployment benefits paid to November, which fell by 7.3 %. It seems both circumstances are due to the sound performance of employment. Lastly, employment-promotion rebates continue to grow at a high rate.

During the period October-December 1998 the ongoing reduction of interest rates on government debt instruments has continued, in step with developments on the money and medium-and long-term debt markets. The continuing volatility on international stock markets drove activity on the market for government securities, which have taken up a portion of the funds in flight from riskier positions. Along with this, the impact of the financial crisis on growth prospects in Europe has prompted a less restrictive monetary policy and, in short, lower interest rates on short-term securities.

In this bearish setting, the Treasury cut its rates at issue considerably. However, redemptions of debt exceeded market placements, whereby the Treasury drew on the sizeable balance of its deposit at the Banco de España accumulated during the year to cover these redemptions and the budget deficit relating to the period in question, as can be seen in Chart 23.

Over the year as a whole, medium-and long-term government bond issues have once again been the main financing instrument for the State, with net placements totalling PTA 2.9 trillion. Foreign currency financing was also relevant, exceeding PTA 1 trillion pesetas. Largely, however, these liabilities have been automatically converted into domestic currency financing with the introduction of the euro, since they largely related to ecu-denominated issues. The outstanding balance of Treasury bills fell by PTA 1.9 trillion in 1998. This debt issuance structure has once again meant an increase in the average life of government debt in Spain, which has risen from 3.5 years at end-1997 to 4.5 years at the end of the third quarter of 1998. Finally, the balance of the deposit at the Banco de España, which is ultimately the item that balances market placements with the State cash-basis deficit, increased slightly during the year.

The outstanding balance of Treasury bills fell in the final quarter of the year by PTA 353 billion, although, unlike previous quarters, there was a positive placement of six-month bills and a negative flow of 12- and 18-month bills. Over the year as a whole, there was an increase only in the outstanding balance of 18-month bills (by PTA 1,472 billion), while that of six- and 12-month bills fell by PTA 775 and PTA 2,699 billion, respectively. As to rates at issue, in the period October-December 1998 the Treasury cut marginal rates by around 100 basis points to 2.7 % for 6-month bills, and by around 60-80 basis points for the 12-and 18-month terms, to 2.9 %-3 %.

The strong demand at the tenders for medium- and long-term debt enabled the Treasury to continue cutting bond yields, in step with market yields. Gross placements amounted to PTA 1,568 billion over the quarter as a whole (approximately 54 % of the amounts applied for), although this amount was lower than the redemptions for the same period, which were, at over PTA 3 trillion, very high. Likewise, PTA 608 billion worth of medium- and long-term bonds were issued via old-debt exchange operations. The reductions in rates at issue in the final quarter of the year gave rise to a total downward movement of about 40-50 basis points for all bond issues in the three-to-15-year segment. For the year as a whole, bond issues were substantially distributed among the different maturities. There were net placements of over PTA 1 trillion in the longer-dated issues (15- and 30-year bonds).

Spain’s move into the Third Stage of Economic and Monetary Union has meant the redenomination of the entire outstanding balance of government debt into euros. This process has made certain changes in the workings of the Government Debt Book-Entry System necessary. These are set out in detail in the «Financial Regulation» section of this Bulletin. Likewise, all new issues have been denominated in the single currency.

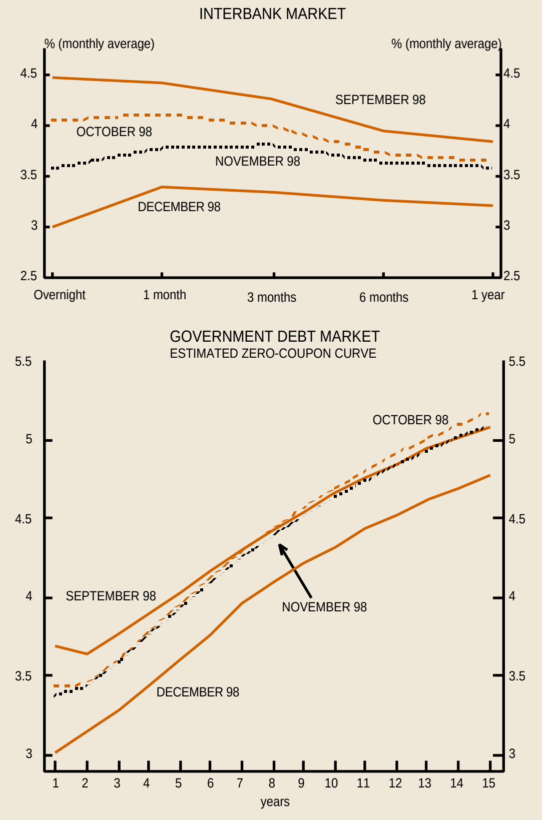
At the tenders held in the period to 22nd January, there have been some notable changes in the interest rates set and in the demand recorded. In the case of Treasury bills, the marginal rate on six-month bills has increased by 20 basis points in relation to the last tender in 1998, to 2.9 %. That is more in line with the yields on money markets at similar maturities. The interest rates on 12- and 18-month bills have declined slightly. As was habitual throughout 1998, there has been a negative net issue at the January tenders: against redemptions totalling e7,339 million (PTA 1,221 billion), only e4,037 million (PTA 672 billion) have been placed.

As regards the first tender of medium- and long-term euro-denominated bonds, there have been fresh reductions in rates at issue: compared with the December 1998 tender, the rates set have fallen by between 20 basis points for 10-year bonds and 45 basis points for 5-year bonds. The total amount issued was e3,776 million (PTA 628 billion), far higher than the redemptions expected in January, which totalled e311 million (PTA 52 billion). Also, demand was notably strong: applications for a value of e7,730 million (PTA 1,286 billion) were made, a significantly higher amount than in the previous months.

On data to November, the main demand for government debt during 1998 was from mutual funds, which accounted for virtually the entire increase in the outstanding balance of government debt. Non-residents’ holdings were unchanged, while the credit system has reduced its outright holdings of government debt. The breakdown of the debt in circulation acquired outright was as follows at the end of November 1998: almost 40 % was held by institutional investors (mutual funds, pension funds and insurance companies); 37 % by the credit system (most of it assigned to other sectors); 17 % by non-residents; and the remaining 6 % by non-financial firms and households.

CHART 24

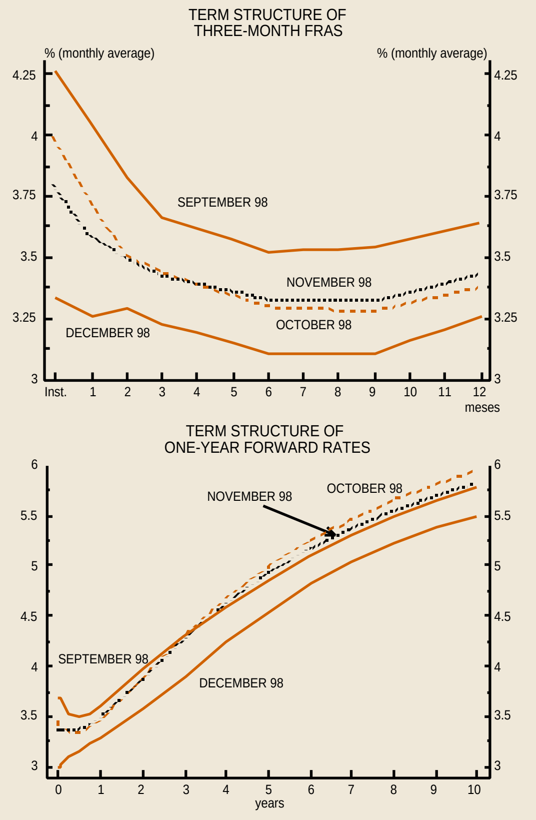
Yield curve



Source: Banco de España.

CHART 25

Forward rates



Source: Banco de España.

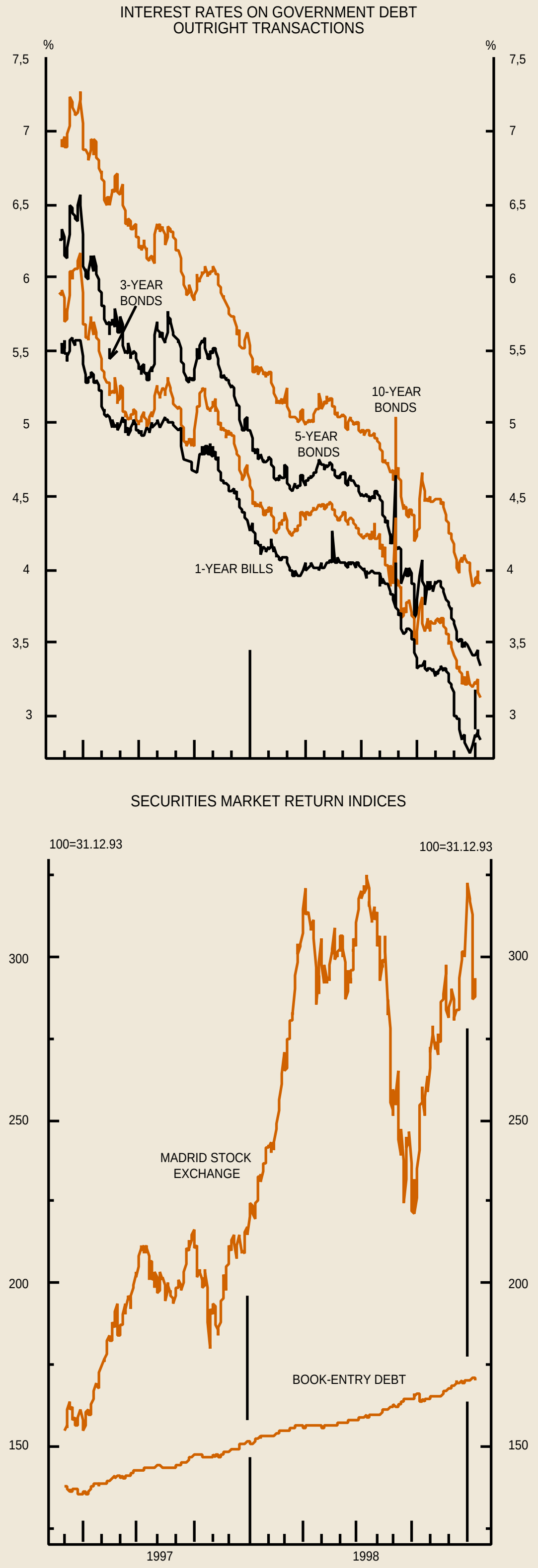
4.5. Monetary and financial developments

A degree of normality was restored on Spanish financial markets during the last quarter of the year following the instability seen in the previous three months, as a result of the international financial crisis. The favourable performance of inflation and national public finances, along with the reduction of the degree of monetary tightness in the United States and in the main European countries, boosted this process of normalisation. Against this background and given the ongoing convergence of interest rates among the countries that have joined EMU, the Banco de España cut its intervention rate on three occasions during the quarter for a total amount of 125 basis points, placing it at 3 %, the level at which the starting interest rate for monetary union was set. This allowed the decline in yields on domestic markets to continue, more markedly so in the short term. And it was also instrumental in the significant recovery by stock markets following the slump in the third quarter of the year.

On the interbank deposit market, the cuts in the intervention rate to the EMU convergence level were conducive to sizeable reductions in yields, more so in the shortest dated terms (see Chart 24). Thus, compared with the levels seen in September, reductions which diminished in size the longer the maturity took place, between 150 basis points for overnight operations and 60 basis points for the 12-month term. These movements led to a most considerable reduction in the negative slope of this market's yield curve, moving it to take up a slightly positive slope at the end of the year, with rates ranging from 3 % to 3.4 % for the overnight and one-month maturities, respectively. The fall in interbank market yields, combined with the lesser decline in interest rates in Germany, translated into a narrowing of the three-month peseta spread from 0.8 percentage points in September to a level of virtually zero at the starting date of EMU. To date in January, and as mentioned in section 3.2 of this report, interbank rates in the euro area (EURIBOR) have fallen further compared with December, standing at

CHART 26

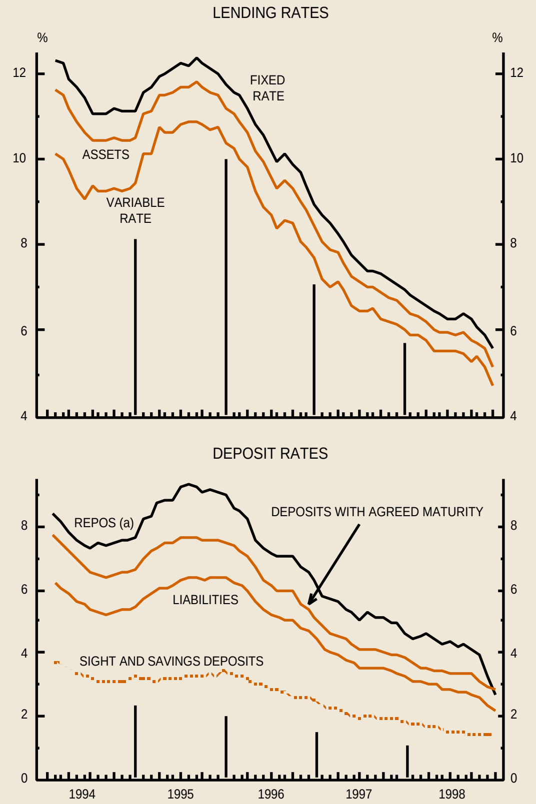
Interest rates and yields on securities markets



Source: Banco de España.

CHART 27

Synthetic bank and savings-bank interest rates



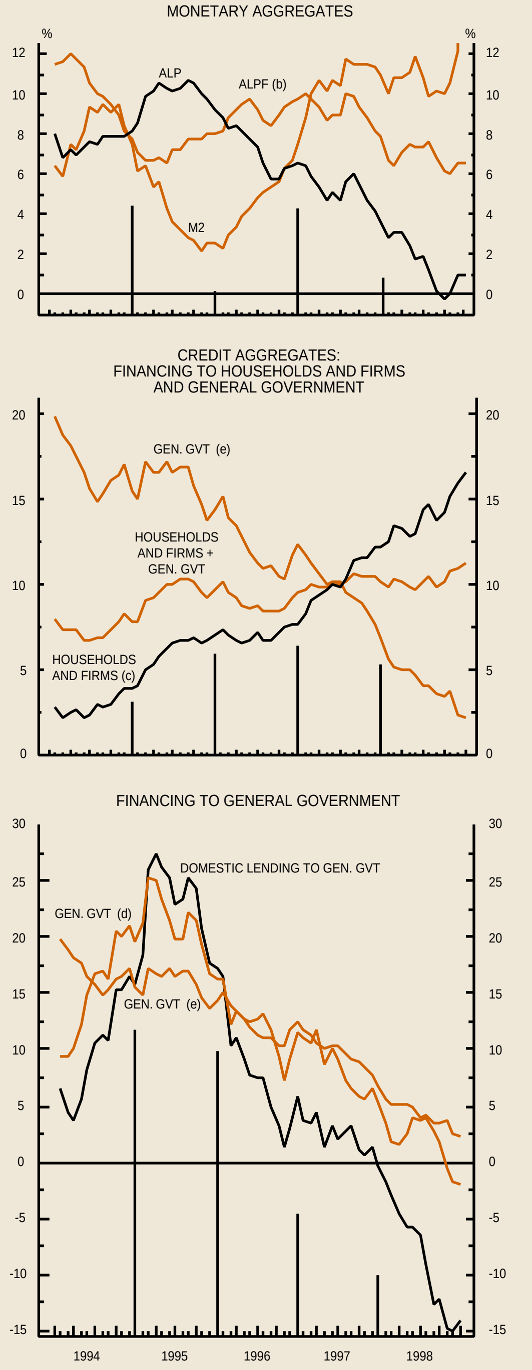
Source: Banco de España.
(a) Not including transactions involving Treasury notes.

the time of this report going to press at levels slightly higher than that of the ECB weekly intervention rate, which has held unchanged at 3 %.

Yields on the secondary market for book-entry debt continued on the declining path they had been following throughout the year during the last quarter of 1998. Over the quarter as a whole, the cumulative reduction totalled 50 basis points for three-and five-year bonds and around 35 basis points for the 10-, 15- and 30-year bonds. So far in January the decline in yields has continued, more sharply so in the longer dated terms. Following these cuts, and at the time of this report going to press, yields on this market stand at between 2.9 % and 4.7 % for the three-year and 30-year maturities, respectively. Hence, the debt market yield curve (the zero-coupon curve) has seen a reduction in its level and the negative slope it showed up until the two-year maturity has disappeared (see Chart 25). This has, in turn, enabled the long-term yield spread over Germany

CHART 28

Monetary and credit aggregates: 12-month growth rates (a)



Source: Banco de España.

(a) Year-on-year rate, original series.
(b) ALP plus fixed-income mutual funds less securities issued by general government belonging to ALP.
(c) Domestic lending to households and firms plus commercial paper and foreign direct financing.
(d) Domestic lending to general government plus outright debt held by the public.
(e) Domestic lending to general government plus outright debt held by the public and foreign direct financing.

to narrow during the quarter, from 40 basis points to its current level, at slightly below 20 basis points.

Turning to the secondary markets for book-entry debt, the pick-up on stock markets has prompted a most considerable decline in traded volumes, countering the high growth observed in the two previous quarters. Traded volumes thus fell by 15 %, as a result of the strong decline in operations with medium- and long-term debt (–18.4 %), which was marginally offset by the increase in Treasury bill trades. As to agents, both activity with non-market members and that involving market-members contracted considerably.

In line with developments on the secondary market for debt, rates at issue on government securities on the primary market fell appreciably in the final quarter of 1998. The marginal rate at issue on Treasury bills declined by between 60 and 100 basis points in the case of six- and 18-month bills, respectively, and the related rates on three-, five-, ten- and 15-year bonds fell by around 40 basis points, while the rate on 30-year bonds rose marginally. These reductions have continued in the tenders of medium- and long-term debt in January, while there has been a minimal rise in those relating to Treasury bills. The marginal rate at issue currently stands at around 2.9 % for the various segments of the market for bills, and between 3.2 % and 4.8 % for the 3- and 30-year bonds, respectively. There was a negative net issue both for Treasury bills and for medium- and long-term debt for a total amount of PTA 1,830 billion.

Notable on the primary market for private securities is the differing behaviour between fixed-income and variable-yield issues. On the information available to November, net fixed-income issues resumed the levels of the first half of the year, after having declined in the third quarter. The net issue exceeded PTA 200 billion, this resulting from the issues by the non-financial firms sector (PTA 375 billion) and the negative net issue by the remaining sectors, credit institutions and non-residents. Equity issues held at a similar level to that of the preceding quarter, with net placements of around PTA 40 billion.

The futures and options markets saw a considerable fall in their traded volumes (–20 %) as a result of the heavy decline on futures markets and of the more moderate fall in the volume of trading on the options market. Except for the IBEX35-linked contracts, which held at similar levels to those of the third quarter, the average number of contracts entered into in the period October-December fell sharply.

TABLE 8

Monetary and credit aggregates (a)

	1997				1998			
	Q I	QII	QIII	Q IV	Q I	Q II	Q III	Q IV
MONETARY AGGREGATES:								
ALPF	9.3	9.0	9.3	7.9	7.0	7.3	6.2	6.5
ALP	5.3	4.7	5.5	3.7	3.1	1.8	–0.2	1.0
M3	2.3	2.7	3.1	3.5	3.5	2.7	1.4	1.4
M2	10.8	10.4	11.5	11.0	10.8	10.8	10.1	13.7
M1	12.5	10.9	12.6	12.4	11.4	12.2	10.9	15.5
CREDIT AGGREGATES:								
Financing to general government and households and firms	9.9	10.0	10.6	10.1	10.1	10.1	10.1	11.2
Financing to general government (b)	10.7	10.3	9.0	6.9	5.0	4.0	3.4	2.2
Domestic lending	*4.3*	*2.1*	*1.1*	*–0.3*	*–4.6*	*–6.4*	*–12.0*	*–14.0*
Financing to households and firms (c)	9.4	9.9	11.5	12.1	13.2	13.9	14.2	16.6
Domestic lending	*10.3*	*10.3*	*12.1*	*13.1*	*13.6*	*13.9*	*14.0*	*16.2*
MEMORANDUM ITEM:								
Outright medium-and long-term debt held by the public (d)	2,708	2,548	1,742	1,971	1,804	3,133	4,018	3,111
Mutual funds	7,880	8,397	9,110	8,324	9,196	8,450	6,124	6,714
Securities funds	*5,940*	*7,117*	*8,206*	*7,652*	*9,073*	*9,088*	*7,147*	*8,545*
Money market funds	*1,940*	*1,280*	*904*	*672*	*123*	*–638*	*–1,023*	*–1,831*

Source: Banco de España.

(a) Four-quarter rate of change of end-quarter series, except mutual funds and debt portfolio, which reflect year-on-year changes in billions of pesetas.
(b) Domestic lending plus outright medium- and long-term debt held by the public plus foreign direct financing.
(c) Domestic lending plus commercial paper plus foreign direct lending.

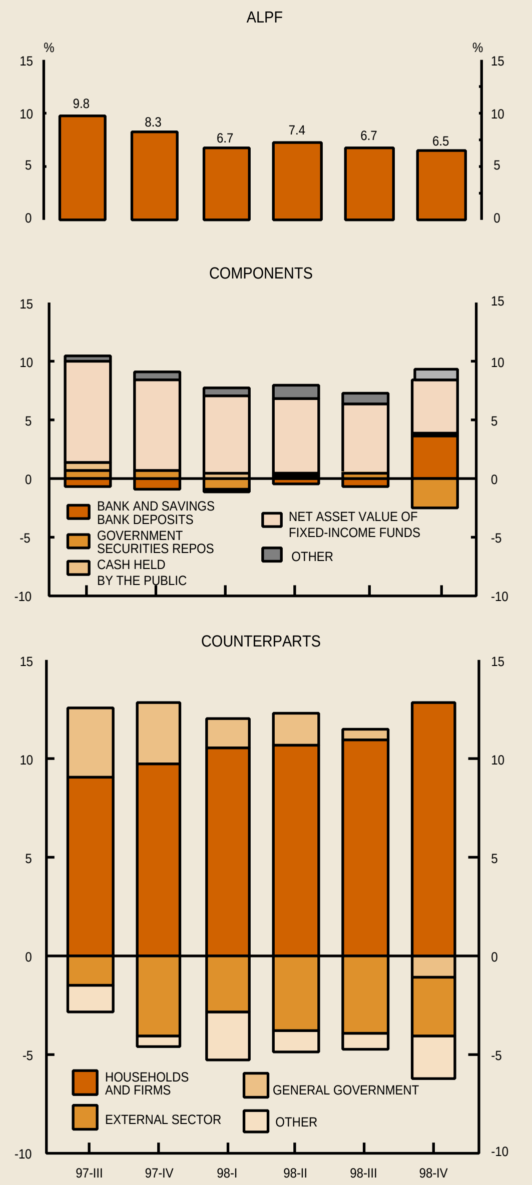
As regards developments on the secondary markets for equity, and following the strong instability and the fall in prices in the previous quarter, interest rate reductions in Europe and the United States were conducive to the recovery of stock prices up to the levels prior to the stock market collapse. This rally came about against a background of some volatility, as a result of profit-taking over the course of the quarter. This has meant that average traded volumes on the secondary markets for equity during the period October-December have held at similar levels to those of the previous quarter, with such levels appreciably down on those of the first half of 1998.

The Madrid Stock Exchange general index, after recording an annual low at the beginning of October, rose by 35 % in this quarter, on a similar trend to that recorded from the beginning of the year (see Chart 26). This rising trend continued during the first week of January, following the start of Monetary Union. Subsequently, however, as a result of the Brazilian crisis, there was a sizeable downward correction in prices. Finally, in the days before this Bulletin went to press, the announcement of the merger between Banco de Santander and Banco Central Hispano prompted an appreciable recovery in price levels.

The downward course of yields on money and government debt markets allowed bank and savings-bank synthetic lending and borrowing rates to resume a falling path, after this process had been slightly checked in the previous quarter (see Chart 27). On the information available to December, the rates on lending operations have undergone cumulative declines during the period of 65 basis points, with a greater fall in operations extended at a fixed rate than those at a floating rate. Rates on borrowing operations underwent a substantially greater reduction than that in the period July-September, with a cumulative fall of 50 basis points. This was the result of a sizeable cut of 145 basis points in the repo rate and a somewhat more moderate cut of 47 basis points in the case of time deposits; the related rates on saving and sight deposits remained unchanged. The fall in the rates both for remunerating liabil-

CHART 29

ALPF growth and contributions
Average quarterly data. Year-on-year growth rates



Source: Banco de España.

ities and for lending operations was slightly greater at banks than at savings banks.

In the last quarter of the year there has been a certain acceleration in the growth rates of both the broad and narrow monetary aggregates compared with previous months. Behind this behaviour, perhaps, is agents' preference to have a portion of their wealth in more liquid positions. Thus, the absence of inflationary pressures, along with the stock market crisis in the summer and the fiscal measures approved by the government (reduction of the tax withholding on deposits and favourable treatment for time deposits at over two years), might be prompting a change in the general public's preferences towards deposits. The growth of time deposits during the quarter, after the decline seen in recent years, and the sustainedly high rate of expansion of sight and savings deposits, appear to confirm these facts. Moreover, the new tax regime for mutual funds (withholdings on account for capital gains and the disappearance of the adjustment coefficients) appears to have affected greatly money market funds. The net asset value of the latter fell significantly in December as a result of redemptions made so as to take advantage of the tax arrangements in force in 1998.

The foregoing developments have meant that the disparity between the greater buoyancy of the narrow monetary aggregates (M1 and M2) and the slow growth of the traditional broad aggregates (M3 and ALP) has persisted during the final quarter of 1998. The aggregate ALPF has behaved similarly to the rest of the monetary aggregates, exhibiting slightly higher year-on-year growth during the quarter than in September. As a result, ALPF has ended 1998 at a rate of 6.5 % year-on-year, a similar rate to that at the start of the year (see Chart 28 and Table 8).

Drawing on provisional information from the CNMV (the Spanish National Securities Market Commission) for December, it is estimated that the net asset value of mutual funds increased by PTA 2,012 billion in the fourth quarter, following their reduction in the period July-September as a result of the stock market crisis. Shares in money market funds fell by PTA 659 billion, owing essentially to redemptions made in December in an attempt to take advantage of the tax benefits available to pooled investment until that month. Once the stock market crisis of the previous quarter was behind, securities funds showed a strong increase in this period. The net asset value increased by PTA 2,670 billion, of which PTA 1,460 billion related to domestic fixed-income funds and the rest to domestic and international equity funds. It is estimated that around 30 % of the growth of the net asset value of these funds is due to the rise in the price of their component instruments during this last quarter.

The ALP aggregate expanded in the period October-December at rates somewhat higher than in the previous quarter. This placed its year-on-year growth rate at 1 % in December; however, that is still two percentage points below the rate posted at the start of the year. Analysis of the ALP components shows that the higher growth rates of the aggregate during the quarter were due to the sizeable growth of bank and savings-bank deposits. The latter exhibited a growth rate of 7.2 % year-on-year in December, five percentage points up on that at the end of the previous quarter.

The type-classification of deposits confirms the foregoing comments. Of note is the considerable moderation of the rates of decline that time deposits had been showing. These fell in December to a year-on-year rate of 5.8 %, compared with the contractions of over 10 % they had been exhibiting since mid-1997. Likewise, sight and savings deposits continued to run at very high annual growth rates, standing at 24.9 % and 11 %, respectively, in December. This has meant that the narrow monetary aggregates remain considerably buoyant, with year-on-year growth rates for M1 and M2 of 15.5 % and 13.7 %, respectively.

As to the remaining ALP components, the behaviour of short-term government securities held by the public was similar to that of the previous quarter. This component thus declined appreciably in the fourth quarter, by an amount of PTA 2,290 billion. This was due to the reduction both in debt repos and in the stock of Treasury bills held by the public, for amounts of PTA 1,942 billion and PTA 348 billion, respectively. Cash held by the public remained, during the quarter, on the slowing path it had shown during the year. As a result, its year-on-year growth in December stood at 0.7 %.

With regard to the counterparts of ALP, the growth rate of domestic credit to households and firms increased in relation to the third quarter, rising to 16.2 % year-on-year in December. That signifies an increase of three percentage points since the start of the year (see Chart 29). These data show that the reductions in interest rates are having a clearly expansionary effect on the demand for credit by households and firms.

On the data available to the third quarter of the year, analysis of credit extended to the private sector according to end-use indicates that both lending earmarked for productive activities, which grew during the quarter by 13 %, and that for consumer finance, which expanded by 23.4%, are sustaining the high growth rates seen in previous quarters. Among productive activities, financing to the construction sector and the services sector has expanded slightly more than that extended to other productive activities. Nonetheless, the credit extended to these sectors showed, in all cases, rates close to or above 10 %. Under consumer finance, the growth of credit for durable goods purchases was, as in the previous quarter, very high (37.3 %), while financing for house purchases and other ends retained the buoyancy it had demonstrated throughout the year.

With respect to credit extended to general government, the period in question saw a fresh deceleration, with the rate of expansion of this variable standing at 2.2 % at the end of 1998. Behind this lay a fresh contraction in financing extended by resident sectors (PTA –2,430 billion), which was offset by an increase of PTA 1,217 billion in financing obtained abroad and by the reduction in the Treasury's deposit at the Banco de España for an amount of PTA 1,365 billion. The favourable trend of credit to the public sector should be seen in the light of the reduction in the budget deficit and, therefore, of the lower borrowing requirements of this sector.

29.1.1999.

Results of non-financial firms in 1997 and in the first three quarters of 1998 (1)

1. INTRODUCTION

This article offers provisional CBA results for 1997 and CBQ results for the first three quarters of 1998. The CBA data confirm, as anticipated by the article on the CBQ for the fourth quarter of 1997 published in the March 1998 *Economic bulletin,* the recovery in activity in the period in question, in contrast to the slowdown detected in 1996 as a whole. This recovery firmed during the first three quarters of 1998, with productive activity holding at a good pace, although it slowed slightly over the year. Healthy investment and consumption demand in the domestic and European market continued to explain the positive trend in activity, despite signs of a decline in sales to third countries. What is most notable from a qualitative point of view, however, given that the firms reporting to the CBQ are large industrial and services firms, is that, for the first time, employment grew at positive rates in the quarterly series in 1998 (in the CBA employment has been growing at positive rates since 1995). These developments explain, to a large extent, the increase in personnel costs in the third quarter of 1998, in relation to the same period of 1997. Compensation per employee, the other item that affects the path of this heading, grew in the same period by more than inflation and at a higher rate than in 1997. However, as explained below, the restructuring processes that affect certain large firms, of singular importance in the total aggregate, continue to have a large impact on the trend. Experience shows that the gradual inclusion of small and medium-sized firms in the 1997 database, up to its closure at end-1999, will give rise to higher employment growth rates and a flattening of the growth in compensation per employee. These rates will be more in line with what really happened, since they will correct, at least partially, the excessive weight that large firms have in the sample.

As a result of the improvement in productive activity, the funds generated by the firms' productive activity (gross operating results or sur-

(1) The data included in this article refer to the firms that have reported to the Central Balance Sheet Office their annual data (CBA survey) to October 31st 1998 and quarterly data (CBQ survey) to November 18th 1998. In all 5,854 firms collaborated in the CBA survey, accounting for 32.5% of the total GVA of all Spanish non-financial firms. Likewise, the 735 firms which on average during the first three quarters reported to the CBQ account for 18.1% of the GVA generated by all non-financial firms. Besides their different periodicity, the CBA and CBQ differ in that the CBA data are received with greater delay but are of greater quality and more detailed than those of the CBQ. Despite these differences, according to the empirical evidence, the profiles of the two series link up fairly closely, so that the CBQ data can be considered a good indication of the main future results of the CBA.

TABLE 1

Profit and loss account. Year-on-year performance
(Growth rates of the same firms on the same period a year earlier/
% of GVA at factor cost in the case of the net result)

		CBA			CBQ			
	Data Bases	1995	1996	1997	QI-IV 95/ QI-IV 94 (a)	QI-IV 96/ QI-IV 95 (a)	QI-IV 97/ QI-IV 96 (a)	QI-III 98/ QI-III 97 (a)
	Number of firms / Total national coverage	8073/36.5 %	7659/36.9 %	5854/32.5 %	726/21.1 %	729/20.6 %	723/19.7 %	735/18.1 %
1.	VALUE OF OUTPUT (including subsidies)	11.9	5.7	9.6	9.6	6.7	8.3	4.7
	Of which:							
	1. Net amount of turnover and other operating income	11.5	6.6	9.4	9.0	7.2	8.1	5.3
2.	INPUTS (including taxes)	14.1	7.3	11.1	11.8	10.0	10.0	4.0
	Of which:							
	1. Net purchases	17.2	6.3	11.2	13.4	10.2	9.7	3.6
	2. Other operating costs	9.7	8.7	10.4	10.3	8.5	9.0	6.2
S.1.	GROSS VALUE ADDED AT FACTOR COST	8.1	2.6	6.8	6.7	2.2	5.8	5.9
3.	Personnel costs	4.0	4.1	3.3	1.7	3.2	2.2	4.2
S.2.	GROSS OPERATING RESULT	13.7	0.7	10.8	12.1	1.3	9.1	7.5
4.	Financial revenue	11.0	4.2	16.3	15.6	13.3	19.4	2.0
5.	Financial costs	–0.6	–13.3	–14.3	–1.5	–11.9	–14.7	–9.6
6.	Corporate income tax	4.6	10.2	23.0	16.9	5.6	19.3	13.1
S.3.	FUNDS GENERATED FROM OPERATIONS	22.7	4.7	17.5	18.8	7.7	16.5	10.0
7.	Depreciation and provisions (b)	3.6	–3.9	16.9	2.5	3.9	4.6	–2.8
S.4.	TOTAL NET RESULT (% of GVA at factor factor cost) (b)	7.4	10.9	15.9	10.6	12.9	19.6	23.6
PROFITABILITY RATIOS								
R.1.	Return on net assets (before taxes) (b)	8.0	8.5	10.4	8.9	8.9	11.0	12.5
R.2.	Interest on borrowed funds/ interest-bearing borrowing	9.0	8.0	6.8	9.0	8.3	7.3	6.2
R.3.	Return on equity (before taxes) (b)	7.1	8.9	12.9	8.8	9.4	13.6	16.4
R.4.	Debt ratio	45.6	42.5	40.8	46.5	42.9	40.7	38.2
R.5.	Financial leverage (before taxes) (R.1 – R.2) (b)	–1.0	0.5	3.6	–0.1	0.6	3.7	6.3

Source: Banco de España.

(a) All the data in this column have been calculated as the arithmetic mean of the quarterly data.

(b) When calculating these items the effect of balance-sheet restatement under Royal Legislative Decree 7/1996 has been removed in order to homogenise the series.

CHART 1

Non-financial firms reporting to the Central Balance Sheet Office (a)

NUMBER OF FIRMS

	1993 (b)	1994 (b)	1995 (b)	1996 (b)	1997 (b)	1998 (c)
CBA	7,336	7,832	8,073	7,659	5,854	
CBQ	696	616	726	729	723	735

% OF GDP OF NON-FINANCIAL FIRMS SECTOR

	1993 (b)	1994 (b)	1995 (b)	1996 (b)	1997 (b)	1998 (c)
CBA	32.6	34.7	36.5	36.9	32.5	
CBQ	18.9	18.4	21.1	20.6	19.7	18.1

NUMBER OF FIRMS

	1993 (b)	1994 (b)	1995 (b)	1996 (b)	1997 (b)	1998 (c)
CBA	7,336	7,832	8,073	7,659	5,854	
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	1993 (b)	1994 (b)	1995 (b)	1996 (b)	1997 (b)	1998 (c)
CBA	32.6	34.7	36.5	36.9	32.5	
CBQ	18.9	18.4	21.1	20.6	19.7	18.1

CBA data
CBQ data

CBA data
CBQ data

Source: Banco de España.

(a) Information available to November 18th 1998 (CBA and CBQ).
(b) The 1993, 1994, 1995, 1996 and 1997 data are based on information from the firms included in the annual survey (CBA) and the average of the four quarters of each year in relation to the previous year (CBQ).
(c) Average of the four quarters of 1998 in relation to the same period in 1997.

plus) increased in 1997, as did the net income and receipts generated by the other items of the profit and loss account (see Box 3). This situation was sustained, with some moderation, throughout the first nine months of 1998, but it should be noted that this is in comparison with the first nine months of 1997, when there was a sharp recovery, and that it coincides with a scenario of stable prices. The decline in financial costs (which have been falling since 1995), stemming mainly from the favourable trend in interest rates, is still one of the main reasons for the change in the balances obtained after the operating surplus. The ultimate consequence of the above-mentioned trend was an across-the-board increase in the profitability of the firms in the periods analysed and, in the third quarter of 1998, new all-time highs for the financial leverage ratio (which measures the combined effect of the return on assets and the cost of financing liabilities).

Finally, as usual, the 1997 data included in this article summarise those published in the monograph *Banco de España. Central de Balances. Resultados anuales de las empresas no financieras, 1997* of November 1998. This publication includes an extensive methodological note, business analysis tables (Chapter II), general economic analysis tables (Chapter III) and other special Central Balance Sheet Office (2) analyses. The current edition has two new features: a) the tables in Chapter III.B, which are a first approximation to the combined accounts and balance sheets of the non-financial firm sector as a whole for the period 1994-1996, an extrapolation as part of the preparation of the financial accounts under the European System of Accounts (ESA 95), and which, although at a preliminary stage, is a new statistical source, and b) publication of the said monograph on CD-ROM, as well as in the traditional form. The CD-ROM also includes: 1) more details than in the conventional edition on aggregates, by sector, ownership status and size; 2) tools to facilitate analysis of the data and, finally, 3) two benefits exclusively for the reporting firms (1998 electronic questionnaire and an individual comparative study with the sector aggregates) (3).

(2) These include those carried out in collaboration with other European central balance sheet offices (the Bach project) and with the Spanish Mercantile Registries. The latter have enabled a data base consisting of a large number of small firms to be created (see Box 1).

(3) During 1998 software enabling the annual questionnaire to be completed on diskette (the "electronic questionnaire") was made available to large firms. Of the firms invited to collaborate in this way 50 % have done so, thereby obtaining the benefits of validation of the data included on the diskette and the reduction to a minimum of revisions after the completed questionnaire has been sent to the central balance sheet office.

2. ACTIVITY

The data of the firms reporting to the CBA confirmed the recovery in activity in 1997, as anticipated by the CBQ. In 1996 a slowdown in output growth was detected. This affected gross value added (GVA) which, in the case of the firms considered grew by 2.6 %, mainly as a consequence of the low activity of the first half of that year. In 1997, the recovery in private consumption, especially domestic, led to growth in productive activity of 6.8 % (see Table 1 and Chart 1), a trend confirmed by the growth detected in purchases and sales in 1997. It was felt particularly intensely in purchases and sales in Spain, which grew significantly more briskly than in 1996. In the first nine months of 1998 productive activity continued to trend very positively; GVA rose by 5.8 %, according to the CBQ, as against 6.8 % in 1997, according to the CBA (very similar rates if the downward bias of the CBQ, evident in Table 1, is taken into account). If the data of the electricity sector, whose value added is affected – as mentioned in previous quarterly articles – by changes stemming from tariff reductions and more expensive inputs as a result of decisions relating to national coal consumption, are excluded, GVA grew by 8.8 % in the first three quarters of 1998, against 9.2 % in 1997. In any event, productive activity in all the firms continued to grow at a strong rate in 1998 consolidating the 1997 trend. This outturn is based on the healthy behaviour of domestic demand and can be expected to continue in the near future to the extent that the financial disturbances of recent months continue to die down or, at least, do not worsen.

By sector of activity (Table 2.a), growth in 1997 is seen to have been across-the-board, with the exception of the electricity sector. In 1998, however, the growth of GVA in the distributive sector stands out (12.2 %, as against 8.8 % in 1997), the best evidence of the vigour of the expansion in the domestic demand for consumer goods. In the rest of the sectors, with the exception of electricity – whose peculiar course over recent months has been referred to above – GVA continued to grow at high rates, albeit below those of 1997.

The manufacturing industry (see Box 2) was affected in the third quarter of 1998 by the lesser buoyancy in the market for capital goods as well as by the fall in industrial prices (in intermediate goods and equipment). The transport and communications sector also grew at slightly more moderate rates than in 1997, when its GVA grew by 8.7 %, a higher rate than in the first three quarters of 1998 (when it reached 6 %). Meanwhile, there is some evidence of the effects on the sample non-financial firms, of the crisis in some international economies during 1998

BOX 1

Results of small firms

As in the January 1998 Economic Bulletin, coinciding with the release of the 1997 Central Balance Sheet Office annual monograph, this box analyses the chapter on the performance and results of firms with less than 50 workers (small firms, according to the European definition), which summarises the information contained in the Central Balance Sheet Office data base of data obtained from Mercantile Registries (CBBE/RM). Although this data base lacks the detail of the annual (CBA) data base, it does enable valid conclusions to be drawn regarding trends in the main magnitudes of the aggregate profit and loss account, and certain details of the balance sheets, due to the significant number of firms it includes. As at the date of this article, it includes data on 172,053 firms for 1996 (covering 10.5 % of the GVA of all non-financial firms), and 46,559 for 1997 (which represent 2.7 % of said GVA) (1). The CBB data display similar profiles to the CBA and CBQ data, although with steeper slopes in the paths of its main aggregate variables (see charts).

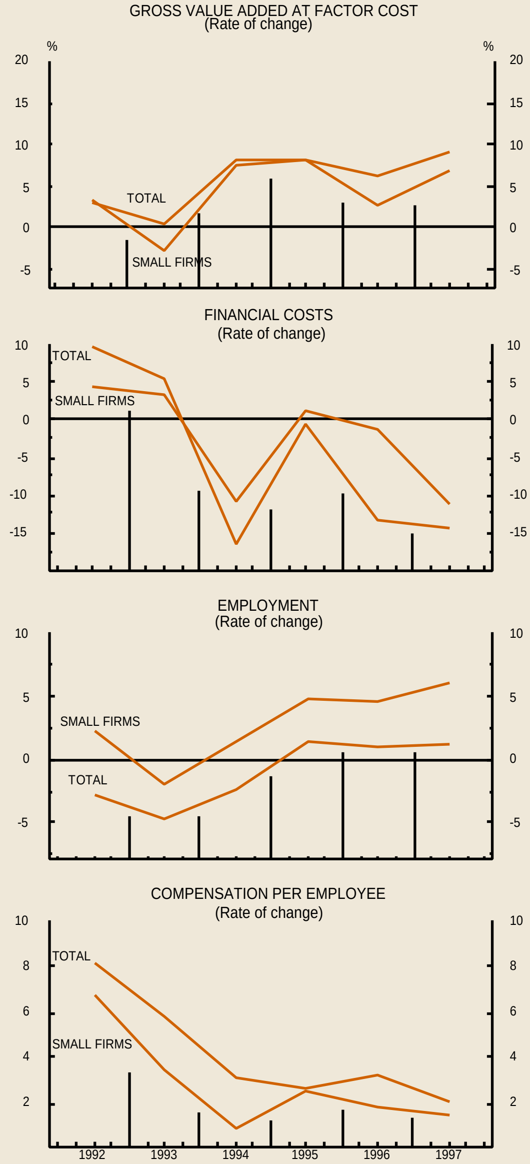
In 1997, the aggregate GVA of the firms grew in nominal terms by 9.1 %, as against 6.4 % in 1996. The expansionary path of output seen in 1994 and in 1995 was thus resumed. By major groups of activity the increase was across-the-board, although in the retail and hotel and catering sectors the rates in 1997 were similar to those of the previous year, as a consequence of the high level of activity recorded in 1996 (in fact, these were the only sectors to increase their level of activity in 1996).

If employment is analysed (2), it can be seen that for the fourth year running there was a net increase in average staffing levels, the increase being larger in 1997 than in previous years. By sector, the firms in the manufacturing, construction and hotel and catering industries were those which, in comparison with the previous year, increased the rate of generation of employment. Average wages and salaries, in line with the decline in inflation, grew by 1.7 %, against 2.2 % in 1996. By sector, it was precisely in those sectors in which the increases in staffing were largest, that the lowest rates of growth in average wages were recorded. Hiring (and, consequently, the change in the ratio of temporary to total employment) had a significant impact on the containment of average personnel costs.

Despite the increase in personnel costs (8.3 %), the gross operating result, or gross surplus, grew at a much higher rate than in 1996 (11.2 %, against 3.7 %), clearly manifesting the recovery in productive activity mentioned above. The successive reductions in interest rates in 1997 were reflected in the financial costs of firms, which fell by somewhat more than 11 %, permitting the funds generated by the firms to grow by 18 %. Finally, as a consequence of this behaviour in these variables, the net result obtained, in percentage terms, reached 10.5 % of GVA (the highest percentage in the whole CBB series), and the profitability ratios rose sharply. The return on equity (R.3) (the only profitability ratio whose definition is comparable to the CBA ratios) grew by somewhat more than two percentage points in 1997, from 8.8 % in 1996 to 11.1 % in 1997, with growth across all the major activity and size groupings.

It was thus confirmed that the performance of this particularly high number of small firms displays similar profiles to those deduced from the two alternative data bases. In 1997, this involved positive trends for activity and margins. The increases in employment, and especially in profitability, have also firmed, providing an additional confirmation of the current good health of the firms and, in short, of the Spanish economy.

(1) Nonetheless, its coverage in the national sphere (small firms) is very high, reaching 30.3 % in 1996.
(2) This heading has been studied only on the basis of those firms that submit consistent information on the number of workers and personnel costs (22,612 firms in the case of 1997).



NUMBER OF FIRMS (a)

CBA	7,176	7,336	7,832	8,073	7,659	5,854	
CBQ	5,929	30,091	49,481	129,320	172,053	46,559	(b)

% OF GDP OF NON-FINANCIAL FIRMS SECTOR

CBA	31.8	32.6	34.7	36.5	36.9	32.5	
CBQ	0.4	2.0	3.4	7.8	10.5	2.7	(b)

CBA data
CBB (CBBE/RM) data
Firms with less than 50 employees

Source: Banco de España.

(a) Data available to November 18th 1998 (CBA and CBB).
(b) In the case of the Employment and Compensation per employee charts, the data correspond to the sub-group of firms reporting consistent employment data (50 %-60 % of the CBB total).

TABLE 2.a

Value added, employees, personnel costs and compensation per employee
Breakdown by size, ownership status and main activity of firms
(Growth rates of the same firms on the same period a year earlier)

	Gross value added at factor cost				Employees (average for period)				Personnel costs				Compensation per employee			
	CBA		CBQ		CBA		CBQ		CBA		CBQ		CBA		CBQ	
	1996	1997	QI-IV 97 (a)	QI-III 98 (a)	1996	1997	QI-IV 97 (a)	QI-III 98 (a)	1996	1997	QI-IV 97 (a)	QI-III 98 (a)	1996	1997	QI-IV 97 (a)	QI-III 98 (a)
Total	**2.6**	**6.8**	**5.8**	**5.9**	**0.9**	**1.2**	**–0.6**	**0.9**	**4.1**	**3.3**	**2.2**	**4.2**	**3.2**	**2.1**	**2.9**	**3.2**
Total, except electricity sector	**2.0**	**9.2**	**9.1**	**8.8**	**1.2**	**1.3**	**–0.4**	**1.5**	**4.3**	**3.6**	**2.5**	**4.4**	**3.1**	**2.3**	**3.0**	**3.2**
SIZE:																
Small	4.5	7.8	—	—	1.9	3.5	—	—	5.1	6.3	—	—	3.1	2.7	—	—
Medium	3.4	9.7	7.5	7.8	2.2	3.4	0.2	3.0	5.1	6.1	4.1	7.6	2.8	2.6	3.9	4.5
Large	2.4	6.4	5.6	5.6	0.6	0.7	–0.8	0.5	3.9	2.8	1.9	3.5	3.3	2.1	2.7	3.1
STATUS:																
Public-sector	0.2	–0.4	–0.1	7.4	–2.8	–3.7	–2.9	0.6	2.7	–0.5	–1.4	4.6	5.7	3.3	1.5	4.0
Private-sector	3.9	8.8	8.2	5.7	2.3	2.5	0.4	1.0	4.8	4.5	3.9	4.1	2.4	2.0	3.5	3.0
BREAKDOWN OF ACTIVITIES BEST REPRESENTED IN THE SAMPLE:																
Manufacturing industries	–1.1	11.4	14.1	10.3	–0.8	0.7	0.7	1.8	3.7	3.9	2.9	5.3	4.5	3.1	2.3	3.4
Production and distribution of electricity, gas and water	6.0	–4.6	–4.3	–3.2	–4.1	–1.6	–2.8	–4.6	1.8	–0.6	–0.2	0.4	6.1	1.1	2.7	5.3
Distributive trade	5.7	8.8	8.3	12.2	5.4	2.6	0.1	3.3	7.4	4.5	2.8	6.1	1.9	1.9	2.7	2.7
Transport, storage and communications	3.1	8.7	6.5	6.0	–1.6	–1.6	–2.4	–1.6	3.0	1.9	1.5	2.4	4.7	3.6	4.0	4.1

Source: Banco de España.
(a) All the data in these columns have been calculated as the arithmetic mean of the quarterly data.

TABLE 2.b

Employment and personnel costs
Detail according to changes in staff levels

	Total CBQ firms QI-III 1998	Firms inceasing (or not changing) staff levels	Firms reducing staff levels
Number of firms	**735**	**442**	**294**
Personnel costs			
Initial situation QI-III 1997 (billions of pesetas)	2,208.7	867.2	1,343.6
Rate QI-III 98 / QI-III 97	4.2	9.6	0.6
Average compensation			
Initial situation QI-III 1997 (thousands of pesetas)	4,236.5	3,809.5	4,574.7
Rate QI-III 98 / QI-III 97	3.2	1.6	5.4
Number of employees			
Initial situation QI-III 1997 (thousands)	521	228	294
Rate QI-III 98 / QI-III 97	0.9	7.9	–4.6
Permanent			
Initial situation QI-III 1997 (thousands)	*461*	*186*	*275*
Rate QI-III 98 / QI-III 97	*–0.2*	*4.9*	*–3.7*
Non-permanent			
Initial situation QI-III 1997 (thousands)	*60*	*41*	*19*
Rate QI-III 98 / QI-III 97	*9.3*	*21.2*	*–18.6*

Source: Banco de España.

(Table 3 shows the fall in the percentage of sales and purchases to/from countries outside the EU).

When analysing the information contained in Chart 2, which classifies the firms according to the growth in their GVA, the existence of a slight moderation in the growth of productive activity in 1998, compared with 1997, is confirmed. Thus, the GVA of 68.7 % of the firms rose in the third quarter of 1997, as against 67.5 % of firms in the same quarter of 1998. This circumstance is more clearly illustrated by the percentage of firms with increases in GVA of more than 20 %; while in the third quarter of 1997 35.6 % of the firms came within this bracket, in the same period of 1998 the percentage fell to 31.5 %.

3. PERSONNEL COSTS, EMPLOYMENT AND COMPENSATION PER EMPLOYEE (4)

Since 1995, employment in firms reporting to the CBA has trended positively. Unlike in the

(4) The employment data, which do not appear in the accounts, are edited firm by firm and compared with the personnel costs of the quarter, with the data of previous quarters and with the data declared by the firms themselves in the annual survey to ensure consistency, insofar as this is possible

TABLE 3

Purchases and turnover of firms reporting data on purchasing sources and sales destinations

	CBA		CBQ	
	1996	1997	QI-IV 97/QI-IV 96 (a)	QI-III 98/IQI-III 97 (a)
Total firms	**7,659**	**5,854**	**723**	**735**
Firms reporting source/destination	7,659	5,854	679	691
	%	%	%	%
Net purchases	**100.0**	**100.0**	**100.0**	**100.0**
SOURCE OF PURCHASES:				
Spain	65.9	64.5	62.7	66.4
Total abroad	34.1	35.5	37.3	33.6
EU countries	*22.7*	*23.0*	*20.1*	*25.5*
Third countries	*11.4*	*12.5*	*17.2*	*8.1*
Net turnover	**100.0**	**100.0**	**100.0**	**100.0**
SALES DESTINATIONS:				
Spain	80.1	80.0	85.5	85.1
Total abroad	19.9	20.0	14.5	14.9
EU countries	*14.7*	*15.0*	*9.9*	*11.3*
Third countries	*5.2*	*5.0*	*4.6*	*3.6*

Source: Banco de España

(a) All the data in these columns have been calculated as the arithmetic mean of the relevant quarters, including the figure for the total number of firms.

case of the other variables, this development was not anticipated by the CBQ. As already mentioned on many occasions, the firms of the latter data base are large, industrial and services firms and, in certain important cases, still involved in staff restructuring processes. Precisely for this reason, the employment creation detected in the CBQ in the first three quarters of 1998 is especially significant. In 1997 as a whole, for the third year running the CBA data show a net increase in employment, of 1.2 %, stemming mainly from temporary employment, which grew by almost 4 % in 1997, as against a 0.6 % rise in permanent employment. The average increase in average staff levels was greater in medium and small firms than in large firms (5). Hence the relevance of the CBQ data for the first three quarters of 1998, showing a net increase in employment of 0.9 %, with respect to the same period a year earlier. As in the first three quarters of 1997, this increase was largely in temporary employment, which grew by 9.3 %, while permanent employment continued to grow at a negative rate, of –0.2 %. As regards sectors, the rises in employment in the distributive trade, with increases of 2.6 % in 1997 and 3.3 % to the third quarter of 1998, and in manufacturing, which increased its employment by 0.7 % in 1997 and by 1.8 % in the first nine months of 1998, stand out. These are also precisely the two sectors that recorded the fastest growth of GVA. The “electricity, water and gas production sector” and the “transport, storage and communications sector”, both in the midst of deregulation, continue to record falls in average employment, owing to the labour restructuring associated with these changes.

These employment developments partly explain the changes in personnel costs which, in 1997, grew at a rate of 3.3 % (see Table 1), significantly more slowly than in 1996 (4.1 %). This trend was not sustained over the first nine months of 1998, when personnel costs grew by 4.2 %, as a result of the increase in employment mentioned above, and the slight upturn in average compensation. In 1997, average compensation moderated significantly with respect to the previous year, growing by 2.1 %, against

(5) For the presentation of the 1997 annual results, the criteria for categorising firms by size (small, medium and large) have been revised, to adapt them to EC Recommendation 96/280/EC, with the nuances and results highlighted in Box 1 *(recuadro 1)* of the annual monograph. The same size-classification criteria have been used for this article (the basic criterion used is employment: small firms, less than 50 employees; medium, between 50 and 250; large, more than 250).

TABLE 4

Personnel costs, employees and average compensation
% of firms in specific situations

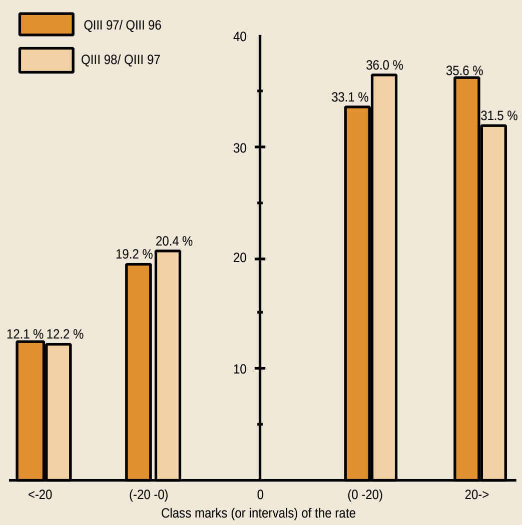
	CBA			CBQ		
	1995	1996	1997	QI-IV 96 (a)	QI-IV 97 (a)	QIII 98
Number of firms	**8,073**	**7,659**	**5,854**	**729**	**723**	**567**
Personnel costs	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Falling	24.5	26.2	24.1	31.5	30.8	26.1
Constant or rising	75.5	73.8	75.9	68.5	69.2	73.9
Average number of employees	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Falling	31.4	32.7	28.4	54.0	49.8	39.9
Constant or rising	68.6	67.3	71.6	46.0	50.2	60.1
Average compensation (relative to inflation) (b)	**100.0**	**100.0**	**100,.**	**100.0**	**100,.0**	**100.0**
Lower growth	51.3	48.3	43.5	43.7	40.6	39.1
Higher or same growth	48.7	51.7	56.5	56.3	59.4	60.9

Source: Banco de España.
(a) Arithmetic mean of the four quarters.
(b) Twelve-month percentage change in the CPI.

3.2 % in 1996. In the first nine months of 1998, as anticipated above, compensation per employee grew by 3.2 %. This meant that the differential with respect to the inflation rate, which had practically disappeared in 1997, widened again. Nonetheless, as two samples of firms with different characteristics are being compared, it is likely that the rate recorded by the CBQ for 1998 will be revised downwards when the annual CBA data become available, owing to the incorporation of small and medium firms.

CHART 2

Distribution of firms by rate of change in GVA at factor cost (QIII 98/QIII 97, QIII 97/QIII 96) (CBQ)



Source: Banco de España.

Table 2.b, which gives figures for the firms that have generated employment and for those which have reduced their staff, seems to confirm this observation. It can be seen that the 442 firms which, in the third quarter of 1998, increased or did not change their average staff levels, recorded a well-below-average rise in average compensation of 1.6 %, the same as the rate of inflation to September 1998. This can be explained basically by the lower cost of the newly hired workers, on whom the impact of wage moderation is greatest. By contrast, the 294 firms which reduced their average employment levels, recorded a rise in average compensation of 5.4 %, basically owing to the costs associated with dismissals. If we consider all the firms reporting to the CBQ, the type of employment responsible for the rise in total employment continues to be temporary employment, although it is notable that, in the firms with net increases in employment, the permanent staff have grown by almost 5 %. As regards sectors, the conclusions are similar to those already stated. In the third quarter of 1998 the employment-creating sectors (especially the distributive trade) recorded more moderate rates of growth of average compensation. By contrast, in those sectors in which jobs continued to be lost, well-above-average increases in compensation per employee continued to be recorded, owing to the additional costs associated with staff restructuring.

BOX 2

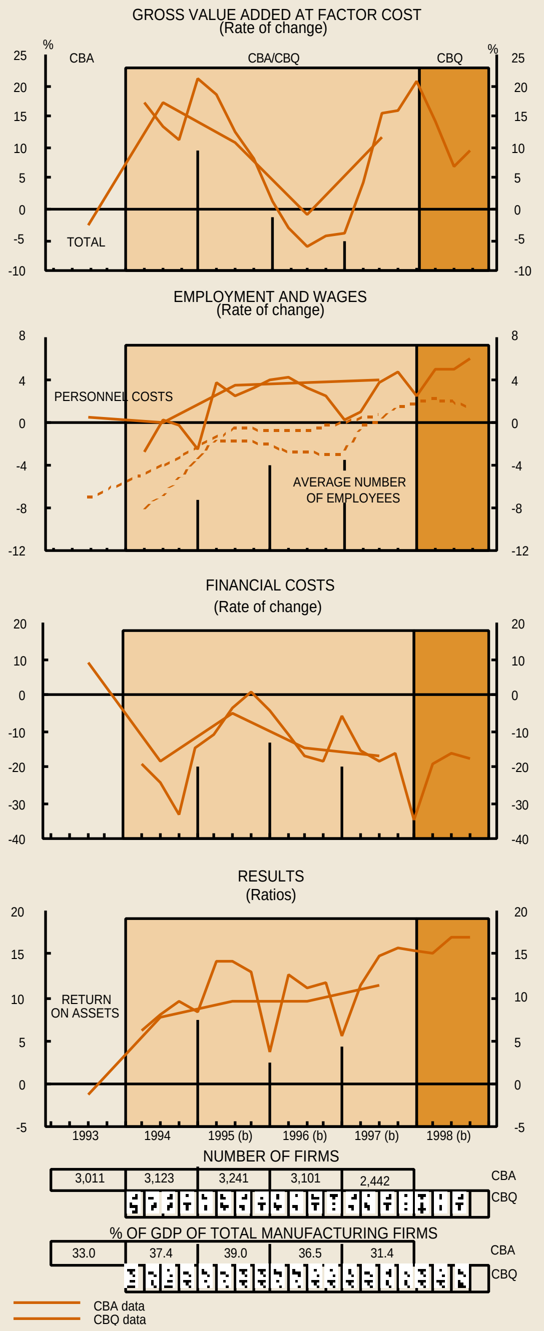
Performance of the manufacturing firms which report to the Central Balance Sheet Office

The importance and representativeness of manufacturing industry, both in the CBA and in the CBQ, justify its now customary separate treatment in this box. Activity in the manufacturing sector recovered strongly in 1997, as reflected in the substantial increase in its GVA (11.4 %), which in 1996 fell by –1.1 %. As already mentioned throughout this article, this spectacular change was caused by the improvement in domestic consumption and capital investment, the effects of which were felt throughout the manufacturing sector, but especially in oil refining, helped by the fall in crude oil prices, and in transport materials, where the Prever Plan prompted a strong increase in demand. In 1998, the quarterly data show that significant levels of activity were sustained, although slightly below those of 1997, with a certain moderation in growth. Notable for their growth in the latter period, at rates well above the average for the manufacturing sector as a whole, were oil refining, transport materials and electrical, electronic and optical material and equipment.

Personnel costs rose by 5.3 % in the first three quarters of 1998, as against 3.9 cent in 1997 as a whole. This is compatible with growth in employment and average compensation stabilising at above 3 % in the two periods analysed, i.e. between one and one-and-a-half percentage points above inflation. In the first nine months of 1998 average staffing levels rose in the different groupings which make up the sector, especially in the electrical, electronic and optical material and equipment industry, and in the glass, ceramic and metal conversion industries.

The recovery in business activity in 1997 bolstered the growth in the gross operating result, which rose by 23.5 % in 1997 and firmed in 1998, when the surplus continued to grow at a good rate (17.3 %). As in the case of the firms reporting to the CBQ as a whole, financial costs continued to fall, leading to a spectacular increase in funds generated in 1997 (28.5 %) and in the first three quarters of 1998 (16.8 %). In this setting, the good expectations and slight reduction in depreciation and provisions have enabled growing profitability ratios to be generated (the return on net assets reached 11.5 % in 1997 and 16.4 % in the first nine months of 1998). This, together with the reduction in the cost of borrowing, has produced the highest financial leverage recorded in the whole series. Once more, the healthy economic and financial position of the sector, and its excellent condition to take full advantage of the opening up of increasingly globalised and competitive markets, is clearly apparent.

Performance of the manufacturing firms which report to the Central Balance Sheet Office (a)



Source: Banco de España.

(a) Information available to November 18th 1998 (CBA and CBQ).

(b) The CBQ data are growth rates on the same quarter of the previous year.

TABLE 5

Gross operating result, funds generated, return on assets and leverage
Breakdown by size, ownership status and main activity of firms
(Ratio and growth rates of the same firms on the same period a year earlier)

	Gross operating result				Funds generated				Return on assets (R.1) (a)				Leverage (a)			
	CBA		CBQ		CBA		CBQ		CBA		CBQ		CBA		CBQ	
	1996	1997	QI-V 97 (b)	QI-III 98 (b)	1996	1997	QI-IV 97 (b)	QI-III 98 (b)	1996	1997	QI-IV 97 (b)	QI- III 98 (b)	1996	1997	QI-IV 97 (b)	QI- III 98 (b)
Total	**0.7**	**10.8**	**9.1**	**7.5**	**4.7**	**17.5**	**16.5**	**10.0**	**8.5**	**10.4**	**11.0**	**12.5**	**0.5**	**3.6**	**3.7**	**6.3**
Total, except electricity sector	**–1.4**	**17.6**	**17.1**	**13.9**	**2.5**	**23.8**	**22.4**	**14.1**	**8.0**	**10.5**	**10.8**	**12.6**	**–0.2**	**3.4**	**3.4**	**6.3**
SIZE:																
Small	3.6	10.2	—	—	5.3	16.3	—	—	12.8	13.5	—	—	1.7	4.7	—	—
Medium	0.8	15.4	12.3	8.5	7.1	20.3	15.1	11.5	11.6	13.8	11.0	11.9	2.3	6.5	3.8	6.0
Large	0.6	10.4	8.8	7.4	4.4	17.2	16.7	9.8	8.0	10.0	11.0	12.6	0.2	3.3	3.7	6.4
STATUS:																
Public-sector	–2.1	–0.2	2.0	15.5	7.5	7.3	10.5	75.5(c)	5.5	5.6	8.0	5.6	–2.1	–0.8	1.5	0.4
Private-sector	2.7	13.6	11.7	6.9	2.9	19.6	18.6	7.5	11.3	12.7	12.3	13.8	2.8	5.7	4.7	7.5
BREAKDOWN OF ACTIVITIES BEST REPRESENTED IN THE SAMPLE:																
Manufacturing industries	–8.1	23.5	33.1	17.3	–5.7	28.5	47.3	16.8	9.7	11.5	14.3	16.4	1.5	4.7	7.6	11.1
Production and distribution of electricity, gas and water	7.4	–5.9	–5.5	–4.2	12.3	0.2	5.5	–2.2	10.2	10.0	11.4	12.4	2.9	4.2	4.4	6.4
Distributive trade	3.2	15.3	18.1	20.9	6.5	15.4	15.6	24.2	13.5	14.5	11.7	13.8	4.8	8.0	4.8	7.4
Transport, storage and communications	3.2	14.5	10.3	8.6	9.4	21.4	14.5	14.0	6.0	8.3	9.4	10.4	–2.7	0.4	1.5	3.4

Source: Banco de España.

(a) When calculating the data in these columns the effect of the balance-sheet restatement under Royal Legislative Decree 7/1996 has been removed in order to homogenise the series.
(b) All the data in these columns have been calculated as the arithmetic mean of the quarterly data.
(c) Meaningless rate.

Finally, Table 4, in which all the firms in the sample are given the same weight, shows that the percentage of firms which created employment in the third quarter of 1998 rose by 10 percentage points (to 60.1 %) from the same period of 1997 (50.2 %). CBA data, likewise, show a significant increase in the number of firms creating employment, to 71.6 % of the sample in 1997. This percentage is notably higher than that in the sample used by the CBQ, owing to the inclusion of small and medium firms not included in the quarterly sample. Table 4 also reveals the rigidity of average compensation in the third quarter of 1998; the percentage of firms recording in that period growth in average compensation at rates equal to or higher than inflation held at around 60 %, similar to the 1997 CBQ figure.

4. RESULTS, MARGINS AND PROFITABILITY

According to the CBA, the recovery in activity in 1997, together with the greater moderation in personnel costs, enabled the gross operating result, or surplus, to grow by 10.8 % (see Table 5), a significantly higher rate than in 1996 (0.7 %). If the continuing positive trend in financial expenses (down 14.3 %) is also taken into account, then this explains the 17.5 % increase in funds generated from operations (a return to the double-digit growth in the annual sample of 1994 and 1995). As already made clear above, productive activity held at a good pace in 1998 (although it was more moderate than in 1997). This, in combination with the slight upturn in personnel costs led to a reduction in the growth in the gross operating result to 7.5 %, three per-

BOX 3

Structure of the profit and loss account

The CBQ quarterly questionnaire is made up of 23 different profit and loss account captions, compared with the 94 requested in the annual questionnaire (CBA). A summary presentation of the profit and loss account, like that in Table 1, is appropriate for this article, due to the differences in detail of the information and the need to link the two sources. The object of this box is to show, by presenting the structure of the profit and loss account that, for the 5,854 firms which had, at the time of writing, responded to the CBA, the weight in this account of the captions which have been omitted (those preceded by the letters a, b, c and d) in order to enable this link to be made is not significant, and that in no case does their absence preclude or distort the analysis and comparisons made.

Although full details of these captions can be found in the Central Balance Sheet Office annual monograph, it is perhaps worth detailing the contents of two of them here. The first is caption "c. Other income included in funds generated", which basically comprises extraordinary results, capitalised interest and other revaluations, and ordinary provisions for liabilities and charges. The other is caption "d. Other income not included in funds generated", which includes capital gains and losses, income and expenses relating to other years and deferred results.

Structure of the profit and loss account

		Number of firms / Total national coverage	**5854/32.5 %**
		YEAR	1997
1.	VALUE OF OUTPUT (including subsidies)		100.0
	1.	Net amount of turnover and other operating income	119.6
	a.	Other items	–19.6
2.	INPUTS (including taxes)		66.3
	1.	Net purchases	43.1
	2.	Other operating costs	22.3
	b.	Other items	0.9
S.1.	GROSS VALUE ADDED AT FACTOR COST (1 – 2)		33.7
	3.	Personnel costs	17.5
S.2.	GROSS OPERATING RESULT (S.1. – 3)		16.2
	4.	Financial revenue	2.5
	5.	Financial costs	3.4
	6.	Corporate income tax	1.7
	c.	Other income included in funds generated	0.1
S.3.	FUNDS GENERATED FROM OPERATIONS (S.2. + 4 – 5 – 6 + c)		13.6
	7.	Depreciation and provisions	11.2
	d.	Other income not included in funds generated	2.9
S.4.	TOTAL NET RESULT (S.3. – 7 + d)		5.3
	e.	Proposed distribution of dividends	3.1
	f.	Retained earnings	2.2
Memorandum item:			
S.5.	SELF-FINANCING (S.3. – e = f + 7 – d)		10.5

TABLE 6

Structure of reporting firms' returns on net assets and on equity

	CBQ			
	Return on net assets (R.1)		Return on equity (R.3)	
	QIII 97	QIII 98	QIII 97	QIII 98
Total firms	**100**	**100**	**100**	**100**
R ≤ 0 %	17.5	18.9	24.4	23.6
0 % < R ≤ 5 %	19.4	13.4	13.2	9.2
5 % < R ≤ 10 %	15.8	13.8	9.6	10.2
10 % < R ≤ 15 %	12.4	13.1	10.1	7.4
15 % < R	34.9	40.9	42.8	49.6
Number of firms	**711**	**567**	**711**	**567**
MEMORANDUM ITEM:				
Average return	12.8	13.0	16.7	17.3

Source: Banco de España.

centage points less than in 1997. Financial costs sustained their downward path in 1998, at a rate of –9.6 %. This was less than the previous year's fall, given the current levels and the recourse to foreign borrowing. Specifically:

	I-III 98/I-III 97
Change in financial costs	–9.6 %
A. Interest on borrowed funds	–10.3 %
A.1. Due to the cost (interest rate)	–17.8 %
A.2. Due to the amount of interest-bearing debt	7.5 %
B. Commissions and cash discounts	0.7 %

This analysis implies that the reduction in financial costs has been due to the fact that the successive reductions in interest rates have been passed through to the cost of debt. It also shows that the sample firms, having spent several years reducing their debts and relying on the self-financing generated by their productive activity, are now increasing their recourse to external sources of finance, taking advantage of the low interest rates. The level of capitalisation achieved by the large domestic firms (as a result of the high self-financing generated) has enabled them to finance their investment through borrowing without increasing their debt ratios, because their own funds have increased – through retained earnings – to a greater extent.

As explained above, the reduction in financial costs enabled funds generated from operations to rise by 17.5 % in 1997 and by 9.6 % in the first three quarters of 1998. Finally, "depreciation and provisions" fell slightly in the first nine months of 1998, basically as a result of depreciation. In contrast to its growth in 1997 (in the form of transfers to provisions for restructuring, coverage of the risk of losses in subsidiaries, etc.), depreciation fell as a consequence of the extension of the useful life of certain assets of the electricity sector. A net result of 23.6 % of GVA was thus achieved, significantly higher than in 1997(15.9 %).

The returns on net assets and on equity were both on a rising trend, in 1997 and in the first three quarters of 1998, in comparison with the preceding periods, reaching 12.5 % and 16.4 % in 1998, respectively. At the same time, the cost of debt has been falling continuously since 1990, reaching the historic low of 6.2 % in the first nine months of 1998. The result was a clearly positive financial leverage both in 1997(3.6) and 1998 (6.3). Positive leverage values were obtained across all of the sectors, especially in manufacturing and in the distributive trade, sectors that reflected the recovery and firming of business activity in 1997 and in the first nine months of 1998 particularly strongly.

Lastly, if the percentage of firms which, irrespective of their size, have seen the largest increases in their profitability is analysed on the basis of Table 6, it can be seen that there has been a gradual shift to higher levels of profitability. It is true that the comparison of the third quarters of 1997 and 1998 shows a stabilisation in the number of firms posting positive profits. Yet a significant increase is seen in the number

TABLE 7

Capital and financial flows
(Structure: GVA at market prices = 100)

	Structure		
Data Bases	1995	1996	1997
Number of firms / Total national coverage	8073/36.5 %	7659/36.9 %	5854/32.5 %
Year	1995	1996	1997
1. Capital resources	32.7	30.5	29.8
1. Gross saving	25.7	26.4	28.4
2. Net capital transfersl	6.9	4.1	1.4
2.1. Uses of capital	27.2	24.9	25.0
1. Gross capital formation	24.7	22.6	23.3
1. Gross fixed capital formation	19.1	20.2	20.3
2. Change in stocks	5.6	2.4	3.1
2. Other uses of capital	2.5	2.3	1.7
2.2. Uses of capital: sale of nuclear moratorium rights	…	–5.7	…
3. Financing capacity (+), Borrowing requirements (–) (1 – 2.1 – 2.2 = –4)	5.5	11.3	4.8
4. Net change in liabilities minus net change in assets	–5.5	–11.3	–4.8
1. Securities other than equity	–4.1	–1.8	–2.3
2. Equity capital	–0.7	–2.7	2.7
3. Credit from credit institutions	2.0	–7.2	3.2
4. Credit from abroad	–0.0	–2.3	–0.3
5. Trade credit and credit between other resident sectors	–0.8	0.7	–0.9
6. Pension funds	0.0	1.0	0.7
7. Other liabilities net of other financial assets	–1.9	0.9	–7.9
MEMORANDUM ITEM			
Investment in tangible fixed assets (a)	10.7	11.5	10.7

Source: Banco de España.

(a) With respect to net tangible fixed assets at the start of the year. This ratio, calculated within the conceptual scope of business accounting, is obtained from the subset of firms with more than 100 employees. The ratio for 1997 has been homogenised by removing the effect of balance-sheet restatement under Roya Legislative Decree 7/1996.

of firms reporting profit rates of more than 15 % (34.9 % in 1997, rising to 40.9 % in the third quarter of 1998).

5. INVESTMENT AND FINANCING

The above observations for 1997 are based on Chapter II of the annual monograph of the Central Balance Sheet Office, and those relating to the first three quarters of 1998 on CBQ data. Both these data bases are used to compile accounting statements and ratios from a business analysis viewpoint. However, to obtain balances and aggregates that are useful for macroeconomic analysis, such as gross saving, gross capital formation and financing capacity or borrowing requirements (surplus/deficit) an accounting framework is needed with a general economic analysis focus, specific to national accounts systems, such as that presented in Table 7. The latter summarises the capital and financial accounts included in Chapter III.A of the annual monograph of the Central Balance Sheet Office. This information can only be compiled from the CBA data, the shorter CBQ questionnaire being insufficiently detailed for these balances to be obtained.

In 1997, as has been the case since 1994, non-financial firms as a whole continued to be net lenders. The strong generation of funds, mainly due to the increase in gross saving, was sufficient to finance the year's investment and to generate a surplus of 4.8 % of GVA at market prices in 1997. Gross capital formation increased, basically as a result of the across-the-board increases in stocks. The discrepancies between the path of gross capital formation according to the Central Balance Sheet Office (very strong growth in 1995, a 6.3 % fall in 1996 and rises of around 5 % in 1997) and to the national aggregate of non-financial firms (less growth than according to the Central Balance Sheet Office in 1995 and positive rates of around 4.8 % and 5.3 % in 1996 and 1997) must be analysed taking into account the singular characteristics of the CBA and CBQ firm samples. Certain sectors are over represented in the CBQ, such as communications, in which there has been strong investment in recent years. Specifically, the firms in the communications sector reporting to the CBA invested PTA 730 billion in 1995, a figure which rose to PTA 840 billion in 1996 (somewhat more than 9 % of the total investment by the non-financial firm sector), 80 % of the total being accounted for by six firms. In 1997, this item held at PTA 805 billion, which, although less than in the previous year, is a clear sign that the investment drive has been sustained (in 1994 investment totalled PTA 560 billion in the sector considered). From 1993-1997 the firms of the sector reporting to the CBA invested PTA 3,500 billion.

The financing capacity generated in 1997 was clearly less than in 1996. However, if the sale of the rights arising from the nuclear moratorium (6) is excluded from the figure for 1996, this surplus becomes 4.7 % of GVA, practically the same level as in 1997.

This financing capacity was sufficient to finance the equity investments made by large domestic firms in transactions to reorganise corporate groups and in direct investment in external markets (mainly South America), which evidence a new external outlook on the part of Spanish firms. There were also sizeable capital gains arising from the sale of shares, mainly in privatisations, in the form of short-term financial assets (basically deposits). Finally, the strong increase in 1997 in trade credit – both to clients and from suppliers – in line with the increase in productive activity in 1997 discussed above, is notable.

In conclusion, the financial situation of the firms at end-1997 was very healthy, gross saving being the main source of funds and investment resuming the growth path of 1994 and 1995 which, in the case of the sample firms, was interrupted in 1996. The scant information available for these variables for the first three quarters of 1998 does not indicate any change in the situation as at end-1997.

27.11.1998.

(6) As a result of this transaction the firms concerned received more than PTA 700 billion (mainly used to repay loans from credit institutions).

Is there scope for inflation differentials in EMU?

The author of this article is Enrique Alberola Ila, of the Research Department (1).

1. INTRODUCTION

Economic and Monetary Union (EMU) entails the de facto disappearance of bilateral exchange rates between the participating countries and the establishment of a single monetary policy managed by the European Central Bank (ECB). The independence of the ECB and its primary objective of price stability mean that the future European inflation rate can be expected to be similar to that of the countries that have historically enjoyed greater monetary stability. This, moreover, is what the nominal convergence that has taken place in recent years would suggest.

Nonetheless, the existence of a single monetary policy does not rule out the possibility of inflation differentials within EMU. EMU eliminates monetary divergences, but this would only entail a uniform rate of inflation if it is accepted that inflation is a purely monetary phenomenon. However, even with a common currency, differences will persist in the economic structure, growth rate and labour and product markets of each country. These real factors have effects on the relative prices between countries, and may generate lasting inflation differentials.

The purpose of this article is to explore the role that real factors may play and to quantify the magnitude of the potential inflation differentials between countries within EMU. It must be emphasised however, that the differentials are calculated by extrapolating past trends, so that the significant effects that monetary union may have on the workings of the national economies are not taken into account. Consequently, the estimates presented may be taken as an upper limit to the differentials that may arise in Stage Three of EMU.

The following section describes the mechanism whereby inflation differentials may arise within a monetary union, and afterwards the results of the estimation are presented. Finally, the results are briefly interpreted and evaluated for the case of Spain.

2. SECTORAL PRODUCTIVITY AND INFLATION DIFFERENTIALS

To explain the real components of inflation, a brief theoretical digression on the determi-

(1) This article is a summary of the Banco de España Working Paper (no. 9823) with the same title, written jointly with Timo Tyrväinen.

nants of the real exchange rate is useful. The real exchange rate (rer) is defined (in logarithmic terms) as the difference between foreign prices (p*) and domestic prices (p). Foreign prices are expressed in domestic currency by adding to them the logarithm of the nominal exchange rate (e):

$$rer = (p^* + e) - p \qquad [1]$$

An increase in rer implies a depreciation of the real exchange rate, i.e. a fall in the relative prices of domestic products. It is often assumed that, in the long run, divergences in prices between countries are exactly offset by changes in the nominal exchange rate, in such a way that the real exchange rate remains constant. Thus, the currency of a country with a systematically higher inflation rate appreciates continuously against those of countries with lower inflation. Note that this argument rules out the possibility of permanent differences in the inflation rates of the EMU countries, given the absence of the nominal exchange rate.

Nonetheless, the hypothesis that the real exchange rate is constant in the long run is usually refuted by empirical evidence (2). The assumption underlying this hypothesis is that prices are determined exclusively by monetary factors and that real factors are not relevant, except in the short run. This view is hardly plausible when we recall that countries grow at different rates, have different productive structures and that their markets do not work in exactly the same way. Without doubt monetary factors play a dominant role in the determination of prices and the nominal exchange rate, but these real differences must also affect relative prices between countries, i.e. the real exchange rate.

This notion has been used in some theoretical models of the real exchange rate to explain its long-run trends. Among these, the most well known proposition is that of Bela Balassa and Paul Samuelson, based on the idea that technological progress has different effects on sectoral productivity. In particular, their model distinguishes between two sectors: the tradables sector (T), consisting mostly of commodities and manufactures, characterised by its openness to foreign competition, and also by its capital-intensive production processes; and the non-tradables sector (NT), consisting mostly of services, which is less exposed to competition and tends to be more labour-intensive. The compensation of each factor depends on its contribution to the productive process, so that real wages are determined by the productivity of labour (the variable prod). If we use w_T and w_{NT} to denote nominal wages in the two sectors, then it follows that relative prices between the sectors depend on productivity and nominal wages:

$$p_T = w_T - prod_T \; ; \; p_{NT} = w_{NT} - prod_{NT} \qquad [2]$$

Given, on the assumptions of the model, that productivity increases are determined by technical progress, that technology is embedded in capital and that, as mentioned above, the tradables sector is typically more capital intensive, it is reasonable to think that productivity growth will be higher in that sector. If, moreover, labour is assumed to be mobile, nominal wages will tend to equalise between sectors in the long run. On these assumptions the above expression implies the so-called productivity hypothesis, whereby prices in the services sector will tend to grow more than in the tradables sector:

$$p_{NT} - p_T = prod_T - prod_{NT} > 0 \qquad [3]$$

Chart 1 shows, in the first two graphs, sectoral productivity in two of the countries considered: Germany and Spain. It can be seen from the chart that the productivity hypothesis holds in both countries, since productivity grows more, and prices less, in the tradables sector. However, to derive more precise estimates, which enable us to make inferences on the divergences in inflation between countries, a more formal econometric analysis is required, based on the long-run statistical (cointegration) relationships between the variables. Moreover, the econometric specification is based on two further considerations: first, the theoretical model – derived in detail in the paper referred to in footnote 1 – gives rise to a formally more complex relationship between prices and productivity, which must be verified by the empirical evidence; second, as seen in Chart 1, the behaviour of wages does not seem to bear out the assumption of uniformity, so that in the long-run statistical analysis sectoral wages are also taken into consideration.

On the basis of these premises, the statistical analysis reveals a robust long-run relationship between sectoral productivities and prices for each of the countries. That said, how can this productivity hypothesis be translated into inflation differentials between countries?

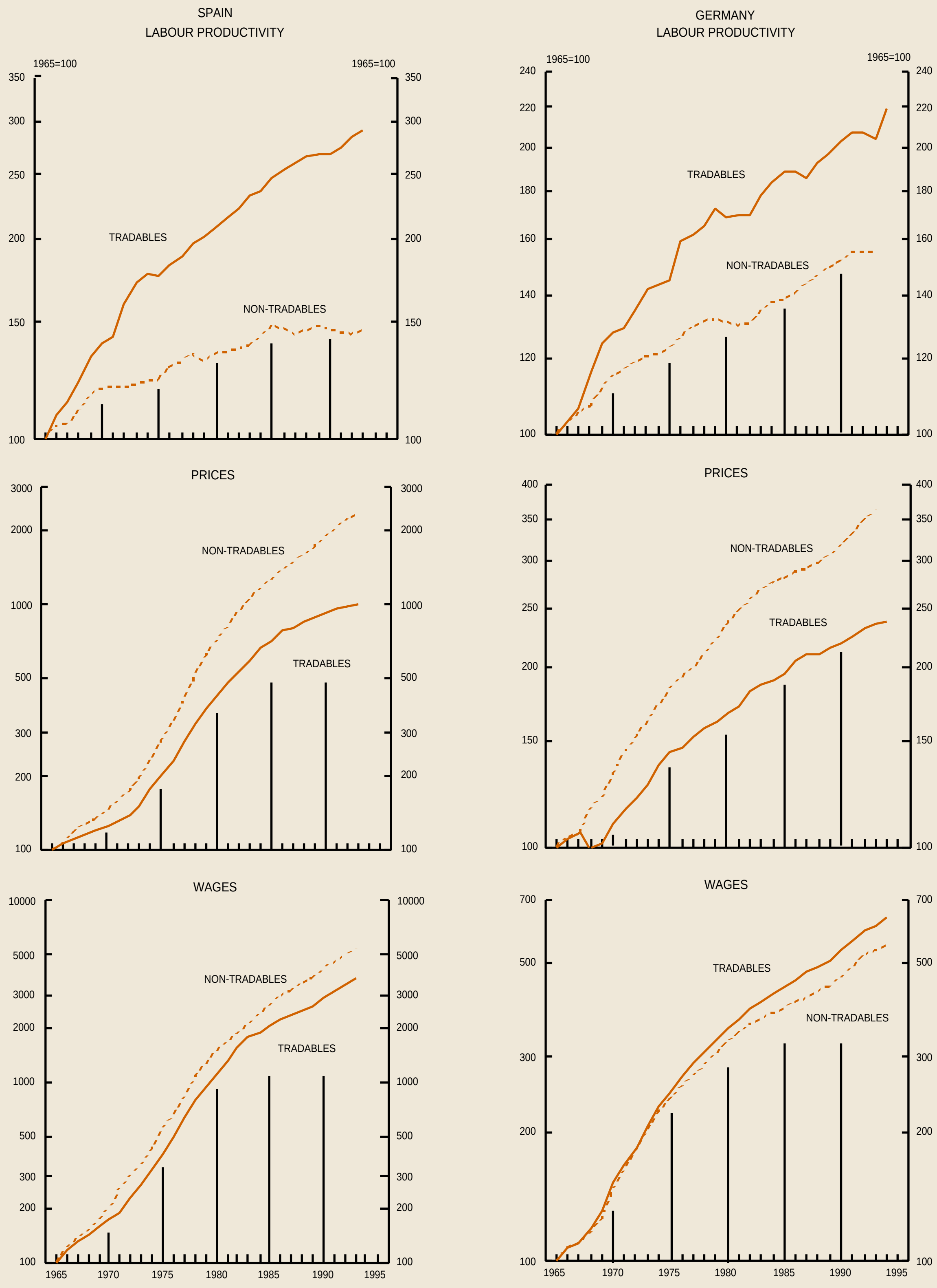
Starting from the definition of the real exchange rate and considering that each country's price index is a weighted average of the prices of tradables and non-tradables, it is simple to express the real exchange rate in terms of the sectoral prices in each country:

$$rer = [p^*_T + e - p_T] + \alpha \, [(p^*_{NT} - p^*_T) - (p_{NT} - p_T)] \qquad [4]$$

(2) See, for example, Rogoff (1996), for a summary of the evidence and a number of qualifications to this result.

CHART 1

Sectoral productivity, prices and wages



Source: OECD.

where α is the proportion of non-tradables, which is assumed to be the same in each country. Competition in the tradables sector at the international level helps ensure that the prices of these goods, expressed in a common currency, tend to be the same in each country ($p_T = p^*_T + e$). Given, also, that the nominal exchange rate is irrevocably fixed in EMU, changes in the real exchange rate are equivalent to the inflation differential between countries. This differential can be written as:

$$\Delta p - \Delta p^* = \alpha\ [\Delta(prod_T - prod^*_T) - \Delta(prod_{NT} - prod^*_{NT})] \quad [5]$$

Note that the inflation differentials are positively related to productivity differentials in the tradables sector, and negatively to those of the non-tradables sector. The intuitive explanation of this result is as follows. Nominal wages in both sectors are determined domestically and, if they grow at similar rates, the differences in productivity between sectors will be reflected in differences in sectoral inflation (3). As seen in Chart 1, productivity growth tends to be higher in the tradables sector and, as its prices are determined abroad, these productivity gains will be reflected, basically, in nominal wages. By contrast, the non-tradables sector, with its slower productivity growth, can accommodate wage pressure by increasing its prices. It follows from all this that the inflation of non-tradables will be higher in those countries in which the productivity of tradables grows most and, given that inflation in tradables is the same in all countries, these countries will have the highest rates of inflation in EMU.

3. ESTIMATION OF INFLATION DIFFERENTIALS

The long-run relationship obtained in the empirical analysis enables the real component of inflation differentials to be isolated. Unlike the monetary component, the real one will not disappear as a consequence of the adoption of a common currency and monetary policy. Trends in sectoral productivity and their international differences thus constitute an indicator of the potential differences in inflation between the participating countries. By extrapolating these trends, on the assumption that the prices of tradables grow at the same rate in all countries, an approximation to the differences in inflation may persist in the euro area can easily be obtained.

(3) The divergence in wages observed in the empirical evidence is not so significant as to change these conclusions.

Chart 2 shows the results of this exercise. As can be seen, inflation – calculated in annual terms – could vary between the countries significantly. Finland is the country with the smallest real component in its inflation (about one percentage point below the area average), while Spain stands out as the country with the most pronounced inflationary pressures from the real sector (1.6 % above the average for the area). Comparing with Germany, it can be seen in Chart 1 again, that productivity growth in the non-tradables sector is similar, but that productivity growth in the tradables sector is rather higher in the case of Spain. According to the model, this difference should translate into a positive potential inflation differential for Spain, as is in fact the case.

It should be underlined that the resulting ranking of the countries does not generally correspond to the historical experience in Europe. A relatively low inflation rate is estimated for countries with little tradition of price stability (such as Italy and, in particular, Finland). By contrast, the Netherlands and Belgium have relatively high inflation rates. The reason, as already pointed out, is that the exercise focuses on real factors, in particular on the relationship between productivity and sectoral prices, ignoring monetary factors, which have dominated trends in relative prices in the past.

4. FINAL COMMENTS

The empirical support for the productivity hypothesis implies that inflation differentials could persist after the transition to EMU, as illustrated by this exercise. Nonetheless, the normative implications are not obvious and depend on the interpretation of the results.

A first interpretation relates these differentials to real convergence. To the extent that greater growth also involves higher productivity growth it is to be expected that countries which grow faster will have higher inflation rates in EMU. This is clearly an optimistic view of inflation differentials within EMU, since they would be explained by a desirable process of real convergence (4).

However, there is a more worrying interpretation. As mentioned above, firms in the non-tradables sector can more readily pass cost increases – in particular, wage increases – through to prices, giving rise to higher sectoral inflation.

(4) Note that, in the model, the price of tradables, which may be considered a measure of competitiveness, is equalised between countries, so that higher inflation need not generate competitiveness problems.

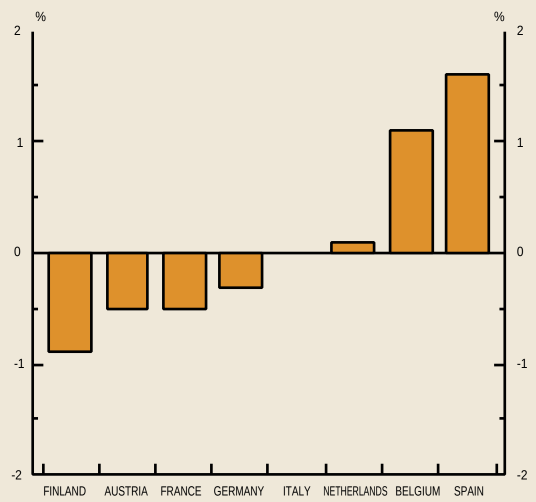
At the same time, in some countries, such as Spain, wage bargaining in each sector is not independent, so that wage pressures may be passed through to the tradables sector. In this case, the productive units of that sector would lose their external competitiveness and, in the long run, adjust their workforce, or simply shut down, thereby increasing apparent productivity, not for the positive reasons we saw above but rather owing to an inadequate functioning of markets.

In fact, recent Spanish experience leads us to suspect that a significant part of the observed productivity and inflation differentials is explained by this type of behaviour: lack of competition in the service sector and labour market rigidities. That said, EMU might be conducive to greater price flexibility in labour and product markets, since agents and regulators are aware that losses of competitiveness cannot be offset by devaluations. This fact may, if this second interpretation is correct, prompt a change in the behaviour of sectoral productivity differentials, so that they generate lower inflationary pressures than those reflected in the estimates for the inflation differential in Spain. In any event, it is clear from this analysis that further structural reforms are necessary in labour and product markets to reduce the real costs involved in the process of adjusting to the new economic environment.

21.11.1998.

CHART 2

Estimated inflation differentials within EMU
Simulation exercise



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Financial regulation: fourth quarter 1998

1. INTRODUCTION

As a consequence of the start of Stage Three of Economic and Monetary Union (EMU), the flow of financial regulations in the fourth quarter of 1998 has been the largest and most significant of recent years. As a result of the volume of regulation, a greater effort has been made to summarise and sort the new provisions, in order to highlight their most relevant and novel aspects.

First, five EU regulations which bring into force certain provisions of the Statute of the European System of Central Banks (ESCB) and the European Central Bank (ECB) for the new stage now commenced are mentioned. Two of them define and develop the minimum reserves requirement, which the credit institutions of the countries that have adopted the single currency (euro-11) will have to comply with as from the present month of January. The three other regulations specify the ECB's powers to impose sanctions and to obtain statistical information both from financial institutions, in general, and in relation to the consolidated balance sheet of the monetary financial institutions sector.

With regard to the Banco de España, first the general clauses that will be applicable to monetary policy operations carried out in the exercise of its functions as a member of the ESCB are highlighted. Mention is then made of the expansion of the scope of collaboration of the Banco de España with the authorities charged with similar functions in other states.

An extensive commentary is included on the legislation amending Spanish law to give effect to the mechanisms for introducing the euro as single currency, establishing a set of general rules which complete and facilitate this task, in accordance with the provisions of Community law. A number of provisions of lower rank – closely linked to this process – which implement and complement the general provisions have been included in this chapter.

This period has also seen the publication of the reform of the securities market. Its basic objective, among other considerations, has been to incorporate the Community legislation promulgated in recent years into Spanish law. This has involved, as in the case of the Second Banking Directive, the introduction of the "Community passport" principle or single licence for investment services firms, which is based on the harmonisation of the conditions for authorisation and pursuit of the business, as well as the prudential supervision systems. This same law has been used to reform partially the law regulating collective investment undertakings

(CIUs), reinforcing the functions of the National Securities Market Commission (CNMV), clarifying the rules on investments in derivative instruments and adding new types of institution to meet the new demands of investors. In the same area, the regulation of the representatives of securities-dealer companies, securities agencies and portfolio management companies is highlighted.

A number of laws affecting different financial institutions are discussed. The updating of the law regulating currency-exchange bureaux, coinciding with the expansion of their activity and the large numbers setting up in Spain in recent years, is mentioned. The information to be submitted by mutual guarantee companies (MGCs) in relation to the funds ratio, their mandatory investments and the limit on tangible fixed assets and shares and other equity is mentioned. The new legal framework for venture capital entities, which reinforces their work in promoting and fostering small- and medium-sized firms engaged in activities relating to technological innovation or the like is also mentioned. Finally, the operating rules for the new general subsystems of fuel and travel cheques in the National Electronic Clearing System (SNCE) are alluded to.

In the area of insurance, the regulation implementing the 1995 Private Insurance Law has been published. Besides incorporating into Spanish law the Community legislation pending incorporation, it clarifies and specifies the content of the law, especially as regards the legal system for insurance undertakings and their cross-border activity.

As regards tax, the most important event this quarter was the reform of personal income tax (IRPF), centred on the establishment of a personal and family tax-free allowance *(mínimo vital),* which depends on the taxpayer's personal and family circumstances. In addition, other tax measures designed to protect and favour the family have been introduced and the taxation of savings has been improved.

The tax on the income of non-residents has been published. It is characterised as a direct tax on income obtained within Spain by individuals and entities not resident therein.

The regulations implementing various provisions relating to the obligations of pension schemes and funds, credit institutions and other entities engaged in banking or credit activities to provide information to the tax authorities on participant agents should also be highlighted. In particular, new obligations are established to provide information to the tax authorities on persons authorised to use bank accounts, on transactions involving financial assets and on operations to issue, subscribe for and transfer securities.

Finally, as usual in this period, there is a discussion of the State Budget. The 1999 budget incorporates the requirements for stability and budgetary discipline deriving from adoption of the euro. Along with the Budget Law, as in previous years, a number of fiscal, administrative and social measures have been adopted in order to facilitate the achievement of economic policy objectives.

2. EUROPEAN CENTRAL BANK: MINIMUM RESERVES

The start of Stage Three of EMU has involved, among other aspects, the development and implementation of the provisions laid down in the Statute of the ESCB and of the ECB. Specifically, under this Statute, the Governing Council of the ECB shall define the basis for minimum reserves that credit institutions of Member States must hold as from January 1999. The Recommendation of the European Central Bank for a Council Regulation (EC) concerning the application of minimum reserves by the European Central Bank (98/C 246/06) was submitted by the European Central Bank on 7 July 1998. Accordingly the Council adopted *Council Regulation (EC) No 2531/98 of 23 November 1998* (OJ of 27 November 1998). This regulation established the general principles, the basic aspects and the limits of minimum reserves, which were subsequently developed by *Regulation (EC) NO 2818/98 of the European Central Bank of 1 December 1998* (OJ of 30 December 1998) on the application of minimum reserves as from the start of Stage Three of EMU on 1 January 1999.

The reserve requirement is the requirement for certain financial institutions to hold minimum reserves on reserve accounts with the national central banks, determined in relation to a specified percentage of their reserve base. As from 1 January 1999, the following credit institutions of the euro-11 countries shall be subject to reserve requirements:

a) Credit institutions (1), other than national central banks.

b) Branches of credit institutions, including branches of credit institutions which have neither their registered office nor their head office in a euro-11 country.

(1) Council Directive 77/780/EEC of 12 December 1977 (First Banking Co-ordination Directive) defines a credit institution as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.

The ECB may, on a non-discriminatory basis, exempt from reserve requirements institutions which are subject to insolvency proceedings or reorganisation measures and institutions for which the purpose of the ESCB's minimum reserve system would not be met by imposing reserve requirements upon them. In reaching a decision on any such exemption, the ECB will take into account one or more of the following criteria: that the institution is pursuing special-purpose functions; that the institution is not exercising active banking functions in competition with other credit institutions; or that the institution has all its deposits earmarked for purposes related to regional and/or international development assistance. The ECB will publish a list of institutions subject to or exempt from reserve requirements.

Council Regulation (EC) No 2531/98 provides that reserve ratios which the ECB may specify shall not exceed 10 % of any relevant liabilities forming part of the basis for minimum reserves but may be 0 %. In accordance with these limits, Regulation (EC) No 2818/98 of the European Central Bank specifies the reserve ratios which shall be applied to liabilities included in the reserve base. These ratios shall be as follows:

1. A reserve ratio of 0 % shall apply to deposits with agreed maturity over 2 years, deposits redeemable at notice over 2 years, repurchase agreements and debt securities issued with an agreed maturity over 2 years.

2. A reserve ratio of 2 % shall apply to all other liabilities included in the reserve base, i.e. liabilities which do not comply with the aforementioned requirement and liabilities resulting from the acceptance of repayable funds.

Liabilities which are owed to any other institution not listed as being exempt from the ESCB's minimum reserve system and liabilities which are owed to the ECB or a national central bank of the euro-11 countries shall be excluded from the reserve base.

The amount of minimum reserves to be held by each institution in respect of a particular maintenance period shall be calculated by applying the aforementioned reserve ratios to each relevant item of the reserve base for that period. Each institution may deduct an allowance of EUR 100,000 (PTA 16.7 million) from the amount of the reserve requirement.

An institution shall have complied with its reserve requirement if the average end-of-day balance on its reserve accounts over the maintenance period is not less than its reserve requirement. The maintenance period shall be one month, starting on the 24th calendar day of each month and ending on the 23rd calendar day of the following month.

Holdings of required reserves shall be remunerated at the average of the ESCB's rate (weighted according to the number of calendar days) for the main refinancing operations according to the formula specified in Regulation (EC) No 2818/98.

An institution may apply for permission to hold its minimum reserves indirectly through an intermediary, which is resident in the same Member State. The intermediary shall be an institution subject to reserve requirements which normally effects part of the administration (e.g. treasury management) of the institution for which it is acting as intermediary, beyond the holding of minimum reserves. The intermediary shall maintain these minimum reserve holdings in accordance with the general conditions laid down in the aforementioned regulations. In the event of non-compliance, the ECB may impose any applicable sanctions on the intermediary, on the institution for which it is acting as intermediary, or on both, in accordance with the liability for non-compliance. In those cases, and in other circumstances specified in the regulations, the ECB or the relevant national central bank may, at any time, withdraw permission to hold minimum reserves indirectly.

The ECB shall have the right to collect and verify the information which financial institutions provide to demonstrate compliance with the minimum reserves. The ECB may delegate the execution of these tasks to the national central banks.

Regulation (EC) No 2531/98 specifies the sanctions, which may be imposed in cases of non-compliance with minimum reserve obligations. These sanctions may be: a payment of up to 5 percentage points above the ESCB's marginal lending rate; or twice the ESCB's marginal lending rate; or the requirement to establish a non-interest-bearing deposit with the ECB or the national central banks up to three times the amount of the minimum reserves.

The first maintenance period started on 1 January 1999 and will end on 23 February 1999. The reserve base of an institution for that period will be defined in relation to the elements of its balance sheet at 1 January 1999. The balance sheet data will be reported to the relevant national central bank in accordance with the reporting framework for the money and banking statistics of the ECB which is laid down in Regulation (EC) No 2819/98, as discussed in the following section.

3. EUROPEAN CENTRAL BANK: SANCTIONS, STATISTICAL INFORMATION AND CONSOLIDATED BALANCE SHEET

The Statute of the ESCB and of the ECB requires the Council of the EU to define the various powers that are to be conferred on the ECB at the start of Stage Three of EMU. Accordingly, the Council has adopted a series of regulations, in particular *Council Regulation (EC) No 2532/98 of 23 November 1998* (OJ of 27 November 1998) concerning the powers of the European Central Bank to impose sanctions and *Council Regulation (EC) No 2533/98 of 23 November 1998* (OJ of 27 November 1998) concerning the collection of statistical information by the European Central Bank. Additionally, the ECB has adopted *Regulation (EC) No 2819/98 of the European Central Bank of 1 December 1998* (OJ of 30 December 1998) concerning the consolidated balance sheet of the monetary financial institutions sector.

With respect to the powers of the ECB to impose sanctions, Regulation (EC) No 2532/98 does not specify the type of institutions which are subject to the imposition of sanctions. The Regulation refers, in general, to natural or legal persons, private or public, with the exception of the public authorities of euro-11 countries, subject to obligations arising from ECB regulations and decisions.

The Regulation specifies in other sections the procedural rules to be applied and the limits within which the ECB may impose fines and periodic penalty payments on undertakings, unless specific Council Regulations otherwise provide. Finally, it should be noted that in determining whether to impose a sanction and in determining the appropriate sanction, the ECB shall be guided by the principle of proportionality.

As regards statistical information, the ECB, assisted by the national central banks, shall collect the statistical information which is necessary for the fulfilment of its tasks according to the Statute of the ESCB. The reference reporting population shall comprise the following reporting agents:

a) Legal and natural persons falling within the financial sector: central banks, other monetary financial institutions (basically credit institutions) and other financial intermediaries, except insurance companies and pension funds.

b) Post office giro institutions, to the extent necessary to fulfil the ECB's statistical reporting requirements in the field of money and banking statistics and payment systems statistics.

c) Legal and natural persons residing in a Member State, to the extent that they hold cross-border positions or carry out cross-border transactions and that statistical information relating to such positions or transactions is necessary to fulfil statistical reporting requirements in the field of balance of payments or the international investment position. Also, legal and natural persons residing in a Member State, to the extent that statistical information relating to the securities or the electronic money issued by them is necessary to fulfil the ECB's statistical reporting requirements.

If a reporting agent is suspected of an infringement of the statistical reporting requirements, the ECB or the national central bank concerned shall have the right to verify the accuracy and quality of the information provided and to carry out its compulsory collection. Finally, the ECB shall have the power to impose the sanctions set out in Regulation (EC) No 2533/98 on reporting agents that fail to comply with the obligations resulting from this Regulation.

As for monetary financial institutions resident in the territory of the euro-11 countries, Regulation (EC) No 2819/98 specifies that, except for given derogations, these institutions shall report monthly statistical information relating to their balance sheet to the relevant national central bank for the purposes of the regular production of the consolidated balance sheet of the MFI sector. Further details on certain items of the balance sheet shall be reported quarterly. This information shall be used, inter alia, to calculate the reserve base or verify the fulfilment of the reserve obligation discussed in the previous section. The Regulation also establishes the right of national central banks to verify or to compulsorily collect the information.

4. BANCO DE ESPAÑA: MONETARY POLICY OPERATIONS

4.1. Introduction

Law 13/1994 of 1 June 1994 on the Autonomy of the Banco de España (2) adapted ahead of schedule the legal status of the Banco de España to the provisions of the Treaty on European Union regarding monetary policy, the rela-

(2) See "Regulación financiera: segundo trimestre de 1994", in *Boletín económico,* Banco de España, July-August 1994, pp. 86-92.

tionship between the Banco de España and the Treasury and its future participation in the ESCB. Later, fulfilling the mandate of the Law of Autonomy, the Banco de España's Internal Rules were issued through the Decision of 14 November 1996 of the Governing Council of the Banco de España (3). These Rules are the basic and highest ranking regulation governing the autonomy of the Banco de España. Subsequently, an additional provision to Law 66/1997 of 30 December 1997 on fiscal, administrative and social measures (4) incorporated into the aforementioned law all the independence requirements laid down in article 107 of the Treaty on European Union. Finally, Law 13/1994 was again amended by Law 12/1998 of 28 April 1998 (5) with a view to ensuring integration into the ESCB. Accordingly, the law recognised, inter alia, the powers of the ECB for the formulation of euro-area monetary policy and its implementation by the Banco de España and the powers of the European Community in relation to exchange rate policy.

In the exercise of its functions as member of the ESCB, the Banco de España shall follow the guidelines and instructions of the ECB. One of these functions will be to participate in the formulation and implementation of the Community monetary policy. In accordance with Law 13/1994 and with its own Internal Rules, the Banco de España shall be responsible, inter alia, for implementing monetary policy following the guidelines of the Governing Council of the ECB.

Furthermore, the *Decision of 11 December 1998* of the Executive Commission of the Banco de España (BOE [Official State Gazette] of 16 December 1998), in which the general provisions applicable to monetary policy operations are laid down, was issued with a view to establishing a general framework for monetary policy operations to be conducted by the Banco de España following the guidelines of the ECB.

4.2. Scope of application

The Banco de España shall operate solely with institutions that fulfil the criteria laid down in these general provisions. Only institutions subject to minimum reserve requirements may access standing facilities and participate in open market operations based on standard tenders.

In particular, the Banco de España will conduct monetary policy operations with institutions which fulfil the following criteria (6): *a)* they must be credit or other institutions subject to the minimum reserve requirements applicable in Spain (7); *b)* they must be financially sound and subject to EU/EEA harmonised supervision by the national authorities (although financially sound institutions subject to non-harmonised national supervision of a comparable standard can also be accepted as counterparties); and c) they must fulfil the operational requirements established by the Banco de España.

4.3. Monetary policy operations

In the performance of its duties, the Banco de España may conduct open market operations and offer standing facilities.

Open market operations will be executed on the initiative of the Banco de España in the financial markets in the form of reverse transactions (8), outright forward transactions, foreign exchange swaps (9) and collection of fixed-term deposits. Open market operations can be executed on the basis of standard tenders, quick tenders or bilateral procedures.

Open market operations are divided into the following categories:

a) Main refinancing operations which are regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks. These operations are executed on the basis of standard tenders (10).

b) Longer-term refinancing operations which are additional liquidity-providing reverse

(3) See “Regulación financiera: cuarto trimestre de 1996”, in *Boletín económico,* Banco de España, January 1997, pp. 104-106.

(4) See “Financial regulation: fourth quarter of 1997”, in *Economic bulletin,* Banco de España, January 1998, p.80.

(5) See “Financial regulation: second quarter of 1998” in *Economic bulletin,* Banco de España, July-August 1998, pp. 90 and 91.

(6) Outright securities transactions are not subject to these requirements.

(7) An institution is deemed to be established in Spain if it has its head office or an authorised branch in Spanish territory.

(8) Reverse transactions are operations whereby the Banco de España buys or sells assets under repurchase agreements or conducts credit operations against collateral.

(9) Foreign exchange swaps are simultaneous spot and forward transactions of one currency against another. The Banco de España will execute open market monetary policy operations in the form of foreign exchange swaps where it buys (or sells) euro spot against a foreign currency and, at the same time, sells (or buys) it back forward.

(10) At its meeting of 22 December 1998, the Governing Council of the ECB decided to conduct the first ESCB main refinancing operation through a fixed-rate tender at a specified interest rate of 3 %.

transactions with a monthly frequency and a maturity of three months. These operations are executed on the basis of standard tenders.

c) Fine-tuning operations which are executed with the aim of managing the liquidity situation in the market and of steering interest rates, in particular in order to smooth the effects on interest rates caused by unexpected liquidity fluctuations in the market.

d) Structural operations which are executed through the placement of ECB debt certificates, reverse transactions and outright transactions.

The Banco de España may also offer *standing facilities* to institutions subject to their fulfilment of the operational access conditions it has established. Through the marginal lending facility, the Banco de España may provide overnight liquidity against eligible assets and, through the deposit facility, it can take overnight deposits from institutions (11). Under exceptional circumstances, the Banco de España may set credit limits or even suspend access to the standing facilities.

4.4. Procedures applied in the conduct of monetary policy operations

All credit or refinancing operations must be based on adequate collateral accepted by all euro-area national central banks under the conditions described below. For intraday refinancing operations, open market operations and the marginal lending facility, the eligible assets will be those accepted by the ESCB for these operations.

Standard tenders will be used by the Banco de España in its regular open market operations and executed within a time frame of 24 hours. All counterparties fulfilling the general eligibility criteria will be entitled to submit bids in standard tenders.

Quick tenders will be used by the Banco de España mainly for fine-tuning operations when it is deemed desirable to have a rapid impact on the liquidity situation in the market. Quick tenders will be executed within a time frame of one hour and will be restricted to a limited set of counterparties.

Finally, through *bilateral procedures* the Banco de España will deal directly with only one or a few counterparties, without making use of tender procedures. Bilateral procedures include operations executed through stock exchanges or market agents.

After detailing the specific allotment procedure for the aforementioned tenders, the Decision specifies the procedures used in standing facilities, with regard to both marginal lending facilities and deposit facilities.

4.5. Eligible assets

Asset eligibility criteria and risk control measures will be established by the Banco de España and announced in advance to counterparties.

The Banco de España will require its monetary policy operations and provision of liquidity to settlement systems to be based on adequate collateral fulfilling the technical and legal requirements that will be communicated by the Banco de España.

The assets eligible for monetary policy operations and for the provision of liquidity to settlement systems will be made public through the media established by the Banco de España or by the ESCB. These will be the only eligible assets accepted by the Banco de España.

Eligible assets for monetary policy operations will, in general, be the same as those required for intraday credit granted by the Banco de España, without prejudice to the particular features which may be specified for certain categories of operation.

The assets eligible for Banco de España operations can be divided into two categories, referred to as “tier one” and “tier two”, which will be made public on a regular basis by the Banco de España.

Tier one will consist of the assets established by the Banco de España and by each national central bank of the EU Member States, subject to approval by the ECB and to the minimum eligible criteria applicable in each case. Tier two will consist of debt instruments and any other assets that the Banco de España may decide to include from time to time, subject to approval by the ECB.

(11) At its meeting of 22 December 1998, the Governing Council of the ECB decided that the interest rates on the marginal lending facility and the deposit facility would be 4.5 % and 2 %, respectively. These would be the interest rates on ESCB standing facilities at the start of Stage Three on 1 January 1999. As a temporary measure, these interest rates would stand at 3.25 % and 2.75 %, respectively, between 4 and 21 January 1999, in order to smooth the adaptation of market agents to the integrated euro money market at the outset of EMU.

The assets included in the tier two list of the Banco de España and those included in the list of other euro-area national central banks may be used, without distinction, as collateral for monetary policy operations of the Banco de España and of other ESCB national central banks. The assets established by national central banks must comply strictly with the following eligibility criteria: *a)* they must be issued by entities established in the euro area or by international financial organisations; *b)* they must be expressed in euro (or in the national denominations of the euro); *c)* and they must be located in the euro area. If they do not comply with the aforementioned criteria their use may be restricted to the national territory of the central bank which has included them in its tier two list, in which case the Banco de España would not undertake to accept them as eligible assets.

It should be noted that non-mortgage loans granted by credit institutions have recently been included in the list of eligible assets. In effect, the third additional provision to *Law 46/1998 of 17 December 1998* on the introduction of the euro (which is discussed below), implemented by *Ministerial Order of 18 December 1998* (BOE of 23 December 1998), envisages the possibility of using non-mortgage loans to ensure compliance with current or future obligations incurred by credit institutions with the Banco de España, the ECB or the national central banks of the euro-11 countries in the conduct of their monetary policy operations. For these purposes, they should comply with the following criteria:

a) Loans may be encumbered, whatever formal or material requirements may have been agreed by the parties with respect to assignment or lien.

b) Such encumbrance will be fully effective against third parties as from registration with the Banco de España.

c) Unless otherwise agreed, yields on encumbered loans will go to the credit institution which provides the collateral.

d) In the event of breach of the collateralised obligations, the beneficiary of the collateral will acquire full ownership of the encumbered loans and will be subrogated to the contractual position of the lending institution. In case of bankruptcy or suspension of payments of the institution that has encumbered the loans, the beneficiary of the collateral will also have full right of severance with respect to the creditor's rights derived from those loans.

Additionally, Law 46/1998 refers to the provisions of the law on securities markets regarding pledges and repurchase agreements securing obligations to the Banco de España arising from the execution of its monetary policy operations. Law 46/1998 specifies that the aforementioned provisions will also be applicable to similar operations carried out in Spain to secure obligations to the ECB and the national central banks of the euro-11 countries arising from the execution of their monetary policy operations.

However, the Decision also provides that the Banco de España may, at any time, communicate the exclusion or suspension of assets previously included in tier one or tier two, on grounds of lack of financial soundness, prudence or events which substantially affect the negotiability or transferability of those assets.

With respect to the legal regime applicable to the provision of collateral, the Decision prescribes a set of valuation criteria depending on whether the collateral provided consists of bonds, equities or other assets.

The Banco de España will apply *initial margins* to the effective amount of each liquidity-providing reverse transaction, calculated as a true percentage of that amount. The Banco de España will also apply *valuation haircuts,* by deducting a certain percentage from the value of the underlying assets, to determine the amount secured by such assets. *Additional haircuts* may be applied to specific assets. Haircuts will be established by the Banco de España according to the type of underlying asset. The main feature of the specific asset reflected in the valuation haircut will be residual maturity.

4.6. Daily collateral valuation adjustment

If the value of the underlying assets, as measured after applying haircuts, falls below the level required to cover outstanding operations, the Banco de España will require counterparties to supply additional assets. Similarly, if the value of the underlying assets, following their revaluation, exceeds the required level, the Banco de España will return excess assets to the counterparties.

To this end, the Banco de España will check on a daily basis that the adjusted market value (AMV) (12) calculated for a pool of underlying assets is sufficient to cover collateralised opera-

(12) In any reverse transaction, the adjusted market value is the market value of the traded assets, following the deduction of any haircut. This percentage or amount is established by the Banco de España according to its expected valuation of underlying assets for monetary policy operations.

tions as a whole, including accrued interest, plus the value of the aforementioned initial margin. If the total AMV of the underlying assets is not sufficient, the counterparty will be required to supply additional assets on the same date, in order to ensure that all the operations are fully covered by the new total effective value, after applying the relevant haircuts. Conversely, if the total AMV of the underlying assets is sufficient, the limit applied to the credit granted will automatically be reduced.

If the AMV of the underlying assets exceeds the amount calculated in the previous revaluation, excess assets will be available to the counterparty, which may withdraw them or apply for additional credit.

Likewise, the Banco de España may establish a trigger point for counterparties to supply additional collateral. When this trigger point, or lower level, is reached, daily valuation adjustments will be applied. As a result, if the AMV of the underlying assets, following their revaluation, exceeds this trigger point, no additional assets will be required.

4.7. Breach

The Decision establishes that the counterparty will automatically be considered in-breach of the obligations arising from these general provisions, if any of the following circumstances occur: *a)* the counterparty has been declared bankrupt and *b)* a universal winding-up decision has been adopted in respect of the counterparty in accordance with the legislation of another EU Member State. If any of these circumstances occur, it will automatically imply the early maturity of the monetary policy operations entered into at the date of the aforementioned breach.

The Decision also envisages the possibility that, after written notification to the counterparty, the Banco de España may declare that the latter is in breach of the obligations arising from the general provisions.

Finally, the Decision specifies other cases in which the counterparty may be in breach of its obligations in relation to tenders, end-of-day closing procedures, use of underlying assets, etc. In all such cases, penalties ranging from EUR 10,000 to EUR 1 million may be imposed and may lead, under certain circumstances, to suspension or exclusion of the counterparty's access to monetary policy operations.

5. BANCO DE ESPAÑA: UPDATING OF LEGISLATION ON INFORMATION AND PROFESSIONAL SECRECY

The eleventh additional provision to Law 37/1998 on the reform of the securities market, discussed below, amended Royal Legislative Decree 1298/1986 of 28 June 1986 (13), which adapted the law on credit institutions to Community law with regard to the information and professional secrecy obligations of the Banco de España. This provision widens the co-operation of the Banco de España with the authorities entrusted with similar responsibilities in other states. The Banco de España shall not only provide information on the conduct, management and soundness of credit institutions but also any other information which may facilitate the supervision of these institutions and permit the avoidances, pursuit or santioning of any kind of misconduct. In the case of non-EU countries, this information shall be provided on the basis of reciprocity.

The data, documents and information held by the Banco de España shall be *confidential* and shall not be disclosed to any person or authority. Parliamentary access to this information shall be through the governor of the Banco de España. To this end, the governor may request that a secret session should be held or that the appropriate procedures for access to classified material should be used.

The cases in which the obligation of secrecy shall not apply to the aforementioned information are extended to include the following:

— Information provided by the Banco de España to the ECB, the national central banks and organisations with functions similar to those of the EU, as well as to the authorities responsible for the supervision of payment systems.

— Information that the Banco de España is required to provide, in the pursuance of its duties, to the bodies or authorities responsible for the supervision of other non-banking institutions. However, this information shall be supplied on the basis of reciprocity and the aforementioned authorities shall be bound to the obligation of professional secrecy under conditions at least equivalent to those established under Spanish law.

— Information that the Banco de España decides to supply to a clearing house or any

(13) See "Regulación financiera: segundo trimestre de 1986", in *Boletín económico,* Banco de España, July-August 1986, pp. 45 and 46.

similar body legally authorised to provide clearing or settlement services in the Spanish markets, whenever such information is considered necessary to ensure the adequate operation of these bodies in the event of any breach of market rules.

— Information required by a Parliamentary Investigation Committee under the terms of its specific legislation, although the members of the Committee shall be required to adopt the appropriate secrecy measures.

6. LAWS ON THE INTRODUCTION OF THE EURO AND THEIR IMPLEMENTATION

6.1. Introduction

The Council of the European Union decided on 2 May 1998 that eleven countries, which included Spain, fulfilled the necessary convergence conditions to participate in the so-called "euro area", which would come into effect on 1 January 1999.

Council Regulation (EC) No 1103/97 of 17 June 1997 (14) and Council Regulation (EC) No 974/98 of 3 May 1998 (15) were issued to prepare the adoption of the single currency, the 'euro'. These Regulations were aimed at providing legal certainty for citizens and firms in all Member States on certain provisions relating to the introduction of the euro. More recently, *Council Regulation (EC) No 2866/98 of 31 December 1998* (OJ of 31 December 1998) on the conversion rates between the euro and the currencies of the Member States adopting the euro set the irrevocably fixed conversion rates between the euro and the national currencies of the eleven Member States participating in the euro area. Specifically, the rate of the Spanish peseta was set at PTA 166,386 per euro.

Although these Community Regulations could be applied directly, most Member States have adapted their national legislation to the changes required by the introduction of the euro. In Spain, *Law 46/1998 of 17 December 1998 on the introduction of the euro (BOE of 18 December 1998)* laid down a set of general rules aiming at facilitating the introduction of the euro as a single currency into the monetary system, in accordance with these Regulations. The government was empowered to implement the Law (also called "Umbrella Law") by issuing the regulations required to ensure the harmonious execution of all of its provisions.

Simultaneously with the publication of Law 46/1998, *Organic Law 10/1998 of 17 December 1998,* supplementary to the Law on the introduction of the euro (BOE of 18 December 1998), amending Organic Law 8/1980 of 22 September 1980, on the financing of the Regional (Autonomous) Governments, was issued to specify a number of points. Financing or issuing operations denominated in euro and carried out within the euro area shall not be considered foreign financing and shall therefore require no authorisation. References in organic laws to amounts expressed in pesetas shall be read as references to amounts in euro at the established conversion rate. Likewise, references to the ECU shall be read as references to the euro or to the relevant amount in euro.

The most important sections of Law 46/1998 and of its implementing regulations are briefly described hereunder, in particular with regard to financial aspects.

6.2. Integration of the Banco de España into the ESCB

One of the consequences of EMU was the integration of the Banco de España into the ESCB, governed by the Governing Council and the Executive Board of the ECB. As a member of the ESCB, the Banco de España will be required to apply harmonised procedures, together with the national central banks of the euro-11 countries and in accordance with the requirements of the ECB and the ESCB. These new requirements, ranging from the implementation of monetary policy to the operation of the TARGET system (16) and to market opening and closing procedures and related activities, will apply to the activities of the Banco de España carried out within a common framework. It was therefore necessary to include in the Law the reorganisation of the Banco de España's services and facilities.

Another consequence of this integration was the need to adapt the organisation and operation of the current STMD (Money-Market Telephone Service) to the new obligations assumed by the Banco de España as a result of the implementation of the TARGET system. Accord-

(14) See "Financial regulation: fourth quarter of 1997", in *Economic bulletin,* Banco de España, January 1998, p. 88.

(15) See "Financial regulation: second quarter of 1998", in *Economic bulletin,* Banco de España, July-August 1998, pp. 100 and 101.

(16) Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) is a general EU interbank payment system which interconnects the different real-time gross settlement systems and the ECB's payment mechanism through an interlinking system.

ingly, the regulations of the STMD were updated by *Banco de España Circular 11/1998 of 23 December 1998 (BOE of 30 December 1998).* As a result, the STMD will change its name to SLBE (Banco de España Settlement Service) and any reference to it in the current legislation shall be read as a reference to the new name. The Circular provides an extensive list of institutions which may participate in the SLBE, if they fulfil the requirements and follow the procedures set out by the Banco de España in its Circular 5/1990 of 28 March 1990 (17). Participation is therefore open to any institution providing clearing and settlement services, if it is supervised by a competent authority. This Circular supplements Banco de España Circular 4/1997 of 29 April 1997 (18), which initially described and regulated the TARGET payment system, by defining *intraday credit* (19) and participants allowed to access such service. Finally, Banco de España Circular 11/1998 refers to *cross-border payment orders* through which participants in the SLBE may order funds transfers, against their account with the central bank, in favour of participants in other real-time gross settlement systems of EU national central banks, or receive transfers from those participants. Such orders shall be irrevocable, although conditional upon the availability of funds to the issuer.

6.3. Modification of national monetary system

As mentioned above, as from 1 January 1999, the currency of the national monetary system is the euro, which has been fully and immediately substituted for the peseta and shall be divided into one hundred cents. However, until 31 December 2001, the peseta may continue to be used as a unit of account in any legal instrument, as a sub-division of the euro and according to the conversion rate. Spanish banknotes and coins shall remain legal tender until 30 June 2002, unless this period is shortened by law.

(17) See "Regulación financiera: segundo trimestre de 1997" in *Boletín económico,* Banco de España, July-August 1997, p. 82.

(18) See "Regulación financiera: segundo trimestre de 1997", in *Boletín económico,* Banco de España, July-August 1997, pp.106 and 107.

(19) Credit extended by the Banco de España to participants against adequate collateral provided by those institutions during a given daily session of the Banco de España Settlement Service. Intraday credit needs to be reimbursed during the day, either by providing sufficient funds or via the marginal lending facility, as defined in the general provisions applicable to the Banco de España's monetary policy operations and in the Law's implementing regulations.

The effects on and the principles applicable to the Spanish monetary system further to the introduction of the euro are the following:

— *Neutrality:* The substitution of the euro for the peseta shall not have the effect of altering the denomination of legal instruments in existence on the date of substitution.

— *Fungibility:* Where in a legal instrument reference is made to monetary amounts, this reference shall be equally valid whether these amounts are expressed in pesetas or in euro, provided that they have been calculated according to the conversion rate and to the rounding rules.

— *Nominal equivalence:* The monetary amount expressed in euro, after applying the conversion rate and the rounding rules, where appropriate, shall be equivalent to the monetary amount expressed in pesetas which was converted into euro.

— *Free of charge:* The substitution of the euro for the peseta shall be free of any fees, commissions, rates, costs or any other charges whatsoever to consumers. Any clause, arrangement or agreement to the contrary shall be null and void and this principle shall be considered a regulatory and disciplinary rule in the case of credit institutions.

— *Principle of continuity:* The substitution of the euro for the peseta shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter such an instrument, unless otherwise agreed by the parties. In particular, customers' and users' rights, which are recognised in customer protection regulations, shall be respected.

— *Rounding rules:* Monetary amounts to be paid or accounted for when a rounding takes place after a conversion into the euro unit shall be rounded up or down to the nearest cent. Monetary amounts to be paid or accounted for which are converted into the peseta unit shall be rounded up or down to the nearest peseta. If the application of the conversion rate gives a result which is exactly half-way, the sum shall be rounded up.

6.4. Transitional period

During the transitional period, i.e. between 1 January 1999 and 31 December 2001, references to monetary amounts in new legal instruments may be expressed either in the peseta unit or in the euro unit. However, to be expressed in euro, in private law relationships the parties must have agreed to it and, in relationships with the general government, the agreement must include the possibility of using the euro unit and the party concerned must have chosen to use it.

Conversions made by credit institutions under the aforementioned regulation, and conversions of funds to be made by investment firms to execute customer orders shall be free of charge. Commissions and fees on financial services in euro shall be equal to those charged on the same services in pesetas. This shall be a statutory requirement for credit institutions.

The law prescribed the following measures to guarantee the use of the two units of account and means of payment during the transitional period:

6.4.1. Redenomination of Banco de España certificates

Law 46/1998 provided that, as from 1 January 1999, all debt issues made by the government or by regional bodies should be in euro. As a result, the recording of these securities in the Central Book-Entry Office, as well as their trading, clearing and settlement should be solely in euro. This requirement applied to Banco de España certificates (CBEs) (20) whose accounts are held by the government debt market Central Book-Entry Office of the Banco de España. These certificates were included in the list of tier one Spanish securities which may be used in the implementation of monetary policy during Stage Three of EMU and had, therefore, to be redenominated in euro. The redenomination procedure was implemented by the Banco de España in accordance with Law 46/1998 through *Banco de España Circular 12/1998 of 23 December 1998* (BOE of 30 December 1998).

According to the aforementioned Circular, the Central Book-Entry Office shall redenominate CBEs by applying the conversion rate to the nominal holdings of security codes of CBEs which were recorded in market members' accounts at the close of the market on the last business day of 1998. The amount of the resulting nominal holdings shall be rounded to the nearest euro cent. Under no circumstances will there be any cash settlement as a result of the rounding process. The minimum tradable amount of redenominated CBEs shall be EUR 1,000 or whole multiples of that amount. Until full redemption, the features of CBEs shall remain unchanged and they shall be governed by the aforementioned Instruction and Circular. In particular, it should be noted that CBEs may not be traded, nor assigned by institutions which have an overdraft on their current account with the Banco de España, unless specifically authorised by the Banco de España. They may be purchased on the market by the Banco de España, which may redeem them early for monetary policy purposes or under exceptional circumstances.

6.4.2. Redenomination of government debt

As described in the previous section, as from 1 January 1999, debt issued by the government or by regional bodies shall be in euro. Outstanding book-entry debt issued before 1 January 1999 shall be redenominated in euro by applying the conversion rate and by rounding, where appropriate, to the nearest euro cent. If a market member's nominal holdings by security code are made up of several entries, each of them shall be redenominated and rounded separately, and they shall be added up to obtain the nominal holdings in euro.

It should be noted that *Ministerial Order of 14 October 1998* (BOE of 23 October 1998) had already determined that the face value of book-entry government debt would be eliminated. Therefore, single debt holdings of the same security code shall be changed into nominal single holdings, in order to facilitate their subsequent redenomination in euro.

Further to the publication of Law 46/1998, *Ministerial Order of 23 December 1998* (BOE of 30 December 1998) regulated the issue of government debt in euro during the month of January 1999. Additionally, two *Decisions of 23 December 1998* (BOE of 30 December 1998) of the Directorate General for the Treasury and Financial Policy (hereinafter the Treasury) regulated certain issues of bonds and Treasury bills in euro to be launched during the aforesaid month.

The features of all the securities shall remain unchanged, except for the denomination unit which shall change from the peseta to the euro. The minimum amount to be subscribed shall be EUR 1,000 (PTA 166.386) for twelve-month and eighteen-month bills and EUR 500,000 (PTA 83.5 million) for six-month bills. Bids for higher amounts shall be whole multiples of EUR

(20) CBEs are eligible assets whose features were defined in the Instruction of 16 March 1990. Banco de España Circular 1/1996 of 27 September established that the aforementioned Instruction would remain in force until full redemption of CBEs.

1,000 for twelve-month and eighteen-month bills and of EUR 100,000 for six-month bills.

With regard to bonds, the minimum amount shall be EUR 1,000 for non-competitive bids and EUR 5,000 for competitive bids. In both cases, bids for higher amounts shall be whole multiples and, in the case of non-competitive bids, their nominal amount shall be higher than EUR 200,000.

The government was empowered by Law 46/1998 to establish the procedure to be applied to the redenomination of book-entry government debt in euro. Accordingly, this procedure was laid down in *Royal Decree 2813/1998 of 23 December 1998 (*BOE of 24 December 1998).

For all purposes, the date of debt redenomination in euro was 4 January 1999 (first market business day). The Central Book-Entry Office redenominated the debt by applying the conversion rate to the nominal holdings of each of the security codes of debt recorded at the close of the market on the last day of 1998, in favour of each market member, either in their own account or through a registered dealer. The resulting amount was rounded, where appropriate, to the nearest euro cent, in accordance with the rounding rules laid down in the Law. Under no circumstances was there any cash settlement as a result of rounding, nor was redenomination considered an exchange transaction. Therefore, no capital gains or losses will emerge for accounting or fiscal purposes.

Each registered dealer was required to perform the same operation for each security code of the nominal holdings of each of its customers or principals. These amounts would be in euro cents and would be the definitive figures. Once the redenomination process was over, registered dealers issued and delivered to market members new book-entry formalisation vouchers in which debt holdings were expressed in euro.

With respect to stripped debt, the Banco de España made the required adjustments to maintain, after redenomination, the equivalence between total outstanding holdings of each security code representing stripped coupons and interest on strips which have the same coupon maturity date and have been stripped. The Banco de España also made the required adjustments to maintain the equivalence between the sum of the nominal amounts of the stripped principals and of the nominal amount of the non-stripped strips of each issue and the nominal amount of the corresponding strip issue. Besides, *Banco de España Circular 1/1999 of 8 January 1999* (BOE of 15 January 1999) implemented Royal Decree 2813/1998 with a view to modifying the minimum amounts in euro in stripped debt transactions. To this end, in each stripping or restoration order in respect of strips, the minimum nominal amount of the strip shall be EUR 500,000. Additional amounts shall be multiples of EUR 100,000. Minimum tradable amounts shall be EUR 100,000 for stripped principals and EUR 1,000 for stripped coupons. Higher tradable amounts shall be whole multiples of EUR 100,000 and EUR 1 for stripped principals and coupons, respectively.

As regards borrowing through single loans, redenomination was carried out by applying the conversion rate to the loan principal. In order to make debt issued as from 1 January 1999 more homogeneous, a minimum tradable amount of EUR 1,000 shall be applied to both Treasury bills and government bonds. Higher tradable amounts shall be whole multiples of that amount. As far as stripped debt is concerned, these minimum amounts shall be EUR 100,000 for stripped principals and EUR 1,000 for stripped coupons. In each stripping or restoration transaction in respect of strips, the minimum nominal amount of the strip shall be EUR 500,000. Likewise, market members holding accounts with the Central Book-Entry Office shall be allowed to pool the nominal holdings of a single security code to reach the required minimum tradable amount or multiples of that amount.

The aforementioned Royal Decree allows access to membership of the book-entry government debt market to the following institutions:

a) Investment firms and credit institutions authorised in another EU Member State provided that, besides complying with the current legislation, the authorisation given by the home country authorities allows these entities to provide the services of book-entry market members.

b) Investment firms and credit institutions authorised in a non-EU country provided that, besides complying with the current legislation, the authorisation given by the home country authorities allows these entities to provide the services of book-entry market members. In this last case, the Ministry of Economy and Finance may deny or condition the authorisation, if Spanish institutions are not given equal treatment in the home country of these entities (principle of reciprocity), or if compliance with Spanish government debt market regulatory and disciplinary rules is not assured.

Finally, this Royal Decree modifies Royal Decree 116/1992 of 14 February 1992 (21) on book-entry, clearing and settlement of securities with a view to allowing access to membership to any Spanish entity which is engaged in activities that are similar to those of the Securities Clearing and Settlement Service (22).

6.4.3. Changeover to the new unit of account in securities markets other than the government debt market

As from 1 January 1999, securities markets other than the book-entry government debt market are authorised to change the unit of account used in their securities trading, clearing, settlement and other financial procedures from the peseta unit to the euro unit. Changeover shall be free of charge to investors in all secondary securities markets.

During the transitional period, the information to be provided by the regulatory bodies of securities markets other than the book-entry government debt market shall be in euro, according to the rules laid down by the Ministry of Economy and Finance in *Ministerial Order of 23 December 1998* (BOE of 30 December 1998). Specifically, as from 1 January 1999, the regulatory bodies of securities markets other than the book-entry government debt market, which opt to change over to the euro unit in their operating procedures, shall provide information in euro on transactions carried out in these markets according to the following rules:

a) Information on quotation of securities and other financial traded instruments, and on payment of dividends and other yields, shall be in euro and cents.

b) Information on trading volumes of securities and other transactions carried out in those markets, and on total traded volume, may be provided in rounded thousand euro.

Similarly, the official information published by the regulatory bodies of official secondary markets in the stock exchange bulletin shall be in euro. Information shall be provided in euro and in pesetas if it refers, at least, to the following data: monetary amounts of closing prices, previous average weighted exchange rate of listed securities and other traded instruments (except forward financial contracts), liquidation value of units and assets of investment funds, as well as notional value of shares of open-end investment companies.

Collective investment undertakings which have adopted the euro unit, on their own initiative or on the decision of their management company, shall provide the information required by law in euro. The Ministry of Economy and Finance, on a report by the CNMV, specified in the aforementioned Ministerial Order the cases and conditions in which the information prepared by collective investment undertakings and their management companies shall be provided in euro and in pesetas. Finally, this Ministerial Order modifies Ministerial Order of 25 March 1991 on the system of credit in spot stock exchange transations (23), and Ministerial Order of 5 December 1991 (24) on special stock exchange transactions, with a view to converting the amounts expressed in pesetas into their equivalent amounts in euro.

In one of its articles, Law 46/1998 refers to private insurance and pension schemes and funds. In the exercise of the powers conferred upon it by this Law, the government issued *Royal Decree 2812/1998 of 23 December 1998* (BOE of 24 December) concerning the adaptation of the specific regulations on insurance and pension schemes and funds to the introduction of the euro, bearing in mind the need for harmonious implementation emphasised by the Law. Additionally, the Ministry of Economy and Finance issued *Ministerial Order of 23 December 1998 (*BOE of 31 December 1998) which implements certain provisions of the regulations on private insurance and lays down the reporting requirements entailed by the introduction of the euro. Accordingly, management companies of pension funds which have adopted the euro unit shall provide the information required by law in euro to control commissions. However, during the transitional period, annual accounts may be prepared, submitted and published in pesetas and in euro. Similarly, *insurance undertakings, including social-welfare mutual societies,* which have adopted the euro unit shall provide the information required by law in euro to policy-holders, insured and beneficiaries. Otherwise, they shall provide it in pesetas, unless the insurance policy is expressed in euro, in which case the

(21) See “Regulación financiera: primer trimestre de 1992”, in *Boletín económico,* Banco de España, April 1992, pp. 68 and 69.

(22) Up to now, members included credit institutions, the Banco de España, the Caja General de Depósitos (government depositary), securities-dealer companies and securities agencies and foreign entities engaged in activities that were similar to those of the Securities Clearing and Settlement Service.

(23) See “Regulación financiera: primer trimestre de 1991”, in *Boletín económico,* Banco de España, April 1991, pp. 49 and 50.

(24) See “Regulación financiera: cuarto trimestre de 1991”, in *Boletín económico,* Banco de España, January 1992, pp. 64 and 65.

information shall be solely provided in euro. As these life insurance operations give rise to redemption and reduction rights, the denomination in euro of these rights shall not be considered an intermediate operation. With regard to accounting aspects, the Ministerial Order defines the scope of application of the regulations on the introduction of the euro for insurance undertakings to which the Chart of Accounts of the insurance sector is applicable. Otherwise, general accounting rules shall be applied.

Lastly, this section should include the publication of *CNMV Circular 7/1998 of 16 December 1998* (BOE of 30 December 1998) which prescribes the changes to be made to certain circulars as a result of the introduction of the euro. Specifically, the circulars which must be modified and adapted refer to secondary securities markets and regulatory bodies, securities-dealer companies and securities agencies, collective investment undertakings, reporting of significant holdings and publication of information on a regular basis by entities admitted to listing.

6.4.4. Redenomination of issues of other bonds

As from 1 January 1999, the issues of bonds other than those regulated in the above sections may be redenominated in euro. The option to redenominate shall be subject to the market on which the issue is traded having adopted the euro unit (25). The issue may be redenominated if so decided by the issuer, unless the redenomination option is expressly excluded until 31 December 2001 in the issue contract. If bonds are traded in a secondary market, the advertising of redenomination shall be in accordance with securities market legislation.

During the transitional period solely, bonds traded in an organised secondary market may also be redenominated by the holder through the redenomination of holdings of securities with the same identification code, under the regulatory conditions laid down in each case, provided that technical or market conditions permit the aggregation of the final nominal holdings of the issue.

6.4.5. National Electronic Clearing System: adaptation to the euro

The adaptation of the National Electronic Clearing System (SNCE) to Stage Three of EMU made it necessary to introduce some changes into its regulations, namely to specify that as from 1 January 1999 the unit of account of the Spanish monetary system would be the euro. Accordingly, the Banco de España issued *Circular 9/1998 of 30 October 1998* (BOE of 19 November 1998) which would enter into force on 1 January and which modified the circulars discussed below.

Banco de España Circular 8/1998 is amended to specify that the amount of interbank transactions processed by the SNCE shall be expressed in euro. However, between 1 January and 31 December 2001, the amount of transactions issued in pesetas shall be expressed in that currency. Under exceptional circumstances, for the purposes of introducing and exchanging data within the SNCE, between 1 January 2002 and 31 March 2002, the amount of interbank transactions issued in pesetas prior to 1 January 2002 may be reported in that currency, without prejudice to their legal equivalence in euro. As from 1 April, the amount of these transactions shall be expressed in euro.

Banco de España Circular 11/1990 is amended to replace references to instruments expressed in pesetas by references to euro. In the section dealing with exclusion from the general commercial paper subsystem regulated by Banco de España Circular 1/1998, two indents are eliminated: instruments paid by banker's order which are debited to non-resident accounts for an amount exceeding PTA 500,000 and instruments which are not drawn or issued in pesetas.

6.4.6. Redenomination of bank accounts

During the transitional period, if so agreed by the parties, credit institutions shall redenominate in euro cash accounts in pesetas held by private individuals and the general government with the institution concerned.

Redenomination shall be free of charge and shall be carried out on the account balance on the redenomination date, by applying the conversion rate and the established rounding rules. Redenomination shall apply to the various instruments through which the account can be used, though cheques against the account may still be issued in pesetas.

6.5. End of the transitional period

As from 1 January 2002, the euro shall be the sole unit of account used by the monetary

(25) At the present time, all organised securities markets have performed redenomination in euro.

system. From 1 January to 30 June 2002 (26), banknotes and coins in pesetas shall be exchanged for banknotes and coins in euro at the conversion rate and in accordance with the established rounding rules.

Banknotes and coins shall be exchanged at the Banco de España, banks, savings banks and credit co-operatives. The only cash exchange allowed shall be of banknotes and coins in euro delivered in exchange for banknotes and coins in pesetas. The reverse exchange shall not be allowed. Exchange shall be free of charge and no fees, commissions, rates, costs or any other charges whatsoever shall be applied.

As from 1 July 2002, banknotes and coins denominated in pesetas shall lose their status of legal tender but shall still be exchanged for banknotes and coins in euro at the Banco de España, at the conversion rate and as determined by the Ministry of Economy and Finance.

As from 1 January 2002, any legal instrument which has not been redenominated during the transitional period shall automatically be deemed to be expressed in the euro unit, by applying the conversion rate and the established rounding rules.

6.6. Measures aimed at facilitating the introduction of the euro

The regulations described in the above sections were supplemented by a series of general measures aiming at facilitating the introduction of the single currency during the transitional period.

In the financial area, as from 1 January 1999, the *official exchange rate* of the peseta against other currencies shall be the euro exchange rate published by the ECB, either directly or through the Banco de España. The Banco de España may also publish euro exchange rates against currencies other than those considered by the ECB. During the transitional period, the Banco de España shall publish, for information purposes, the equivalent value of the official exchange rate in pesetas.

The *one-year interbank offered rate* (MIBOR) to be applied to outstanding mortgage loans at 1 January 1999 shall continue to be calculated and published as long as it can technically be calculated. If it cannot be calculated due to technical or market difficulties, the Ministry of Economy and Finance is empowered by the Law to determine its calculation formula or to establish a new equivalent reference rate or index to replace the MIBOR. This shall not affect the parties' freedom to modify their relevant contracts. In other financial transactions using as a reference a MIBOR rate which cannot be calculated because it has lost any financial meaning, the interest rate which is the closest substitute for the MIBOR shall be applied instead. However, this will be so, provided that the parties have not established a substitute or subsidiary rate to replace the initially agreed one, or rules to be applied in case this rate disappears or is no longer meaningful.

In relation to accounting obligations, in addition to the general rules laid down in Law 46/1998, the Government, in the exercise of the powers conferred upon it by the Law, issued *Royal Decree 2814/1998 of 23 December 1998* (BOE of 24 December 1998) which defines the rules applicable to the accounting aspects of the introduction of the euro, taking into account the special characteristics of Spanish entities. During the transitional period, an optional asymmetrical system shall allow entities to choose to express their individual and consolidated annual accounts either in euro or in pesetas but, if they opt to use the euro unit in their account books and annual accounts, this decision shall be irreversible. However, credit institutions shall be required to keep their accounts solely in euro. With respect to the valuation of certain assets as a result of the introduction of the euro, the Royal Decree regulates specific aspects, such as the accounting treatment of exchange differences arising in the currencies of euro-11 countries, and the translation differences in consolidated annual accounts when they include companies from euro-11 countries. The Royal Decree also addresses the treatment of expenses arising from the introduction of the euro and of rounding procedures, as well as cases in which the close of the financial year of undertakings does not coincide with the calendar year. Finally, the aforementioned regulation specifies the information to be included in the annual financial report in relation to the effects of the introduction of the euro.

As regards company law, the redenomination of the amount of the share capital of commercial companies by applying the conversion rate and, where appropriate, the established rounding rules to that amount is regulated. Likewise, a simple formula is allowed to adjust to the nearest euro cent the face value of shares which, as a result of redenomination, would have more than two decimals.

(26) Or at an earlier date, if the period is shortened by law.

As far as tax regulations are concerned, the Ministry of Economy and Finance or other competent authorities are empowered by the Law to establish the terms, conditions, procedures and models for submitting tax returns in euro. In doing so, they shall combine a flexible system with an irreversible process, in the same way as for accounting obligations. Equivalent regulations are applied to social security contributions and general government proceedings, contracts and general provisions shall be required to include the equivalent amount in euro as long as the peseta unit is used.

7. REFORM OF THE SECURITIES MARKET

7.1. Background

Comprehensive reform of the Spanish securities markets, as carried out in Law 24/1988 of 28 July 1988 (27), was undertaken somewhat later than the modernisation effected in other EU countries. As stated in the preamble to the Law, one of its main objectives was to strengthen the Spanish Securities market in the lead up to a single securities market in 1992.

The construction of a single European financial market has been based in recent years on three important directives:

First, the Second Banking Directive [Directive 89/646/EEC of 15 December 1989 (28)] was essential to achieve a common framework for the activities of credit institutions within the European Union (EU), from the point of view of both the right of establishment and of freedom to provide services. The Directive was incorporated into Spanish law by means of Law 3/1994 of 14 April 1994 (29), which basically widened and modified the contents of Law 26/1988 of 29 July 1988 (30) on the discipline and administration of credit institutions, in order to include the provisions of this Directive.

Second, Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions was published, with the aim of harmonising the elements considered essential to secure the mutual recognition of authorisation and of prudential supervision systems of investment firms.

Finally, Directive 93/22/EEC of 10 May 1993 (31) on investment services in the securities field (32) was essential to the achievement of the internal market, from the point of view of both the right of establishment and of the freedom to provide services, in the field of investment firms. The investment services Directive, like the Second Banking Directive, introduced the principle of the Community passport or single licence (33), which is based on the harmonisation of the conditions for authorisation and pursuit of the activity, as well as of the prudential supervision systems (34) for investment firms.

Ten years after the promulgation of Law 24/1988 of 28 July 1988, and with the aim of incorporating into Spanish law Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (ISD), *Law 37/1998 of 16 November 1998* (BOE of 17 November 1998) (35) has been published. Adaptation to the ISD means that any investment services firm (ISF), whether or not Spanish, that is authorised in one EU Member State, has the right to *enter all EU markets,* including the Spanish market, as a member, with the possibility of access to or membership of clearing and settlement systems. In other words, both Spanish ISFs and those authorised in other EU countries are acknowledged to have the right to operate as members in official secondary markets. However, in view of the exception made in the Directive, credit institutions shall not have such a right until 1 January 2000.

At the same time, with the start-up of Stage Three of EMU and the adoption of the single

(27) See “Regulación financiera: tercer trimestre de 1988”, in *Boletín económico,* Banco de España, October 1988, pp. 61-62.

(28) See “Regulación financiera: primer trimestre de 1990”, in *Boletín económico,* Banco de España, April 1990, pp. 71-72.

(29) See “Regulación financiera: segundo trimestre de 1994”, in *Boletín económico,* Banco de España, July-August 1994, pp. 92-96.

(30) See “Regulación financiera: tercer trimestre de 1988”, in *Boletín económico,* Banco de España, October 1988, pp. 56-58.

(31) See “Regulación financiera: segundo trimestre de 1993”, in *Boletín económico,* Banco de España, July-August 1993, pp. 106-108.

(32) Its content has already practically been incorporated into Spanish law. See Banco de España Circular 5/1993 of 26 March 1993 and CNMV Circular 6/1992 of 30 December 1992.

(33) This principle means that an investment services company, under the authorisation granted by the State in which its registered office is located, may provide investment services and undertake complementary activities in the rest of the EU, both by establishing branches in other Member States and offering services there.

(34) Recognition of supervision systems enables the principle of supervision by the home Member State to be applied.

(35) This Law entered into force on 18 November 1998, except for the provision stipulating that credit institutions, of whatever nationality, may be members of the Stock Exchanges, which shall not enter into force until 1 January 2000.

currency on 1 January 1999, the government has promulgated *Royal Decree 2590/1998 of 7 December 1998* (BOE of 18 December 1998), in order to increase efficiency and competition in the securities markets, while preserving the basic operating and organisational principles.

7.2. Scope of the reform

7.2.1. Extension of the scope of application of the Law

The scope of application (36) is extended to include, in addition to marketable securities, the following:

a) Contracts of any kind that are traded on official or unofficial secondary markets.

b) Financial futures, options and swap contracts, provided that the underlying assets are marketable securities, indices, currencies, interest rates or any other kind of financial asset, irrespective of the way in which they are settled and even if they are not traded on any official or unofficial secondary market.

c) Contracts or operations involving other instruments, provided that they are capable of being traded on an official or unofficial secondary market, even if their underlying asset is not financial, but rather merchandise, commodities or any other fungible good.

7.2.2. Keeping of securities accounting records

As from the entry into force of the Law, the accounting records for marketable book-entry securities not traded on official secondary markets shall no longer be kept exclusively by securities-dealer companies and securities agencies; rather the entity concerned shall be freely designated by the issuer from among the ISFs and credit institutions authorised to pursue this activity.

7.2.3. New composition and new powers for the Consultative Committee of the CNMV

The composition of this committee has been updated so that the members are appointed to represent the members of all official secondary markets, the issuers and investors. In addition, a further representative is appointed by each of the Regional (Autonomous) Governments with powers in relation to securities markets in whose territory there is an official secondary market.

The Committee has also been conferred new responsibilities, among which the following are noteworthy: *a)* the mandatory reports for the granting and revocation of authorisation for the branches of ISFs of non-EU countries, as well as for other securities market agents, where regulations so establish, and *b)* reports on proposed legislation of a general nature on matters directly relating to the securities market.

7.2.4. Official secondary securities markets

The new law defines official secondary securities markets as those which regularly operate in accordance with the provisions of this Law and its implementing provisions, in particular, as regards the conditions of access, admission to listing and operating, information and publicity procedures. In addition to stock exchanges and the government debt market, *futures and options markets,* whatever the type of underlying asset, are now considered to be official secondary securities markets too. The possibility is also left open that other nationwide markets, authorised pursuant to this Law and its implementing provisions, and other regional markets authorised by the Regional (Autonomous) Governments with powers in this field, may be so defined.

The new law distinguishes between ordinary and extraordinary transactions. The former are those subject to the basic rules of operation of the market (in particular, those requiring the mediation of members and the processing of the transaction through the ordinary dealing systems). Extraordinary transactions are those which are not subject to all or some of these basic rules, and can only be carried out in three cases:

1. When the buyer and the seller are habitually resident or established outside Spain.

2. When the transaction is not carried out in Spain (37).

3. When the buyer and seller have previously expressly authorised an investment services firm (securities-dealer company or securi-

(36) Previously it only included marketable securities.

(37) The requirements which must be fulfilled for an operation to be deemed carried out outside Spain shall be determined in regulations.

ties agency) or a credit institution in writing to carry out the transaction in question without it being subject to the rules of operation of the market (38).

In any event, and regardless of whether or not they are market transactions, ISFs are placed under an obligation to notify all kinds of transactions to the market regulatory bodies, in order to ensure their proper operation and the protection of investors.

Likewise, repurchase agreements (both the Spanish and ordinary variety) may be recognised as secondary market operations.

For its part, Royal Decree 2590/1998 amends Royal Decree 116/1992 of 14 February 1992, on the representation of securities by means of book-entries and clearing and settlement of Stock Exchange transactions, to regulate a special procedure for the clearing and settlement of Stock Exchange transactions that are a consequence of monetary policy operations conducted by the Banco de España, the ECB and the central banks of the ESCB. Thus, irrespective of the nationality of the issuer, and in order to facilitate the settlement of the government-securities transactions which the ESCB uses to implement monetary policy, the Banco de España may establish the connections with the securities settlement systems in which such classes of securities are recorded. In particular, these links may take the form of:

a) The opening of accounts at the Central Book-entry Office of the government debt market for other securities clearing and settlement systems in which the overall balances of Spanish government debt held by foreign investors through such systems may be recorded.

b) Likewise, the Central Book-Entry Office may keep accounts with the securities settlement systems of other countries in which the balances of foreign government securities – both those acquired by the Banco de España itself to implement monetary policy and those acquired by institutions belonging to the STMD (Money-Market Telephone Service), now the SLBE (Banco de España Settlement Service), and to the Central Book-Entry Office – may be recorded. The latter shall record the individual balances of these kinds of securities held by its member institutions.

(38) The content of the requirements for the said authorisation shall be determined in regulations. Among other aspects, the nature of the investor, the amount of the operation and the price conditions shall be taken into account for the purpose.

7.2.5. Lending of securities traded on secondary markets

In relation to market operations, it has been considered appropriate to clarify the regulations for a certain type of lending of securities traded on secondary markets, in order to increase market depth and efficiency and at the same time to establish the regulatory framework for the relevant tax regime conducive to the development of the same. It shall be subject, inter alia, to the following principles:

a) Only those securities which, by reason of the frequency with which they are traded and their liquidity or of their suitability to serve as collateral in monetary policy operations, have been designated by the regulatory body of the market in question may be lent. Securities identical to those of the issuer which are subject to a public offering or securities subscription may also be lent, provided that the operation is recorded in the prospectus.

b) Securities delivered on loan must belong to and be in the possession of the lender.

c) The lender, unless otherwise agreed, shall be entitled to the proceeds of the financial rights inherent in the securities.

d) The maturity of the loan may not exceed one year.

e) The borrower must secure the return of the securities by means of the guarantees that may be determined by the CNMV.

7.2.6. Pledging of book-entry securities

Law 37/1998 lays down new regulations for security based on the *pledging of book-entry securities* in order to favour the development and efficient operation of secondary markets. Pledges may be created over book-entry securities admitted to listing on secondary markets to secure the general obligations contracted vis-à-vis a secondary market or its clearing and settlement systems, or to secure the performance of the obligations arising from transactions in these markets. Such pledges may be created:

a) By a contract authorised by an official broker *(corredor de comercio colegiado)* or by a notarial deed.

b) By a private document, the entity responsible for keeping the accounting records being required to make the relevant entry when it has notice of the consent of the person who appears as the holder in such records and of the entity in whose favour the pledge is created.

c) By a unilateral declaration, including by electronic-data transmission methods, by the person who appears as holder in the accounting records. In this case, acceptance of the entity in whose favour it is created shall be deemed to have occurred from when such unilateral declaration is notified to the entity responsible for keeping the accounting records of the securities, provided that this is envisaged in the regulations of the market or clearing and settlement system in question, or that the parties concerned have expressly agreed upon this form of acceptance beforehand.

The pledge so created shall be effective with respect to third parties from the date on which it is recorded in the accounting records.

As regards the execution of pledges, notwithstanding the provisions of the Commercial Code, it shall be sufficient to evidence the documents stipulated, if applicable, by the regulatory and disciplinary rules of the market when regulating the creation of the pledge to evidence the existence of the pledge and the amount owed. When the guarantees consist of cash deposits, with or without a power of management, the execution of the same shall be by means of simple set-off. In other cases, if there is no procedure specially provided for by law, they shall be executed by auction conducted by a Notary Public or official broker, notice having been given to the debtor and, if not the same person, the owner of the asset, security or right given as security.

This regime shall also be applicable to pledges to secure obligations contracted vis-à-vis the *Banco de España in the conduct of its monetary policy operations* as well as those which institutions participating in an interbank payment system have to create as security for the performance of their obligations.

For their part, the regulatory bodies of secondary markets and their clearing and settlement systems shall enjoy the privileges which the Civil Code confers on secured creditors with respect to the assets, securities and rights subject to the guarantees executed in their favour by the members or investors in such markets. This is regardless of the nature of the assets, securities or rights concerned and the formalities of their creation, provided that they have been created in accordance with the legislation applicable and the particular rules of each market.

7.2.7. Members of official secondary securities markets

As mentioned above, another fundamental aspect of the reform, in line with Directive 93/22/EEC of 10 May 1993, on investment services, is the acknowledgement of the right of access with member status to official secondary markets of the following institutions:

a) Securities-dealer companies and securities agencies.

b) Spanish credit institutions.

c) Spanish ISFs and credit institutions authorised in other EU Member States, provided that, in addition to fulfilling the requirements laid down in this Law to operate in Spain, they are empowered under the authorisation of their home country to provide certain investment services (the execution of orders on behalf of third parties and trading for own account).

d) Spanish ISFs and credit institutions authorised in a non-EU state, provided that, in addition to fulfilling the requirements laid down by this Law to operate in Spain, they are empowered under the authorisation of their home country to provide the investment services mentioned in the previous paragraph. This notwithstanding, the Ministry of Economy and Finance may refuse these entities access to Spanish markets or place conditions on such access for prudential reasons, where Spanish entities are not accorded the same treatment in their home country, or where compliance with the Spanish securities regulatory and disciplinary rules is not assured.

e) Such others as the Regional (Autonomous) Governments with responsibilities in this area may determine.

7.2.8 New issues and public offerings of securities

The opportunity afforded by the reform has also been used to redefine the concept of a public offering of securities (39), in such a way that it includes not only an offering of unlisted securities, but also an offering of securities already traded on a secondary market. For its part, Royal Decree 2590/1998 amends Royal Decree 291/1992 of 27 March 1992 (40), on

(39) A public offering shall be considered to be an offering to the public, for own account or for that of a third party, of previously issued marketable securities.

(40) See “Regulación financiera: primer trimestre de 1992”, in *Boletín económico,* Banco de España, April 1992, pp. 70-72.

new issues and public offerings of securities, to improve advertising activities. Advertising activities shall be deemed to include all forms of communication directed at investors in order to promote, either directly or through third parties acting on behalf of the issuer or offeror, the subscription or acquisition of marketable securities, including telephone calls, home visits, personalised letters, e-mail or any other electronic-data transmission method, provided that, in all cases, the issuer or offeror of the securities is actively facilitating the acquisition of the same.

Special mention is required of the changes made to prospectuses, to improve them and to widen the range of types available, so as to enable issuers to have more efficient access to markets. Thus, to reduce the costs of enabling a security to be traded on the market, the new issue prospectus may also serve as the prospectus for admission to listing on the market in question. The changes introduced into the shortened prospectus and the two possible varieties: the new issue or offering prospectus (41) and the programme prospectus (42) should be noted. Also, the concept of the "triptych", a leaflet containing extracts from the prospectus, is introduced in order to improve information for potential investors. Finally, fulfilment of the requirements is made more flexible when changes are made to securities in circulation, as well as the parties involved in a new issue or public offering (placing entity, lead-manager, co-ordinator or underwriter).

7.2.9. Book-entry government debt market

The new Law covers trading in fixed-income securities issued by the ECB and EU national central banks (43).

It also introduces the possibility of securities admitted to listing on this market being traded, on the terms laid down by regulations, on other official secondary markets. This trading shall be subject to the rules regulating the book-entry government debt market.

The new legal regime for the book-entry government debt market should be governed by this Law and its implementing provisions, as well as by a Regulation to be approved by the Ministry of Economy and Finance at the proposal of the Banco de España, following a report by the CNMV. This Regulation – which may be issued in the form of Banco de España circulars – will regulate:

— Tthe rules relating to listing, trading, obligations to provide information to the Banco de España and to publicise transactions, including the rights and obligations of market members.

— The recording, clearing and settlement of transactions, potentially including procedures to ensure that securities are delivered and paid for, as well as the requirement for guarantees to this end.

— The rights and obligations of the holders of accounts in their own name and managing entities.

As regards members of the book-entry government debt market, in addition to the Banco de España, the same entities as specified for official secondary securities markets, as well as such other entities as may be determined by regulations, shall be entitled to hold the status of market members.

7.2.10. Official book-entry futures and options secondary markets

The Law renames Chapter IV of Law 24/1988 to introduce official book-entry futures and options secondary markets. These have already been developed in the Spanish financial system. They shall be authorised by the government, in the case of nationwide markets, at the proposal of the CNMV, and, in the case of regional markets, by the relevant Regional (Autonomous) Government with responsibilities in this area.

Futures and options contracts, whatever the underlying asset, may be traded on these markets. Other financial derivatives may also be traded, on such conditions as may be determined in regulations.

As in the case of the government debt market, the same entities as specified for official secondary securities markets may be members of these markets. In the case of markets in which financial derivatives with non-financial underlying assets are traded, the acquisition of such status by entities other than those mentioned may be determined in regulations, provided that they fulfil the requirements of specialisation, professionalism and solvency. There shall be a regulatory body, in the form of a public limited company, whose basic functions shall

(41) Relating, exclusively, to a specific new issue or public offering of securities.

(42) Referring to a plan of different issues or securities offerings which a single person or entity intends to make in Spain over the following 12 months.

(43) Traditionally, the book-entry government debt market was solely for trading fixed-income securities in the form of accounting entries issued by the State, Regional (Autonomous) Governments, other public entities and corporations and by international bodies of which Spain was a member.

be to organise and supervise, record the contracts and, where applicable, manage the clearing and settlement. It may also hold an account with the Central Book-Entry Office for the purpose of managing the system of guarantees.

These markets, besides being governed by this Law and its implementing provisions, shall be governed by a specific Regulation which shall specify the classes of members, legal relations with clients, rules of supervision, system of guarantees, settlement operations, contracts, and any other aspects specified in regulations.

7.2.11. Investment services firms (ISFs)

Title V of Law 24/1988, which refers to securities-dealer companies and securities agencies, has been renamed *empresas de servicios de inversión* (investment services firms), to use a wider term and to introduce the terminology used by Directive 93/22/EEC. This category includes, in addition to securities-dealer companies and securities agencies, *portfolio management companies.* The investment services shall be provided in relation to the marketable securities and financial instruments discussed in previous paragraphs.

The following are considered to be *investment services:*

1. The receipt and transmission of orders and, where applicable, the execution of such orders on behalf of a third parties.

2. Trading for own account.

3. Discretionary and individualised management of investment portfolios in accordance with the mandates conferred by investors.

4. Mediation, directly or indirectly, on behalf of the issuer in the placement of new issues and public offerings of securities, as well as underwriting the subscription of new issues and public offerings.

Additional activities which they may pursue include, inter alia: the custody and administration of financial instruments, the rental of safe-deposit boxes, the extension of credit or loans to new investors to enable them to enter into transactions in relation to one or more of such instruments and acting as registered entities to enter into currency transactions connected with investment services.

Credit institutions, even though they are not ISFs, may normally carry out all the above-mentioned activities, provided that their legal regime, their articles of association and their specific authorisation enable them to do so. However, they cannot be members of stock exchanges until 1 January 2000.

The government may regulate the creation of other entities, and also permit other persons or entities which, even though they are not ISFs, may perform some of the latter's activities (44), or which help to improve the development of securities markets.

As regards the conditions for taking up the business, ISFs, in the same way it was securities-dealer companies and securities agencies, shall be authorised by the Ministry of Economy and Finance, at the proposal of the CNMV. Along with the application for authorisation and others such documents as may be determined in regulations, the shall submit a *programme of activities,* in which they shall specify which type of services of those stipulated as potentially provided by ISFs they intend to pursue, as well as their organisation and resources. The authorisation of an investment firm shall also be subject to *prior consultation* with the supervising authority of the relevant EU Member State, when certain circumstances pertain, including, when the new firm is going to be controlled, directly or indirectly, by an investment services firm or, as the case may be, a credit institution already authorised in that State.

To obtain the authorisation they must fulfil a number of requirements, similar to those specified for securities-dealer companies and securities agencies, but with a few changes. Hence, they must join the Investment Guarantee Fund (see below) and have internal rules of conduct, adjusted to the provisions of this Law, as well as safety and control mechanisms in the area of information technology and adequate internal control procedures.

7.2.12. Significant holdings in ISFs

As envisaged in Law 24/1988, a direct or indirect holding in an ISF representing at least 5 % of the capital or voting rights of the firm is deemed to be a significant holding. In addition, a holding which, without reaching the above-mentioned percentage, nonetheless enables a *significant influence* to be exercised in the firm is also deemed to be a significant holding (45).

(44) They may only provide investment services in relation to marketable securities, in their different forms, including shares in mutual funds and money-market instruments which have such status, provided that they do not receive from their customers funds or financial instruments on deposit.

(45) Regulations shall determine the circumstances in which it is presumed that a person exercises a significant influence.

Persons – legal or natural – intending to acquire a significant holding shall first inform the CNMV. They must also do so if they intend to increase a holding to the extent that it would reach or rise above any of the following thresholds: 10 %, 15 %, 20 %, 25 %, 33 %, 40 %, 50 %, 66 % or 75 %. The CNMV shall have two months in which to object to the acquisition. If it fails to do so, the intention shall be deemed approved. Likewise, if as a consequence of the acquisition, the ISF becomes controlled by an ISF or credit institution belonging to an EU Member State, the CNMV must consult the competent supervising authority in that State. If it becomes controlled by a firm authorised in a non-EU country, the CNMV shall take into account the reciprocity principle.

Finally, if the acquisition or increase in the holding takes place without the CNMV being informed or when it has expressly objected, the following effects shall arise: *a)* the voting rights corresponding to the irregularly acquired holdings may not be exercised or, if they are exercised, shall be void; *b)* the firm may be ordered to suspend its activities, and *c)* where necessary, an administration order or an order for replacement of the directors shall be issued.

3. Cross-border activities of ISFs

Cross-border activities of EU-domiciled ISFs

In accordance with the provisions of Directive 93/22/EC, now being incorporated into Spanish law, ISFs authorised in another EU Member State may carry on in Spain, either by opening a branch, or else under the freedom to provide services (without a permanent establishment), all the specific activities of these institutions mentioned above. For this purpose, it is essential that the authorisation, the articles of association and the legal regime of the institution empower it to pursue the activities it intends to carry on.

In the pursuit of their business in Spain they must observe all the provisions issued before the general interest, the rules of conduct, including *physical presence in markets whose method of trading so requires,* and the regulatory rules applicable to them. Under the principle of a single licence for the whole EU (Community passport) proposed in the Directive, the establishment of branches and the freedom to provide services can never be made conditional upon the obligation to obtain an additional authorisation, or to provide an endowment of funds, or any other measure having the same effects.

Cross-border activities of ISFs not domiciled in the EU

Non-EU ISFs which intend to open a branch in Spain shall be subject to the authorisation procedure provided for in the general conditions for taking up the business, as adapted by regulations, if any. The authorisation may be denied or made subject to conditions for prudential reasons, where Spanish institutions are not given the same treatment in their home country, or where compliance with the regulatory and disciplinary rules of the Spanish securities markets is not assured.

Cross-border activities of Spanish ISFs

Spanish ISFs intending to open a branch or provide services without a branch in a non-EU country must first obtain an authorisation from the CNMV. The provision of services without a branch in a Member State merely requires prior notification to the CNMV, specifying the activities, which are to be carried on.

Where a Spanish ISF or a group of Spanish ISFs intends to create a foreign ISF or intends to acquire a holding in an existing foreign ISF, and such company is going to be established or is domiciled in a non-EU country, prior authorisation of the CNMV shall be required.

7.4. Investment Guarantee Fund (FGI)

Directive 97/9/EC of the European Parliament and of the Council of the 3 March 1997 on investor-compensation schemes, now being incorporated into Spanish law, required the introduction and official recognition in the territory of each Member State of one or more investor-compensation schemes, so that no investment firm authorised in that Member State may carry on investment business unless it belongs to such a scheme.

Pursuant to the above, FGIs (similar to the deposit guarantee funds of credit institutions) are now regulated for the first time to ensure that investors are covered in the event of situations of insolvency or when ISFs are unable to meet their obligations to investors. Such obligations include both those arising from the provision of their services and from the supplementary activity of custody and administration of financial instruments. However, FGIs are not given certain other functions which deposit guarantee funds have (such as to take preventive or restructuring measures).

FGIs shall be created as separate pools of assets, without their own legal identity, which shall be represented and managed by one or more management companies with the status of a public limited company. The capital of the latter shall be distributed among the investment services firms belonging to the FGI in the same proportion as their contributions to its/their respective funds.

The following shall join an FGI:

— Spanish ISFs are obliged to join. Nonetheless, regulations may provide for certain exceptions.

— The branches of Community ISFs may join voluntarily.

— The branches of non-EU ISFs shall be subject to such rules as may be established in regulations.

An ISF may be excluded from the FGI when in breach of its obligations. This entails the automatic revocation of the authorisation granted to the firm. The guarantee of the FGI shall extend to clients who have made their investments up to that time. The CNMV shall have the power to order exclusion, after a report from the fund's management company. The exclusion ruling must be disseminated sufficiently to ensure that the clients of the ISF concerned are immediately aware of the measure taken.

It should be noted that investors who are unable to obtain directly from a member institution repayment of the amounts or return of the securities or instruments belonging to them may apply to the management company of the same for execution of the guarantee provided by the fund, in any of the following circumstances:

a) When the institution has been declared insolvent.

b) Where proceedings applying for a declaration of suspension of payments by the institution have been instituted.

c) Where the CNMV declares that the FSI is apparently unable to meet its obligations to its investors, provided that the latter have requested the return of their funds and have not obtained satisfaction from the institution within 21 business days.

As regards their tax regime, it should be noted that FGIs shall enjoy an exemption from the indirect taxes which may be payable in connection with their establishment, their operations and the acts and transactions they may perform in pursuit of their objectives. The exemption shall also cover transactions subject to indirect taxes, the amount of which shall be charged to them in accordance with the provisions regulating the taxes.

7.5. Redefinition of the rules of conduct and sanctioning regime for ISFs

The new arrangements for the securities market have obliged both the rules of conduct and the scope of supervision of the CNMV and its sanctioning regime to be redefined. Thus, the ISFs, credit institutions and persons or entities operating in the securities market must observe the rules of conduct laid down in the Law and its implementing provisions and those contained in its own internal conduct regulations.

These institutions must give absolute priority in their operations to their clients' interests, in conformity with the spirit already indicated in Law 24/1988, and where there is a conflict of interests between different clients, no particular client shall be given any special preference. Other principles of good conduct are: diligent and transparent dealings with clients, orderly and prudent management, etc.

The new Law specifies the meaning of *privileged information,* this being information of a specific nature which refers to one or more securities and one or more issues, which has not been made public and which, if it were to be, might influence or would have influenced significantly the price of such securities. Likewise, it specifies the measures which firms must take to ensure that secret or *privileged information* is not, directly or indirectly, accessible to the staff of the same institution who provide their services in a different area of activity, so that each function is exercised autonomously.

7.6. Other issues

The thirteenth additional provision to Law 37/1998 makes certain amendments to Royal Legislative Decree 18/1982 of 24 September 1982 on *the deposit guarantee funds of credit institutions,* in order to afford protection to investors who have entrusted money, securities or other financial instruments to them for the provision of some investment service. The provision cited indicates the circumstances which give rise to such protection (insolvency or suspension of payments preventing the return of the securities, or the proven impossibility of securing their return), the obligation to compensate in cash and the way in which the funds shall be subrogated to the rights of the compensated investors. Finally, in the event that a fund's resources are exhausted, the possibility is envisaged of imposing special levies on the members, in proportion to their current contributions.

The fourth additional provision to the same Law provides for the possibility of creating, with due legal certainty and transparency, mortgage securitisation funds, regulated by Law 19/1992 of 7 July 1992, made up of *shares in impaired mortgage loans,* provided that such loans and the mortgages created to secure them meet the other requirements laid down in the mortgage market legislation, mechanisms or instruments are established to improve their credit quality and they are duly supervised by the CNMV.

Finally, the fifteenth additional provision should be mentioned. This makes various amendments to the consolidated text of the Public Limited Companies Law, approved by Royal Legislative Decree 1564/1989 of 22 March 1989. As a result companies are permitted to issue shares without voting rights which will give entitlement to the same dividends as ordinary shares, and it is possible for *repurchaseable shares* to be issued. The latter may be repurchased upon the request of the issuer itself (in which case they shall have a minimum duration of three years) or their holders or both. They shall be repurchased using profits, distributable reserves or the proceeds of a new issue of shares.

8. REFORM OF THE LAW GOVERNING COLLECTIVE INVESTMENT UNDERTAKINGS

Law 37/1998 (already mentioned above) also amends certain provisions relating to collective investment undertakings (CIUs). First, the functions of the CNMV are reinforced to facilitate the setting up of CIUs; the corporate objects of CIU managers are widened; a new type of institution is added to the existing ones, namely that of the *Fund of Funds* (umbrella fund) and *Principal and Subordinate Funds,* a category of securities fund characterised by having most of their funds in the securities of other CIUs.

Three new categories of CIU are created: fund closed-end investment companies (SIMF), fund open-end investment companies (SIMCAVF) and fund securities funds (FIMF), which are characterised by investing most of their assets in the shares or other equity of one or more financial CIUs.

Within these categories, subordinate and principal CIUs are distinguished. Subordinate CIUs are those which invest in a single CIU, their Spanish acronyms being: SIMS, SIMCAVS and FIMS. Principal CIUs are those whose *shareholders* are subordinate CIUs, their Spanish acronyms being: SIMP, SIMCAVP and FIMP. Rules on investments in the shares or other equity of one or more CIUs, on risk diversification, minimum capital ratios, valuation and accounting, and for share subscription and redemption will be established in regulations.

Also, closed-end (SIMs) and open-end (SIMCAVs) investment companies can be set up as securities funds (FIMs) which invest most of their assets in *securities not traded on regulated securities markets;* and as securities funds (FIMs) or money-market funds (FIAMMs), as well as any financial CIU in the form of a mutual fund whose shareholders are exclusively *institutional or professional investors.*

At the same time, the rules on the investments of CIUs in derivative instruments are more clearly stated; and, as regards CIU management companies, on one hand they are attributed the power to market securities representing CIUs, and, on the other, the provision for intervention and supervision is extended.

9. REGULATION OF THE REPRESENTATIVES OF SECURITIES-DEALER COMPANIES AND SECURITIES AGENCIES

Royal Decree 276/1989 of 22 March 1989, established that natural and legal persons not connected with securities-dealer companies and securities agencies can perform their activities, as representatives of the latter, without this being considered to violate the principal of exclusivity, when their actions are carried out for and on behalf of a single securities-dealer company or securities agency. These representation relationships must be notified by the securities-dealer companies and securities agencies to the CNMV. Subsequently, CNMV circular 7/1989 of 5 December 1989, specified the way such notice must be given and the publicity required.

Recently, the CNMV has regulated, by means of CNMV circular 5/1998 of 4 November 1998 (BOE of 19 November 1998), a new procedure for notifying such representation relationships, simplifying the present procedure. It should be pointed out that the principle of exclusivity and of compulsory declaration of the activities to be performed by the representative will appear in the contractual documents. As regards the method and period for notifying representation relationships to the CNMV, the forms included in this circular must be used and submitted by a computerised medium, in accordance with the technical requirements established by the Commission, within the 20 days following the end of each calendar quarter.

Finally, the above-mentioned decree removes the obligation on credit institutions (46) to notify the CNMV of the activities of their agents in the securities market, provided that they are included in the programme of activities that the institution has declared to the Banco de España.

10. CHANGE IN THE LEGAL REGIME FOR CURRENCY-EXCHANGE BUREAUX

Law 13/1996 of 30 December 1996 (47), on fiscal, administrative and social measures, which accompanied the 1997 Budget Law, pointed to the need to complete the regulation of currency-exchange bureaux, other than credit institutions, with more comprehensive legislation, similar to that in other European countries, regarding the persons who perform such operations, authorising the government to implement the same. This has now been done by Royal Decree 2660/1998 of 14 December 1998 (BOE of 15 December 1998), which regulates the activity of these establishments while giving due regard to free competition and the proper protection of clients.

As regards its scope of application, the activity of currency-exchange bureaux, whatever they may be called, is widened to include not only the exchange of currency (the purchase and sale of foreign banknotes) but also the management of transfers received from or sent abroad through credit institutions. Currency-exchange bureaux authorised to make such transfers shall channel the movements of debits, credits and settlements of balances which arise or are necessary to perform this activity through accounts with credit institutions operating in Spain. Likewise, settlement by clients, orderers or beneficiaries of the transfers, where the amount exceeds PTA 500,000, shall necessarily be made by crediting or debiting the amount to a bank account in the name of the currency-exchange bureau.

Authorisation to engage in this activity shall still be given by the Banco de España and shall be granted providing the following requirements are fulfilled:

a) The owners of the bureaux and, as the case may be, the partners, managers, managing directors, and the like shall be persons of recognised business and professional integrity.

b) Bureaux shall have the legal status of a public limited company with the sole object of engaging in transactions to buy and sell foreign banknotes and travellers cheques and to manage cross-border transfers.

c) Their share capital shall be fully subscribed and paid up in cash. Its amount shall depend on the transactions to be performed: when their objects are limited exclusively to the sale and purchase of foreign banknotes and travellers cheques it shall be PTA 10 million; and when their objects also include the management of cross-border transfers for various purposes it shall be PTA 300 million.

d) They shall have taken out insurance against the liabilities that may arise from their activities of managing cross-border transfers, for an amount of between 50 and 100 million pesetas, depending on the circumstances.

Among the obligations of the currency-exchange bureaux, the Royal Decree mentions exchange rates and the protection of clients, the recording of transactions and obligations to provide information to the Banco de España. As regards the exchange rates applicable to foreign-currency buying and selling transactions, these shall be freely determined, provided that the rules on publicity, transparency and client protection that may be established by the provisions implementing this Royal Decree are observed. As regards the recording of transactions, bureaux must identify individually the persons who participate in transactions and report to the Banco de España and the tax authorities in the manner and subject to the limits laid down by current legislation. In particular, when a bureau performs cross-border transfer management operations for a single client for an amount of more than PTA 500,000, it shall first obtain all material data on the transfer: full identification of both the orderers and beneficiaries, their tax identification codes, the amount and the reason for the transfer. Finally, currency-exchange bureaux must send to the Banco de España such information as it may request of them regarding their accounting statements, boards of directors and any other similar data that it may deem appropriate.

Lastly, the Royal Decree specifies the supervision and sanctioning regime for currency-ex-

(46) This obligation shall however continue to exist for portfolio management companies.

(47) See “Regulación financiera: cuarto trimestre de 1996”, in *Boletín económico,* Banco de España, January 1997, p. 115.

change bureaux. The Banco de España shall be responsible for supervising and inspecting their activities, and may request all such financial, accounting or other information as it shall deem fit to perform its functions. As for the sanctioning regime, it shall be that laid down in Law 26/1988 of 29 July 1988 on the discipline and administration of credit institutions, adapted to the particular characteristics of currency-exchange bureaux, and it may result in the revocation of their authorisation.

11. MUTUAL GUARANTEE COMPANIES: INFORMATION ON THEIR MINIMUM OWN FUNDS

Law 1/1994 of 11 March 1994 (48) on mutual guarantee companies (MGCs), amended the regulation of these entities (49). The aim was to facilitate the expansion of the mutual guarantee system, thereby improving the access of small- and medium-sized companies to finance and making MGCs genuine instruments of business promotion. Among the changes included in the Law, was the classification of MGCs as financial institutions, which helps to clarify the position of these companies within the Spanish financial system; the system of administrative authorisation of the Ministry of Economy and Finance for their establishment; and an increase in solvency and liquidity requirements. Subsequently, Royal Decree 2345/1996 of 8 November 1996 (50) on the administrative authorisation rules and solvency requirements for MGCs, laid down the minimum solvency requirements, the minimum amount of own funds, and the conditions under which these companies may issue bonds.

The Banco de España has recently issued *Banco de España Circular 10/1998 of 27 November 1998* (BOE of 9 December 1998), which lays down the information MGCs must submit in relation to the own-funds ratio, their mandatory investments, and the limit on tangible fixed assets and the shares and other equity regulated by said Royal Decree 2345/1996. It also reproduces some of the provisions of this Decree to facilitate compliance therewith.

Given that the MGCs are subject to the same regime as credit institutions as regards the solvency ratio, currency risk and limits on large risks, the Circular specifies this regime by referring to Banco de España Circular 5/1993 of 26 March 1993 (51), on the determination and monitoring of own funds, including in its text only the special rules which the particular characteristics of the MGCs make appropriate. In this respect, the MGCs shall send weekly (52) returns to the Banco de España, in the forms included in the annex to the Circular, relating to: compliance with the minimum own-fund requirements; eligible own funds; the own-fund requirements for credit, counterparty and currency risk; the limits on large risks and the limit on tangible fixed assets and the shares, other equity and bonds in which the own-funds are invested.

As Royal Decree 2345/1996 obliges these companies to send their current articles of association to the Banco de España for registration, the Circular extends to the MGCs the rules established for credit institutions in Banco de España Circular 7/1993 of 27 April 1993, to ensure that this obligation is applied uniformly to all the institutions subject to it.

Finally, in view of Spain's adoption of the single currency and in order to facilitate the treatment of the accounting and statistical information sent to the Banco de España, the Circular takes the opportunity to require MGCs, as from 1 January 1999, to express their prudential and year-end returns in thousands of Euro.

12. VENTURE-CAPITAL ENTITIES AND THEIR MANAGING ENTITIES

The legal regime for venture-capital entities, initially contained in Royal Legislative Decree 1/1986 of 14 March 1986, on urgent administrative, financial, fiscal and labour measures, has been subject to a number of amendments aiming to bring it up to date (53).

Law 1/1999 of 5 January (BOE of 6 January 1999) has now been promulgated in order to

(48) See "Regulación financiera: primer trimestre de 1994", in *Boletín económico,* Banco de España, April 1994, pp. 98 and 99.

(49) Royal Decree 1885/1978 of 26 July, regulated for the first time the legal, fiscal and financial regime for mutual guarantee companies set up under Royal Legislative Decree 15/1977 of 25 February.

(50) See "Regulación financiera: cuarto trimestre de 1996" in *Boletín económico,* Banco de España, January 1997, pp. 109 and 110.

(51) See "Regulación financiera: primer trimestre de 1993", in *Boletín económico,* Banco de España, April 1993, pp. 88 and 89.

(52) Although the Banco de España may request certain institutions, depending on their particular circumstances, to send their returns quarterly.

(53) Worthy of note are those introduced by Law 33/1987 of 23 December, Law 3/1994 of 14 April, whereby Spanish law on credit institutions is adapted to the Second Banking Directive, and those effected by Royal Legislative Decree 7/1996 of 7 June, on urgent measures of a social nature and for the promotion and deregulation of economic activity.

establish a stable and complete legal framework for these entities. This establishes and reinforces the foundations enabling these entities to continue promoting and fostering small- and medium-sized non-financial firms engaged in activities relating to technological innovation or other activities, through the acquisition of temporary holdings in their capital.

Among the main changes introduced by the Law is the establishment of a legal regime for authorisation, supervision, inspection and sanctioning comparable to that which applies to the other entities operating in Spanish financial markets. Accordingly, the CNMV is conferred most of the powers of supervision over the new entities: venture-capital companies (SCRs), venture-capital funds (FCRs) and their managing companies. The Law even allows CIU management companies to manage FCRs or the assets of SCRs.

SCRs are public limited companies whose main corporate object is to take temporary holdings in the capital of unlisted non-financial firms. In order to facilitate the pursuit of this object, venture-capital companies may grant equity loans or other forms of financing to the companies in which it takes holdings. Likewise, they may provide professional consultancy to the companies in which they take holdings. As for FCRs, these are funds administered by a management company and they have the same main object as SCRs.

Equity loans, already regulated by Royal Legislative Decree 7/1996 of 7 June 1996 (54), on urgent measures of a social nature and for the promotion and deregulation of economic activity, are characterised by a variable rate of interest fixed in accordance with the activity of the borrowing companies, as measured by criteria such as: net profit, turnover, total assets or any other indicator that may be freely agreed upon by the contracting parties. With regard to the priority of claims, equity loans shall be ranked behind unsecured creditors, and shall be deemed to be own funds, as defined in commercial law. Finally, the interest accrued shall be deductible from the borrower's corporate income tax base.

As regards investment policy, the line followed by Royal Legislative Decree 7/1996 is extended. Thus, they shall hold at least 60 % of their assets in the shares and other equity of firms that come within the scope of their corporate objects. Of this percentage they may assign up to 30 % of their assets to equity loans to firms that come within the scope of their corporate objects. The rest of their assets may be held in other assets, such as fixed-income securities traded on organised secondary markets, holdings in the capital of other firms, in cash, to satisfy the liquidity ratio, according to the terms that may be determined regulations, etc. In the case of SCRs, they shall hold 20 % of their assets in fixed assets necessary for carrying on their activity.

With respect to the investment limits, venture-capital entities may not invest more than 25 % of their assets in a single firm, nor more than 35 % in firms belonging to the same group of companies.

Other important sections of the law refer to significant holdings, as well as the supervision, inspection and sanctioning regime for these entities.

Finally, the Law takes the opportunity to boost and favour the financial activity known as "factoring", in particular, reinforcing the protection of certain assigned loans against the insolvency of the assignor or ultimate debtor.

13. NATIONAL ELECTRONIC CLEARING SYSTEM: GENERAL SUBSYSTEM OF CHEQUES TO PAY FOR FUEL AND TRAVEL

Among the numerous exchange subsystems provided for by the National Electronic Clearing System (SNCE) Regulation, the Banco de España, by means of *Banco de España Circular 8/1998 of 30 October 1998* (BOE of 19 November 1998), has published the rules of operation for the new general subsystem of fuel and travel cheques (implemented by Regulation SNCE-06).

The purpose of this subsystem is to process certain documents (55) by extracting the representative data from the original documents and exchanging it by electronic transmission, for the purposes of collection from the paying and issuing entity, as well as the clearing of the relevant amount, reconciliation and the establishment of the respective resulting positions for notification to the Banco de España Settlement Service (SLBE).

As in the other subsystems, the original documents are not exchanged in this one either,

(54) See "Regulación financiera: segundo trimestre de 1996", in *Boletín económico,* Banco de España, July-August 1996, pp. 68-72.

(55) Being cheques to pay for fuel and travel.

but rather the representative data, which are transmitted electronically. The subsystem operations are performed on the basis of these data.

The participating entities are those entered in the SNCE Register of member entities which have submitted an application to the Banco de España in the manner laid down in the Circular. In addition, the payee must correspond to the entity holding the documents and the addressee must be the entity paying and issuing the same.

Finally, the Circular specifies the commitments and obligations of entities participating in the subsystem.

14. PRIVATE INSURANCE: NEW REGULATION

14.1. Introduction

Insurance activity and activity relating to pension schemes and funds have evolved apace in Spain. This has made it necessary to make parallel amendments to the law governing and the public supervision of such activities. Likewise, Spain's commitment to fully adapt its legislation to Community law has required it to do so with respect to private insurance. These two factors – primarily – prompted the publication of Private Insurance Law 30/1995 of 8 November 1995 (56), which repealed Private Insurance Law 33/1984 of 2 August 1984. Law 30/1995 incorporated essential and necessary aspects of Community legislation, but by no means completed the harmonisation of Spanish law in relation to private insurance with the body of existing Community law. Moreover, the Law made constant references to the necessary subsequent implementing regulation.

This regulation has now been published as *Royal Decree 2486/1998 of 20 November 1998* (BOE of 25 November 1998). At the same time as it adapts Spanish law to the Community law pending incorporation (57), it clarifies and specifies the content of Law 30/1095 whenever necessary. Also, it repeals, as from 1 January (the effective date) the current Private Insurance Regulation, approved by Royal Decree 1348/1985 of 1 August 1985.

As regards the content of the Regulation, like the Law it can be divided into two major parts: regulation of the activity of insurance undertakings domiciled in Spain subject to supervision by the Ministry of Economy and Finance; and the regulation of the activity of foreign insurers when they operate in Spain, distinguishing between those domiciled in the European Economic Area (EEA) and those domiciled in third countries.

14.2. Scope

This regulation applies to private insurance and, in particular:

a) Direct life assurance, direct insurance other than life assurance and reinsurance.

b) Capitalisation operations based on actuarial techniques consisting of obtaining commitments with a specified duration and amount in exchange for single or periodic payments fixed in advance.

c) Operations that are preparatory or supplementary to those of insurance or capitalisation performed by insurance undertakings in their function of channelling saving and investment.

d) Loss prevention activities connected with insurance activity using own resources, which tend to reduce the risk, reduce and/or cancel out the consequences of the loss or stimulate loss prevention.

14.3. Legal regime for Spanish insurance undertakings

14.3.1. Administrative authorisation to engage in the activity

Prior administrative authorisation is needed from the Ministry of Economy and Finance to engage in insurance activity. Authorisation permits insurance undertakings to perform operations only in those branches for which they have been given specific authorisation and in respect of any of their ancillary or complementary risks, where appropriate. They shall adjust their rules of action to the programme of activities, articles of association and other requirements determined in the authorisation.

(56) See "Regulación financiera: cuarto trimestre de 1995", in *Boletín económico,* Banco de España, January 1996, pp. 86-91.

(57) The new regulation, in a way which is hardly usual for this kind of implementing legislation incorporates into Spanish law Coucil Directive 92/49/EEC of 18 June 1992, on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance; Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance; and certain aspects pending incorporation of Council Directive 91/674/EEC of 19 December 1991, and of Council Directive 91/371/EEC of 20 June 1991.

14.3.2. Conditions for engaging in the activity

The regulation, like the Law, specifies a number of financial guarantees that insurance undertakings must comply with in their activities. The following are worth highlighting:

a) *Technical reserves.* Insurance undertakings shall be obliged to establish and maintain technical reserves of a sufficient amount to guarantee, applying prudent and reasonable criteria, all the obligations arising under their insurance and reinsurance contracts, as well as to maintain the necessary stability of the undertaking in the face of random fluctuations in or cycles of claims and possible special risks. The regulation specifies the different technical reserves, which shall be calculated and established in accordance with the criteria laid down in said Regulation.

   As regards the cover of these reserves, insurance and reinsurance undertakings shall be obliged to cover all the technical reserves that are a consequence of direct insurance and accepted reinsurance operations, without any deduction being permitted for reinsurance. Composite undertakings shall manage the investments earmarked to cover the technical reserves corresponding to each activity separately, identifying those assigned to each of them.

   The regulation specifies suitable assets, the maximum percentages which may be invested in each and the criteria for valuing such investments, in accordance with principles of consistency, return, safety, liquidity, dispersion and diversification, taking into account the type of operations performed and the obligations assumed by the undertaking.

b) *Solvency margin and guarantee fund.* Individual insurance undertakings and, where applicable, the consolidable groups to which they belong must maintain, at all times, with respect to all their activities in and outside Spain, sufficient unobligated assets as a solvency margin. As regards consolidable groups, the consolidated unobligated assets shall cover the legal solvency requirements applicable to the group, which will take into account the insurance and reinsurance operations performed between the undertakings belonging to it. The legal solvency requirements shall be calculated in accordance with the legislation applicable in each country in which the undertakings belonging to the group are domiciled.

   In the case of composite insurance undertakings, calculation of the solvency margin and compliance with the legal minimum shall be done separately for the life and non-life activities.

   The regulation, after setting out the items making up the unobligated assets, both of insurance undertakings and the consolidable groups to which they belong, establishes the minimum solvency margin for life assurance and also for non-life businesses. Finally, mention is made of the items making up the guarantee fund which must be evidenced in order to engage in each activity.

14.3.3. Other specific requirements

The regulation also stipulates some other more specific requirements which must be satisfied when insurance activity is performed. For example, the accounts for the operations must be adapted to the Chart of Accounts for Insurance undertakings, approved by Royal Decree 2014/1997 of 26 December 1997 (58), and its implementing provisions. Consolidable groups must keep consolidated accounts, the Directorate General of Insurance *(Dirección General de Seguros,* DGS) being responsible for their supervision, on a consolidated basis.

14.3.4. Portfolio transfer

One important aspect of insurance activity is portfolio transfer, which requires authorisation from the Ministry of Economy and Finance. Certain documentation – specified in the regulation – must be submitted to the DGS. Subsequently, the Ministry of Economy and Finance shall resolve the opening of a one-month period of public information for policyholders to notify the DGS of any reasons they may have to oppose the transfer. When this period has expired and any statement of disagreement has been examined, the appropriate ministerial order shall be issued. Pursuant thereto, the portfolio shall be transferred and the administrative authorisation of the transferor declared revoked.

14.3.5. Revocation of the administrative authorisation

The administrative authorisation to engage in insurance activity shall be revoked by the Ministry of Economy and Finance in certain cases, including the following:

a) When the insurance undertaking specifically renounces it.

(58) See “Financial regulation: fourth quarter of 1997”, in *Economic bulletin,* Banco de España, January 1998, pp. 89-90.

b) When the undertaking has not commenced its activity within one year or has ceased to perform it for a period of more than six months.

c) When the insurance undertaking makes a general transfer of its portfolio in one or more businesses.

d) When the insurance undertaking ceases to comply with any of the requirements established for the grant of the authorisation, becomes liable to be wound up, or has had the administrative sanction of revocation of the authorisation imposed on it.

Likewise, the regulation envisages the winding up of insurance undertakings, as well as their administration which, in certain cases, may be resolved by the DGS in order to safeguard the interests of policyholders and insureds or other insurance undertakings.

14.4. Cross-border activity of insurance undertakings

14.4.1. Cross-Border activity of Spanish insurance undertakings within the EEA

Spanish insurance undertakings which have obtained an authorisation valid for the performance of their activity in the EEA may pursue their activities both under the right of establishment – by means of the opening of branches – and under the freedom to provide services throughout its territory, with the exception of insurance operations whose risks are covered by the Insurance Compensation Consortium *(Consorcio de Compensación de Seguros)* and certain life and non-life operations.

Spanish insurance undertakings operating under the right of establishment must annually submit to the DGS statistical and accounting information on the activity performed in each EEA member state. As regards the establishment of branches, insurance undertakings shall submit to the DGS the documentation referred to in the regulation and the latter, if it raises no objections, shall send it to the supervisory authority of the Member State of the branch.

Spanish insurance undertakings proposing to operate in one or more EEA member states under the freedom to provide services must first notify the DGS of their business project, as well as the nature of the risks or commitments they intend to guarantee. In turn, if the DGS is not opposed to this activity, it will send the documentation to the supervisory authorities of the Member States in which the undertaking wishes to perform the activities.

14.4.2. Cross-Border activity of foreign insurance undertakings in Spain

A) Domiciled in other EEA member countries

Insurance undertakings domiciled in EEA member countries which operate in Spain under the right of establishment – by opening branches – or under the freedom to provide services must present, on the same terms as Spanish insurance undertakings, all the documents required of them by the DGS, in order to verify that they are observing in Spain the legal rules and regulations applicable to them.

As regards the establishment of branches, foreign insurance undertakings shall present to the DGS the same documentation as the regulation stipulates for Spanish undertakings, as well as a certificate evidencing that the undertaking satisfies the minimum solvency margin legally required for the businesses or risks in which it is authorised to operate. The branch may be established and its activity in Spain commenced when the supervisory authority of the home Member State notifies it that the DGS has given its approval or has specified the conditions on which, for reasons of general interest, such activities must be performed in Spain.

Insurance undertakings domiciled in other EEA member states may commence activity in Spain under the freedom to provide services from when they receive notice that the supervisory authority of the home Member State has sent the DGS the relevant communication. They shall be obliged to designate a representative – an individual normally resident or an entity established in Spain – to represent them for tax purposes.

B) Domiciled in countries that are not members of the EEA

Insurance undertakings domiciled in countries that are not members of the EEA require the prior administrative authorisation of the Ministry of Economy and Finance to be able to establish branches in Spain. To obtain this, the undertakings must send to the DGS the documentation specified in the regulations. When authorisation has been granted, the branch may perform its insurance activity in Spain provided that its risks are situated and its commitments assumed in Spain, with the exception of the assets which correspond to that part of the solvency margin which exceeds the amount of the guarantee fund, which may be domiciled in any EEA country.

14.5. Other matters

Other aspects addressed by the regulation relate to the alteration of status, merger and demerger of insurance undertakings. In all cases, authorisation from the Ministry of Economy and Finance is necessary, for which purpose the relevant documentation set out in the regulation must be submitted to the DGS. As for the economic interest groupings and joint ventures that may be formed, information on the constituent undertakings and the shareholders or persons responsible for their management should be submitted to the DGS along with a certified copy of the deed of formation and their statutes.

Finally, the sanctioning regime provides for the possibility of special intervention measures or, where applicable, administration, pursuant to Law 30/1995.

15. REFORM OF PERSONAL INCOME TAX

The 1977 tax reform, contained in Law 44/1978 of 8 September 1978, involved a far-reaching overhaul of personal income tax (IRPF). Subsequently, experience showed the desirability of changes to some aspects of this tax, which were enacted in Law 48/1985 of 27 December 1985. Later, the regulation of the tax entered a provisional period following the Constitutional Court judgment of 20 February 1989, which declared certain articles on the taxation of households unconstitutional. This led to its urgent amendment by Law 20/1989 of 28 July 1989, and subsequently Law 18/1991 of 6 June 1991 (59), which included a number of changes to adapt the Spanish tax system to that existing in other Community countries.

Since 1991 the problems with the above-mentioned regulation have worsened. On one hand, this has been due to the excessive complexity of the tax and the dispersion and lack of organisation of its provisions, as a consequence of the successive adjustments and amendments made to it over these years. On the other hand, the need to adapt the tax to the model existing in other industrial countries, against a background of economic globalisation, has made radical revision necessary. This has been effected through the publication of *Personal Income Tax Law 40/1998 of 9 December 1998* (BOE of 10 December 1998), which shall come into force in fiscal year 1999. Implementation of this Law has commenced with *Royal Decree 1717/1998 of 18 December 1998* (BOE of 19 December 1998). This regulates payments on account of IRPF and the tax on the income of non-residents (discussed below), and amends the regulation of corporate income tax in relation to withholdings and payments on account.

The core of the reform, in line with the model of other European countries, is the establishment of a personal and family tax-free allowance *(mínimo vital)* which depends on the taxpayer's personal and family circumstances. The tax is thus charged on the taxpayer's disposable income, i.e. after deducting an amount to cover his own and his dependants needs. This allowance shall be applied, first, to reduce the general portion of the taxpayer's taxable income, which cannot become negative as a result of the reduction. The remainder, if any, shall be used to reduce the special portion of the taxpayer's taxable income, which cannot become negative either. As for the amount, the personal allowance shall generally be PTA 550,000 per annum, although there are higher amounts for the over-65s and the disabled, depending in the latter case on the degree of disablement. As regards the family allowance, it shall be PTA 100,000 per annum for each ascendant over the age of 65 who depends on and cohabits with the taxpayer and whose income, including tax-exempt income does not exceed the national minimum wage. Likewise, the family allowances shall include a minimum amount of PTA 200,000 for each unmarried descendant below the age of 25. This amount shall be higher for descendants below the age of three, to cover school materials between the ages of 3 and 16, and for disabled descendants.

In addition to the family allowance, the Law includes other fiscal measures aiming to protect and favour the family, such as the joint return, the food exemption for pensions, the deduction for investment in one's habitual residence, and favourable taxation of pensions with child beneficiaries, etc.

As regards *earned income,* its taxation is lowered through the application of a specific reduction for this type of income, so reducing the weight of its contribution with respect to other sources of income. Thus, certain reductions are established for earnings received more than two years after they accrued; for pensions and public-sector supplementary pensions, as well as most of the benefits received from general mutual societies, pension schemes and other insurance contracts. As regards the specific reduction, it affects all taxpayers who receive such earnings, an amount of PTA 500,000 be-

(59) See "Regulación financiera: segundo trimestre de 1991", in *Boletín económico,* Banco de España, July-August 1991, pp. 63-64.

ing established for income of less than or equal to PTA 1,350,000, and PTA 375,000 for income of more than PTA 2,000,000. Between these two limits an intermediate amount is established, which is obtained by multiplying the difference by a coefficient. Also higher specific amounts are established for the economically active disabled, which depend on the degree of disablement.

With the aim of releasing a large number of taxpayers from the obligation to submit a tax return, the provisions thereon of Law 18/1991 has been amended for recipients of earned income. The total annual earnings exempt from the obligation to submit returns and settle tax has been raised significantly, to stand, generally, at PTA 3,500,000 as against the previous amount of PTA 1,250,000. Consequently, taxpayers below this threshold who satisfy the other requirements laid down in the Law, and who, due to their economic capacity, must pay tax, shall do so through withholdings and payments on account.

To quantify the withholding rate, the Law uses a method similar to that used to determine the taxable income and the tax payable: first, total earned income is reduced by the amount of certain deductible expenses, as well as the personal and family allowance for descendants, producing a base for calculating the withholding rate similar to the taxable income. Subsequently the tax scale is applied to this base, producing a withholding amount (which should correspond to the tax payable in the return). Finally the withholding rate is obtained by dividing this amount by the total amount of earned income. A maximum withholding rate of 48 % is established against the 56 % of the previous legislation.

With regard to *property income* the estimated income from a habitual residence and the interest on borrowed capital used to acquire or improve such a residence are no longer relevant. In the case of rented property, the amount of deductible expenses – including the interest on borrowed capital – may not exceed the amount of the total income obtained.

With regard to *income from capital* an important change has been made to the taxation of saving, in an attempt to achieve a neutral treatment of the various forms of saving: the tax on income from capital at more than two years, like bank deposits, is reduced, various exemptions available in relation to so-called capital gains/losses are abolished, the taxation of alternative systems to pension funds is clarified, and a more favourable treatment is given to long-term saving and income from insurance contracts. Significant changes have also been made to the system of withholdings on income from capital, the rate being reduced from 25 % to 18 % for income deriving from the transfer of capital to third persons, i.e. the financial products most used by small savers, such as current and fixed-term deposits. This reduction does not apply to other income from capital which, generally, remains subject to a 25 % withholding rate. The base for the withholding shall be calculated taking into account the reductions provided for in the Law which depend on the period between the accrual and receipt of the income.

It should be noted that income from securities issued by the Banco de España which constitute an instrument for intervening in the money market and income from Treasury bills remain free from withholdings. Nonetheless, credit institutions and other financial institutions which enter into contracts with their clients for accounts for Treasury bill transactions shall be obliged to make withholdings on the income obtained by the holders of such accounts.

Income deriving from the transfer of financial assets with an explicit yield and, in the case of corporate income tax payers, the income from marketable fixed-income securities traded on Spanish official secondary securities markets shall also be free from withholdings on account of IRPF, on the condition, in both cases, that they are represented by book entries, the purpose being to improve the efficiency of organised fixed-income markets and the financing of Spanish firms and general government.

Turning to other matters, the terminology for capital gains and losses has been changed. They shall now be known as *ganancias y pérdidas patrimoniales* instead of *incrementos y disminuciones de patrimonio.* Both terms refer to changes in the value of the assets of the taxpayer revealed at the time of any alteration in their composition, except where the law classifies them as income. It should be stressed that the new Law abolishes the threshold of PTA 500,000, beyond which net capital gains were deemed to be made as a consequence of transfers for consideration made during the calendar year. It should be pointed out here that the capital gains generated by the transfer or redemption of shares or other equity representing the capital or assets of CIUs have been incorporated into the withholding system, and are subject to a 20 % rate. This is applied to gains deriving from CIUs domiciled both in and outside Spain obtained by their shareholders resident in Spain. Income from life assurance contracts is also subject to a 25 % withholding, although reductions are applicable depending on the period between the accrual and receipt of the income.

As for the tax rates, there have been two changes worth stressing. The tax burden has been reduced, with a general reduction in rates, including the lowest and highest rates, and the brackets have been reduced in number and redefined. As regards the deductions from tax payable, that for the acquisition of a habitual residence is retained and those for payments which coincide with the public interest, such as donations, are favoured.

Finally, the rules on special regimes, mostly regulated until now outside the law of the tax, such as those for attributing income and collective investment undertakings are incorporated into the Law. The regulations governing the administration of the tax are modified, introducing the necessary measures to improve and make it more flexible, significantly reducing the number of persons submitting returns and avoiding payments on account in excess of the net tax payable.

16. INCOME OF NON-RESIDENTS AND OTHER TAXATION PROVISIONS

The growing internationalisation of economic relations and the role played by Spain in the process of European integration, all the greater since its admission to Stage Three of EMU, have shown the need for a law to regulate the taxation of non-residents in the area of income tax in a unified manner. This has been achieved with the publication of *Law 41/1998 of 9 December 1998* (BOE of 10 December 1998), on the income of non-residents and tax provisions.

The tax on the income of non-residents is a direct tax charged on the income obtained in Spain (60) by non-resident natural and legal persons. In this respect, inter alia, the following shall be considered income obtained in Spain:

a) Income from economic activities and operations carried out by a permanent establishments situated in Spain.

b) Income from economic activities and operations obtained without a permanent establishment when the economic activities or operations are carried out in Spain, or when services are provided that are used in Spain.

c) Earned income, inter alia, when it derives directly or indirectly from work performed in Spain.

d) Dividends and other income, interest, fees and other income from capital, capital gains, etc.

The Law also establishes certain cases in which income shall be considered free of tax, among which it is worth stressing: income obtained from government debt without a permanent establishment and income from securities issued in Spain by non-resident natural or legal persons without a permanent establishment

As regards *income obtained through a permanent establishment,* the Law specifies its component items, as well as the way in which the tax base is determined. The rate applicable to the tax base is 35 %, except when the activity of the permanent establishment is oil exploration and production, when the rate shall be 40 %.

Permanent establishments are obliged to keep separate accounts of their operations and the assets deployed therein. They are also subject to the system of withholding of corporate income tax on the income they receive, they are obliged to make advance payments on the same terms as entities subject to corporate income tax and to make withholdings and payments on account on the same terms as entities resident in Spain.

As regards *income obtained without a permanent establishment,* the rate of 25 % shall generally be applied to the tax base determined in accordance with the Law in order to obtain the tax payable. Pensions and public-sector supplementary pensions received by individuals not resident in Spain shall be taxed in accordance with the scale reproduced in the Law, the rates of which range from 8 % for the lowest pensions to 40 % for the highest. In general, the earned income of non-resident individuals will be taxed at 8 %, provided that other specific legal provisions are not applicable. Other income worth mentioning is that derived way from reinsurance operations, taxed at 1.5 %, and that derived from capital gains at 35 %.

In addition taxpayers operating in Spain without a permanent establishment shall be obliged to make withholdings and payments on account with respect to the earned income they pay, as well as in respect of other income subject to withholding which constitutes a deductible expense for the obtaining of income.

After determining the persons obliged to make the withholdings end payments on account with respect to the income subject of this tax, the Law specifies the limits or, if there exists a convention for the avoidance of double taxation, the rules applicable.

(60) All this without prejudice to the regional tax regimes of the Basque country and the region of Navarra. In the Canaries, Ceuta and Melilla the special features resulting from the application of their specific legislation shall be taken into account.

Book-entry government debt market registered dealers shall be obliged to withhold and pay to the Treasury, on behalf of the taxpayer, the amount of this tax corresponding to in income from the Treasury bills and other securities representing the government debt as established by a sheet Ministry of Economy and Finance obtained by investors are not resident in Spain without a permanent establishment, provided that the exemptions for income from their respective instruments provided for in the Law are not applicable.

Another section of the Law relates to the *special tax on the property of non-resident entities,* charged on property or the right to the use and enjoyment thereof. The tax base is the officially assessed value of the property *(valor catastral)* or, where applicable, the value determined in accordance with the provisions applicable for the purposes of wealth tax *(impuesto sobre el patrimonio).* The special rate shall be 3 %. The Law establishes certain cases in which this tax shall not be payable, including, for example, by foreign States and public institutions and international agencies, entities with the right to the benefit of an international convention for the avoidance of double taxation, when the applicable convention contains a clause for the exchange of information, by companies listed on officially recognised secondary securities markets and entities which continuously or habitually carry on economic operations in Spain that amount to more than merely holding or leasing the property.

Taxpayers who are individuals resident in an EU Member State, who have obtained during the year at least 75 % of all their income in Spain, either as earned income or through economic activities, may opt to be taxed as Spanish IRPF taxpayers. The relevant tax regime shall be developed in regulations.

Finally, this Law, which entered into force on 1 January, makes the necessary references to the IRPF and the corporate income tax to avoid potential legal loopholes which could arise from the replacement of the provisions referring to the obligation to pay tax on property contained in that Law.

17. NEW OBLIGATIONS TO SUPPLY INFORMATION TO THE TAX AUTHORITIES

In recent years the obligations to provide information to the tax authorities on economic, professional and financial relations with third persons have been increased. Thus, in an additional provision to Law 13/1996 of 30 December 1996, the obligation was established for credit institutions and all natural and legal persons engaged in banking or credit business to supply to the tax authorities the full identity of persons authorised by the holder to use and dispose of bank accounts (current, time or credit) open at their establishments in Spain.

Corporate income tax law 43/1995 of 27 December 1995 (61) regulated and reformulated certain information obligations in relation to operations with financial assets, in response to changes in the financial markets. Likewise, by virtue of Securities Market Law 24/1988 of 28 July 1988, entities issuing securities, securities-dealer companies and securities agencies and other financial intermediaries must notify the tax authorities of any operation for the issuance, subscription and transfer of securities in which they are involved.

The recently published *Royal Decree 2281/1998, of 23 October 1998* (BOE of 14 November), establishes regulations implementing the above-mentioned provisions. It also modifies the information obligations relating to pensions schemes and funds, regulated by Royal Decree 1307/1988 of 30 September 1988, and to social welfare mutual societies.

As regards the information on persons authorised to use bank *accounts, credit institutions and other entities engaged in banking business* shall notify the tax authorities of the identity of all persons authorised by the holder to use and dispose of any type of account, irrespective of their form or denomination, even when the holder or, as the case may be, the authorised person, is not resident in Spain.

Second, *government certifying officers (fedatarios públicos)* involved or mediating in the issuance, subscription, transfer, exchange, conversion, cancellation and redemption of government bills, securities or any other financial assets or certificates, shall be obliged to notify such operations to the tax authorities. The operations on which information must be supplied include, in particular: operations relating to property rights, including security rights and other kinds of charges over such securities; operations involving the lending of securities and shares in private limited companies.

Credit institutions, securities-dealer companies and securities agencies and those financial intermediaries which habitually engage in the

(61) See "Regulación financiera: cuarto trimestre de 1995", in the *Boletín económico,* Banco de España, January 1996, pp. 91-92.

intermediation and placement of securities and other financial assets shall also be subject to this obligation, as shall entities issuing registered securities not listed on an organised market, with respect to the operations for issuance of the same, and the *regulatory companies* of futures and options markets, with respect to the operations carried out on such markets.

For their part, CIU *management companies* shall be obliged to inform the tax authorities of the operations involving shares in such institutions.

In the case of securities issued abroad or derivative instruments created abroad, the information must be notified by the entities selling such securities in Spain or, in default thereof, by the relevant custodians in Spain.

The information must include the full identity of the persons involved in the operations, indicating the status in which they acted, their forename and surname or company name, their address and tax identification number, as well as the class and number of the securities, and the amount and date of each operation.

In the area of pensions schemes and funds, management entities must submit an annual return listing all the members of the schemes to which the funds are assigned and the amount of the contributions made to them, whether directly by the members or by the promoters of the schemes. For their part, the promoters who make contributions to the schemes must submit an annual return listing all the members on whose behalf they made contributions and the amount contributed for each member.

Finally, social welfare mutual societies must submit an annual return listing all their members and the amounts paid by them to cover contingencies, which it may be possible to deduct from the IRPF tax base.

18. 1999 STATE BUDGET

As usual in December each year, the 1999 State Budget was approved by means of *Law 49/1998 of 30 December 1998* (BOE of 31 December 1998).

The keynote of this budget, the first prepared in Stage Three of EMU, is the reflection of the stability requirements that are going to apply under the single currency. These will involve greater budgetary discipline, fiscal policy being the main instrument for pursuing the objectives of macroeconomic stability.

In this respect, the budget attempts to maintain a policy of stringency in reducing the government deficit and discipline in spending compatible with sustained growth and control of the basic imbalances of the economy, in order to achieve a high rate of employment creation.

In accordance with this legislative spirit, the following aspects are worth highlighting, due to their importance or novelty:

In the field of financial regulation, the legal interest rate and the interest rate payable on tax debts have been reduced from 5.5 % to 4.25 % and from 7.5 % to 5.5 %, respectively. Also, the ceiling on the increase in the outstanding stock of State debt during the year is set at PTA 2,340 billion. This limit which may be revised if certain circumstances envisaged in the Law arise, shall apply to the increase as at the end of the year, and may be exceeded with the prior authorisation of the Ministry of Economy and Finance, in certain limited cases.

In the fiscal sphere, the keynote is the desire to support and implement the reform of the IRPF, contained in Law 40/1998 of 9 December 1998, and of the taxation of non-residents. Specifically, in relation to the IRPF, the coefficients exclusively used to update the acquisition values of property are regulated. In relation to corporate income tax, the inflation-adjustment coefficients applicable to property conveyances are updated, and the amount of the advance payments that the entities subject to this tax must pay is determined. With regard to the wealth tax, the exempt amount and the rates applicable in the event that the Regional (Autonomous) Governments do not approve of specific amounts or have not assumed responsibilities in this area are updated.

As for public spending, the suspension of the possibility of making further appropriations, except in certain specific cases, and the prohibition on transferring appropriations from capital to current operations have both been maintained for 1999, with the same provisos as last year.

In relation to the Regional (Autonomous) Governments, their percentage shares in State receipts are fixed for the five-year period 1997-2001. A distinction is made between the final percentage shares in the territorial receipts of the State from the IRPF and those in general State receipts. Likewise, a distinction is drawn in the financing through shares in State receipts for 1999, between the Regional (Autonomous) Governments to which the model of the financing system for the said five-year period is applicable and those which have not adopted the agreement on the financing system.

19. FISCAL, ADMINISTRATIVE AND SOCIAL MEASURES

As usual in recent years, to facilitate the achievement of the economic policy objectives set out in the 1999 State Budget Law, a number of fiscal, administrative and social measures have been adopted. These are contained in Law 50/1998 of 30 December 1998 (BOE of 31 December 1998). They have been included in a different law due to their specific content, so enabling the large number of matters which budget laws normally contain to be reduced.

The Law introduces certain amendments in the areas of taxation and social security and to the rules regulating general government employees, and responds to specific needs both in relation to the organisation and management and the activities of government.

In the financial area, the regulation of State debt is amended to enable marketable State securities acquired by the State in the secondary market not only to be cancelled but also held in a special Treasury securities account and traded. Also, the special reasons for opening Treasury accounts outside the Banco de España are abolished, with prior notice from the Treasury being required in all cases stating the purpose of the account and the conditions of use. In the securities market, changes have been made to the sanctioning regime and the circumstances in which serious faults occur have been widened.

In the fiscal area, in view of the reform of the IRPF contained in Law 40/1998, this Law merely makes some very specific adjustments to the rules in force. In relation to corporate income tax, FGIs (regulated by Law 37/1998 of 16 November 1998, on reform of the securities market) are included as taxpayers, although like the Banco de España and deposit guarantee funds they are exempt from the tax.

In relation to the wealth tax, the valuation criteria for shares in CIUs are altered. They shall now be valued at their net asset value as at 31 December. As regards VAT, its regulations have been adapted to the judgment of the European Court of Justice of 5 May 1998, resulting in a widening of the scope of application of the exemption for sports services provided by non-commercial entities.

In relation to insurance undertakings the Law has also been used to adapt the legal regime of the Insurance Undertakings Settlement Commission (CLEA) to Law 6/1997 of 14 April 1997, on the Organisation and Operations of Central Government. In particular, its legal status has been changed from that of a public-law entity to an autonomous government agency.

Finally, a number of extraordinary measures are included to adjust the scope of the activities of the National Mint to the requirements arising from the introduction of the euro.

25.1.1999.

ARTICLES IN ENGLISH AND PUBLICATIONS OF THE BANCO DE ESPAÑA

ARTICLES PUBLISHED IN THE ECONOMIC BULLETIN IN RECENT YEARS

1994	Month	Page
Quarterly report on the Spanish economy	Jan	5
Monetary policy in 1994	Jan	49
The performance of Spanish non-financial firms in 1992	Jan	55
The Spanish securities markets and the common financial area. Recent developments and outlook	Jan	69
The matador bond market	Jan	85
Quarterly report on the Spanish economy	Apr	5
The interest rate transmission mechanism: sectoral estimates for Spain	Apr	47
The British gilt-edged market: some differences from the Spanish bond market	Apr	57
Unemployment benefits in Spain	Apr	63
The Bretton Woods institutions and the globalisation of financial markets. Closing address by the Governor of the Banco de España at the seminar "The Spanish economy in Europe and the world"	Jul	5
Quarterly report on the Spanish economy	Jul	13
Unit trust performance in 1991-1993 and outlook	Jul	59
The markets for banking operations in Spain: productive specialisation and competition	Jul	75
The transformation of Spanish large-value payment systems from the perspective of the European Union	Jul	79
Is exchange-rate risk higher in the ERM after the widening of fluctuation bands?	Jul	89
Law of Autonomy of the Banco de España	Jul	95
Quarterly report on the Spanish economy	Oct	5
Is the ALP long-run demand function stable?	Oct	51
Interrelatedness and cyclical synchrony between Spain and the main economies	Oct	55
Female labour force participation in Spain in the 1980s	Oct	65

1995	Month	Page
Monetary Policy Objectives in 1995: Address by the Governor of the Banco de España to the Spanish Parliamentary Committee on Economic Affairs in November 1994	Jan	5
Quarterly report on the Spanish economy	Jan	15
Monetary policy objectives and implementation in 1995	Jan	59
Forecasts of financial flows in 1995	Jan	63
Quarterly report on the Spanish economy	Apr	5
Results of non-financial firms in the fourth quarter of 1994 and summary year-end data	Apr	45
Repurchase agreements and indicators of non-residents' activity	Apr	55
Do financial derivatives destabilise the spot market? The Spanish experience in the government debt market	Apr	71
FRAs as pointers to market expectations about interest rates	Apr	79
Supervision of foreign-exchange risk	Apr	85
Address by the Governor of the Banco de España, Mr. Luis Ángel Rojo, on his investiture as doctor "honoris causa" by the University of Alcalá de Henares	Jul	5
Preliminary address by the Governor of the Banco de España to the Parliamentary Committee on Economic, Trade and Public Finance Affairs	Jul	15
Quarterly report on the Spanish economy	Jul	19
Non-financial firms in the first quarter of 1995	Jul	61
The Central Book-Entry Office and the markets for public debt. 1994 annual report	Jul	69
Quarterly report on the Spanish economy	Oct	5
The ALP demand equation: short-run properties and use in monetary analysis	Oct	49
Non-financial firms in the second quarter of 1995	Oct	59
Capital income in 1990-1994 and outlook	Oct	67
Notes on the new data for external assets and liabilities in the *Boletín Estadístico del Banco de España*	Oct	79

1996	Month	Page
Monetary policy objectives in 1996: address by the Governor of the Banco de España to the Spanish Parliamentary Committee on Economic Affairs	Jan	5
Quarterly report on the Spanish economy	Jan	11
Monetary policy objectives and implementation in 1996	Jan	57
Forecasts of financial flows in 1996	Jan	61
Non-financial firms in 1994 and to the third quarter of 1995	Jan	67
Unemployment duration in Spain: the effects of benefit duration and of the business cycle	Jan	79
Monetary Union. Speech by Mr. Luis Ángel Rojo, Governor of the Banco de España, at the APD Working Lunch	Apr	5
Quarterly report on the Spanish economy	Apr	11
Results of non-financial firms in the fourth quarter of 1995 and summary year-end data	Apr	55
Volatility in Spanish financial markets: the recent experience	Apr	67
Productivity and inflation: implications for the Maastricht convergence criteria and for inflation targets after EMU	Apr	75
Quarterly report on the Spanish economy	Jul	5
Non-financial firms in the first quarter of 1996	Jul	49

1996	Month	Page
An empirical investigation into the peseta's exchange rate dynamics	Jul	61
Recent hiring developments in the labour market	Jul	67
Address by the Governor of the Banco de España to the Spanish Parliamentary Commission on Economic Affairs	Oct	5
Quarterly report on the Spanish economy	Oct	9
Results of non-financial firms in the second quarter of 1996	Oct	57
Spanish securities markets: implications of the single market and currency	Oct	67
An empirical analysis of *ex ante* real interest rates in Spain	Oct	85

1997	Month	Page
Presentation by the Governor of the Banco de España of the monetary policy objectives for the Spanish Parliamentary Commission on Economic Affairs	Jan	5
Quarterly report on the Spanish economy	Jan	11
Monetary policy objectives and implementation in 1997	Jan	59
Forecasts of financial flows in 1997	Jan	63
Non-financial firms in 1995 and to the third quarter of 1996	Jan	71
Quarterly report on the Spanish economy	Apr	5
Results of non-financial firms in the fourth quarter of 1996 and summary year-end data	Apr	49
The exchange rate as an instrument of macroeconomic adjustment: empirical evidence and relevance for European Monetary Union	Apr	61
Stabilising effects of fiscal policy	Apr	69
Quarterly report on the Spanish economy	Jul	5
Results of non-financial firms in the first quarter of 1997	Jul	51
The use of monetary conditions indices from a central bank's viewpoint	Jul	63
Net bank and savings-bank indebtedness vis-à-vis the Banco de España and intermediation activity	Jul	73
Address by the Governor of the Banco de España to the Spanish Parliamentary Budget Committee	Oct	5
Quarterly report on the Spanish economy	Oct	9
Results of non-financial firms in the second quarter of 1997	Oct	53
An approximation to changes in the market value of financial wealth	Oct	65

1998	Month	Page
Presentation by the Governor of the Banco de España of the monetary policy objectives for 1998 to the Spanish Parliamentary Commission on Economic Affairs	Jan	5
Quarterly report on the Spanish economy	Jan	11
Monetary policy objectives and implementation in 1998	Jan	55
Results of non-financial firms in 1996 and to the third quarter of 1997	Jan	59

1998	Month	Page
Madrid Clearing House: the Spanish interbank payment service	Jan	73
Financial regulation: fourth quarter of 1997	Jan	83
Appearance by the Governor of the Banco de España before the Spanish Parliamentary Committee on Economic Affairs	Apr	5
Convergence report presented by the Governor of the Banco de España to the Spanish Parliamentary Committee on Economic Affairs	Apr	9
Quarterly report on the Spanish economy	Apr	29
Results of non-financial firms in the fourth quarter of 1997 and summary year-end data	Apr	69
The nature of monetary transmission mechanisms in Spain and in the main European countries	Apr	81
Comparison between banks' consolidated profit and loss accounts in Spain and in European Economic Area countries in 1996	Apr	97
Financial regulation: first quarter of 1998	Apr	103
Quarterly report on the Spanish economy	Jul	7
Results of non-financial firms in the first quarter of 1998	Jul	51
Implications for central bank conduct of the development of electronic money	Jul	63
Indicators of prices, cost and margins in the various productive branches	Jul	73
Financial regulation: second quarter of 1998	Jul	81
Quarterly report on the Spanish economy	Oct	7
Results of non-financial firms in the second quarter of 1998	Oct	53
The controllability of monetary aggregates	Oct	65
Financial regulation: third quarter 1998	Oct	71
Appearance by the Governor of the Banco de España before, the Spanish Parliamentary Committee on Economic, Trade and Finance Affairs	Jan	7
Quarterly report on the Spanish economy	Jan	13
Results of non-financial firms in 1997 and in the first three quarters of 1998	Jan	55
Is there scope for inflation differentials in EMU?	Jan	69
Financial regulation: fourth quarter 1998	Jan	75

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