

3 The financial account in 2008

3.1 Introduction

Spain's foreign financial transactions in 2008 were affected by the heightening of the international financial crisis and by the deepening and widespread nature of contractionary trends worldwide. The tensions on financial markets worsened following the collapse of Lehman Brothers, in mid-September, exacerbating the downward trajectory of global stock markets, the rise in their attendant volatility and the increase in risk premia, all of which had been under way since the start of the crisis. Governments and central banks reacted forcefully to the heightening of the tension, adopting a broad range of far-reaching measures¹ whose effects began to be felt in the closing months of 2008 and, above all, as from spring 2009.

Financial markets in 2008 were characterised by high instability, a marked lack of confidence and, overall, very tight lending conditions. Against this background, interbank rates remained high and the cost of bank lending to companies scarcely eased, while the cost of funding through fixed-income issues rose, in step with corporate bond spreads and credit risk premia on derivatives markets holding at very high levels. Long-term interest rates on government bonds oscillated strongly, rebounding to July and falling – markedly so in the shorter-dated segments – in the second half of the year. This was accompanied by the widening of the main euro area countries' sovereign spreads over German debt. In 2009 to date, interbank interest rates and those on loans to companies and on corporate bonds have tended to decline, although the functioning of financial markets is still far from normal. The spread of Spanish long-term government debt rates over the German bond initially rose and subsequently fell back, standing at 70 bp in early May.

International stock markets posted significant falls throughout 2008. Over the year as a whole, the S&P 500 index fell by 38%, the EURO STOXX 50 by 44% and the IBEX 35 by 39% (see Chart 3.1). This downward trend slackened in the opening months of 2009; in May, the IBEX 35 stood at a level similar to that seen at end-2008. The euro appreciated over the course of the year, both against the dollar (7.3%) and, especially, against sterling (16%). However, from June to December, the euro depreciated by 13% against the dollar, partly reflecting the consideration of the dollar as a safe-haven currency, given the worsening financial instability. In the opening months of 2009, the euro continued to depreciate against the dollar and sterling.

According to the non-financial accounts of the institutional sectors, the economy's net borrowing as a whole fell by 0.6 pp of GDP in 2008 to 9.1%. The dependence of non-financial corporations on external resources fell by 3.6 pp of GDP to 7.5%, while households generated net lending in 2008 (for an amount equivalent to 0.6% of GDP), compared with high net borrowing the previous year (of 2.7% of GDP). The net borrowing of MFIs declined by 0.2 pp to 1.7% of GDP. Conversely, the general government financial position worsened significantly during the year, posting a deficit of 3.8% of GDP in 2008, compared with a surplus of 2.2% of GDP the previous year.²

On balance of payments data, the net borrowing generated by the overall non-financial transactions of the Spanish economy contracted in 2008 to 9% of GDP, equivalent to €98,899

1. Central banks, in addition to making significant interest rate cuts, took unprecedented concerted action and, in some cases, adopted non-conventional measures. Governments, for their part, agreed on common financial-system-support principles within the G20 and at the November EU Summit of Heads of State and of Government. For a more detailed description of the scale of the measures adopted by the main developed countries, see Box 1.1 in the Banco de España *Annual Report, 2008*. 2. For a more detailed description, see Box 5.1 in the Banco de España *Annual Report, 2008*.



SOURCES: ECB and Banco de España.

a. Three-month interbank rates.

b. Ten-year government bond yields.

million. Financial transactions between Spain and the rest of the world in 2008 as a whole generated net inflows of funds totalling €64,733 million³ (6% of GDP, 2.3 pp down on 2007), which proved insufficient to meet the aforementioned net borrowing requirements. Accordingly, the Banco de España's net assets vis-à-vis the rest of the world fell by €30,137 million (see Table 3.1).

All the institutional sectors raised financing abroad, with monetary financial institutions (MFIs) leading the way, followed by general government and other resident sectors (ORSs) (see Chart 3.2), which include not only households and non-financial corporations but also non-monetary financial institutions (e.g. securitisation special-purpose entities (SPEs) and the subsidiaries of MFIs specialising in the issuance of securities), whose weight in foreign portfolio investment transactions was significant (see Table 3.2). The financial crisis has substantially

3. Unless otherwise indicated, Banco de España operations and positions are excluded.

**BREAKDOWN OF THE FINANCIAL ACCOUNT
OF THE BALANCE OF PAYMENTS**

TABLE 3.1

% of GDP	2003	2004	2005	2006	2007	2008
CURRENT ACCOUNT PLUS CAPITAL ACCOUNT BALANCE	-2.5	-4.2	-6.5	-8.4	-9.6	-9.0
FINANCIAL ACCOUNT BALANCE (a)	2.1	5.8	6.9	11.3	8.3	5.9
CHANGE IN EXTERNAL LIABILITIES (b)	16.2	18.2	24.6	25.9	22.9	10.8
<i>Foreign direct investment</i>	2.9	2.4	2.2	2.5	4.8	4.1
– Monetary financial institutions	-0.1	-0.1	0.0	0.0	0.1	0.0
– Other resident sectors	3.0	2.5	2.2	2.5	4.7	4.1
<i>Portfolio investment</i>	5.0	13.4	15.2	19.9	9.2	-1.6
– General government	-1.0	2.7	0.3	1.4	-1.5	1.6
– Monetary financial institutions	3.4	5.9	6.2	8.3	3.6	-1.2
– Other resident sectors	2.5	4.8	8.8	10.2	7.1	-2.1
<i>Other investment</i>	8.3	2.4	7.1	3.5	9.0	8.3
– General government	-0.1	0.6	0.0	0.1	0.0	0.3
– Monetary financial institutions	7.1	1.8	5.6	0.4	7.2	6.9
– Other resident sectors	1.3	0.0	1.5	3.0	1.7	1.2
CHANGE IN FOREIGN ASSETS (c)	14.1	12.4	17.6	14.6	14.7	4.9
<i>Foreign direct investment</i>	3.2	5.8	3.7	8.5	9.6	4.8
– Monetary financial institutions	-0.9	1.6	0.1	0.6	3.0	0.8
– Other resident sectors	4.1	4.2	3.6	7.9	6.6	4.0
<i>Portfolio investment</i>	8.4	3.2	8.8	-0.4	-0.8	-2.0
– General government	0.0	0.1	0.5	1.1	0.6	0.2
– Monetary financial institutions	4.2	0.6	4.5	-3.1	0.3	0.7
– Other resident sectors	4.2	2.5	3.7	1.6	-1.7	-2.9
<i>Other investment</i>	2.0	3.4	5.2	6.7	5.4	1.4
– General government	0.0	0.2	0.1	0.0	0.1	0.1
– Monetary financial institutions	1.1	2.0	4.4	6.0	4.8	0.8
– Other resident sectors	0.9	1.2	0.8	0.7	0.5	0.5
<i>Financial derivatives (d)</i>	0.4	0.0	0.0	-0.2	0.4	0.7
NET CHANGE IN FOREIGN ASSETS OF BANCO DE ESPAÑA (e)	0.2	-1.7	-0.2	-2.6	1.4	2.8
Of which:						
<i>Reserve assets</i>	1.7	0.6	0.2	0.0	0.0	-0.1
<i>Net assets vis-à-vis the Eurosystem</i>	0.6	-1.6	1.6	-1.3	2.7	2.9
<i>Other net assets</i>	-2.1	-0.6	-2.0	-1.3	-1.3	-0.1
MEMORANDUM ITEMS:						
FINANCIAL ACCOUNT BALANCE INCLUDING BANCO DE ESPAÑA	2.3	4.1	6.7	8.7	9.6	8.7
Errors and omissions (f)	0.2	0.1	-0.2	-0.4	0.0	0.4

SOURCE: Banco de España.

a. Excluding Banco de España.

b. A positive sign denotes an increase in liabilities, i.e. an inflow of capital.

c. A positive sign denotes an increase in assets, i.e. an outflow of capital.

d. They are recorded net of netted out amounts and have been allocated, by convention, to the net change in assets.

e. A positive (negative) sign denotes a decrease (increase) in Banco de España foreign assets.

f. A positive (negative) sign denotes a receipt (payment) not recorded in another balance of payments caption.

altered the way in which MFIs had previously channelled funds from abroad (see Chart 3.3), when they had already set about narrowing the credit-deposit gap. Specifically, MFIs stepped up their resort to raising deposits, short-term debt issues, interbank loans and Eurosystem liquidity, while securitisations, in contrast to what had been the case to August 2007, ceased to be a source of financing.

The smaller amount of net inflows seen in 2008 was the outcome of a strong contraction in inflows and outflows, in line with the pattern observed in the main developed countries. Investment in Spain by non-residents fell by 51% in 2008 to €118,405 million, while residents' in-

NET CROSS-BORDER FINANCIAL FLOWS BY SECTOR
NCL – NCA (a)

CHART 3.2



SOURCE: Banco de España.

a. Net change in liabilities minus net change in assets. Monetary financial institutions excluding Banco de España.

vestment abroad fell by 65% to €53,632 million. Net financing raised by the Spanish economy in 2008 arose both from non-residents' investment in national assets and from divestment by Spanish residents of securities issued by non-residents.

The demand for foreign funds was met in 2008 mainly by capital inflows in the form of other investment (essentially loans, deposits and repos) and, to a lesser extent, by portfolio investment, representing a change from previous years (see Chart 3.4). In this latter case, foreign funds were raised through equity transactions, since bond transactions generated a net outflow. Foreign direct investment (FDI) operations and financial derivatives also gave rise to capital outflows. In addition to the change in the type of instruments through which foreign capital has been raised since the onset of the financial crisis, 2008 also saw a significant shift towards shorter-dated financing, as can be seen in fixed-income instruments, with outflows in long-term securities.

BREAKDOWN BY INSTRUMENT OF THE OTHER RESIDENT SECTORS (ORS) SECTOR

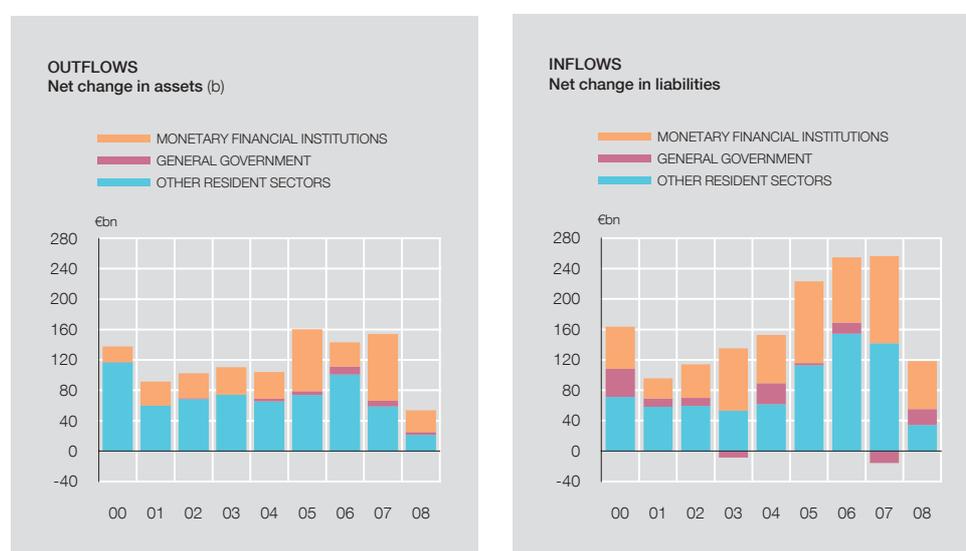
TABLE 3.2

€m		2007			2008			
		TOTAL ORS	NON-MONETARY FINANCIAL CORPORATIONS	NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS AND NPISH	TOTAL ORS	NON-MONETARY FINANCIAL CORPORATIONS	NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS AND NPISH	
NCA	TOTAL	56,904	-22,880	79,785	17,463	-26,881	44,344	
	FOREIGN DIRECT INVESTMENT	69,429	2,203	67,226	44,124	2,027	42,097	
	PORTFOLIO INVESTMENT	SHARES AND MUTUAL FUNDS	-9,862	-14,032	4,169	-25,272	-21,198	-4,073
		MEDIUM AND LONG-TERM BONDS	-5,281	-8,577	3,296	-9,383	-11,023	1,640
		MONEY MARKET INSTRUMENTS	-2,313	-2,413	100	2,817	2,289	528
OTHER INVESTMENT	4,933	-61	4,994	5,177	1,024	4,153		
NCL	TOTAL	141,785	57,316	84,469	34,394	-17,916	52,311	
	FOREIGN DIRECT INVESTMENT	49,266	2,217	47,049	44,369	-2,030	46,400	
	PORTFOLIO INVESTMENT	SHARES AND MUTUAL FUNDS	15,293	-363	15,656	-5,535	-6	-5,528
		MEDIUM AND LONG-TERM BONDS	63,174	61,173	2,001	-28,214	-28,691	477
		MONEY MARKET INSTRUMENTS	-4,253	-4,136	-117	11,142	11,330	-188
OTHER INVESTMENT	18,305	-1,574	19,879	12,632	1,481	11,151		

SOURCE: Banco de España.

CAPITAL INFLOWS AND OUTFLOWS BY SECTOR (a)

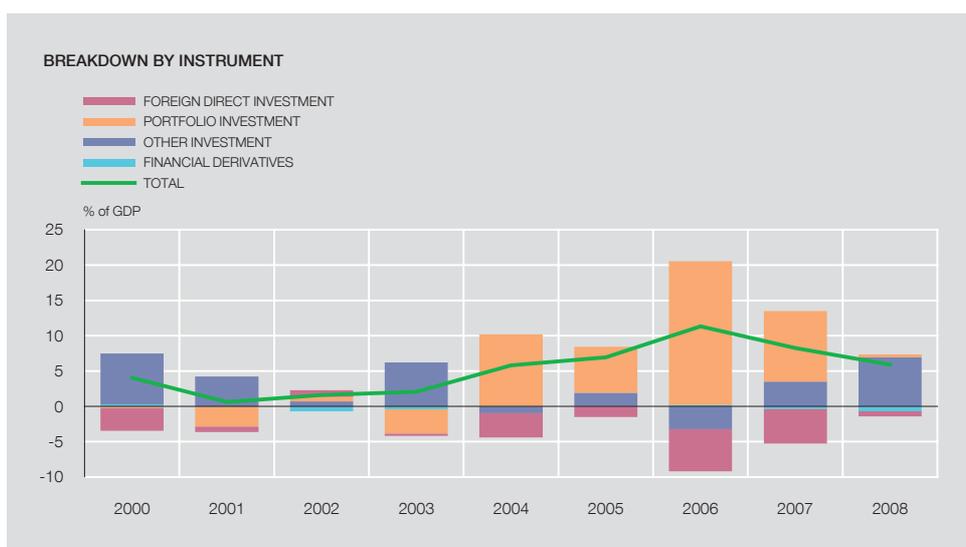
CHART 3.3



SOURCE: Banco de España.

a. Excluding Banco de España.

b. Including financial derivatives, which are recorded net of netted out amounts and have been allocated, by convention, to the net change in assets.



SOURCE: Banco de España.

a. Net change in liabilities minus net change in assets. Excluding Banco de España.

The changes that have altered the amount and nature of foreign capital flows in Spain's case form part of the effects the financial crisis has exerted on international capital movements. In general, financial flows declined in 2008, checking the process of growing financial integration of the past decade. The high uncertainty over the depth and duration of the financial and economic crisis increased investors' preference for safer and more liquid assets, and their home bias. Against this background, in 2008 most developed countries saw declines in direct investment transactions, divestment from equity instruments issued by foreigners, and fewer flows in international transactions of fixed-income instruments and, in particular, in other investment. Box 3.1 offers a more detailed description of developments in the financial account of the main euro area countries, the United Kingdom and the United States.

3.2 Foreign direct investment

The Spanish economy recorded net FDI outflows in 2008 totalling €8,040 million (0.7% of GDP), compared with €50,902 million in 2007 (4.8% of GDP), against a background of a sharp decline in Spanish direct investment abroad (48%) and an albeit smaller decrease in foreign investment in Spain (11%) (see Chart 3.5). It should be recalled that Spanish balance of payments FDI figures include, on both the assets and liabilities sides, the transactions of the so-called foreign-equity holding companies (ETVEs by their Spanish name), which generally do not give rise to either capital inflows or outflows, but which chiefly represent accounting entries.⁴ Stripping out these transactions, the behaviour of FDI does not change significantly.⁵

4. These companies have frequently been set up in recent years by non-resident multinational groups to centralise holdings of foreign direct investments in third countries. See Law 43/1995 on corporate income tax and Title IV of Law 6/2000 on measures to support the internationalisation of firms (BOE of 14 December 2000). To ensure that these transactions, which are difficult to identify using the ordinary reporting system, are included in the balance of payments, information from the Investments Register of the Spanish Ministry of Industry, Tourism and Trade is analysed. This heading includes other holding companies which, although not strictly ETVEs, have been set up in Spain for the main purpose of channeling direct investment. 5. Once ETVEs' operations were stripped out, FDI generated net outflows totalling €9,799 million (€53,654 million in 2007).

As a consequence of the international financial crisis, in 2008 the Spanish economy has had to have greater recourse to short-term instruments, rather than medium and long-term bonds, to meet its financing needs, in contrast to the situation before the crisis broke in August 2007. This change in the source of financing, driven by the dwindling activity primarily on the capital markets (especially the securitisation markets), reflects the decline in confidence among international financial intermediaries and investors. Given the global scale of the crisis, the cross-border financial flows of the main developed countries have also altered significantly, according, logically, to whether they had a net lending or net borrowing position vis-à-vis the rest of the world.

Panels 1 and 2 depict the net financial flows according to the financial account of the balance of payments for the main developed countries in 2008 and 2006 (the last complete year before the financial crisis broke), showing how, as in Spain, the form of raising (lending) funds in (to) the rest of the world has changed. Among the countries with borrowing requirements, both the United Kingdom and the United States have recorded sizeable net outflows in other investment since the onset of the international financial crisis, with portfolio investment their main source of financing in 2008. This contrasts with the case of Spain, where financing needs have been met with the net inflows generated by other investment and (as in France) by the change in the central bank's net assets vis-à-vis the Eurosystem. In turn, the countries with net lending capacity, such as Germany, have continued to lend to the rest of the world, through other investment and foreign direct investment (FDI).

A detailed analysis of residents' investments abroad (net change in assets: NCA) and of non-residents' investments in Spain (net change

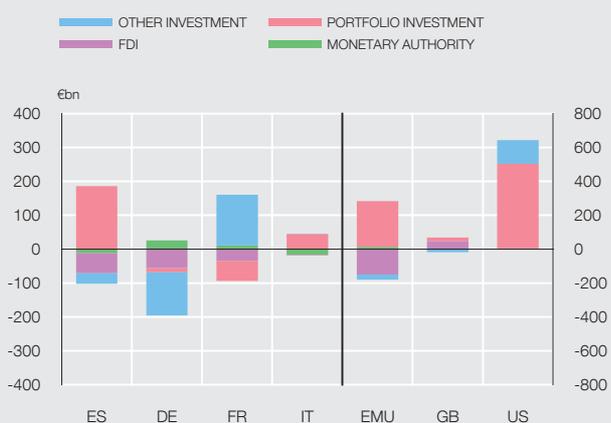
in liabilities: NCL) reveals other changes in international financial flows.¹ First, as Panels 3 and 4 show, the financial crisis has led to a decrease in both investment abroad and foreign investment in all the countries analysed. This seems to indicate that the growing financial integration of previous years has been checked as a result of the crisis, which has led, not only to greater risk aversion and higher liquidity preference among investors, but also to a greater home bias in investment portfolios. Specifically, there has been a widespread decline in the foreign equity holdings of residents of the countries analysed. In 2008 as a whole, there was a widespread and significant decrease both in NCA and NCL in comparison with 2006. This is particularly striking in the United Kingdom, where financial flows have not only decreased in volume but have also turned negative, with disinvestments abroad (negative NCA) and in the UK (negative NCL). These differential features reflect the country's position as an international financial and banking centre.

Lastly, in contrast to what has been seen in Spain, most countries reflect a shift in the channel used to obtain net foreign financing (NCL – NCA), from other investment to investment in fixed income (included under the heading of portfolio investment). Panel 5 shows the proportion that net flows in other investment and in fixed income represented for the countries and areas analysed in 2006 as a whole and in 2008. A positive (negative) sign indicates that the transactions in these instruments vis-à-vis the rest of the world gave rise to net capital inflows (outflows), while the arrow indicates

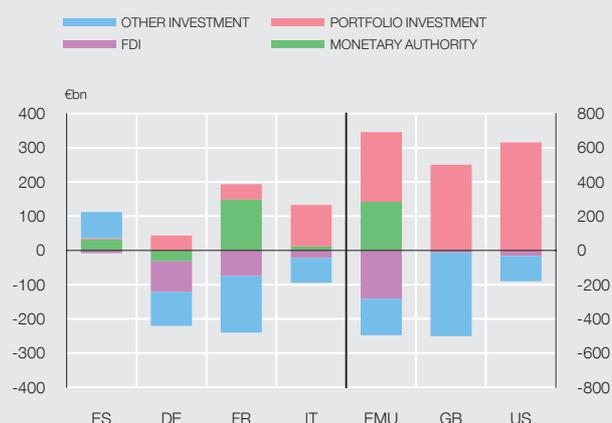
1. It is important to recall here that a reduction in the balance of securities held by non-residents in a country may be due to net sales by investors or to net repayments by the issuers of the securities.

FINANCIAL ACCOUNT COMPONENTS (a) (b) (c)
NCL - NCA

1 2006



2 2008



SOURCES: IFS and national sources.

a. ISO country codes (ES: Spain; DE: Germany; FR: France; IT: Italy; EMU: euro area; GB: United Kingdom; US: United States).

In the case of the United States, the 2008 data refer to the four quarters ending in September 2008.

b. Other investment excludes the monetary authority, save in the case of the United Kingdom. The monetary authority series includes other investment transactions and reserves (save in the UK where it includes only reserves).

c. The right-hand scale corresponds to the countries to the right of the vertical line (euro area, United Kingdom and United States).

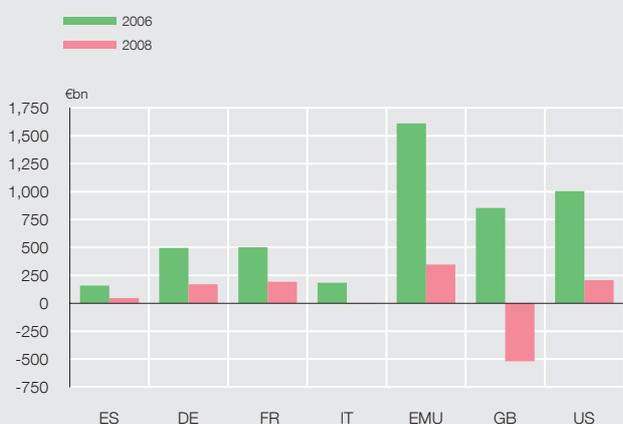
the direction of the shift seen between the two years. Thus, for example, in Spain, in 2006, other investment transactions gave rise to net outflows amounting to 3.2% of GDP, while fixed-income transactions produced net inflows amounting to 23% of GDP. As the panel shows, in 2008 this situation reversed, as other investment gave rise to inflows and fixed income produced outflows, of 7% and 2%, respectively, of GDP. In all other countries or areas plotted (with the exception of Germany), the net outflows from other investment rose. Net funds raised abroad through fixed-income transactions also rose (save in Italy, where they remained virtually flat). Accordingly, in the euro area as a whole, in the United States and, particularly, in the United Kingdom, outflows generated

by other investment were offset (in full or in part) by higher inflows from fixed income.

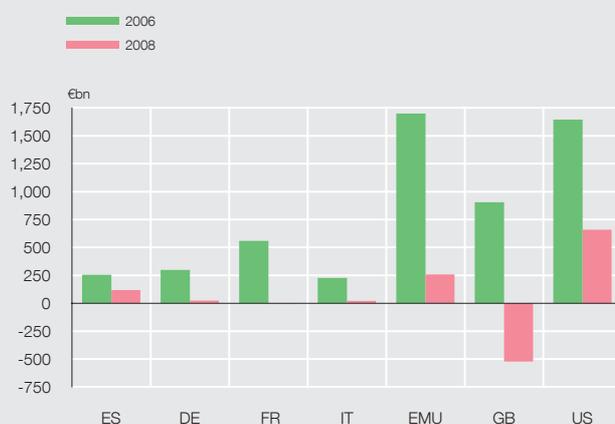
To sum up, the financial crisis has affected both the scale and the make-up (by type of investment) of international capital flows, with a widespread decline in the volume of financial transactions conducted with the rest of the world. This, together with net sales by investors of shares and holdings in capital issued by non-residents, points to a growing home bias in investment portfolios and to a preference for safer assets. Finally, of the countries analysed, Spain is the only one in which other investment has replaced portfolio investment in fixed-income securities as the channel for raising funds abroad.

FINANCIAL ACCOUNT (a)

3 NET CHANGE IN ASSETS VIS-À-VIS THE REST OF THE WORLD



4 NET CHANGE IN LIABILITIES VIS-À-VIS THE REST OF THE WORLD

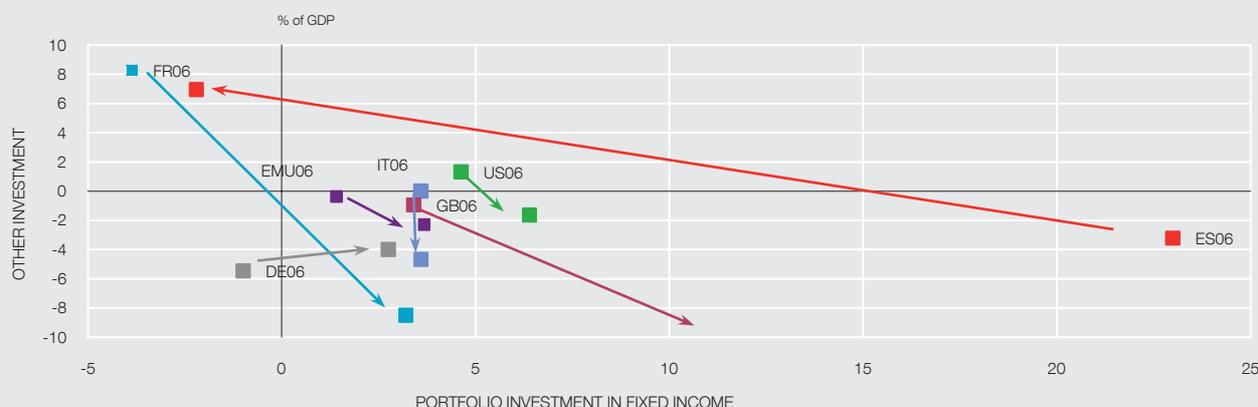


SOURCES: IFS and national sources.

a. Excluding the monetary authority.

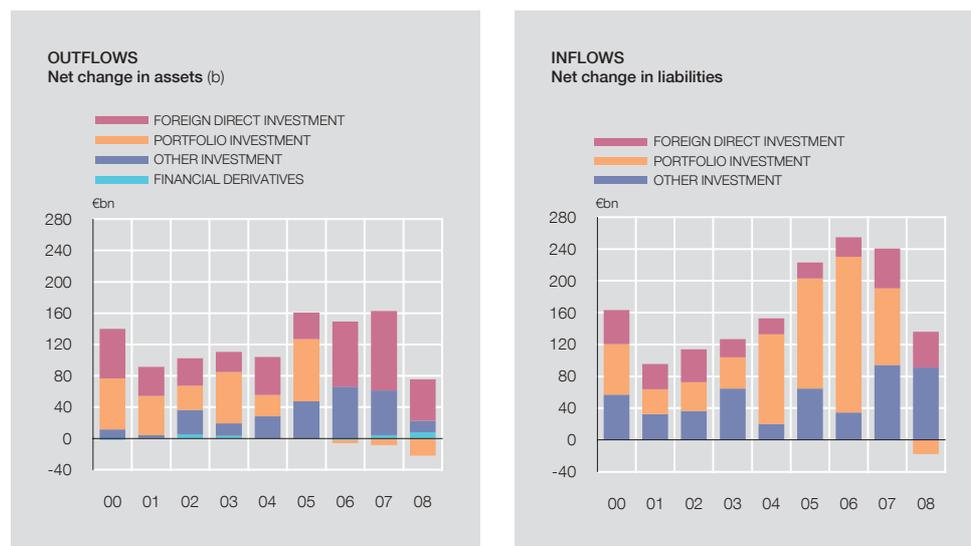
OTHER INVESTMENT REPLACES FIXED INCOME IN NET FINANCIAL FLOWS

5 PORTFOLIO INVESTMENT IN FIXED INCOME AND OTHER INVESTMENT (NCL - NCA) (a)



SOURCES: IFS and national sources.

a. The United Kingdom recorded divestments in other investment amounting to 30% of GDP that have had to be offset with portfolio investment inflows amounting to 22% of GDP. This explains why its 2008 position is not plotted in the chart, only the arrow showing the direction of the shift.



SOURCE: Banco de España.

a. Excluding Banco de España.

b. Financial derivatives are recorded net of netted out amounts and allocated, by convention, to the net change in assets.

As in Spain, global FDI transactions fell significantly in 2008, declining by 21% (in dollar terms).⁶ Heightened economic uncertainty, considerable financing difficulties for firms and the fear of protectionist measures being adopted that might affect multinational companies' interests have put back direct investment projects. This deferral has affected the developed economies the most, with FDI inflows down 33% in 2008 (compared with growth of 33% in 2007), reflecting a fairly widespread decline that was most acute in the United Kingdom (-51%) and Germany (-49%). While the pace of funds invested in the developing economies slowed significantly, they continued to grow (3.6%, against 21% the previous year). In line with the trend of FDI, mergers and acquisitions contracted by 28% globally, with a particularly pronounced fall in the EU (-34%) and a more moderate decline in the United States (-17%). Conversely, M&As increased in the developing economies (16%).

Spanish direct investment abroad amounted to €52,783 million in 2008, 48% down on the previous year (see Chart 3.6). In terms of GDP, outward FDI accounted for 4.8%, half of what it was in 2007 and substantially below the average for the period 2000-2007. Outward FDI in 2008 was influenced by several significant transactions in the financial and electricity industries. In terms of instruments, net acquisitions through equity purchases (accounting for 48% of the total), followed by reinvested earnings and other equity investments (22% and 18% of the total, respectively), were to the fore. Inter-company debt transactions and real estate accounted for only a small proportion of the total (9% and 3%, respectively).

The breakdown by branch of economic activity, excluding ETVEs,⁷ shows that the degree of concentration in outward Spanish FDI remained very high in 2008, as the first three branches, which generally represent the bulk of Spanish investment abroad, accounted for more than 72% of the total (see Table 3.3). First, "Financial intermediation", with 33% of the total, followed

6. See the UNCTAD press release, *Global Foreign Direct Investment now in decline*, of 19.1.2009. These preliminary estimates should be treated with caution, as in most countries the figure for 2008 as a whole corresponds to the annualised figures of the first three quarters of the year. 7. ETVEs are included under "Real estate and business activities".

CAPITAL OUTFLOWS (a)
Net change in foreign assets

CHART 3.6



SOURCE: Banco de España.

a. Excluding Banco de España.

by “Manufacturing”, which accounted for 22% of direct investment abroad, and somewhat farther behind, “Electricity, gas and water supply”, with 17% of the total. The other branches had only a small share in Spanish FDI abroad, although there was a notable increase in the share of “Construction”, which accounted for 3% of the total in 2008. The share of “Real estate” held steady at 3% of the total; however, considering the contraction in FDI, this represents a significant decline in nominal terms to below the 2006 level.

As regards the geographical breakdown of Spanish FDI outflows (excluding ETVEs), the EU was the recipient of just under half the total (47%, against 68% in 2007) (see Table 3.4). Investment in the euro area declined significantly, to 23% of the total (from 41% in 2007), primarily due to lower investment in Germany and the Netherlands. The United Kingdom continued to account for some 15% of the total, the proportion of FDI going to Latin America rose to 24%, and the United States accounted for 18%, making it the leading recipient of Spanish direct investment abroad.

FOREIGN DIRECT INVESTMENT TRANSACTIONS IN 2007 AND 2008
Breakdown by economic sector

TABLE 3.3

€m	SPANISH DIRECT INVESTMENT OUTFLOWS		SPANISH DIRECT INVESTMENT INFLOWS	
	2007	2008	2007	2008
TOTAL	101,191	52,783	50,289	44,742
Agriculture, hunting, forestry and fishing	44	51	-22	15
Mining and quarrying	1,408	2,445	97	-1,660
Manufacturing	12,556	12,065	731	25,320
Electricity, gas and water supply	23,933	9,157	20,158	12,055
Construction	752	1,545	1,853	71
Wholesale and retail trade and repairs	3,668	2,774	3,343	-4,465
Hotels and restaurants	963	1,293	281	1,220
Transport, storage and communication	1,503	-425	3,421	-1,318
Financial intermediation	35,979	17,443	4,502	-1,594
Real estate and business activities	12,687	2,505	11,013	4,317
<i>Of which: ETVE (a)</i>	<i>4,229</i>	<i>-771</i>	<i>6,981</i>	<i>988</i>
Other services (b)	561	914	-330	607
Unclassified	7,137	3,015	5,241	10,175
<i>Real estate</i>	<i>3,383</i>	<i>1,741</i>	<i>5,347</i>	<i>5,440</i>
<i>Other</i>	<i>3,754</i>	<i>1,275</i>	<i>-106</i>	<i>4,735</i>

SOURCE: Banco de España.

a. Estimate based on CNAE classification. Includes transactions of ETVEs and other holding companies that are not strictly ETVEs but which, like them, have been established in Spain for the main purpose of channelling direct investment flows.

b. Other services include "Public administration, defence and compulsory Social Security", "Education", "Health and veterinary activities and social services", "Other community, social and personal service activities", "Private households and employed persons" and "Extra-territorial organisations".

Foreign direct investment in Spain totalled €44,472 million (4.1% of GDP), slightly higher than the average of the period 2000-2007. These figures were affected, in 2008, by the purchase, by a German electric utility, of a subsidiary of a Spanish electric utility with interests throughout Europe, and by the takeover bid launched by a British tobacco company on a Spanish company belonging to the same sector.

The breakdown by instrument shows the significance of investment operations involving equities, which accounted for 34% of total FDI in Spain, while inter-company debt transactions and FDI in the form of other equity holdings amounted to 20% and 18%, respectively. FDI in real estate accounted for 12% of the total, similar to the 2007 figure, while undistributed profits represented some 16% of foreign direct investment in Spain.

The breakdown by branch of activity (excluding ETVEs) also reflects a high degree of concentration, as investment in "Manufacturing" accounted for 58% of the total, and investment in "Electricity, gas and water supply" for 28%.

The EU continued to be the main source of direct investment in Spain (excluding ETVEs), as is customary, with 91% of the total. The main investors from within the euro area, which accounts for 52% of the total, were Germany and the Netherlands. Investment from the United Kingdom represented 37% of the total received.

3.3 Portfolio investment

Portfolio investment transactions have been influenced, since August 2007, by the almost complete squeeze on fixed-income market activity, as shown by the marked decline in net is-

FOREIGN DIRECT INVESTMENT TRANSACTIONS IN 2007 AND 2008 (a)
Breakdown by geographical area

TABLE 3.4

€m	SPANISH DIRECT INVESTMENT ABROAD				FOREIGN DIRECT INVESTMENT IN SPAIN			
	2007		2008		2007		2008	
	TOTAL	ETVEs (d)	TOTAL	ETVEs (d)	TOTAL	ETVEs (d)	TOTAL	ETVEs (d)
WORLD TOTAL	101,191	4,229	52,783	-771	50,289	6,981	44,742	988
EUROPEAN UNION 27 (b)	69,551	3,288	23,871	-1,507	47,170	8,696	40,377	340
Euro area	43,233	2,966	10,411	-1,889	39,043	9,197	23,494	531
Germany	14,887	349	2,335	79	-2,269	634	13,616	-129
France	5,465	1,012	920	163	2,734	234	2,017	296
Netherlands	13,626	1,983	853	-785	5,441	3,271	14,340	60
Italy	5,744	.	1,666	.	20,283	.	1,156	.
Luxembourg	618	-609	-1,375	-1,256	8,589	2,973	-9,986	-245
Portugal	1,224	88	2,388	68	2,223	2,064	1,253	.
United Kingdom	15,281	222	8,432	230	7,656	-534	16,159	-234
New EU members (c)	9,442	74	4,603	84	282	.	172	.
Switzerland	-936	-869	1,384	-223	982	389	282	-307
United States	15,560	2,134	9,643	218	1,297	94	.	-715
LATIN AMERICA	13,997	961	13,367	590	858	-1,119	1,829	956
Argentina	1,646	215	1,710	274	-62	-70	.	.
Brazil	6,088	139	2,452	92	821	95	129	85
Chile	302	102	1,483	51
Mexico	4,276	191	4,323	96	.	.	192	.
Morocco	207	.	737
Japan	-1,356	-1,378	134	.	-278	.	83	.
Australia	481	.	106	.	.	.	78	.
MEMORANDUM ITEM: OECD	88,592	3,338	40,277	-1,399	48,574	8,066	41,328	.

SOURCE: Banco de España.

a. "." Amount below €50 million in absolute value.

b. European Union: International institutions of the European Union, ECB, France, Belgium, Netherlands, Germany, Italy, United Kingdom, Ireland, Denmark, Greece, Portugal, Luxembourg, Austria, Finland, Sweden, Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Malta, Poland, Slovenia, Slovakia, Romania, Bulgaria and their dependencies.

c. New member countries: Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Slovenia, Slovakia, Bulgaria and Romania.

d. Estimate based on CNAE classification. Includes transactions of ETVEs and other holding companies that are not strictly ETVEs but which, like them, have been established in Spain for the main purpose of channelling direct investment flows.

sues of fixed-income instruments worldwide. In this setting, there was a sharp drop in 2008 in foreign funds raised by the Spanish economy through portfolio investment securities (from €104,779 million in 2007 to €4,268 million). Moreover, these net inflows reflect repatriation of capital from abroad due to divestments by residents in Spain, as non-residents also reduced their holdings of Spanish portfolio instruments. By sector, MFIs gave rise to net outflows of funds, while ORSs, similarly to the general government, raised net funds from abroad.

Spanish portfolio investment abroad recorded divestments totalling €21,841 million in 2008, reflecting the reduction in shares and other holdings (€27,766 million), as the outstanding balance in fixed-income securities rose (by €5,925 million). As to *foreign portfolio investment in Spain*, non-residents' holdings of portfolio investment securities issued by residents declined in 2008 by €17,573 million. These net outflows are due to the decrease, to the tune of €28,808 million, in non-residents' holdings of medium and long-term bonds, while holdings of money market instruments issued by residents rose (by €11,015 million). The balance of shares and mutual funds held by non-residents rose slightly (see Chart 3.7).

CAPITAL INFLOWS (a)
Net change in foreign liabilities

CHART 3.7



SOURCE: Banco de España.

a. Excluding Banco de España.

An analysis by institutional sector shows high net divestments in securities issued by ORSs (which include issuers of asset-backed securities), amounting to €22,607 million, and, to a lesser extent, in securities issued by MFIs, amounting to €12,747 million. By contrast, non-residents' holdings of general government securities rose by €17,781 million in 2008.⁸ However, the proportion of government debt held to maturity held by non-residents at end-December 2008 was similar to that at end-2007, representing almost 45% of the total.

The decline in non-residents' holdings of medium and long-term bonds affected instruments issued by ORSs and by MFIs, in a period in which private issues contracted by 66% to €80,713 million.⁹ As was the case in the final stretch of 2007, in 2008 as a whole non-residents reduced

⁸. After making net debt repayments of more than €4,000 million in 2007, general government issued securities for a value of €51,580 million in 2008. ⁹. It should be noted here that asset-backed bonds are issued by ORSs, whereas covered bonds are issued by MFIs.

their holdings of asset-backed securities issued by residents by €24,052 million.¹⁰ This decrease centred on asset-backed bonds, which gave rise to net capital outflows (€23,619 million), in contrast to covered bonds which recorded net capital inflows (€5,942 million). Despite the freeze on these markets, institutions continued to launch these issues, as in other countries, to be used as collateral at ECB auctions. Lastly, non-residents reduced their holdings of securities issued by subsidiaries of resident financial institutions, to the tune of €6,375 million.

The growing investor preference for liquidity led to a significant increase in foreign funds raised through money market instruments (€11,015 million, up 75% on 2007). These investments were mainly securities issued by ORSs and by the general government, offsetting the divestments in securities issued by MFIs.

3.4 Other investment (loans, deposits and repos)

Other investment transactions (essentially loans, deposits and repos) resulted in net inflows of €76,229 million in 2008, double the 2007 figure. This increase was due to the intense activity at MFIs, which raised funds from abroad amounting to €66,254 million, while the net inflows generated by ORSs and the general government were much more modest (€7,455 million and €2,520 million, respectively). The breakdown by maturity shows that net capital inflows were centred on short-term instruments (€80,623 million), as long-term instruments gave rise to net outflows (€4,394 million). Thus, other investment replaced portfolio investment in fixed-income securities as the main financing vehicle for the Spanish economy. In turn, the increase in short-term financing reflects the scant activity and tightening of financing conditions on international wholesale markets, especially the long-term debt markets.

Other Spanish investment abroad recorded net outflows of €15,007 million in 2008 (see Chart 3.7). MFIs' net investments in long-term instruments (€16,766 million) more than offset divestments (i.e. repatriation of capital) of short-term assets (€7,643 million), while ORSs' net investment abroad rose somewhat in 2008 (by 5%, to €5,177 million). Lastly, general government activity in instruments of this type was modest, as usual, growing by €706 million.

Other foreign investment in Spain gave rise to inflows of €91,236 million in 2008. As in the case of investment abroad, MFIs determined the overall pattern, recording net inflows of €75,377 million, practically a repeat of the 2007 figure. The bulk of these funds was raised through short-term instruments, while net inflows in long-term instruments were low (€1,161 million, down 71% on 2007). As is usual, ORSs and the general government had much less recourse to other investment as a means of raising funds abroad, recording net inflows of €12,632 million and €3,227 million, respectively.

3.5 Derivative financial instruments

Transactions involving derivative financial instruments gave rise to net outflows totalling €7,683 million in 2008. It should be borne in mind that these transactions are not due to the need to cover a financing gap in the economy, but rather to strategic decisions and to agents' hedging decisions, which is why they are usually highly volatile and why they grow at times of uncertainty such as at present. Most of these net outflows corresponded to transactions with instruments traded on organised markets (52% of the total).¹¹ By institutional sector, ORSs' and MFIs' transactions involving financial derivatives generated most of the net outflows of funds, representing 52% and 42% of the total, respectively, while general government accounted for some 7%.

¹⁰. Issues of asset-backed bonds fell by 18% year-on-year, to €91,606 million, against a backdrop of scant trading of these instruments on the secondary market and high risk premia, even in the case of bonds with a high credit rating. Net issues of covered bonds were down 17% on 2007 at €16,019 million, while subsidiaries of MFIs made net issues for a value of €2,226 million in 2008 (€36,413 million in 2007). ¹¹. According to the annual statistics of the Spanish derivatives market (MEFF), trading in these instruments rose by 70% in 2008, compared with 10% in 2007.

3.6 Net assets of the Banco de España

In 2008 the net assets of the Banco de España fell by €30,137 million (€14,322 million in 2007), indirectly reflecting the impact of the financial crisis on the way in which Spanish MFIs met their liquidity requirements in the year, with greater resort to Eurosystem liquidity auctions. However, Spanish MFIs' share of these auctions has stabilised at a level consistent with their relative weight in the euro area and with the variables that determine the Banco de España's share in the capital of the ECB.

Over the year as a whole, net assets vis-à-vis the Eurosystem declined by €31,713 million (€28,329 million in 2007). Conversely, the Banco de España's other net assets¹² (basically debt securities, classified under the heading of portfolio investment) rose by €931 million and reserves by €645 million.

12. For a description of these assets, see Chapter 5 of this report.