BANCO DE ESPAÑA

economic bulletin

January 2000

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Conventions used

M1	Money supply = Notes and coins held by the public + sight deposits.
M2	M1 + savings deposits.
M3	M2 + time deposits.
ALP	Liquid assets held by the public = M3 + other liquid assets.
ALPF	ALP + fixed-income mutual funds.
H1/H2	First/second half
bn	Billions (10^9).
m	Millions.
a	Projection.
p	After a date [January (p)], this means that all the related figures are provisional; after a figure, only said figure is provisional.
pp	Percentage points.
	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 of the last digit indicated in the series.
*	Series of seasonally adjusted data.

Abbreviations

AIAF	Association of Securities Dealers
BE	Banco de España
BIS	Bank for International Settlements
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
DM	Deutsche mark
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECOFIN	EU Council (Economic and Financial Affairs)

EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EPA	Official Labour Force Survey
ERM	Exchange Rate Mechanism
ERM II	New Exchange Rate Mechanism for currencies of EU Member States outside the euro area
ESA 79	European System of Integrated Economic Accounts (1979)
ESA 95	European System of National and Regional Accounts (1995)
ESCB	European System of Central Banks
ESP	Pesetas
EU	European Union
EU-15	The fifteen current EU Member States
EUR	Euro
EUROSTAT	Statistical Office of the European Community
FIAMMs	Money-market funds
FIMs	Securities funds
GDP	Gross Domestic Product
GDP cp	GDP at constant prices
GNP	Gross National Product
GVA	Gross Value Added
G7	Group of Seven
HICP	Harmonised index of consumer prices
HF	Households and firms
IMF	International Monetary Fund
INE	National Statistics Office
INVERCO	Association of Portfolio Investment Institutions and Pension Funds
IPI	Industrial Production Index
MEFF	Financial Futures and Options Market
MFIs	Monetary financial institutions
MINER	Ministry of Industry and Energy
MMFs	Money-market funds
NBER	National Bureau of Economic Research
OECD	Organisation for Economic Co-operation and Development
PPI	Producer price index
R + D	Research and development
RENFE	National railway company
SEPI	State industrial holding company
SGP	Stability and Growth Pact
SIB	Stock-exchange interconnection system
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
ULCs	Unit labour costs
VAT	Value Added Tax
WB	World Bank

Contents

Quarterly report on the Spanish economy

1. Overview

It is estimated that Spanish real GDP posted a year-on-year growth rate of 3.8 % during the fourth quarter of 1999, slightly up on the provisional QNA figure for the preceding quarter (1). The indicators available for the final months of the year show that national demand held on a moderately decelerating path, which was checked by a less negative contribution of net external demand to the increase in GDP. This was because the real rate of increase of exports rose, underpinned by the pick-up on international markets, and imports held at a sustained level, similar to that of the previous quarters. Economic activity in the euro area is clearly assisting the recovery on world markets, as can be seen in its real GDP growth in the third quarter, running at 2.3 % year-on-year.

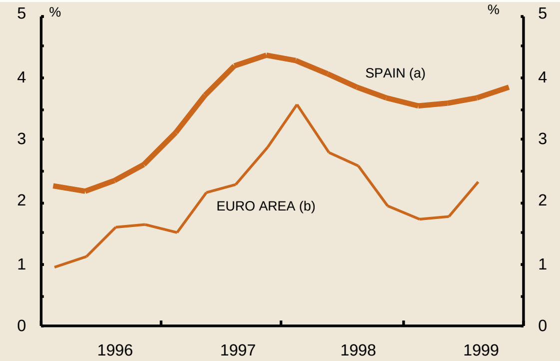
If confirmed, the figures estimated for the fourth quarter imply that the real rate of change of Spanish GDP was around 3.7 % on average in 1999, higher than forecast at the beginning of the year and only three-tenths of a percentage point down on 1998. The gap in relation to growth in the euro area as a whole remains considerable, although it is tending to narrow (see Chart 1). The contribution of national demand to the increase in Spanish GDP in 1999 was notable and extensive to most of its components. It is possible that its real rate of growth will not differ significantly from that recorded in 1998. The contribution of real external demand, however, was somewhat more negative, at around 1.3 percentage points. This was three-tenths of a point more than the previous year, in absolute terms, which explains the differences in the growth of real output between both years. The growth of employment in terms of equivalent jobs, in keeping with the QNA estimate, was notable for the third year running. The related rate was approximately 3.3 %, slightly lower than the previous year.

However, and as indicated, the pattern of behaviour discernible from the results for the year in average terms masks changes during the course of 1999, as the high, real growth rate of national demand tended to moderate and exports came more to the fore, bringing in tow industrial activity, which had been depressed at the start of the year. This pattern exhibits certain distinguishing features compared with developments in most of the euro-area economies. External demand is the factor driving recovery in the area whereas domestic demand, especially in Germany and Italy, is more muted but is now beginning to show the first signs of overcoming its past sluggishness. It

(1) Unless otherwise indicated, the year-on-year rates mentioned are calculated on the basis of QNA trend-cycle series.

CHART 1

Gross domestic product



Sources: ECB, Instituto Nacional de Estadística and Banco de España.
(a) Non-centred annual rate of change calculated on the basis of the trend-cycle series.
(b) Non-centred annual rate of change calculated on the basis of the seasonally adjusted series.

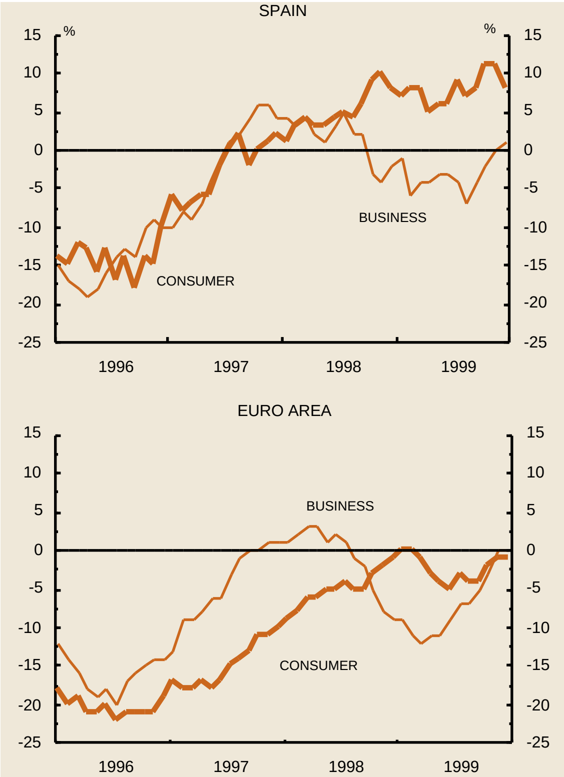
thus seems that the cyclical differences recorded in recent years, as a result of the resilience of Spanish national demand and also perhaps the lesser impact of the international crisis on our exports, are beginning to lessen, although domestic demand in Spain continues to play a considerably more prominent role.

Clearly, then, the firming of the favourable external environment is contributing decisively to recovery in the euro area and to its effects being felt also in the Spanish economy. The continuing strength of the US economy and a rapid recovery in the south-east Asian zone are the key underpinnings of the expansion of the world economy, and are seconded by a more incipient and hesitant improvement in Japan and in the Latin-American economies. Ongoing oil price rises on international markets are, however, an increasingly patent factor of risk. Far from turning down, as expected, the intensity of these rises appears to have gained in vigour at the start of the current year and their effects are, against the aforementioned background of growth in world activity, feeding through to other price indicators.

The harmonised index of consumer prices (HICP) for the euro-area countries rose in the second half of the year as a result of the ongoing acceleration in its energy component (set against the depreciation of the euro exchange rate) and the rise in the prices of certain unprocessed foods. The 12-month growth rate of the HICP last December was 1.7 %, almost one percentage point up on that recorded at the start of 1999 (see Chart 3). This bleaker outlook for future price developments and their possible

CHART 2

Confidence indicators



Source: European Commission.

influence on wage behaviour, the confirmation of greater buoyancy in the area (although certain doubts will linger until the recovery in domestic demand becomes widespread) and the persistence of generous monetary conditions all led the European Central Bank (ECB) to tighten its relaxed monetary policy stance.

On 4th November, the Governing Council announced a rise of 50 basis points in the rate on the Eurosystem's main refinancing operations to 3 %. During the fourth quarter, the course of money market interest rates was marked, first, by this decision by the Eurosystem and, second, by the uncertainty surrounding the transition to the year 2000. The longer-dated rates responded to the aforementioned changes in domestic economic conditions and to the knock-on effects of the US bond market. The growth of the monetary and credit aggregates remained high, in step with the relatively low levels of interest rates and the brighter growth prospects for the area.

In this situation, the monetary and financial conditions of the Spanish economy continued to exert an expansionary affect during the fourth quarter of 1999. Although the interest rates applied by credit institutions to their customers began to rise mid-year, the increases were modest and, overall, interest rates continued to encourage debt as opposed to saving (see Chart 4). Indeed, it is estimated that lending to households and non-financial firms increased by 17 % in the fourth quarter of the year, entailing a slight deceleration in relation to the preceding quarters. Meantime, liquid financial instruments continued to increase at a more moderate rate.

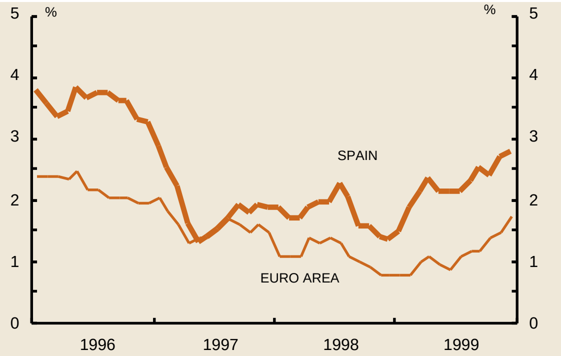
Turning to the public sector, the State accounts in the closing months of the year continued to move closer to the initial moderate path envisaged. The year closed with a cash-basis deficit of ESP 1057 billion, 5.1 % less than in 1998, with both revenue and expenditure posting growth rates higher than initially forecast. The contribution of general government to household income in 1999 was notable, owing to the effect of the personal income tax reform and, to a lesser extent, the favourable behaviour of social benefits.

Against this backdrop of recovery on external markets, employment growth and generous monetary conditions, with real interest rates encouraging expenditure, economic agents' decisions contributed to the Spanish economy maintaining a sustained growth rate in 1999, as reflected in the foregoing paragraphs. The resilience of consumer spending, the real annual average increase in which might even exceed that of 1998, was underpinned by the growth of disposable income, low real interest rates and the increase in wealth, with a moderate decline in the saving ratio being posted. As the year unfolded, purchases of certain durable goods tended to dip, following four years of notable buoyancy in the case of cars. The above-mentioned factors also help explain the increase in private residential investment, whereby household lending capacity fell considerably and household debt increased. Indeed, the quarterly-financial-accounts estimate of net household financial saving for the third quarter of the year places this variable below 2 % of GDP, and it is not expected to increase in the fourth quarter. This level is lower than the trough it reached in the second half of the eighties, which is indicative of the loose financial conditions prevailing and the favourable prospects harboured by households (see Chart 2) in the setting of employment growth and a diminishing unemployment rate.

The slowdown in investment in construction during the first three quarters of 1999, which ran into the fourth quarter, is mainly linked to the behaviour of public works; notwithstanding,

CHART 3

Harmonised indices of consumer prices



Sources: Eurostat and European Central Bank.

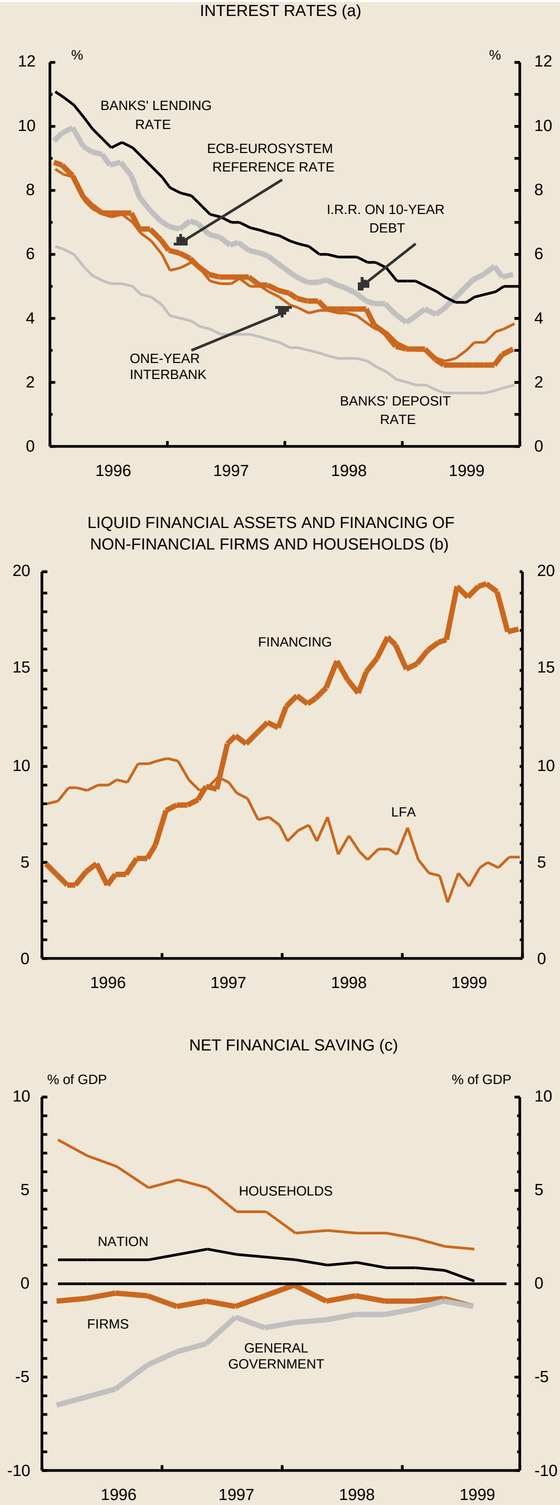
its annual average growth will far exceed that recorded in 1998. As to capital investment, the indicators available show that it will have ended the year with considerable strength, although its growth rate is tending to moderate. This latter feature is, as stated, common to most of the national demand indicators. The sound situation companies are enjoying (with high rates of return on assets and borrowing costs that are still falling as a result of the influence of earlier interest rate cuts) and the need to improve the efficiency of the productive system so it may hold up in an increasingly more competitive environment are among the reasons behind the persistence of this investment cycle. Unlike with households, this has not entailed a significant decline in companies' net financial saving.

As earlier stated, the growth of employment during the year has remained firm, and its slowing trend appears to have eased in recent months. The estimated increase for apparent labour productivity is once again abnormally low, for the second year running. But it has picked up slightly and is expected to continue doing so in the coming quarters. The slight moderation seen in unit labour costs is therefore not due to productivity gains but to wage moderation. Employee compensation is estimated to have increased by around 2.5 % on average during the year.

The 12-month growth rate of the consumer price index (CPI) stood at 2.9 % at the end of the year (2.8 % in terms of the harmonised index). This was essentially due to the increase in the price of oil products, and in that of certain foodstuffs, against a backdrop of persistently buoyant domestic demand and abundant financing of expenditure. The growth rate of other components, such as services and non-ener-

CHART 4

Financial indicators of the Spanish economy



Source: Banco de España.
(a) The series are averages of daily data.
(b) Financing includes bank loans extended by resident and non-resident credit institutions and fixed-income securities.
(c) Cumulative four-quarter data.

gy industrial goods, fell during the year, although less than expected. The gap between the growth of the Spanish harmonised index (HICP) and that of the euro-area countries, which had reached 1.3 points in September, stood at year-end at one point. The widening of the gap has been particularly marked in food products and, to a lesser extent, in industrial goods, while it has narrowed slightly in services. The pressures exerted by energy prices have been manifest in other price indicators such as the import unit value and wholesale industrial price indices, and they have worsened once more at the onset of the current year.

The previous quarterly report highlighted the danger of these price pressures –which, in principle, should be temporary– ultimately feeding into wage bargaining and becoming permanent, impairing the economy's competitiveness in the process. At a time when international markets are expanding considerably, the Spanish economy should direct all its efforts to entrenching an export- and investment-driven growth pattern. The persistence of inflation differentials with the euro-area countries, the strong increase in the external deficit in 1999 (which, after several years, has seen the resumption of a negative current- and capital-account balance, the expression of a shortage of saving in the economy) and low productivity growth are all factors clearly pointing to where economic policy measures and decisions should be directed. In short, the expansiveness of domestic demand has to be held in line with the supply side's capacity to respond.

In this respect, the success in cutting the budget deficit in 1999 and the targets included in the updated stability programme presented by the government are a step in this direction. Setting a scenario of stable growth firmly in place will no doubt help achieve these objectives, although fiscal policy strategy should continue to be steered by fresh efforts to contain expenditure. Further headway should be made in the structural reforms aimed at liberalisation in order to enhance the possibilities of meeting greater demand without incurring price and cost deviations or seeing competitiveness eroded.

2. The external environment of the euro area

The economic recovery initiated in the external environment of the euro area in mid-1999 continued into the fourth quarter of the year. The strong growth rate sustained by economic activity in the United States, the resilience of domestic demand in the United Kingdom, the vigorous recovery by the south-east Asian economies and, finally, the stabilisation of financial conditions in Latin America have been conducive to the economic upturn spreading to other areas that are behind in the business cycle. Against this backdrop of higher economic growth, inflation was generally low, albeit on a rising path fuelled by the feed-through of the high growth of oil prices to producer and consumer prices and by the pressures discernible in certain labour markets.

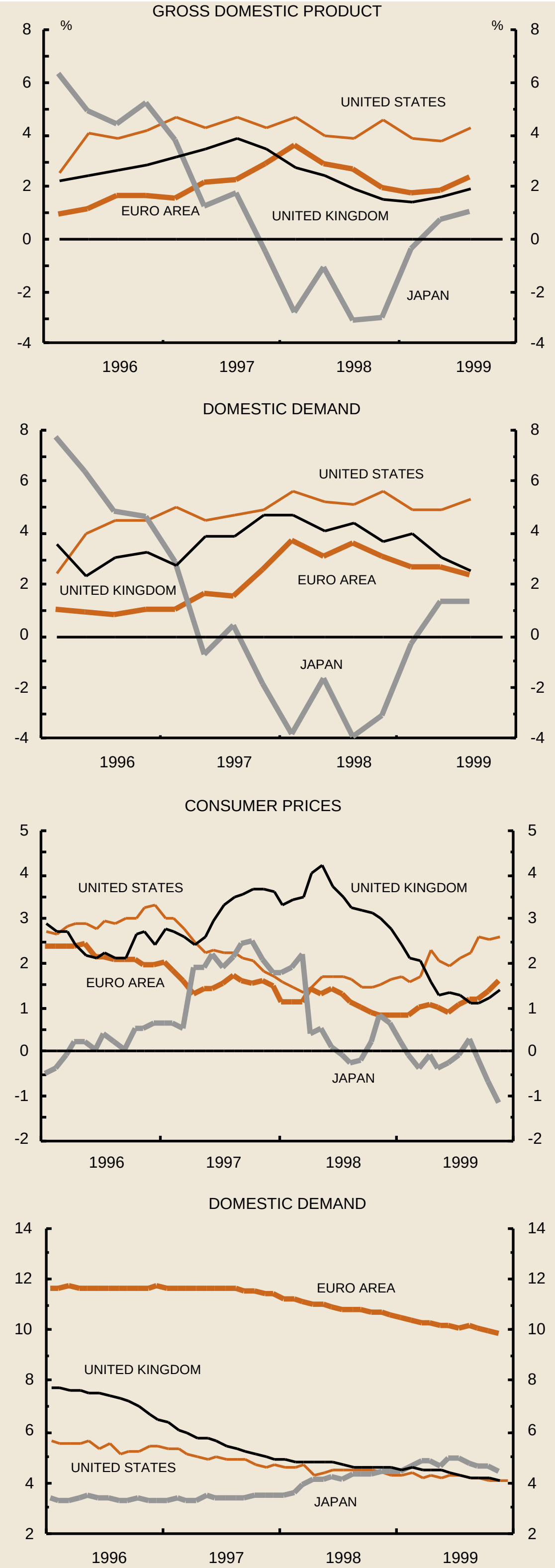
According to US national accounts data, GDP growth ran at a rate of 4.3 % year-on-year in the third quarter, slightly up on the two previous quarters. This was due both to the greater strength of all domestic demand components (see Chart 5) and to a less negative contribution of net external demand to GDP growth. The increase in world demand, against a background of the stability of the real effective exchange rate of the dollar, was propitious to the favourable trend of exports. The information available for the fourth quarter of 1999 indicates that the buoyancy of the US economy in the first half of the year continued and even heightened in the closing months (2). In this connection, mention may be made of the positive trend of consumption indicators, the rise in industrial production in the fourth quarter of the year and the strong increase in non-farm dependent employment in December.

Nonetheless, in the third quarter of 1999 the marked deterioration in the terms of trade checked the favourable course of real exports, prompting a further worsening of the trade balance in that period in relation to the preceding quarters. As a result, the trade deficit rose to \$ 72.1 billion. The current-account deficit for the third quarter of 1999 stood at a record \$ 89.9 billion, accounting for 3.9 % of GDP (see Chart 7). For the first three quarters of 1999, the current deficit climbed to –3.5 % of GDP, one point up on the deficit for the same period in 1998 (–2.5 %). The future correction of the US trade and current-account imbalance should be assisted as the respective growth rates of domestic demand in the United States and in the rest of the world progressively draw closer in the fourth quarter.

(2) After having closed this Bulletin, the provisional data for GDP growth in the fourth quarter were released, placing it at 5.8 % in annualised quarter-on-quarter terms and thus confirming the trends indicated.

CHART 5

Main macroeconomic indicators
Percentage change on previous year



Sources: Banco de España, national statistics and Eurostat.
(a) As a percentage of the labour force.

Both consumer and producer prices (on information to November in the latter case) were, in contrast to the deterioration seen in the previous three quarters (see Chart 5), highly stable in the fourth quarter of 1999. The 12-month growth rate of the US CPI stood at 2.7 % in December, one-tenth of a point above the September figure, while the index excluding fresh food and energy grew 1.9 % in December, two-tenths of a point down on September. The latest information on wage costs reflected in the average hourly earnings indicator (see Box 1) points to growth of around 4 % year-on-year in October and November, showing no acceleration in relation to the opening months of the year, despite signs of labour shortages in various activities. In this respect, the unemployment rate fell further in the fourth quarter to 4.1 %. Nonetheless, strong labour productivity gains are expected to continue in the final months of the year. Such gains are easing the pressure of wage costs on prices, especially in the so-called «new technologies» sectors.

In Japan, GDP grew by 1 % year-on-year in the third quarter of 1999. Although this rate was slightly higher than that of the previous quarter (0.7 %), it continues to evidence the sluggishness of the recovery initiated in early 1999. The acceleration in activity was, above all, the outcome of a less negative contribution of net external demand derived from the high growth of exports of goods and services, as imports also gained in strength. The thrust of external demand in the third quarter of 1999 was favoured by the rapid pick-up in Asian markets last year and by the buoyancy of US imports, since the appreciation of the yen in the second half of 1999 is prompting a significant loss in the competitiveness of the Japanese economy (see Chart 7). The sluggishness of domestic demand reflects both continuing caution on the part of consumers and the financial and industrial restructuring in which Japan is immersed.

The indicators available for the fourth quarter of 1999 confirm the slow recovery in domestic demand and the thrust of the export sector. The unemployment rate has been on a moderately declining course, and deflationary pressures continue to affect prices. Indeed, in relation to a year earlier, consumer prices fell in the final quarter, with inflation standing at –1.2 % in November. Industrial prices have also continued to fall in year-on-year terms, although they have moderated in recent months.

Turning to the EU economies not currently forming part of the euro area, the pace of activity in the United Kingdom continued to improve

BOX 1

Wage costs and productivity in the United States

The absence of inflationary pressures marking the current upturn in the United States is prompting the careful scrutiny of wage and productivity developments in the economy. Nonetheless, there is considerable confusion when it comes to assessing the course of wage costs; there are various indicators, devised with heterogeneous methodologies and differing scope, that offer information which does not always coincide. This is why it is best to list the main US wage cost indicators, pointing out their chief characteristics.

There are three basic statistical sources for labour costs in the United States: average hourly earnings (monthly), drawn from the «establishment survey» (employment report); the employment cost index (quarterly), which is published as part of the «employment cost trends programme»; and, lastly, compensation per hour (quarterly), which is included in the «productivity report». There are notable methodological differences in their content and the way they are prepared, and these are summarised below and illustrated in the adjoining table.

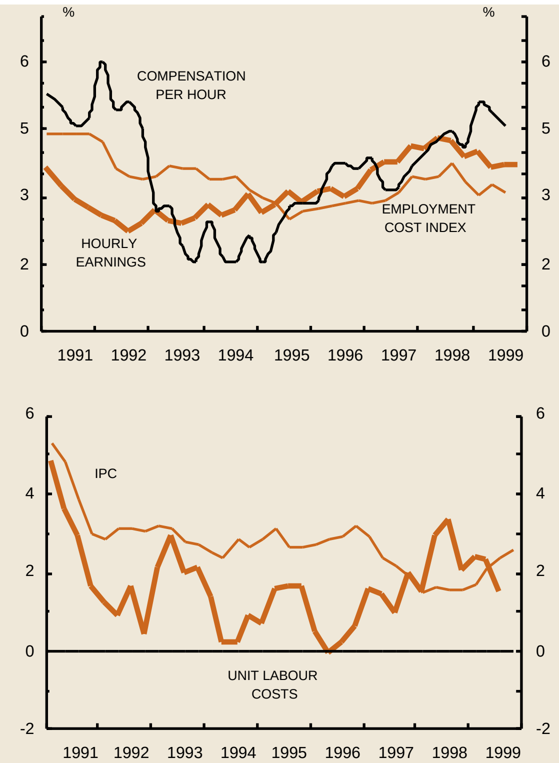
The monthly series of average hourly earnings is obtained from the monthly survey conducted by the Bureau of Labor Statistics. The series refers to non-management, non-supervisory payroll employees at non-farm private-sector companies. The measurement is in gross terms (before any deduction or withholding) and does not include payments in respect of commissions, bonuses, or any other non-wage payment unless it is regularly made. Further, it is published in levels, i.e. in the number of dollars per hour. This series covers approximately 82 % of private-sector employment and 68 % of total employment. It covers less than the other two indicators but, as it is published monthly, its advantage is that it can be taken as a leading indicator of the trend of wage pressures.

The quarterly series of the employment cost index is also obtained from a survey. It includes a series of regular payments (wages and salaries, productivity-linked commission), which account for 70 % of the index, and irregular payments (bonuses, overtime, contributions to pension schemes, private insurance and compulsory insurance), making up the remaining 30 % of the index. The population coverage of this indicator is the broadest of the three considered, since it refers both to the private sector and to the public sector: it accounts for approximately 95 % of total employment.

Compensation per hour is the overall cost incurred by employers for the work of their employees. It therefore includes wages and salaries, benefits (all sorts of paid leave, bonuses, incentive payments, employee discounts ...) and employers' contributions to employee welfare schemes (medical, life and unemployment insurance). The population covered is that of the non-farm private sector, and it is estimated drawing on the information provided by GDP from the income standpoint. The compensation per hour series has certain advantages over the other two indicators. It is based on national accounts, making it consistent with the other aggregates published within the national accounts framework, and it includes more wage items. On the other hand, it also has certain drawbacks. Its population coverage is less than that of the employment cost index, and it is published with something of a delay in relation to the other two. Dividing the prior series of compensation per hour by that of hourly productivity (obtained from the national accounts output series) gives the series of unit labour costs (ULCs).

The top chart tracks the three wage cost indicators in question in recent years. The interpretation of labour cost developments that may be inferred differs notably depending on the indicator monitored. Indeed, both the compensation per hour series and the employment cost index show a slowdown in wage costs in the first half of the nineties that is reversed from 1995 onwards. The average hourly earnings series, however, points to a gradual increase in wage costs over the same period. Further, the hourly earnings series and the employment cost index give a more favourable perspective of wage costs since end-1998 than the compensation per hour series. The lower chart depicts the change in unit labour costs and in the CPI. Productivity gains, running at a rate of close to 3 % year-on-year since 1996, had not sufficed to offset wage increases. As a result, ULCs have, as from that year, posted positive but lower rates of change than the rate of consumer-price inflation. Following a period in which the growth of unit labour costs outpaced that of inflation in 1998, the acceleration in productivity over the past year has meant that real wages have grown at lower rates than unit output, thereby easing the pressure of wages on prices.

United States: wage costs
Annual percentage change



Source: Bureau of Labor Statistics.

Wage coverage
Components included in each indicator

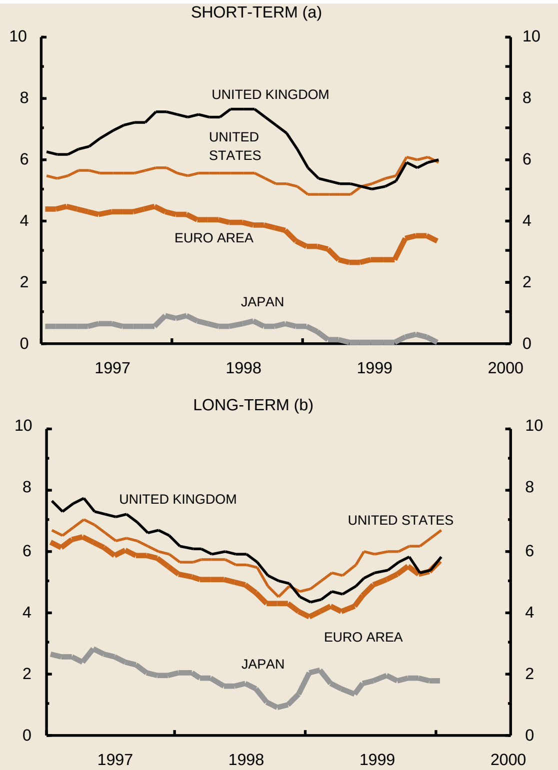
	Average hourly earnings (a)	Employment cost index	Compensation per hour
COMPONENTS:			
Basic wage and salaries	x	x	x
Benefits	x	x	x
Overtime	x	x	x
Paid leave	x	x	x
Tips			x
Productivity payments and extra salary payments		x	x
Severance payments		x	x
Payments related to housing, withholdings and deferred payments			x
Stock options			x
Payments in kind			x
Contributions to pension schemes and insurance	x	x	x
Work disability insurance			x

Source: Bureau of Labor Statistics.

(a) The monthly series of average hourly earnings may include some additional non-wage item if payment thereof is on a regular basis.

CHART 6

Interest rates



Source: Banco de España.

(a) Three-month interbank market interest rate. Euro area: until December 1998, weighted average of the eleven euro-area countries; in 1999 and 2000, three-month EURIBOR.

(b) Ten-year government bond yields. Euro area: until December 1998, weighted average of the eleven euro-area countries.

during the second half of 1999. In the third quarter, economic growth quickened to a rate of 1.9 % year-on-year, four-tenths of a point up on the rate for the first half of 1999, owing to the less negative contribution of the external sector. The latest information appears to indicate that the favourable trend of activity has continued throughout the fourth quarter of the year. Labour market tightness is becoming increasingly evident. Indeed, the unemployment rate reached a new low of 4 % in December, whereas the year-on-year growth of employee compensation grew by 5.1 % in October, exceeding the average rate for the first nine months of the year by almost half a percentage point. However, the main consumer price indicators do not point to a significant rise in the inflation rate, although producer prices continue to rise at increasing rates.

As to the improvement in the south-east Asian economies, the data available for the third quarter of 1999 confirmed the broad recovery in the pace of economic activity. This seems to be particularly sound in economies such as South Korea, Malaysia and Singapore, where the respective year-on-year growth rates exceeded 12 %, 8 % and 6 % in this period. The average growth forecast for 1999 stands, for the area as a whole, at around 5 %, slightly above the estimates available in mid-1999.

Lastly, in the Latin American region, a large number of countries were still mired in recession during the second half of last year. As a result, 1999 will foreseeably close with a fall in the area's overall GDP. Brazil has seen a moderate recovery which, on the forecasts available, will allow growth of between 0 % and 1 % to be achieved for 1999 as a whole. Argentina, however, remains beset by a strong recession, testifying to which was the 4.1 % year-on-year decline in GDP in the third quarter of last year. Among the main economies of the area, only Mexico expanded significantly. In year-on-year terms its growth rate was 4.6 % in the third quarter of 1999, thanks to the strong knock-on effect from the US economy. Nonetheless, the relative stability of the financial markets in the second half of 1999 should be conducive to overcoming the recession beleaguering this region in 1999. Specifically, there has been a gradual reduction in long-term interest rates in the area, perceptible rises in the stock exchange indices of many of its economies and less exchange rate volatility. Lastly, it should be mentioned that the government of Ecuador, which is facing a deep-seated recession accompanied by the collapse of its currency against the dollar, has proposed substituting the dollar for its national currency against a background of great political instability.

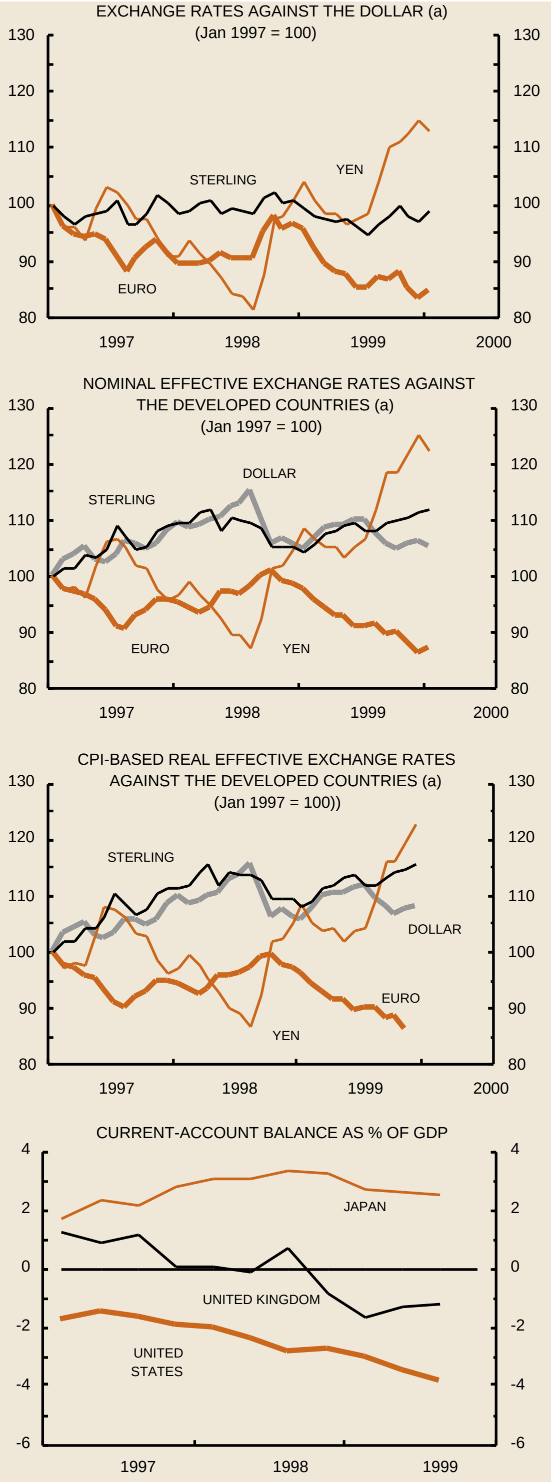
The keynote in terms of fiscal policy developments in the closing months of 1999 is the effect that the strength of US economic activity is having on the federal budget balance. Indeed, a general government financial surplus of close to 1.5 % of GDP is forecast for the year as a whole. Conversely, in Japan, recent forecasts for 1999 point to a sizeable budget deficit of around 7-8 % of GDP, accompanied by a strong increase in the level of gross public debt, which could climb to around 110-120 % of GDP. At the end of last November, the Japanese government approved a new supplementary fiscal package (which will come into force at the end of the first quarter of this year) for a total value of JPY 18 trillion, 6.8 trillion of which accounting for public spending programmes.

During the fourth quarter of 1999, there was a fresh phase of monetary policy tightening in the United States and in the United Kingdom. On 16th November the Federal Reserve decided to raise its two main reference rates by one-quarter of a point, placing the Federal funds target and discount rates at 5.5 % and 5 %, respectively. The Bank of England also raised its repo rate by one-quarter of a point on 4th November, implementing a fresh rise on 13th January 2000 and taking its main rate up to 5.75 %. The Bank of Japan has persisted with its policy of interest rates at close to zero, holding its discount rate at 0.5 % while its daily intervention rate has stood at 0.15 % since the fourth quarter of last year. On the international bond markets, the favourable conditions of the US economy and signs of latent inflationary pressures have prompted a significant rise in long-term interest rates (see Chart 6). Since the start of the final quarter of 1999, US 10-year bond yields have risen by almost half a percentage point to 6.65 % as of early January 2000. This tendency, which has also spread to the European markets, has not been seen in Japan, where 10-year government debt rates have held stable. Stock markets, for their part, have trended favourably. The New York and Tokyo stock exchange indices have posted increases for the year of close to 11 % and 7 %, respectively, in the fourth quarter of 1999, and have exhibited great stability in the opening weeks of January.

On the currency markets, the main developments in the fourth quarter were the dollar's depreciation against the yen and its appreciation against the euro. From September to December last year, the dollar depreciated 4.1 % (see Chart 7) in relation to the yen and appreciated 3.9 % against the euro. However, in the first fortnight of January, there was a turnaround in this trend with the dollar rallying against the yen and depreciating in relation to the euro. That said, this latter movement has been a temporary one since, on 20th January, the dollar/euro exchange rate stood once again very close to parity. In nominal effective terms, the dollar showed a high degree of stability against the basket of currencies of the developed countries during the fourth quarter of 1999, in notable contrast to the Japanese currency's sizeable loss of nominal and real competitiveness. Thus, while the dollar appreciated slightly by 0.2 % in the fourth quarter, the yen, on the upward path initiated at the end of the second quarter of 1999, appreciated in effective terms by 5.7 % against the developed countries over the same period. Lastly, on the request of the Greek authorities, the central parity of the drachma against the euro was revalued by 3.5 %.

CHART 7

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) Before 1999 the euro is represented by 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 developments

During the closing months of 1999 there was added impetus to economic activity in the euro area. The improvement in the external environment and the trend of the euro exchange rate gave renewed momentum to the area's exports. However, the recent course of inflation in the area highlights more sharply the effects of the rise in oil prices as the offsetting effect that had been exerted by the trend of other components has petered out.

On the latest Eurostat estimates (see Chart 8), GDP growth in the euro area in the third quarter of 1999 compared with the same period a year earlier stood at 2.3 %, notably up on the average rate posted in the first half of the year (1.7 %). In terms of quarter-on-quarter rates, GDP growth in the third quarter of 1999 has signified the extension of the recovery initiated in the euro area in early 1999.

The vigour of economic activity in the third quarter of 1999 (see Chart 8) was essentially due to the appreciable increase in the contribution of net exports to GDP growth. After having been negative for five quarters, this contribution has turned positive in year-on-year terms (0.1 percentage points). The contributions of private consumption and of government consumption also increased slightly, while that of gross fixed capital formation declined moderately. The negative contribution of the change in stocks, both in quarter-on-quarter and year-on-year terms, should be attributed to the lag with which production decisions may have reacted to increases in demand.

In the countries where the breakdown by component of the third-quarter national accounts results are known (Germany, France, Italy, Spain and Finland), a common component is the generalised recovery in exports, especially in relation to the second quarter of the year. Although activity has accelerated notably in Germany and Italy, these countries continue to post the most muted GDP increases (1.3 % and 1.2 %, respectively, in year-on-year terms). This is due to the limited buoyancy of domestic demand in both countries.

The indicators available on developments in the euro area in the fourth quarter of 1999 (see Chart 9) largely coincide in highlighting the ongoing recovery observed in the previous months. The industrial confidence indicator stood at year-end at a higher level than the average for the preceding ten years, with the sustained increase in both overall and foreign orders particularly prominent. With data to October, industrial production in the area reflects a mild acceleration in response (perhaps somewhat lagged) to the increase in orders. Regarding the consumption indicators, both the consumer confidence indicator (which stood in the closing months of 1999 at practically the same level as the historical high attained in the first quarter) and the retail sales indicator trended favourably in October.

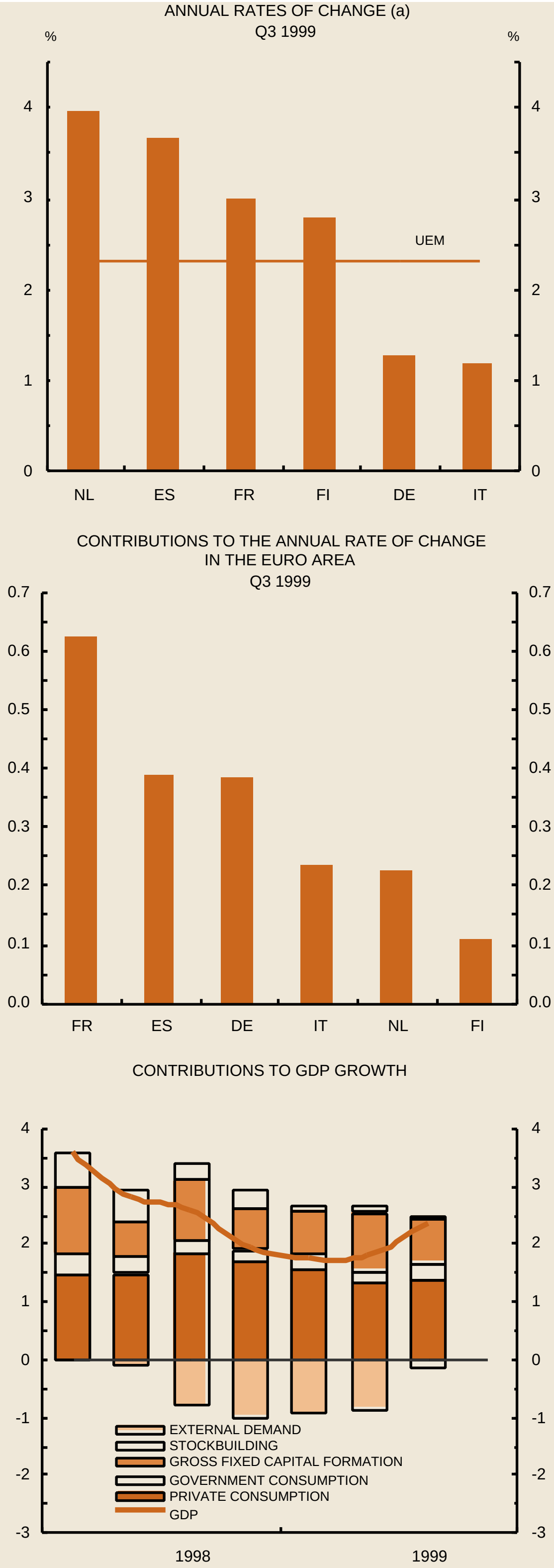
Turning to the labour market, the pace of employment creation is not yet reflecting the greater momentum of economic activity during 1999. In year-on-year terms, employment growth ran at 1.4 % in the third quarter, one-tenth of a point down on the previous quarter and two-tenths lower than in the first three months of the year. This has resulted in a significant pick-up in apparent labour productivity in the third quarter of 1999, after it had reached growth rates close to zero in the preceding quarters. Nonetheless, the unemployment rate has continued to fall moderately, standing at 9.8 % of the labour force in November. Wage costs, measured by the labour costs index, have quickened gradually since mid-1998, as reflected in the 2.2 % growth in this index in the third quarter of 1999 compared with the same period a year earlier. This figure is two-tenths of a point above the increase in the first half of last year.

In October 1999, the euro-area trade surplus widened to EUR 6.9 billion (EUR 2 billion in September), as a result of an acceleration in exports (9 % year-on-year compared with 6 % in September) and the sustained growth rate of imports (10 % in September and October). In the third quarter of the year, the current-account balance for the area ran a surplus of EUR 7.8 billion (ECU 15.5 billion in the same period in 1998). The services balance, for it part, showed a deficit of EUR 1.6 billion in the third quarter compared with a deficit of 0.4 billion in the same period a year earlier.

The most representative indicators of prices in the euro-area economy worsened during the fourth quarter. This was largely brought about by the upward trend of crude oil prices on international markets (a 145 % increase between February and December 1999), by the depreciation of the euro against the dollar (16 % over the course of the year) and by the turnaround in the falling trend of food prices. The annual percentage change in the HICP for the area was 1.7 % in December, five-tenths of a point above that of September (see Chart 10). The deterioration in the goods index during the year and the mild improvement in that of services has been conducive to convergence between the growth rates of both these components of the HICP. In December these rates were, in 12-

CHART 8

GDP in the euro area

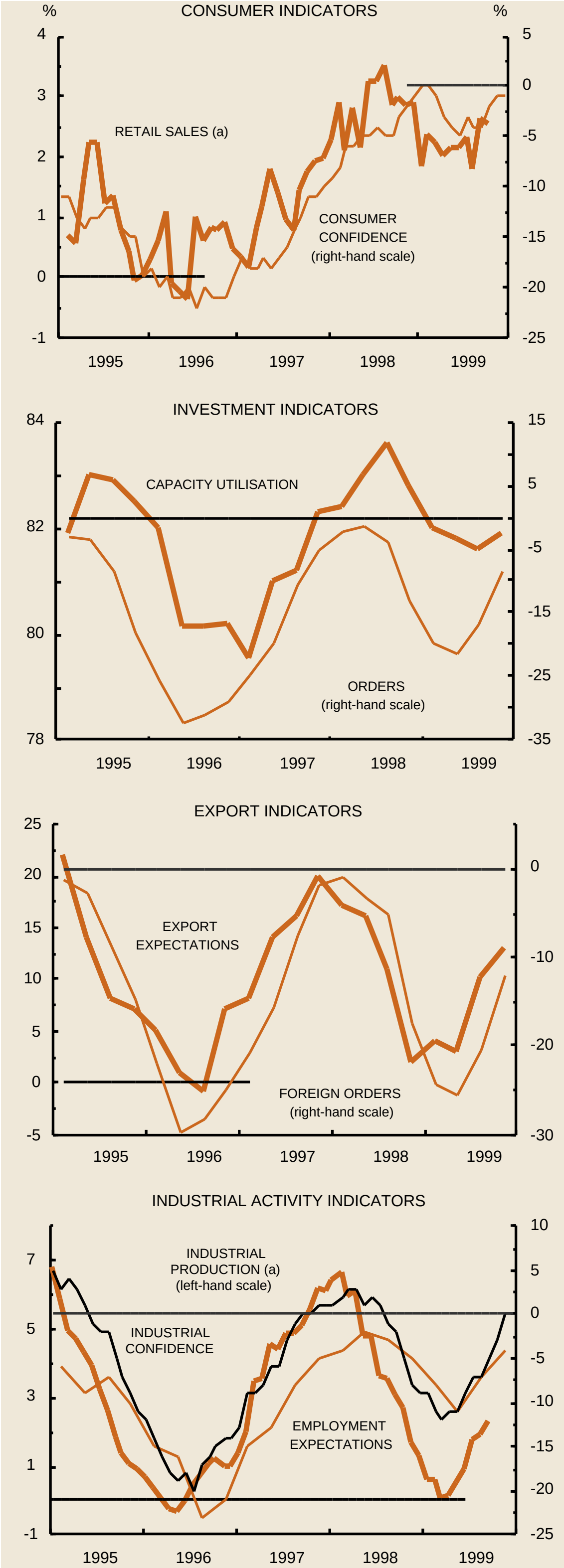


Sources: Eurostat and national statistics.

(a) Excluding Belgium, Ireland, Luxembourg, Austria and Portugal for which no quarterly national accounts data are available.

CHART 9

Euro area. Real indicators



Sources: Eurostat and European Commission.
(a) Non-centred annual percentage changes calculated on the basis of the quarterly moving average of the seasonally adjusted series.

month growth terms, 1.8 % and 1.5 %, respectively. Under the goods aggregate, both the index of foodstuffs and that of industrial goods worsened further during the fourth quarter. In the case of the food index, the deterioration was largely prompted by the unfavourable performance of unprocessed foods (which moved from a negative rate of –1.2 % in September to –0.3 % in December); and, in the case of industrial goods, by the rise in energy prices to a growth rate of 10.2 % year-on-year, almost four points up on September. Lastly, the growth of the other components of the goods aggregate remained virtually stable from September to December. Excluding the figure for Ireland, the latest HICP data continue to reveal a gradual reduction in the dispersion of the inflation rates of the various euro-area countries, set against the higher maximum and lower minimum values recorded since August. In the fourth quarter, the producer price index continued on the accelerating course it has followed since the start of 1999. It climbed to a 12-month growth rate of 3 % in November, in contrast to the negative rate it had posted from the second quarter of 1998 to July 1999.

The inflationary outlook is for fresh increases in the opening months of the current year, which should subsequently be reversed. Nonetheless, there are certain risks which may lead to a degree of persistence in price rises. Specifically, compounding the risk that the oil price may not moderate as from next spring is the possibility that the pass-through of dearer crude oil at source to final prices may intensify in the coming months in a context of vigorous final demand. Further, there are no foreseeable circumstances in which the uptrend in agricultural prices seen in recent months may be restrained. Accordingly, it does not seem that the food component of the HICP can continue, as it did until the third quarter of 1999, lessening the effects of the trend of the energy component on the general index. Moreover, there is a risk that the combination of wage bargaining with the temporary increase in prices may give rise to wage settlements that are not propitious to continuing low rates of inflation. Set against this, it is to be expected that the policies of deregulation and liberalisation in the markets for goods, services and factors applied in recent years will continue to exert a restraining effect on prices.

According to the notifications submitted by the Member States to the European Commission in September 1999, under the excessive deficit procedure, most countries will meet the targets for 1999 set in their original stability programmes, assisted by the expansion of tax revenue at a higher than expected rate (see Table 1). However, there may be some minor

TABLE 1

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

	1995	1996	1997	1998	1999 (a)
Belgium	–3.8	–3.1	–1.6	–0.9	–1.0
Germany	–3.3	–3.4	–2.7	–2.1	–1.9
Spain	–7.1	–4.5	–2.5	–1.7	–|.6
France	–4.9	–4.1	–3.0	–2.9	–2.2
Ireland	–2.1	–0.2	1.0	2.4	3.2
Italy	–7.7	–6.6	–2.7	–2.7	–2.4
Luxembourg	1.8	2.8	3.8	2.5	1.7
Netherlands	–4.1	–1.8	–1.0	–0.7	–0.5
Austria	–5.1	–3.7	–1.8	–2.2	–2.0
Portugal	–5.7	–3.3	–2.5	–2.2	–1.8
Finland	–4.6	–3.1	–1.2	1.0	2.5
MEMORANDUM ITEM:					
Euro area					
Primary balance (b)	0.7	1.3	2.5	2.4	
Total balance (b)	–5.0	–4.1	–2.5	–2.1	
Public debt	74.8	76.1	75.4	73.6	

Sources: European Commission and ECB (until 1998).
(a) Balances notified to the Commission under the excessive deficit procedure.
(b) Deficit (–) / surplus (+).

slippage in Austria and Italy. In the latter country, the deficit is finally expected to stand somewhere between the figure forecast in its stability programme (2 % of GDP) and the revised target of 2.4 % of GDP announced by the Italian authorities last spring.

Budgetary plans for the year 2000 indicate that fiscal consolidation will continue to be pursued by most countries in the area during the year. In many cases, the objectives set are more demanding than those reflected in the original stability programmes. Thus, in Germany and France, the deficits programmed for the current year are 1.25 % and 1.8 % of GDP, respectively, compared with the figure of 2 % in the programmes presented last year. In Italy, the budget seeks to hit exactly the target set in the 1998 stability programme (a deficit of 1.5 % of GDP). Austria faces the biggest problems in attaining its original target. There, the preparation of the budget continues to be delayed as a result of the difficulty in forming a government after the elections last autumn.

As to medium-term budgetary plans, mention may be made of the announced tax reform in Germany, which envisages a staggered reduction of the direct tax burden in the period to the year 2005. Income tax rates will be substantially cut, while minimum allowances and family allowances will increase. That entails bringing forward and stepping up the tax reduction previously announced in spring 1999. Finally, corporate income tax will be reduced from 40 % to 25 % at the outset of the year 2001.

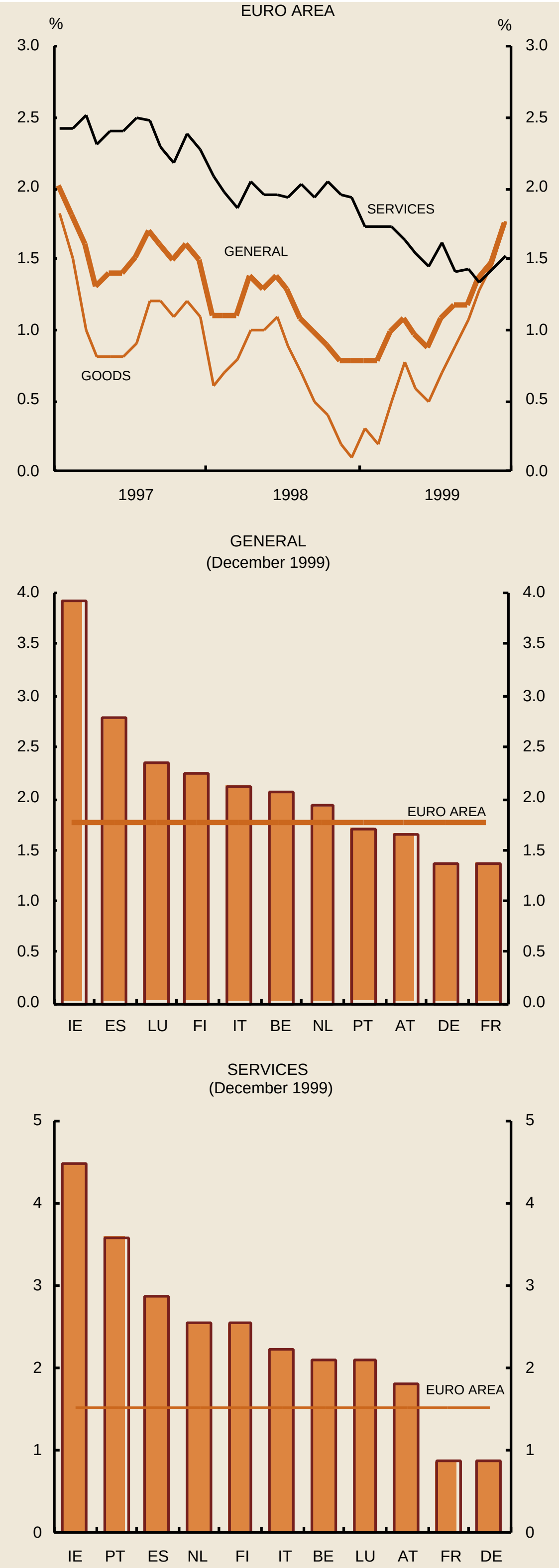
3.2. Monetary and financial developments

The fourth quarter of 1999 saw the continuation of relatively generous monetary and financial conditions in the euro area, despite the expectations of interest rate rises prevailing at the start of the quarter and the subsequent raising of ECB intervention rates decided upon by the Governing Council on 4th November (see Chart 11). In this respect, real short- and long-term interest rates remained very low, the former below 2 % and the latter between 3.5 % and 4 %. The tendency witnessed since the start of the year for the euro to depreciate against the dollar and the yen continued. Further, the reference monetary aggregate for the area, M3, and financing to the resident private-sector continued to display high growth rates. Regarding the reference value for M3, the Governing Council of the ECB announced on 2nd December 1999 that it would maintain the figure of 4.5 % as a reference for the year 2000. This was based on the fact that there had been no significant changes in the economic assumptions underpinning the setting of this value in December 1998. Likewise, it was announced that this reference would be revised annually.

On 4th November the Governing Council of the ECB announced a rise of 50 basis points in

CHART 10

Harmonised indices of consumer prices
Twelve-month percentage change



Source: Eurostat.

the interest rate on the main refinancing operations of the Eurosystem to 3 %, and a simultaneous increase in the rates on both the marginal lending facility and the deposit facility to 4 % and 2 %, respectively. Following this measure, the overnight interbank rate (EONIA) held at levels very close to 3 % except on 30th December, the last trading day in 1999. Then, owing to the uncertainty associated with the potential Y2K effect, and despite ample market liquidity, the EONIA stood at 3.75 %. The longer-dated interbank rates held fairly stable until late November, when they began to be affected, to differing degrees depending on the term, by market uncertainty over the possible effects of the transition to the year 2000. These effects were temporary and were corrected in the opening days of the current year. As a result of these movements, one- and three-month EURIBOR rates stood at 3.1 % and 3.3 %, respectively, on 21st January, 53 basis points and 58 basis points above their average levels in September 1999.

Long-term interest rates in the euro area had risen in October, placing 10-year interest rates at around 5.6 %. Days before the rise in intervention rates, long rates initiated a downward course that took them to levels close to 5 % in mid-November. Subsequently, they rose again as a result both of the increase in US bond yields and of the firming of brighter growth prospects for the area. A further probable cause was the perception by agents of certain risks to price stability in the area, as the Eurosystem had been warning. As a result of these movements, 10-year yields in the euro area stood on 19th January at 5.75 %, 52 basis points above the average level in September. These movements gave rise to upward shifts in the euro-area yield curve (see Chart 12), whose slope is currently significantly higher than was the case in December 1998.

Interest-rate movements in the euro area were, it is true, generally in the same direction as those on US markets. However, the 10-year yield spread over the United States tended to widen during the quarter as a whole, totalling 110 basis points on 19th January. The changes in this spread were quite in keeping with the euro's position against the dollar on the foreign exchange market. Thus, the euro appreciated against the dollar in October, rising to an average exchange rate of $1.071 and, subsequently, although somewhat volatile, it tended to depreciate, standing in the first fortnight of January at levels very close to parity with the US currency.

With regard to other interest rates relevant for economic agents' spending decisions, average retail bank lending rates in the euro area, which reflect with something of a delay the movements in money-market and long-term interest rates, increased in the fourth quarter in relation to their level in September. Nonetheless, in November (the latest month for which information is available) the rates on longer-dated loans to companies along with the rates on consumer credit and mortgage loans tended to stabilise and even to fall slightly. This ran counter to the rates on shorter-dated financing, which rose. In any event, the interest rates on bank lending transactions with the private sector remained below their average 1998 levels (see Chart 13).

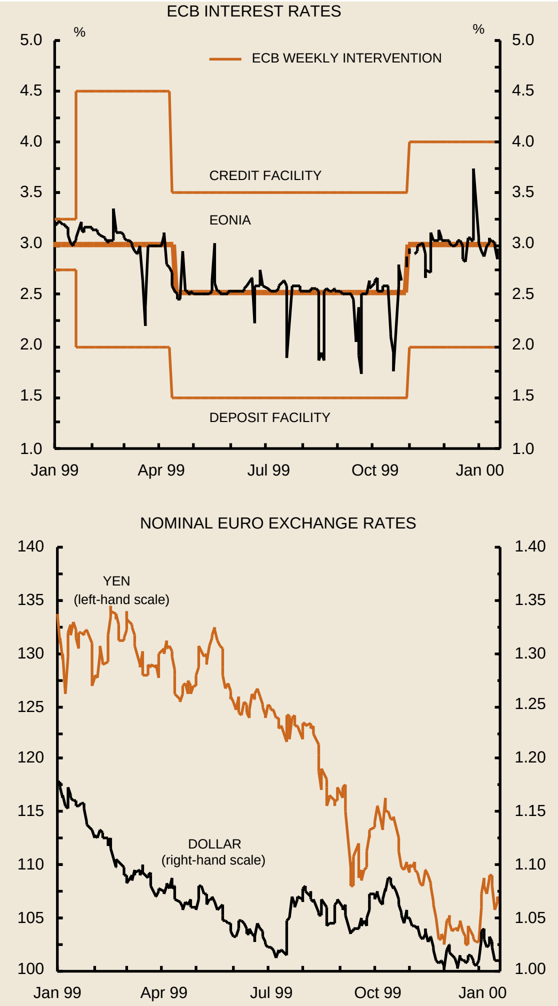
Equity markets in the euro area trended favourably during the fourth quarter of 1999, although they exhibited particular volatility in October. Generally, the course of prices on these markets was fairly independent of that of interest rates and, although it was linked to some degree to the situation on the US stock market, higher increases ensued. Hence, in December 1999 the average level of the Dow Jones EURO STOXX index stood 19.5 % above the related level for September. And by mid-January 2000, the index had risen by 34 % in relation to its average level in January 1999.

The euro-area monetary and credit aggregates continued to expand at high rates. This was largely related to the progressive improvement in growth prospects and to as yet relatively low interest rates. Up to December (the latest month for which information is available), the three-month moving average growth rate of the reference monetary aggregate, M3, stood at 6.1 % in relation to a year earlier, with the figure for this month at 6.4 %. The more liquid instruments making up this aggregate continue to expand forcefully, as testified by the behaviour of overnight deposits, which sustained year-on-year growth rates of around 13 % in the final quarter of the year. Likewise, there was a pick-up in the demand for negotiable instruments included in M3, such as shares in money-market mutual funds, and for other longer-dated financial assets not included thereunder, such as deposits maturing at over two years.

The year-on-year growth recorded in M3 throughout 1999 was persistently above the established reference value. That partly reflected the strong growth of overnight deposits in the euro area during the opening months of 1999, associated with certain one-off effects arising from the introduction of the euro and from the start-up of EMU. However, the expansionary behaviour of M3 continued in the subsequent months, thereby confirming that liquidity conditions in the area have been relatively generous during 1999.

CHART 11

ECB interest rates and euro exchange rates

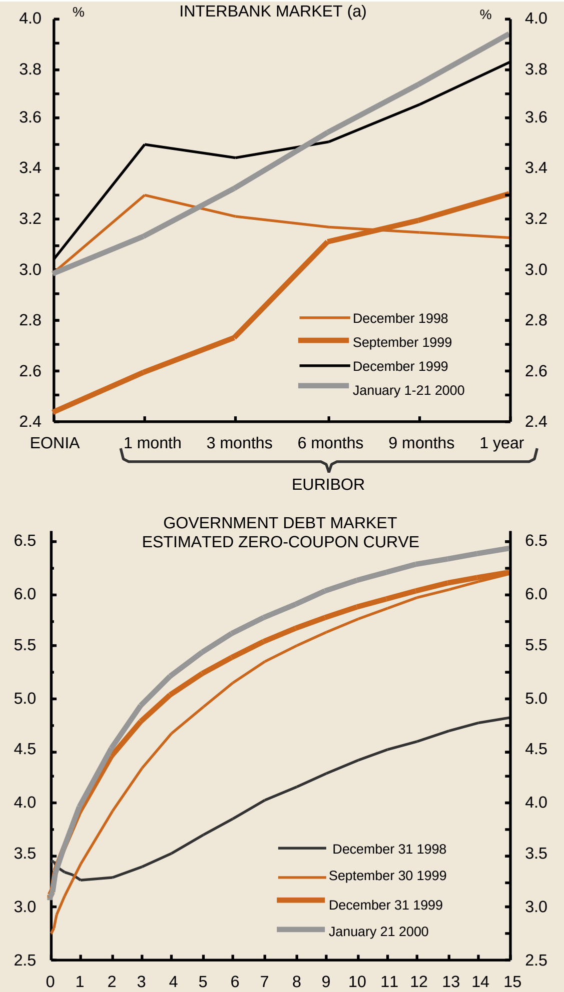


Sources: Banco de España and ECB.
(a) Dollar/euro and yen/euro exchange rate.

The foregoing monetary developments were compatible with the sustained, strong growth rate of finance extended to euro-area residents, which duly posted a year-on-year increase of 8.4 % in December. This was largely due to the behaviour of finance extended by MFIs to the private sector, which ran at 10.5 % in December on a year earlier, compared with the 2.5 % growth of finance extended to general government. The net external position of MFIs continued to diminish as a result of the gap between the growth of claims on residents and liabilities vis-à-vis this same sector, whereby this position had fallen by EUR 200 billion in December

CHART 12

Euro area yield curves

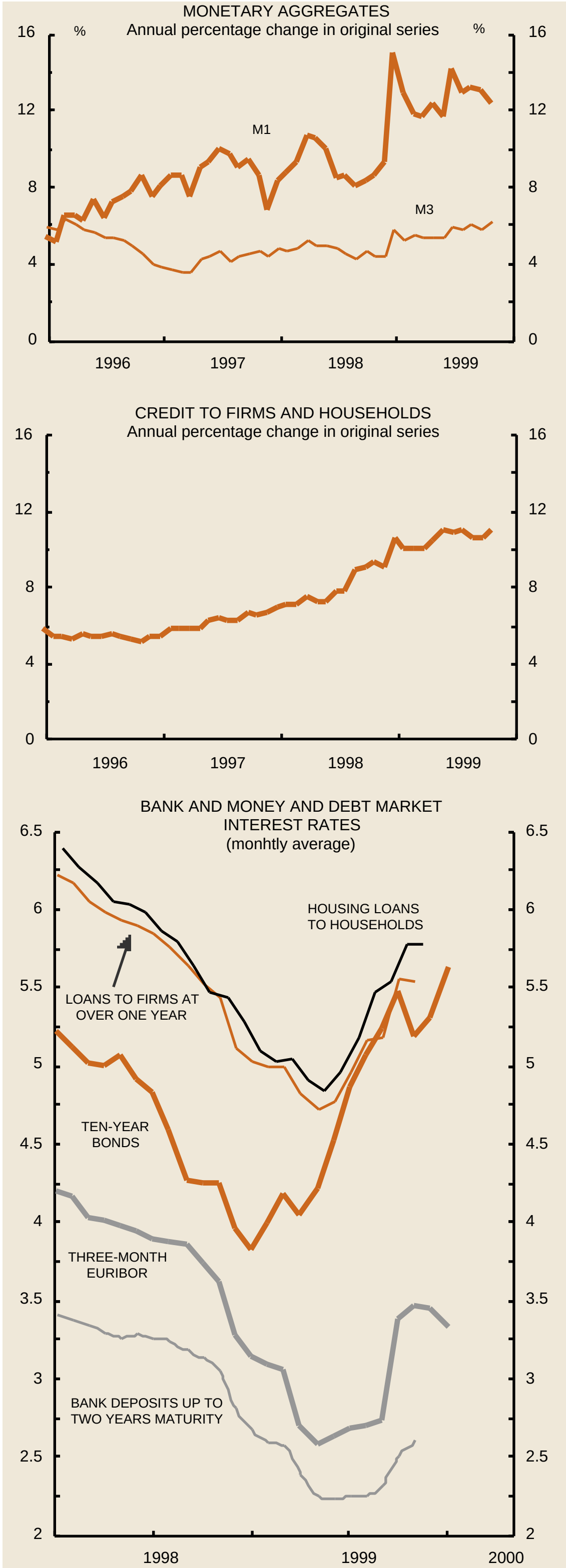


Sources: Banco de España and ECB.

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

CHART 13

Monetary and credit aggregates and interest rates in the euro area



Sources: Banco de España and ECB.

1999 compared with the same month a year earlier.

With regard to monetary policy implementation, the pattern mentioned in previous reports continued in place during the fourth quarter of 1999. That said, in order to pre-empt any possible influence derived from the transition to the new year, the ECB implemented some preventive measures aimed at ensuring sufficiently generous liquidity conditions in the opening days of the year 2000. In this respect, the ECB had already decided in May 1999 that the maturity date of the longer-term refinancing operation to be conducted on 30th September should be 23rd December rather than 30th December, as would have normally been the case. It was further announced in September that the main refinancing operation to be conducted in the first week of the year 2000 would be cancelled, extending, in turn, the maturity of the last two refinancing operations to be conducted in 1999 from two to three weeks. In addition, it was decided in October to increase the liquidity that would be allotted in the last three monthly longer-term refinancing operations by EUR 10 billion to EUR 25 billion. Likewise, in the main refinancing operation on 30th December, the amount allotted to MFIs was relatively large in an attempt to avert potential problems in the money market. All these measures helped ensure a problem-free transition to the new year. In this connection, it should be mentioned that, on 4th January, the ECB announced a fine-tuning operation –the first of its type since the start of the third stage of EMU– aimed at restoring normal liquidity conditions. This operation involved a variable rate tender on 5th January aimed at capturing one-week deposits in the Eurosystem and thus draining liquidity.

The liquidity provided by the Eurosystem during the last three reserve maintenance periods, the latest of which ended on 23rd December, amounted to EUR 187.7 billion, 194.3 billion and 214.7 billion, respectively. As has been the norm to date, the resort to the standing marginal lending and deposit facilities was relatively insignificant in these periods.

4. The Spanish economy

4.1. Demand

On INE data, national demand grew by 4.8 % (3) year-on-year during the third quarter of 1999, confirming the slight acceleration that began to be observed in the preceding quarter (see Chart 14). This behaviour was common to all the components of demand, unlike in the first half of the year, when the greater strength of household final consumption made up for the moderate loss of buoyancy of gross fixed capital formation. The reduced vigour of national demand in the summer months did not prevent GDP accelerating slightly, to a growth rate of 3.7 % year-on-year, since net external demand reduced its negative contribution to output growth considerably, to -1.1 percentage points. This was the result of a slight downturn in import growth and of the greater buoyancy of exports, which began to benefit from the strengthening economic recovery in certain areas of the world.

The information available at the time this report was prepared seems to suggest that these trends were sustained in the fourth quarter of 1999. On the basis of this information it is estimated that national demand continued to grow at high, albeit slightly lower, rates (of around 4.6 %), dragged down by the slowdown in gross fixed capital formation, and to a lesser extent, by household consumption. At the same time, the negative contribution from net external demand to output growth fell again in absolute terms. This was attributable to the recovery of exports, since imports remained vigorous. As a result, in the fourth quarter of 1999 GDP growth ran at around 3.8 % year-on-year, one-tenth of a percentage point higher than in the third quarter, making the increase in 1999 as a whole 3.7 %. This rate is three-tenths of a percentage point lower than in 1998, basically reflecting the impact of the International crisis, which was at its deepest at the end of that year and in early 1999. It is estimated that in 1999 as a whole the external sector reduced GDP growth by around 1.3 percentage points (three-tenths of a point more than in 1998), while national demand grew at a similar rate to the previous year (5 %).

In the third quarter of 1999, final consumption spending by households and private non-profit institutions grew in real terms by 4.2 % year-on-year, one-tenth of a percentage point below the second-quarter estimate (see Chart 14). This confirms the turning point, of which

(3) Quarterly National Accounts data, referred to in this chapter, are defined in trend-cycle terms, according to the terminology used by INE.

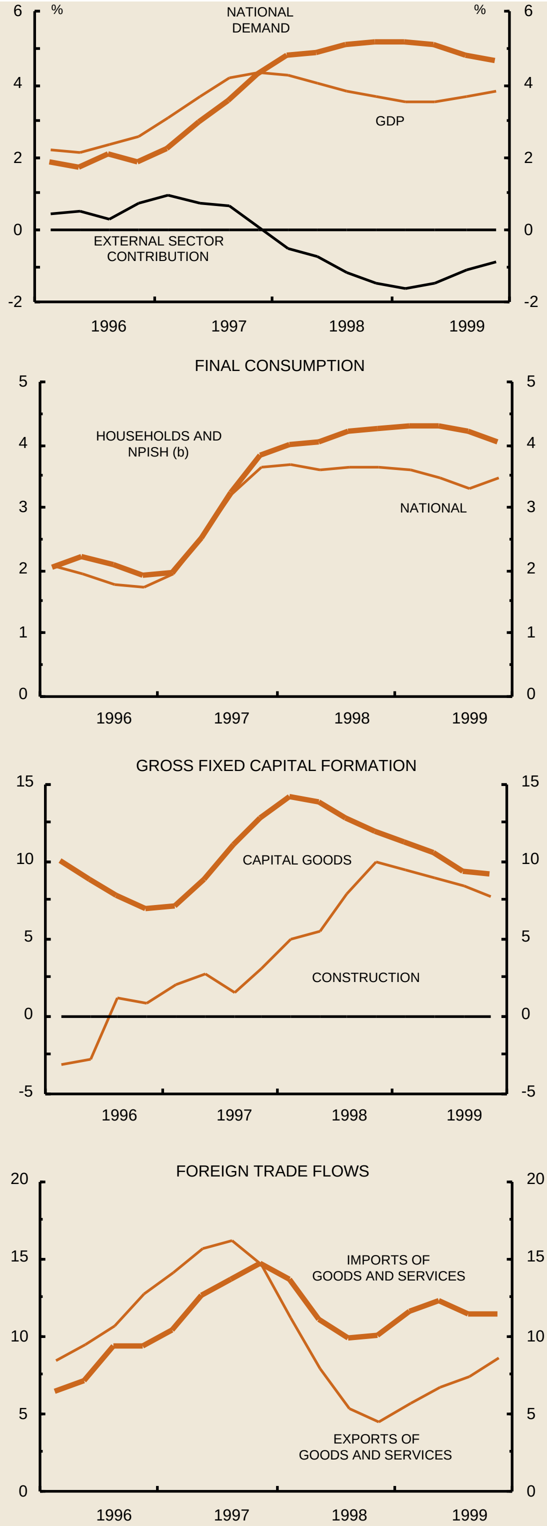
there was some indication in the previous quarter and which, in accordance with the latest short term indicators for this aggregate, was consolidated in the last quarter of 1999, when there was a further slight slowdown in consumption. In fact, as can be seen in Chart 15, the indicator of apparent consumption of goods and services (calculated on the basis of incomplete information) slowed slightly in the fourth quarter, while the growth in the index of retail sales flattened out. The weakness of indicators of consumption of durable goods was more marked, although new car registrations grew by more than 15 % in the year as a whole.

With the first INE sectoral accounts within the ESA 95 framework still to be released, the available information on certain items of household disposable income indicates that the increase, in real terms, in the purchasing power of households in 1999 may have been somewhat lower than in the previous year, compared with growth in consumption that was, on average, slightly higher than in 1998. Income from employment and net transfers from the public sector had opposite effects on real disposable income. Income from employment moderated to some extent, due to the more subdued performance of employment and the unexpected rise in the rate for inflation, which had a negative effect on the growth in the real wages of dependent employees. It should be recalled here that, although a high percentage of wage earners have inflation-adjustment clauses in their collective agreements which protect them when inflation is higher than forecast, the payments under these clauses will be received at the beginning of the year 2000. However, this does not prevent some households anticipating this income in their spending decisions. By contrast, the reform of personal income tax and the favourable trend in social benefits received by households amplified the expansionary impact of the public sector on household income. In the case of pensions, compensation for the higher-than-expected rate of inflation in 1999 will also be received this year.

As already mentioned, the path of disposable income in 1999 implies a reduction in the household saving ratio which would be consistent with the backdrop of growing optimism reflected by consumers and with the low level of interest rates. It should also be noted that, although household financial wealth rose in 1999 to a lesser extent than in previous years, due to stock market developments, the substantial rise in the price of housing meant that non-financial wealth still trended favourably.

CHART 14

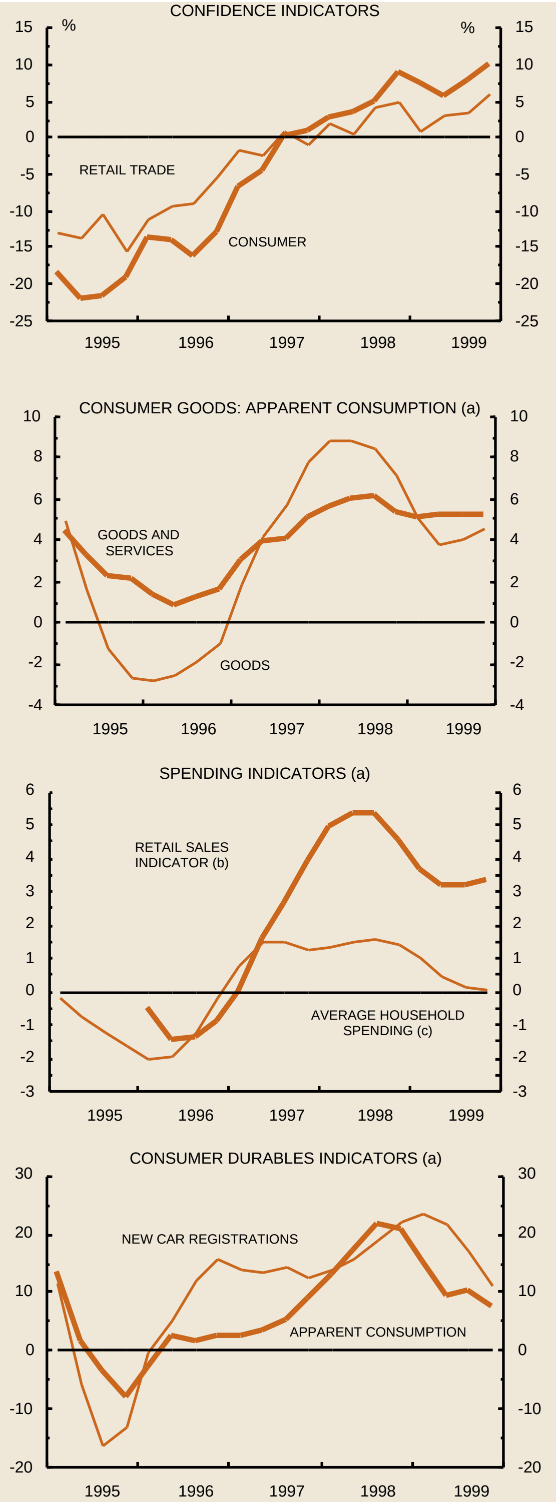
Main macroeconomic aggregates (a)



Sources: Instituto Nacional de Estadística and Banco de España.
(a) Non-centred annual percentage change, based on the trend-cycle component.
(b) Non-profit institutions serving households.

CHART 15

Private consumption indicators



Sources: Instituto Nacional de Estadística, European Commission Dirección General de Tráfico and Banco de España.
(a) Non-centred annual percentage change, based on the trend of the indicator.
(b) Deflated by the CPI.
(c) Household expenditure survey, deflated by the CPI.

On provisional Quarterly National Accounts (QNA) estimates, in the third quarter of 1999 general government final consumption expenditure grew in real terms by 0.3 % year-on-year, five-tenths of a percentage point less than in the second quarter. This would mean an intensification of the moderation already seen in previous quarters. However upward revisions to this variable can be expected with the close of the year, when more complete information on the whole of general government is incorporated. Particularly notable was the subdued behaviour of employee compensation, although expenditure on goods and services also moderated.

Gross fixed capital formation grew by 8.7 % year-on-the year in the third quarter of 1999, almost one percentage point less than in the second quarter. The slowdown, discernible in a weaker form since the beginning of the year, was strongest in the case of capital goods investment, but was also apparent in construction investment. The information on investment in the fourth quarter of 1999 suggests that there was a further deceleration (see Chart 16).

In the third quarter of 1999, real capital goods investment grew by 9.3 % with respect to the same period of the previous year, more than one percentage point down on the first half. The slowdown seems to have continued in the fourth quarter, according to the indicator of apparent expenditure on such goods. Both apparent investment in transport equipment and that in other capital goods displayed a similar profile, although the deterioration was less severe in the former case. However, the business confidence indicator in the capital goods sector has tended to indicate a progressively more optimistic situation, with the recovery in order books being especially notable. In any event, capital investment was highly buoyant, and this was associated with the growth in final demand, which has remained notably strong. At the same time, the slowdown in investment over the past year may have been induced by the completion of an equipment-renewal process set in train earlier, or by the deterioration in demand expectations at the beginning of the year, when the international crisis was that its most severe. That said, the current replacement of domestic by external demand, in the form of a surge in external orders, will help sustain current levels of investment. Moreover, according to the quarterly data of the Central Balance-Sheet Office (CBQ) the financial position of firms, with high levels of profitability, is still very healthy, even though the positive effect of the reduction in interest rates on funds generated is tailing off and business margins are tending to flatten out.

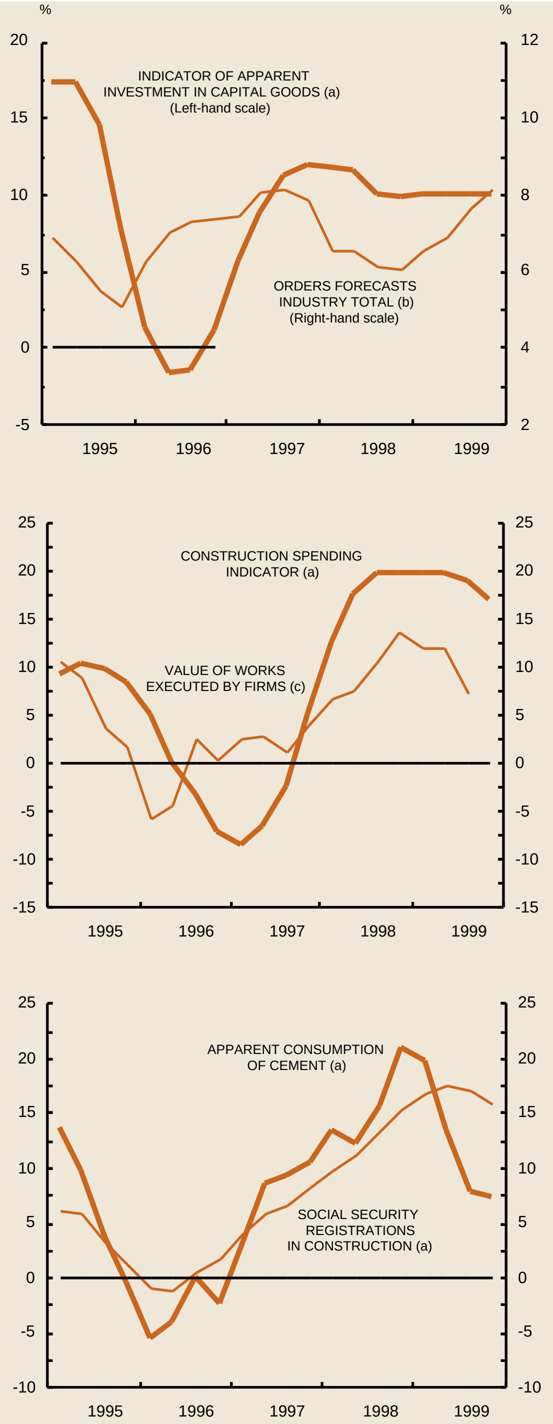
QNA data show a loss of momentum in construction investment in the third quarter of 1999, with real growth of 8.3 % on the same period of the previous year, as against 9.2 % in the first half of the year. According to the quarterly survey of the construction industry, the slowdown affected both civil engineering and building, and according to the trends in the most up-to-date indicators of construction activity construction investment continued to weaken in the fourth quarter. In particular, year-on-year growth of apparent consumption of cement fell again in October and November, to 3.9 %; the PPI for construction materials rose in October at a similar rate to that in the third quarter, and survey data showed a four-percentage-point reduction in the level of confidence of construction employers during the fourth quarter. From a medium-term perspective, the recent performance of leading indicators for construction also points to a further weakening in this component of demand. Government civil-engineering tenders in the first eight months of 1999 were 12.1 % lower than a year earlier, and according to project-approvals statistics, there was a slowdown in 1999 in the number of square metres to be built, especially in the case of non-residential construction. Residential investment shows signs of being more sustained, bolstered by the notable rise in demand, although indicators point towards a mild deceleration in the year 2000 following the strong increase in supply in 1999.

To round off the analysis of the components of gross capital formation, stockbuilding added two-tenths of a percentage point to the year-on-year rate of growth of GDP in the third quarter of 1999, in line with the first half of the year. Business sentiment indicators seem to indicate that stockbuilding was more moderate in the last quarter.

As mentioned previously, on QNA estimates the negative contribution of net external demand to year-on-year GDP growth fell in absolute terms to -1.1 percentage points in the third quarter of 1999. The smaller negative contribution by the foreign balance was primarily a consequence of the recovery in exports of goods and services, which rose in real terms by 7.5 % year-on-year. Although imports moderated slightly they still grew at the significant rate of 11.4 % year-on-year (see Chart 14). The incomplete information available for the fourth quarter (see Chart 17) indicates that there was a further correction in the negative contribution of the foreign balance to growth, stemming from the strengthening of foreign sales that has accompanied the significant improvements in the international environment and, to a lesser extent, from the depreciation of the euro against

CHART 16

Gross fixed capital formation indicators



Sources: Instituto Nacional de Estadística, Ministerio de Industria y Energía, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.

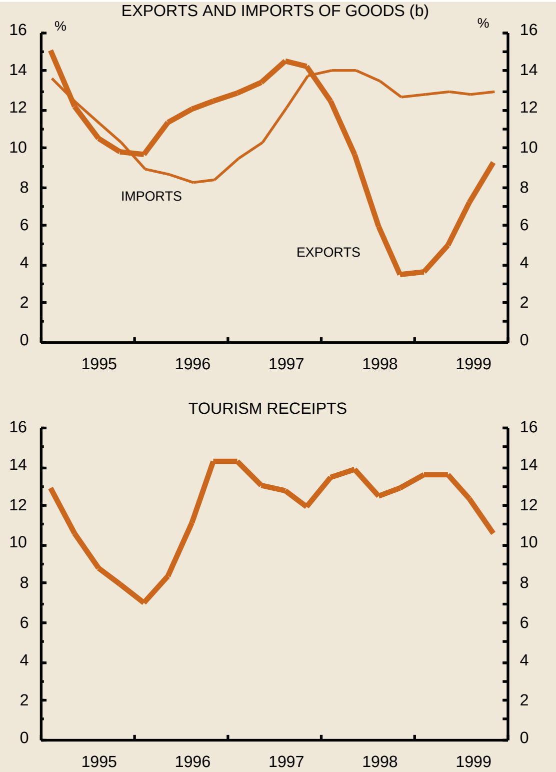
(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

(b) Trend level.

(c) 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 (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.

(b) Series deflated by the corresponding unit value indices.

the dollar. The growing optimism of industrial employers about their future external orders corroborates these results.

On QNA data, goods exports, which had been notably weak since the second half of 1998, commenced a mild upturn from the second quarter of 1999, to reach a year-on-year growth rate of 5.7 % in the third quarter. Customs data for exports in October and November show an even more expansionary performance, associated with the renewed vigour of sales to the EU, including those to France and Germany (which had been the weakest) and with the recovery in markets outside the EU. This began with an improvement in the Asian economies and was strengthened more recently by the pick-up in exports to Eastern Europe and Latin America. As regards type of product, the strongest growth was in capital-goods exports, against a background of sharply falling prices, although the rest of the components displayed an accelerating profile. Tourism receipts, which were very expansionary throughout the year, were helped by the growing optimism of consumers in the euro area, the main source of tourists visiting Spain, and by the weakness of the European currency, which has attracted visitors from other areas, in particular the UK. Notwithstanding this, tourism receipts in the balance of payments tended to slow mildly from mid-1999. As for other services, receipts from financial, IT and insurance services were notably healthy.

Goods imports slowed slightly in the third quarter of 1999, growing by 11 % with respect to the same period of 1998, in line with the growth of domestic demand. However customs data for October and November indicate that they continued to be highly buoyant. By product group, purchases of capital goods and non-food consumer goods were the most expansionary (in step with the rise in these components of internal demand), although the latter moderated in the third quarter as the demand for consumer durables began to show signs of tailing off. As for imports of intermediate goods there was a notable difference between the profiles displayed by energy goods and by other intermediate goods; while purchases of energy products have been falling since the second quarter, as a consequence of the sharp rise in their prices, the profile of purchases of other intermediate goods shows consolidated recovery. Lastly, the growth of services imports held steady at very high rates (13.4 % year-on-year). This buoyancy extends both to payments for tourism and other services, which is related in turn to the high level of investment abroad in 1999.

4.2. Output and employment

From the viewpoint of the productive branches, the slight acceleration in GDP in the third quarter of 1999 was the result of differing behaviour by the more exposed and more sheltered sectors. There was a pick-up in both agriculture (whose negative contribution to GDP growth fell) and in the industrial and energy branches, while growth moderated in services and, above all, in construction, although these were still the most dynamic branches (see Chart 18). The available short-term indicators point to a strengthening of these trends in the fourth quarter. Employment generation continued to display notable vigour, with an increase in the number of full-time equivalent jobs of 3.2 % in the third quarter of 1999 on a year earlier. However, employment slowed somewhat with respect to the first half of the year, so that apparent labour productivity continued to recover, growing by 0.4 %. The branch of activity responsible for this upward productivity profile was industry, traditionally the most dynamic in this respect. None the less, productivity gains were still low compared with those achieved during the last decade. In the fourth quarter of 1999, the employment indicators display a stable growth rate, enabling the growth rate of apparent labour productivity to continue rising in that period.

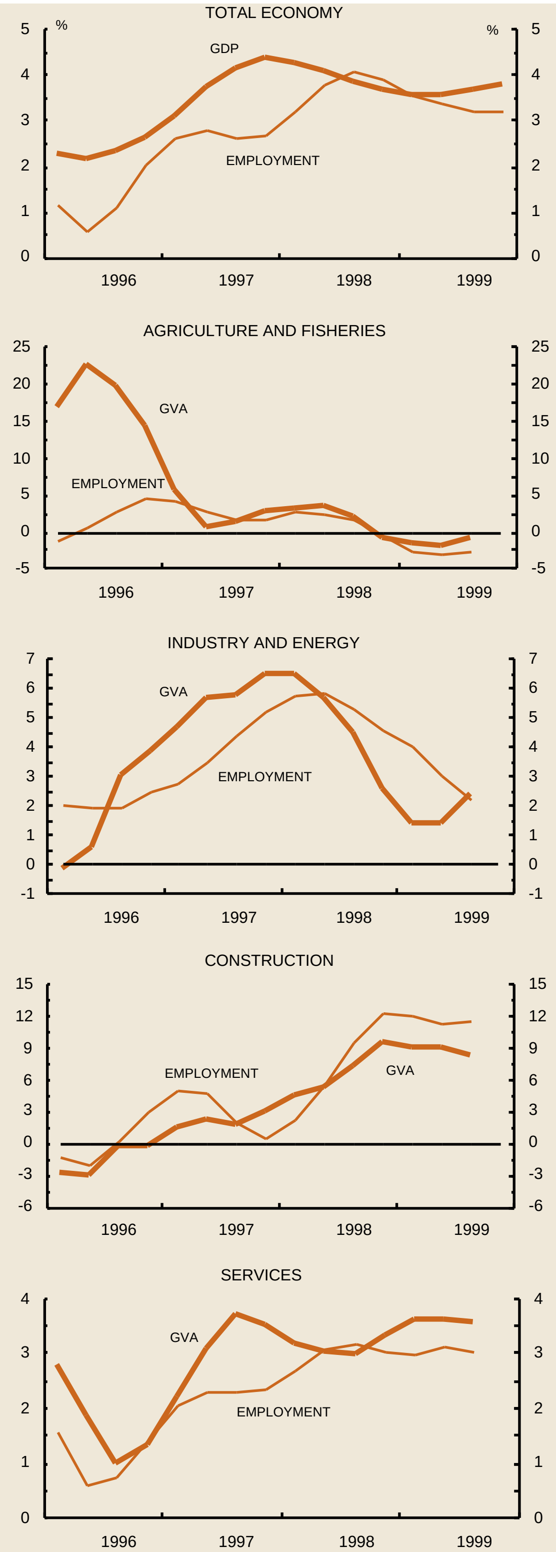
In the third quarter of 1999, agricultural activity fell by 1.1 % year-on-year, almost one percentage point less than in the preceding quarter. The ongoing decline in the gross value added of this branch is related to the scant rainfall in Spain over the past year, although the fact that the unfavourable weather conditions have not affected all regions equally explains why certain crops, such as cereals, tubers and olives were negatively affected, while there were significant increases in the growth rates of citrus and other fruits. Another effect of the scant rainfall was the reduction in pasture for cattle. As the latter was replaced by industrial feed, the estimated value-added of agriculture for a given level of output has been reduced. In any event, the improvement in the weather in the latter months of the year may prompt a more favourable performance in forthcoming quarters.

The progressive recovery in external demand has been the key factor explaining the upturn in industrial activity, which grew in the third quarter of 1999 by 2.3 % year-on-year, almost one percentage point more than in the preceding quarter. Moreover, the short-term indicators suggest that the expansion continued in the fourth quarter. Thus, although the industrial production index lost some of its momentum in October and November, it continued to grow at a healthy rate, and surveys indicate that the business climate improved in the fourth quarter of the year. At a more detailed level, some diversity is apparent in developments in industrial activity, since the recovery has been limited to a certain number of branches. While the recovery has gone practically unnoticed in the metal processing, clothing and footwear branches, in the chemicals and non-metallic minerals branches output growth is very high.

Construction activity, as already seen in the preceding section, remained very buoyant in the third quarter of 1999, but its growth rate, at 8.2 % year-on-year, was almost one percentage point lower than in the second quarter. The loss of momentum was greatest in civil engineering, although it also extended to building. The coincident indicators of activity show a further loss of steam in the fourth quarter, which could carry over into the year 2000, in view of the recent behaviour of the leading indicators.

CHART 18

Gross value added and employment by branch of activity (a)



Sources: Instituto Nacional de Estadística and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend-cycle series published by the INE. Employment refers to full-time equivalent jobs.

Value-added in services grew by 3.5 % year-on-year in the third quarter of 1999, one-tenth of a percentage point less than in the previous quarter. This slight slowdown was caused by non-market services, as market services held at a rate of 4.4 %. The scant information on the fourth quarter points to a further slowdown in services activity, which in the case of market services would extend to all the sub-branches, except for the restaurant and hotel industry, whose indicators have shown renewed vigour.

As mentioned above, the QNA data confirm that the Spanish economy continued to generate employment at a high rate in the third quarter of 1999. In terms of full-time equivalent jobs, a variable which standardises the measurement of employment in terms of working hours, employment grew by 3.2 % year-on-year, two-tenths of a percentage point less than in the preceding quarter. These figures are very similar to those in terms of the number of employed persons or of jobs, the other two variables estimated in the National Accounts framework. The fourth-quarter information on social security registrations indicates that they remained highly buoyant, and this is also confirmed by the rate of decline in registered unemployment. By branch of activity, the growth in employment in the third quarter was consistent with the differences in output growth. Thus, growth in construction and services was higher (11.4 % and 3 %, respectively) than in industry (2.3 %), while employment in agriculture continued to fall. As a result, with the sole exception of construction, there were increases in apparent labour productivity in all the branches. All the employment created was dependent employment, while self-employment continued to decline, as in the first half of the year.

For a more detailed analysis of the nature of the employment creation process in the third quarter it is necessary to consider the information provided by the Labour Force Survey (EPA). However, when analysing the results of the survey it is necessary to bear in mind that a number of changes were made to the survey at the beginning of 1999, in order to bring it into line with European legislation in this area. Although these changes have led to more precise measurement of the level of employment in Spain, they have affected comparisons over time in the historical series. In this respect, the year-on-year growth in the third quarter in the number of employed persons was 4.7 % according to the EPA, very much higher than what was finally estimated by the QNA, as in the two previous quarters. In terms of contract duration, the third-quarter EPA showed very similar growth in permanent and temporary wage-earners, so that the seasonally adjusted ratio of temporary to total employment held steady at around 33 %. In terms of the length of the working day, there was a greater increase in part-time than in full-time employment, which was reflected in a higher part-time ratio. Thus, the effects of the new regulations to boost permanent part-time employment, approved at the end of 1998, are beginning to be discerned.

The EPA recorded a rise in the labour force of 0.9 % with respect to the third quarter of 1998, a slight acceleration in relation to the first half of the year. As a result, the activity rate for the population between the ages of 16 and 64 years rose to 63.8 %, which means that it is getting closer and closer to the European average. Although this progressive rise certainly has a demographic component (particularly in the case of more mature women who have significantly lower activity rates than younger women), the healthy performance of the labour market must also be stimulating re-entry into the labour market of previously excluded sections of the population. Despite this, the rate of unemployment continued to fall, to stand at 15.4 %, more than three percentage points lower than a year earlier. In year-on-year terms, unemployment fell by 16 %, which was greater than the fall in registered unemployment. The latter indicator suggests that the unemployment rate continued to fall in the fourth quarter. Lastly, it should be noted that the reduction in unemployment is spreading to all groups (based on sex, age, qualifications and duration of unemployment), although with varying degrees of intensity.

4.3. Prices and costs

On QNA estimates, in the third quarter of 1999 the GDP deflator grew by 2.9 % year-on-year, three-tenths of a percentage point more than in the second quarter. This acceleration was attributable to the rise in the gross surplus per unit of output, since both unit labour costs and net indirect taxes per unit of output slowed slightly.

Unit labour costs grew by 1.9 % year-on-year in the third quarter of 1999, two-tenths of a percentage point down on the second, since the higher growth in apparent labour productivity more than offset the acceleration in employee compensation, which rose by 2.3 %, as against 2.2 % in the previous quarter. On wage survey data, the year-on-year growth in average hourly earnings, in terms of total pay, was 2.5 % in the third quarter, the same rate as in the second quarter. In terms of average monthly earnings, the rise was somewhat smaller (2.3 %), but this represented a slight acceleration. By branch of activity, in industry there was a slowdown in average hourly earnings, which rose by 2.3 %, while services (2.3 %) and construction (4.1 %) were characterised by stronger growth. Comparing these results with those for collective bargaining gives an approximation of wage drift. As in recent years, this was not significant, except in the construction branch. In fact, on data to 31 November, settlements held at 2.3 %, with those under existing agreements at 2.3 % and those under newly signed agreements at 2.4 %. Growth by branch remained very similar in the final quarter.

With regard to wage growth in 1999 and 2000, it should be noted that since the 12-month rise in the CPI in December was, at 2.9 %, well above the objective initially set in the budget (1.8 %) and the revised objective (2.4 %), the inflation-adjustment clauses included in many of the agreements signed in 1999 will be activated. This means that the wage settlement eventually shown by the statistics for 1999 will be somewhat higher than currently estimated, and the slowdown on 1998 will disappear. In terms of wage survey and QNA data, the payments arising under the inflation-adjustment clauses will be recorded when received by workers (presumably in the first quarter of the year 2000). Accordingly, wage acceleration can be expected to continue in forthcoming quarters, probably halting the downward trend in unit labour costs.

The upward profile of the GDP deflator was accompanied by an acceleration in the import deflator, so that the final demand deflator grew by 2.2 % in the third quarter, six-tenths of a percentage point more than in the preceding quarter. Import prices remained on an upward path throughout 1999. In terms of their unit value indices, their 12-month growth rate reached 4.9 % in October. The price of imported energy, pulled up by the rise in the price of a barrel of oil on international markets, was the main cause of this acceleration, although other goods have been purchased at progressively higher prices. As regards the final demand deflator, the upward trend spread to all its components, and the different indicators available for the fourth quarter signal a strengthening of these trends.

The 12-month rise in the main indicator of final prices, the CPI, was 2.9 % in December, four-tenths of a percentage point higher than in September (see Chart 20). This outcome is attributable to goods prices, since services prices rose by 3.2 % in December, one-tenth of a percentage point less than in September. The rise in goods inflation, from 2.2 % in September to 2.6 % in December, stemmed from the surge in its most erratic components, especially energy prices, which increased by 11.5 %, more than two percentage points up on September. Food prices also accelerated, growing by 2.4 % in December. The poor harvests, associated with the adverse weather conditions, problems with fish supplies and speculative behaviour in relation to certain products, seem to be the reasons for this outcome. Given that the prices of non-energy industrial goods only slowed slightly, the rate of growth of the index of non-energy processed goods and service prices rose to 2.4 % in December.

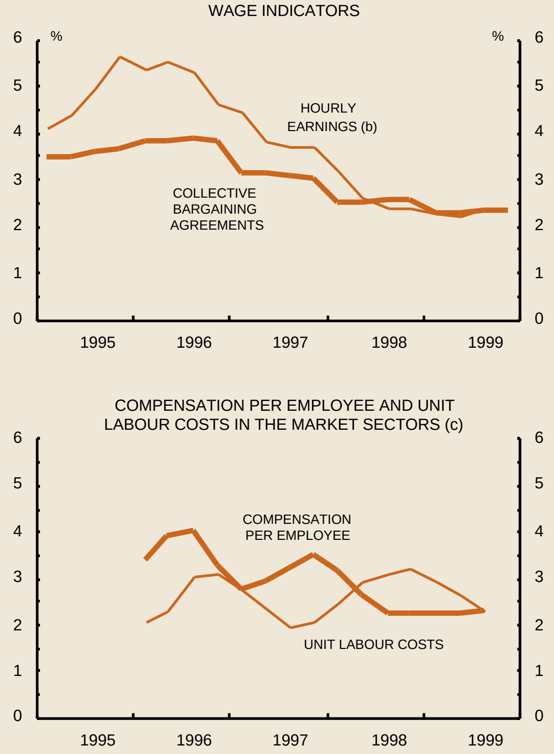
To make comparisons with price developments in the other EU countries and in the euro area it is better to use the harmonised index of consumer prices (HICP). In the case of Spain, the 12-month rise in the HICP at end-1999 was 2.8 %, one-tenth of a percentage point less than that of the CPI, making a differential with respect to the euro-area average of 1.1 percentage points. This differential was slightly smaller than in previous quarters. As seen in Chart 21, during 1999 there was a significant rise in the differential in the food components of the HICP. In the case of processed foods, this was associated, to a large extent, with oil and wine prices. These products also explain the widening in the differential calculated in terms of the prices of consumer industrial goods. At the same time, the rise in energy prices, which has affected the whole of Europe, has nonetheless been translated into a significant widening of the inflation differential, both in terms of the energy component of the CPI and of the related component of the producer price index.

As regards developments in other price indicators, the producer price index also accelerated in the latter months of 1999, to a 12-month rate of 3.1 % in November, seven-tenths of a percentage point higher than in September. The acceleration affected all its components. In contrast, the prices received by farmers continued to fall in the third quarter of 1999.

It is possible, on the basis of the price and cost information analysed above, to infer developments in the price formation process at the aggregate level and in the major branches of activity. As can be seen in Chart 22, until the third quarter of 1999 both final prices and average variable costs were tending to accelerate in the non-financial private sector as a whole, although the acceleration was greater in costs, so that the process of widening margins came to a halt. The acceleration in costs stemmed from inputs, while unit labour costs were compara-

CHART 19

Wages and labour costs (a)



Sources: Instituto Nacional de Estadística, and Ministerio de Trabajo y Asuntos Sociales.
(a) Percentage change on same quarter a year earlier.
(b) Basic pay.
(c) Rates based on QNA trend-cycle series.

tively more stable. At a more detailed level it can be seen that the services branches set this profile for margins. In manufacturing there was a stronger recovery in final prices than in variable costs, as the acceleration in input prices was partly offset by the slowdown in unit labour costs. In services, by contrast, the strong rise in intermediate costs (these branches are highly dependent on energy) produced an accelerating profile for variable costs. In any event, the slower growth in margins in services should be considered in the light of the significant expansion seen in previous years.

4.4. State budget

The state budget outturn in 1999 posted a deficit of ESP 1,057 billion, 5.1 % down on the 1998 deficit (see Table 2). In terms of the State borrowing requirement (National Accounts), figures are only available to November. These show a deficit of 0.3 % of GDP. In the light of the reduction in the cash-basis deficit for the year as a whole and the available National Accounts data, the objective for a general government deficit of 1.3 % of GDP in 1999, contained in the recently published Stability Programme update, can be expected to be met. The most recent developments in revenue and expenditure are discussed below, using cash-basis information, which was more up to date at the time this report was prepared.

The reduction in the State cash-basis deficit for 1999 as a whole, compared with the previous year's outturn, was due to higher growth in revenue (4.7 %) than in expenditure. As already pointed out in previous reports, on the revenue side, VAT and corporate income tax were particularly buoyant and, on the expenditure side, the restraint of government consumption and the strong growth of current transfers were notable. It should be noted that these two headings of expenditure are affected by the transfer of responsibilities for education to various Regional (Autonomous) Governments.

The reduction in the State budget outturn for 1999 was, however, somewhat lower than that officially estimated in the initial projection. This was a consequence of the slightly smaller than forecast increase in revenue, primarily attributable to lower receipts from current and capital transfers. By contrast, tax receipts exceeded the official forecast in the initial projection, largely as a result of the strong buoyancy of corporate income tax, and total State expenditure was slightly lower than forecast. This overall result for expenditure conceals, however, diverse behaviour among the various items. Current transfers paid were notably higher than forecast, this being more than offset by the better performance of the other headings.

In the fourth quarter of 1999, revenue accelerated with respect to the first nine months of the year. The year-on-year growth rate of receipts from direct and indirect taxes for the whole of 1999 was higher than that for the first three-quarters of the year, while the rate of decline in other net revenue was lower. At the same time the contrast between the strength of indirect taxes and the weak growth in direct taxes and, within the latter, between the growth in personal income tax and corporate income tax receipts was maintained.

Having fallen during the period to September by 3.8 % on the same period a year earlier, personal income tax receipts during the year as a whole rose by 2.1 % on the previous year, basically due to the cancelling out of the effect of rebates being paid earlier in 1998. The growth in withholdings on earned income, despite the im-

BOX 2

Telephone services in Spain: competitions and prices

In recent years, telephony in Spain has been fundamentally transformed by the liberalisation that has accompanied the elimination of the monopoly regime in the provision of these services. This process was completed on 1 December 1998, with the complete liberalisation of the telephone service. This box provides a first approximation of the effects of opening up the sector, comparing with the other EU countries, given that this process has been guided by European guidelines for the implementation of the Single Market. It should be noted here that in most EU countries the sector was liberalised at least 11 months sooner than in Spain.4 In any event, it should be taken into account that very little time has elapsed since the introduction of competition and also that it is difficult to isolate the effects of liberalisation when significant technological progress is being made in this area and from the impact of certain administrative measures.

When analysing the growth in the number of operators, both the licences granted and the number of companies now operating in the various segments should be taken into account. As seen in the upper part of the adjoining table, in Spain, as in the other countries considered, there has been a very significant increase in the number of licences granted for fixed telephony, especially to operators permitted to offer services at the local level, a segment in which Spain stand outs within the EU. Although most of the licences correspond to cable operators, their market share is very low because, among other reasons, urban planning and environmental requirements have hampered the development of the necessary infrastructure. The number of operators now offering this kind of services is also higher in Spain than in the other EU countries (see the lower part of the table). The number of licences for national operators has also risen significantly, although there is a certain lag compared with the situation in other European countries. This lag is accentuated if the comparison is made in terms of the number of operators operating in the so-called national long-distance or international calls segments. This reflects, at least in part, the shorter time during which the sector has been deregulated in Spain5. Unlike in fixed telephony, there have been no significant advances in mobile telephony since the liberalisation of the sector, as the operators currently providing services (three digital and one analogue operator) are the same ones that had licences before 1 December 1998. Notwithstanding this, the situation in Spain is similar to that in the other EU countries (in which it is possible to find around one analogue licence and three or four digital ones).

Before analysing tariff developments, it should be recalled that the regime of administered prices is to be maintained for the former monopoly until 1 August of the year 2000. Thereafter, the Telecommunications Market Commission will establish maximum average prices that this company can charge for a basket of services, which will give it a certain margin to adjust the prices of the services included in this reference basket. The new companies are able to set their tariffs freely.

The elements that have traditionally made up telephone bills, apart from VAT, are the following: the subscription charge, the flat-rate charge per call and the cost of the units consumed. Moreover, the latter varied with the time of day and the type of call. To gain market share, the new operators have made changes to certain aspects of the aforementioned elements, reducing the cost of calls. For example, they began by introducing charges per second, instead of per unit. In addition, certain companies have eliminated the subscription charge and/or the flat-rate charge for each call, while low-tariff periods have been extended and the differences in the tariffs between certain kinds of call have even disappeared. The incumbent operator has also adopted some of these changes. As a result of all this, the Telecommunications Market Commission estimates that liberalisation of the sector has led to a reduction in telephone bills of more than 10 %.

Despite this significant cut, comparison of the tariffs of the dominant fixed-telephony operators with those in other EU countries shows the persistence of certain differences which could mean that there is room for further price reductions as a consequence of increased competition. The European Commission6, using August 1999 data, has compared the real cost (in terms of purchasing power parity) of a basket of national calls (local, provincial and interprovincial) taking into account different times of day and days of the week. With the caveats required by the margin of uncertainty involved in these estimates, this information indicates that the real cost of the telephone service in Spain is still above the EU average, especially in the case of national business calls, a situation which seems to stem from provincial and inter-provincial calls. A similar exercise, comparing the prices of a basket of international calls to all the OECD countries, produces similar results.

Number of authorised fixed telephony operators

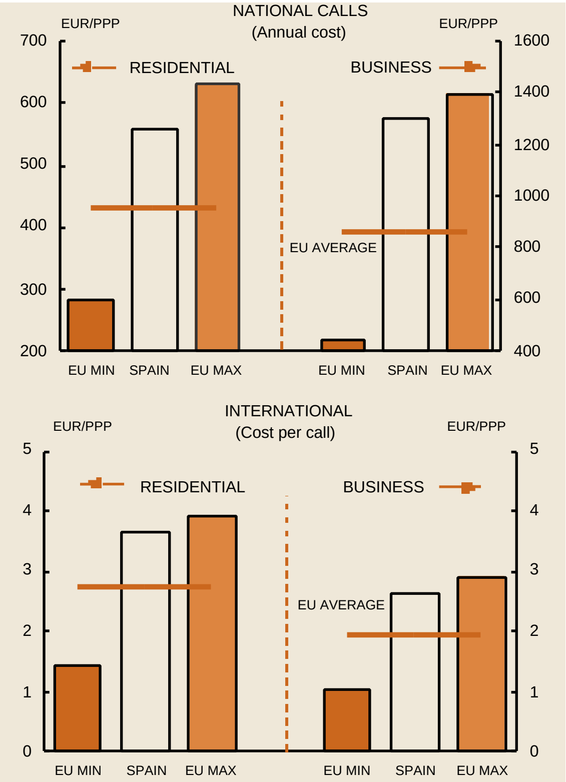
Country	Local operators (a) August 1998	Local operators (a) September 1999	National operators August 1998	National operators September 1999
A. AUTHORISED:				
Germany	95	147	21	47
Spain	**22**	**63**	**3**	**27**
France	36	59	24	40
Italy	9	39	5	36
United Kingdom	172	293	31	135

Country	National calls: Local	National calls: Long-distance	International calls
B. ACTUALLY OFFERING SERVICES September 1999):			
Germany	22	47	47
Spain	26	10	10
France	8	31	31
Italy	1	12	12
United Kingdom	36	26	66

Source: European Commission

(a) IIncluding both national and local oerators authorised to offer local callss.

Cost of telephone calls
August 1999



Source: European Commission.

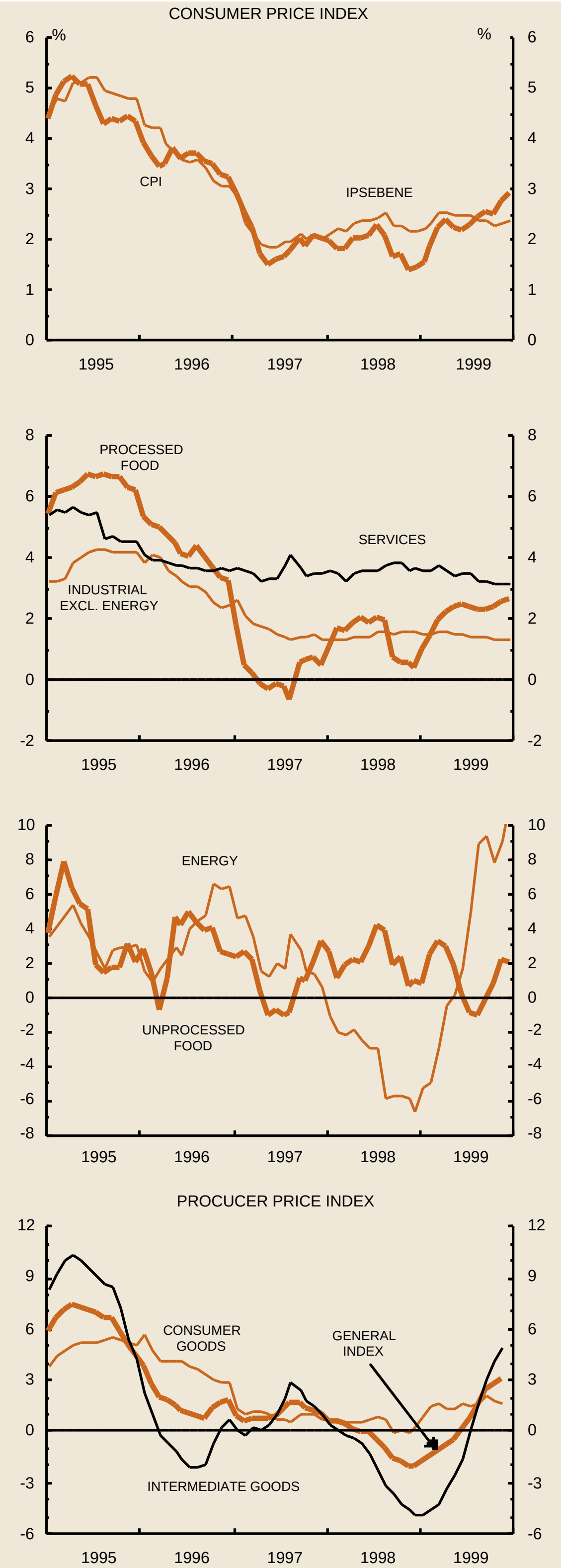
(4) Except for: Luxembourg, where liberalisation took place five months earlier; Ireland, where the timetable coincides with that of Spain; Portugal, where it is due in January 2000; and Greece, where it is due by the end of the year.

(5) It should be noted that countries such as the United Kingdom initiated deregulation in the eighties. This may distort the comparison of the figures in the adjoining table.

(6) "Fifth Report on the Implementation of the Telecommunications Regulatory Package".

CHART 20

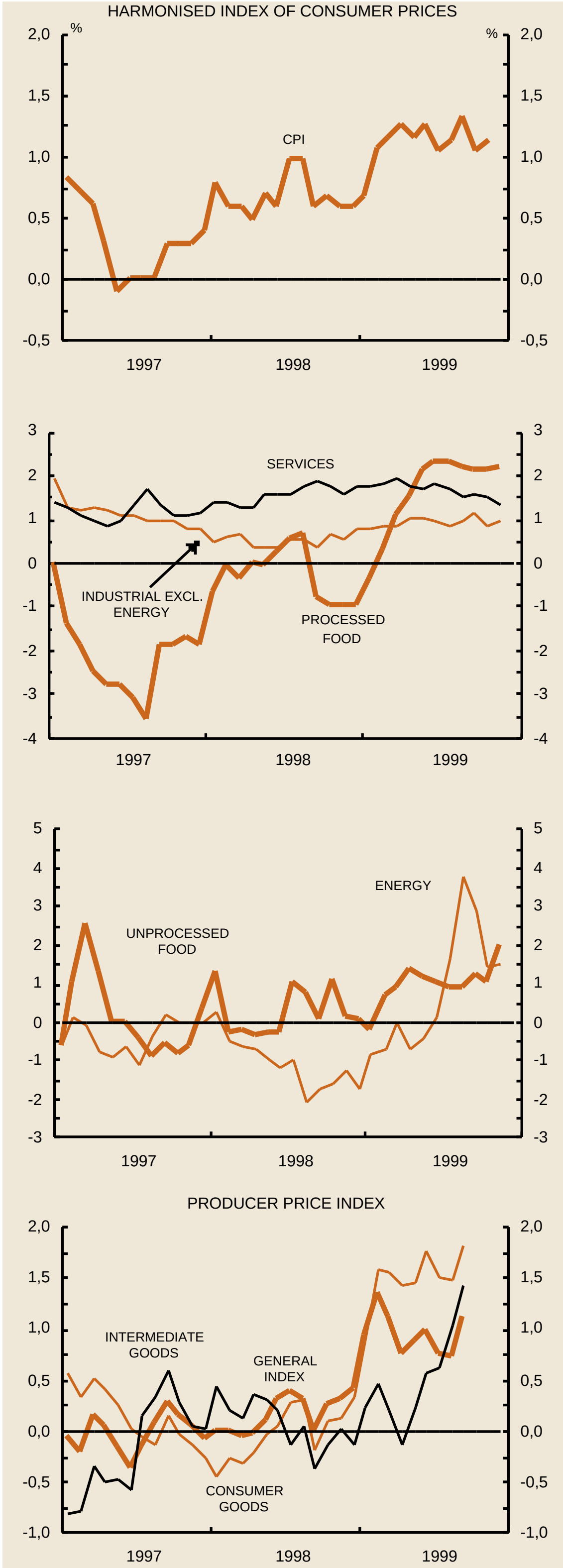
Price indicators (a)
Spain



Source: Instituto Nacional de Estadísitica.
(a) Twelve-month percentage change based on the original series.

CHART 21

Price indicators
Differential vis-à-vis the euro area (a)



Sources: Eurostat and Banco de España.
(a) Twelve-month percentage change based on the original series.

TABLE 2

State Budget outturn

PTA bn and %

	Outturn	Initial Projection		Outturn JAN-SEP	Outturn		
	1998	1999	Percentage change	Percentage change 1999/1998	1998 JAN-DEC	1999 JAN-DEC	Percentage change
	1	2	3=2/1	4	5	6	7=6/5
1. Revenue	**17,534**	**18,450**	**5.2**	**3.9**	**17,534**	**18,364**	**4.7**
Direct taxes	7,457	7,696	3.2	4.4	7,457	7,817	4.8
Personal income tax	*4,992*	*5,103*	*2.2*	*–3.8*	*4,992*	*5,098*	*2.1*
Corporate income tax(a)	*2,324*	*2,430*	*4.5*	*27.0*	*2,324*	*2,558*	*10.0*
Other	*140*	*164*	*16.6*	*14.0*	*140*	*161*	*14.9*
Indirect taxes	7,015	7,916	12.8	12.0	7,015	7,951	13.3
VAT	*4,373*	*5,090*	*16.4*	*14.5*	*4,373*	*5,114*	*17.0*
Execise duties	*2,391*	*2,557*	*7.0*	*7.6*	*2,391*	*2,567*	*7.4*
Tariffs	*132*	*142*	*7.3*	*11.9*	*132*	*144*	*9.2*
Other	*120*	*127*	*5.9*	*4.1*	*120*	*126*	*5.3*
Other net revenue	3,063	2,837	–7.4	–16.7	3,063	2,597	–15.2
2. Expenditure	**18,649**	**19,445**	**4.3**	**6.2**	**18,649**	**19,421**	**4.1**
Wages and salaries	3,053	3,108	1.8	–0.8	3,053	2,979	–2.4
Goods and services	388	468	20.4	10.7	388	436	12.3
Interest payments	3,334	3,277	–1.7	9.7	3,334	3,178	–4.7
Current transfers	9,906	10,330	4.3	7.9	9,906	10,809	9.1
Investment	898	1,184	31.9	11.4	898	957	6.6
Capital transfers	1,071	1,079	0.7	–8.1	1,071	1,063	–0.8
3. Cash-basis deficit (3 = 1 – 2) (b)	**–1,114**	**–995**	**–10.7**	**39.7**	**–1,114**	**–1,057**	**–5.1**
MEMORANDUM ITEM: NATIONAL ACCOUNTS (c):							
Revenue	17313	—	—	6.2	15,880	17,037	7.3
Expenditure	18,529	—	—	8.8	16,129	17,307	7.3
Net borrowing (–) or lending (+) (d)	**–1,216**	**–1,194**	**–1.8**	**49.9**	**–249**	**–270**	**8.2**

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

(a) The January-November 1999 outturn includes all revenue from the tax on the income of non-residents.
(b) This is the cash-basis deficit as defined by the IGAE (National Audit Office).
(c) The outturn figures in columns 5 and 6 correspond to the period January-November, as these are the latest available for 1999.
(d) The annual figures (columns 1 and 2) are drawn from the Spanish Finance Ministry's response to the Excessive Deficit Procedure questionnaire (ESA 79 methodology).

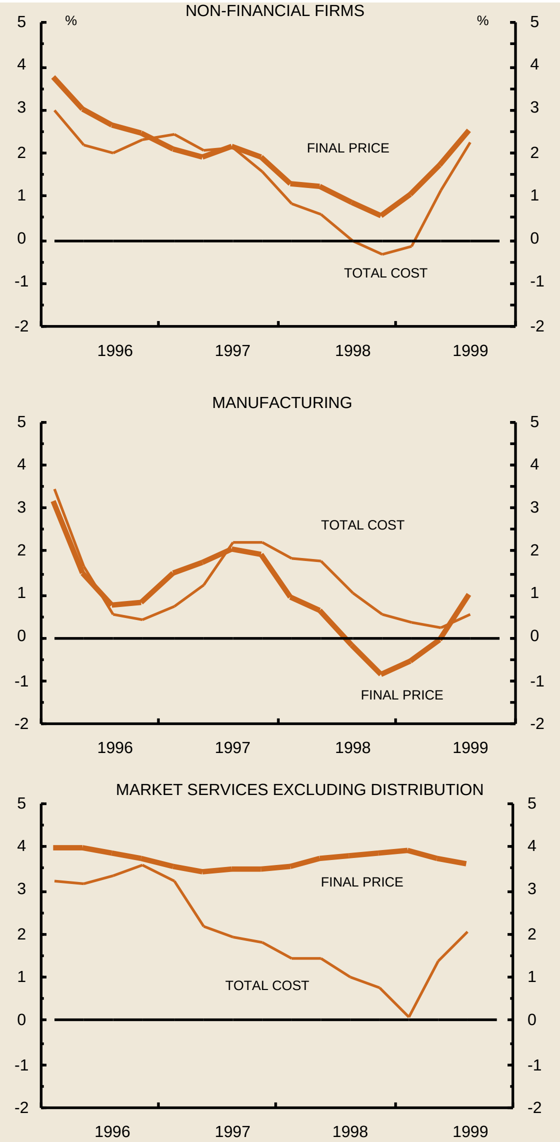
plementation of the reform of the tax, held at around 3.5 %, as a result of the positive employment developments. By contrast, the decline in withholdings on income from capital accelerated to a rate of -19.1 %, primarily as a consequence of the lower withholding rates applied in 1999. Unlike in the case of personal income tax, the growth rate of corporate income tax receipts for 1999 as a whole was lower than in the period to the third quarter, essentially due to the smaller capital gains realised in privatisation operations. Despite this, receipts still grew at a high rate. Besides the healthy corporate results, this was due to the lower rebates in the first few months of 1999 and, to a lesser extent, to the withholdings on capital gains on mutual fund shares (only applied from February 1999).

Receipts from indirect taxes accelerated in relation to the first nine months of the year, driven by VAT which, as mentioned in previous reports, posted in 1999 as a whole higher growth than, according to the historical relationships estimated, would be explained by consumption and imports. This buoyancy was also seen, albeit in a weaker form, in the other indirect taxes, notably the taxes on energy (due to the rise in oil prices) and the tax on certain means of transport, reflecting the strong growth in new vehicle registrations.

The decline in the rest of the revenue items was lower than in the period to September, primarily as a consequence of the trend in current and capital transfers. The decline in other net revenue in 1999 (-15.2 %) was mainly due to the fall in privatisation proceeds and to the differences between the value of public debt upon redemption and at issue. By contrast, the profits of the Banco de España posted strong growth, due to the capital gains generated by

CHART 22

Price and cost indicators (a)



Sources: Instituto Nacional de Estadística and Banco de España.

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

TABLE 3

Balance of payments: summary table (a)

EUR m

	JAN-OCT 1998	JAN-OCT 1999
	Receipts	Receipts
Current account	**140,353**	**148,014**
Merchandise	82,265	84,921
Services	37,238	42,122
Tourism	*23,004*	*25,993*
Other services	*14,234*	*16,130*
Income	10,655	10,014
Current transfers	10,195	10,957
Capital account	**5,012**	**5,534**
	Payments	Payments
Current account	**138,783**	**154,250**
Merchandise	94,958	106,597
Services	20,775	23,739
Tourism	*3,791*	*4,321*
Other services	*16,984*	*19,418*
Income	16,308	16,386
Current transfers	6,743	7,528
Capital account	**607**	**757**
	Balance	Balance
Current account	**1,569**	**–6,236**
Merchandise	–12,693	–21,676
Services	16,464	18,383
Tourism	*19,213*	*21,672*
Other services	*–2,750*	*–3,289*
Income	–5,653	–6,372
Current transfers	3,452	3,429
Capital account	**4,404**	**4,777**

Source: Banco de España,

(a) First provisional results.

the transfer of reserves to the European Central Bank.

Turning to expenditure, the year-on-year growth rate for 1999 as a whole was lower than in the period to September, basically due to interest payments. Having grown by 9.7 % to the third quarter, affected by the different timing of debt maturities in 1998 and 1999, interest payments fell by 4.7 % in 1999 as a whole. However, this heading of expenditure exceeded the initial forecast as a result of early redemption of debt for the purpose of its exchange. Current transfers grew by 9.1 %, mainly due to the transfers to the Social Security System and to Territorial Government, the increase of 14.9 % in transfers to the Regional (Autonomous) Governments in respect of their share in State revenue being notable. As stated in previous reports, part of this increase was attributable to the transfer to certain Regional (Autonomous) Governments of responsibilities for non-university education, which also explains the decline in State expenditure on wages and salaries. The contribution to the Social Security System to finance the current operations of INSALUD (the national health service) rose by 10.2 %, due to the assumption by the State of the full cost of healthcare. By contrast, transfers to INEM (the national employment office) fell by 28.5 %, as a consequence of the favourable labour market developments.

BOX 3

Social security budget outturn

On budget outturn data to October 1999, the social security system ran a surplus of ESP billion 879 billion, ESP 374 billion higher than in the same period of 1998. This is a significant improvement on the budget forecast for the year as a whole, which was for an increase in the deficit of ESP 57 billion with respect to the 1998 outturn. It is also an improvement on the data to July, discussed in the previous «Quarterly report on the Spanish economy».

This performance results from growth in revenue of 8.2 % to October, well above the budget forecast (4.9 %), and an increase in expenditure of 4.8 %. Receipts from social security contributions rose by 8 % (6.3 % in the whole of 1998), exceeding the budget forecast by more than four percentage points. This was attributable, above all, to the notable buoyancy of registrations: the number of registered workers grew by 5.5 % in 1999, against 5.1 % in 1998. The other major source of revenue, current transfers from the State, also increased by more than budgeted.

The growth of expenditure during the first ten months of 1999 was somewhat below the budget forecast for the year as a whole. Developments in spending on contributory pensions were notable, with growth of 4.6 % to October (5.3 % in 1998 as a whole), more than one percentage point lower than budgeted. By contrast, growth in sick pay was still higher than budgeted.

As regards INEM (the National Employment Office), information is available on the unemployment contributions received to July, which grew by 11.3 % with respect to the same period a year earlier, and on unemployment benefits to November, which fell by 2.9 %. Both developments are explained by the healthy performance of employment. However, although registered unemployment fell in 1999 by more than in 1998, the decline in unemployment benefits was rather less than in 1998 as a whole (7.9 %). This may be due to the fact that the decline in unemployment seems to have been concentrated among certain groups, such as the long-term unemployed, who are not entitled to benefits, which led to a rise in the replacement ratio. Finally, employment-promoting rebates increased by 56 % to August.

Social security system (a)
(Transfers to Regional Governments allocated) (b)
(Current and capital transactions, in terms of recognised entitlements and obligations)

ESP bn and %

	Outturn	Budgeted		Outturn JAN-JUL	Outturn JAN-OCT		
	1998	1999	% change	% change	1998	1999	% change
	1	2	3=2/1	4	5	6	7=6/5
Revenue	**12,891**	**13,519**	**4.9**	**8.5**	**10,893**	**11,785**	**8.2**
Social security contributions (c)	8,715	9,032	3.6	8.2	7,155	7,722	7.9
Current transfers	4,023	4,326	7.5	8.9	3,617	3,931	8.7
Other (d)	153	160	4.3	9.4	122	132	8.1
Expenditure	**12,909**	**13,593**	**5.3**	**4.9**	**10,388**	**10,905**	**5.0**
Wages and salaries	2,049	2,144	4.7	5.8	1,744	1,837	5.3
Goods and services	1,249	1,285	2.9	6.3	1,010	1,077	6.6
Current transfers	9,438	9,959	5.5	4.5	7,531	7,881	4.6
Benefits	9,377	9,896	5.5	4.5	7,476	7,823	4.6
Contributory pensions	*7,453*	*7,892*	*5.9*	*4.5*	*5,851*	*6,122*	*4.6*
Sick pay	*526*	*505*	*–4.1*	*2.1*	*406*	*414*	*1.9*
Other (e)	*1,397*	*1,499*	*7.3*	*5.1*	*1,219*	*1,287*	*5.6*
Outher current transfers	61	64	4.3	6.0	55	58	5.8
Other(f)	174	205	18.2	10.9	103	110	6.8
Balance	**–18**	**–75**	**—**	**134.8**	**505**	**879**	**74.1**

Sources: Ministries of Economy and Finance and of Employment and Social Affairs, and Banco de España.
(a) Only data relating to the System, not to the entire Social Security Funds sector, are given. This is because the figures for other Social Security Funds for the year 1999 are not available.
(b) Transfers to Regional Governments to finance the health-care and social services responsibilities they have assumed have been distributed among the various expenditure captions on the basis of the percentages resulting from the General Government accounts for 1995 (the latest year available)
(c) Including surcharges and fines.
(d) Excluding surcharges and fines, and the contribution from the pharmaceutical industry.
(e) Reduced by the contribution from the pharmaceutical industry.
(f) Reduced by the disposal of investments.

As regards capital transactions, the growth of investment moderated, while capital transfers fell slightly. This was mainly due to the sharp decline in subsidies for interest paid on loans to purchase dwellings. By contrast, the payments to the Regional (Autonomous) Governments under the Inter-territorial Compensation Fund increased significantly.

4.5. The Spanish balance of payments and capital account

In the first ten months of 1999, the current and capital accounts ran an overall deficit of EUR 1,459 million, in marked contrast to the surplus of EUR 5,974 million in the same period a year earlier. This outcome basically reflects the strong rise in the trade deficit during this period, which was not fully offset by the notable improvement in the tourism surplus. Despite their recovery in recent months, goods exports posted moderate growth over the period as a whole, while imports remained highly vigorous. This, together with the sharp worsening in the terms of trade in recent months, prompted a significant deterioration in the trade balance (see Chart 3).

As for the other current-account items, the income deficit widened to EUR 719 million, due to the decline in the income of the credit system, which was only partially offset by the buoyancy of the income of the non-credit private sector, as a consequence of the strong growth in their external assets. On the payments side, there was sustained growth in those by the credit sector and the public sector, due to the increase in the bond investments of non-residents. The current-transfers surplus held steady at practically the same level as in 1998, while the surplus on capital account grew as a consequence of the higher growth in transfers from the EU under ERDF and EAGGF-Guidance.

Overall these data reflect a substantial increase in the nation’s net borrowing, which would signal a simultaneous weakening in the non-financial balances of the household and corporate sectors, given the ongoing decline in general government net borrowing. In turn, the developments in household and corporate balances stem from the buoyancy of residential investment and private productive investment, against a background of favourable prospects for growth and progress in reducing the budget deficit.

5. The financial markets and flows of the Spanish economy

5.1. Interest rates and the financial markets

The Spanish, like the other European financial markets, were influenced in the fourth quarter by the rise of fifty basis points in the Eurosystem's intervention interest rate, which prompted increases in money market rates, and by the consolidation of a significantly higher level of long-term interest rates than at the beginning of 1999. Compared with interest rates in December 1998, three-month money market rates in January 2000 stood at a similar level (of around 3.3 %), while long-term interest rates are currently 170 basis points higher (see Chart 4).

On primary markets, the interest rates on the various issues made generally rose during the quarter, in line with developments on secondary markets. Thus, for example, the Treasury increased the marginal rate on one-year bills to 3.8 % at the latest tender in January, which is almost one percentage point higher than the yield offered at end-1998. In the case of ten-year bonds, the marginal issuance rate at the January tender stood at 5.8 %.

Domestic equity markets surged in the last quarter of 1999, especially in November and December. This was primarily a result of the lower uncertainty surrounding interest rates after the rise in the official Eurosystem rate, and of the favourable prospects for economic growth in the year 2000 in the euro area as a whole and in Spain in particular. The general index of the Madrid stock exchange recorded the highest growth in Europe in November and December, making for a rise of 16 % since end-1998, in contrast to the slackness to October. However, despite this favourable performance at the end of the year, the Spanish stock market rose less in 1999 than in 1998, when it moved up by 37 %. Also, these gains were smaller than those on the other European markets. In any event, it should be noted that the strong buoyancy of the stock market at the end of the year was characterised by considerable asymmetry, in so far as the price increases were concentrated in the telecommunications sector, while increases in the other sectors were modest. In January to date, the stock markets have again been characterised by highly erratic behaviour, and dominated by profit taking. Telecommunications is practically the only sector driving the market.

As regards bank rates, during the final quarter of the year banks continued to pass through to their deposit and lending transactions the increase in yields on financial markets. However, as mentioned in the latest monthly economic re-

TABLE 4

Domestic interest rates and financial markets (a)

	1998		1999				Memorandum item: JAN 2000
	Q 3	Q 4	Q 1	Q 2	Q 3	Q 4	
MONEY MARKET RATES:							
Three-month Euribor	3.73	3.17	3.05	2.63	2.73	3.44	3.32
RETAIL BANK RATES:							
Deposit synthetic rate	2.67	2.06	1.91	1.66	1.69	1.93	…
Lending synthetic rate	5.80	5.15	5.02	4.54	4.71	5.03	…
TREASURY RATES:							
12-month Treasury bills (b)	3.67	2.95	2.94	2.75	3.17	3.75	3.90
3-year government bonds	3.96	3.54	3.51	3.29	4.28	4.56	4.83
10-year government bonds	4.75	4.32	4.40	4.59	5.27	5.38	5.79
SECONDARY MARKETS:							
6/12-month Treasury bills	3.64	2.88	2.91	2.68	2.99	3.60	3.54
10-year government bonds	4.47	4.08	4.25	4.60	5.31	5.37	5.74
Yield spread over German *bund*	0.43	0.20	0.22	0.25	0.26	0.19	0.20
Spread between commercial paper and Treasury bills	0.19	0.33	0.18	0.21	0.20	0.17	…
Spread between private bonds and public debt at over 2 years	0.11	0.58	0.07	0.08	0.22	0.21	…
Madrid Stock Exchange General Index (c)	8.72	37.19	–0.12	4.22	–1.21	16.22	–1.20

Source: Banco de España.

(a) Average daily data of last month in quarter.
(b) Marginal interest rate.
(c) Cumulative percentage change in index since start of year.
Latest data available: 20 January 2000.

ports, since the summer when rates on lending and deposit transactions reached a low, this process has been slow. Since July, the composite rate on deposits transactions has been revised upwards by almost 30 basis points, to 1.9 %. The banks have raised their rates on lending transactions more rapidly. From July they rose by 43 basis points to stand at 5 % at the end of the year. The rise in money market rates has meant that in the fourth quarter of 1999 Spanish bank rates were closer to those offered in the euro area as a whole, which depend, to a greater extent, on the path of long-term interest rates.

5.2. Financial flows in the economy as a whole

The third quarter information on the financial accounts of the Spanish economy show that the slow decline in the nation's net financial saving continued. This process, which began in the last few years, has been prompted mainly by the fall in private sector saving, that has only been partially offset by the rise in general government saving (see Table 5). This trend has a cyclical component, given that in times of high economic growth private-sector agents tend to borrow more while public finances improve, although overall the nation's saving falls as domestic demand expands at a higher rate than output. In the third quarter therefore the nation's net lending was close to equilibrium (at around 0.2 % of GDP), as against a level of almost 1 % of GDP in 1998.

A different view is obtained if the financial situation is analysed in terms of outstanding financial assets and liabilities. These balances are the outcome of both the financial transactions actually performed and the changes in the prices of financial instruments. So, for example, the debit balance of the nation's financial position, obtained as the difference between financial assets and liabilities vis-à-vis the external sector, fell in 1999 to stand in the third quarter at around -17.5 % of GDP (i.e. outstanding liabilities to the external sector exceeded the outstanding claims on non-residents). In the case of households and non-financial firms, the significant growth in their net financial position (sometimes also called net financial wealth) since 1992 came to a standstill in 1999. It

TABLE 5

Saving and financial position

FINANCIAL SAVING AS A % OF GDP
(Cumulative data over four quarters)

	Average 1988-1992	Average 1993-1997	1997	1998 Q 1	1998 Q 2	1998 Q 3	1998 Q 4	1999 Q 1	1999 Q 2	1999 Q 3
Financial saving of the nation	–2.6	0.5	1.5	1.3	1.0	1.1	0.9	0.9	0.7	0.2
Non-financial firms and households	–0.2	4.9	3.1	2.6	2.0	2.1	1.7	1.5	1.1	0.7
Non-financial firms	*–4.0*	*–0.7*	*–0.7*	*–0.1*	*–0.9*	*–0.7*	*–1.0*	*–0.9*	*–0.9*	*–1.2*
Households	*3.8*	*5.6*	*3.8*	*2.7*	*2.9*	*2.8*	*2.8*	*2.5*	*2.0*	*1.9*
Credit institutions (a)	1.4	0.7	0.6	0.7	0.8	0.6	0.6	0.6	0.6	0.6
Institutional investors (b)	–0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
General government	–3.8	–5.3	–2.4	–2.2	–2.0	–1.7	–1.7	–1.4	–1.1	–1.3

FINANCIAL POSITION AS A % OF GDP (c)
(Fourth-quarter data)

	1992	1993	1994	1995	1996	1997	1998	1999 (e)
Financial position of the nation	–16.5	–18.9	–19.3	–18.0	–17.7	–18.1	–19.2	–17.6
Non-financial firms and households	39.4	47.5	52.9	59.2	68.5	77.2	86.2	86.2
Non-financial firms (d)	*–17.1*	*–16.2*	*–13.6*	*–10.9*	*–6.8*	*–4.8*	*–0.4*	*0.8*
Households	*56.5*	*63.6*	*66.4*	*70.1*	*75.3*	*82.0*	*86.6*	*85.4*
Credit institutions (a) (d)	12.4	13.9	12.9	12.1	12.8	14.2	14.2	14.7
Institutional investors (b)	–1.1	–1.2	–1.0	–0.9	–0.6	–0.5	–0.6	–0.6
General government	–34.9	–41.7	–46.2	–50.3	–52.6	–52.0	–49.7	–48.0

Source: Banco de España.
(a) Defined according to the 1st Banking Directive.
(b) Insurance companies, portfolio investment institutions and securities-dealer companies and securities agencies.
(c) Calculated as the difference between outstanding financial assets and liabilities.
(d) Shares excluded from liabilities.
(e) Third-quarter data.

should be noted that, apart from saving and borrowing transactions, changes in this position have been heavily influenced by the path of the prices of financial assets and, in particular, of equities. The slackness of the domestic stock markets during the first three quarters of 1999 affected developments in the financial position of households and firms. However, the recovery in prices in the final quarter of the year will have probably led to an increase in their net financial wealth at and-1999.

The developments described above in the nation's net financial savings are consistent with the available information on the financial account of the balance of payments for which data is currently available to October (see Table 6). According to this financial account the net flow of financing vis-à-vis the external sector changed direction in 1999. Thus, unlike in previous years, the Spanish economy obtained more financial resources from non-residents than it invested abroad. In the period January-October the net capital inflow totalled EUR 4,172 billion.

As regards assets acquired abroad, the most significant development during the first 10 months of 1999 was the sharp increase in direct investment, at double the rate in the same period of 1998. This process reflects the expansion of Spanish firms, especially in Latin America. In 1999 it was strongly influenced by the significant acquisition of external assets entailed by Repsol's takeover of the Argentine firm YPF. It should also be pointed out that the creation of the single currency and the progressive internationalisation of financial flows have stimulated the diversification of portfolio investment. Investment in domestic securities has been losing the attraction it had in the environment of a distinct domestic currency, and the domestic securities markets (especially the markets for private fixed-income securities and stock markets) are too narrow. The recent exemption from withholdings on account of corporate income tax granted to the income from the fixed-income securities of OECD countries may further boost the demand for foreign securities.

Adoption of the single currency has not led to an increase in the foreign deposits of the

TABLE 6

Balance of payments on financial account

EUR m

	1997	1998	JAN-JUL 1998	JAN-JUL 1999
BALANCE ON FINANCIAL ACCOUNT	**–2,775**	**–1,188**	**–2,891**	**4,172**
CHANGE IN LIABILITIES VIS-A-VIS EXTERNAL SECTOR	**34,479**	**65,681**	**68,014**	**78,393**
Direct investment (a)	**5,621**	**10,152**	**7,913**	**7,898**
Portfolio investment (b)	11,068	15,354	19,629	30,842
General government	9,952	4,125	9,409	18,226
Other resident sectors	1,183	8,469	7,732	6,621
Credit system	–67	2,760	2,488	5,995
Other investment	**17,790**	**40,176**	**40,472**	**39,653**
General government	21	866	–60	–545
Other resident sectors	544	4,319	3,900	10,997
Credit system	17,226	34,991	36,632	29,201
CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR	**37,255**	**66,870**	**70,905**	**74,221**
Direct investment	**10,970**	**16,507**	**14,440**	**29,708**
Other resident sectors	9,844	14,756	12,199	30,656
Credit system	1,126	1,751	2,241	–948
Portfolio investment	**14,377**	**40,985**	**26,554**	**39,399**
Other resident sectors	10,049	29,873	19,055	23,768
Credit system	4,328	11,112	7,499	15,631
Other investment	**1,555**	**21,625**	**29,042**	**25,303**
General government	331	388	308	154
Other resident sectors	12,392	17,668	20,236	–6,168
Credit system	–11,168	3,569	8,498	31,317
Reserves	**10,352**	**–12,248**	**869**	**–20,189**

Source: Balance of payments, Banco de España.
(a) Includes portfolio investment in unlisted shares.
(b) Includes direct investment in listed shares.

non-financial private sector; rather some of the deposits made previously have been cancelled. This could be a sign of the effectiveness of payment systems in the euro area, enabling payments to be made abroad safely and at a low cost without the need for funds to be held where they are needed. Finally, as mentioned in previous reports, the credit system's foreign deposits and loans followed a similar path to that of the previous year. The higher figure seen in Table 6 was largely a consequence of the claims on the Eurosystem arising in the balance sheet of the Banco de España as a consequence of the financial flows between Spanish credit institutions and the rest of the euro area.

The most significant developments in relation to external liabilities were, first, the recovery in placements of public debt abroad. This, together with the evidence on the portfolios of Spanish investors, suggests that a far-reaching process of portfolio diversification is under way in the euro area as a whole. Second, it should be noted that private-sector borrowing abroad has been relatively high compared to 1998. This may mean that some Spanish firms are financing their acquisitions of foreign assets with foreign funds. Third, Spanish credit institutions are continuing to depend heavily on foreign financing to cover the gap between the growth rates of lending and deposits. Finally, direct investment in Spain in the period of 1999 for which information is available has displayed a very similar profile to that of the previous year. This suggests that the Spanish economy has finally reached a level of maturity that is more conducive to its corporate sector investing abroad than to its being the target of foreign capital.

In short, considering capital flows by sector, it can be seen that the non-financial private sector has continued to acquire assets abroad in net terms. This capital outflow, together with the overall balance on current and capital account, has been financed by means of funds raised

TABLE 7

Financial assets and liabilities of households and non-financial fimrs

	Latest quarter balance (a) (b)	Four-quarter %change					
		1998		1999 (b)			
		Q 3	Q 4	Q 1	Q 2	Q 3	Q 4
HOUSEHOLDS AND NON-FINANCIAL FIRMS:							
Total financial assets	**1,399.1**	**11.8**	**14.3**	**11.0**	**12.1**	**14.5**	**14.9**
Liquid financial assets	568.8	5.1	5.4	4.5	4.4	5.1	5.4
Cash and cash equivalents	*271.7*	*10.2*	*14.6*	*14.8*	*17.5*	*17.5*	*12.2*
Other liquid financial assets	*297.1*	*1.8*	*–1.1*	*–2.7*	*–4.9*	*–4.0*	*–0.1*
Other financial assets	830.4	18.1	22.6	16.5	18.3	22.3	22.5
Total financial liabilities	**910.4**	**11.6**	**13.2**	**14.4**	**16.3**	**16.8**	**15.8**
Bank financing plus fixed-income securities	589.0	14.8	16.2	15.9	19.2	19.3	17.2
Credit from resident credit institutions	*467.5*	*15.9*	*15.7*	*14.8*	*16.6*	*15.9*	*14.9*
Other financial liabilities	321.4	6.4	8.3	11.9	11.2	12.5	13.4
HOUSEHOLDS:							
Total financial assets	**888.3**	**9.0**	**12.9**	**8.7**	**9.1**	**11.7**	**12.0**
Liquid financial assets	462.8	4.5	3.6	2.2	1.5	1.1	3.1
Cash and cash equivalents	*205.6*	*6.5*	*8.9*	*10.5*	*14.1*	*15.3*	*14.1*
Other liquid financial assets	*257.2*	*3.3*	*0.4*	*–2.8*	*–6.3*	*–7.8*	*–4.3*
Other financial assets	425.5	16.1	27.7	17.7	19.3	26.9	23.6
Total financial liabilities	**369.7**	**11.1**	**13.3**	**15.4**	**15.1**	**15.7**	**14.7**
Bank financing plus fixed-income securities	260.4	16.5	18.3	18.5	18.3	18.3	16.2
Credit from resident credit institutions	*235.7*	*17.2*	*19.1*	*19.3*	*19.0*	*18.9*	*16.7*
Other financial liabilities	109.2	0.8	3.4	9.0	6.0	9.8	11.2
NON-FINANCIAL FIRMS:							
Total financial assets	**510.8**	**17.5**	**17.1**	**15.6**	**17.7**	**19.7**	**20.5**
Liquid financial assets	106.0	8.6	14.8	17.2	19.6	26.4	17.1
Cash and cash equivalents	*66.1*	*24.7*	*35.4*	*30.2*	*28.8*	*24.9*	*6.8*
Other liquid financial assets	*39.9*	*–9.9*	*–13.6*	*–1.4*	*6.1*	*28.6*	*39.5*
Other financial assets	404.8	20.0	17.8	15.1	17.2	18.0	21.4
Of which: *Claims on non-financial firms and households*	*190.6*	*10.5*	*8.3*	*8.5*	*9.0*	*8.9*	*10.5*
Claims on rest of the world	*124.2*	*61.2*	*48.4*	*37.3*	*41.7*	*39.9*	*44.8*
Total financial liabilities	**540.8**	**11.9**	**13.1**	**13.7**	**17.1**	**17.7**	**16.7**
Bask financing plus fixed-income securities	328.6	13.5	14.5	13.7	19.9	20.2	18.0
Credit from resident credit institutions	*231.8*	*14.7*	*12.5*	*10.4*	*14.2*	*13.0*	*13.0*
Other financial liabilities	212.2	9.7	11.1	13.6	12.9	13.9	14.6

Source: Banco de España.
(a) EUR billions.
(b) The data for the fourth quarter of 1999 are provisional estimate.

abroad by general government and, especially, by credit institutions.

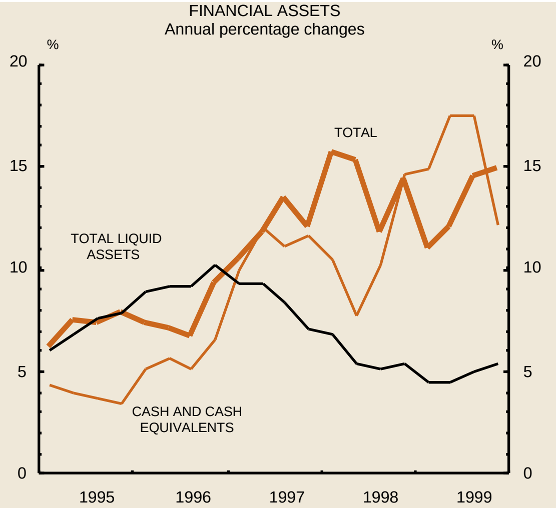
5.3. Financial flows of households and non-financial firms

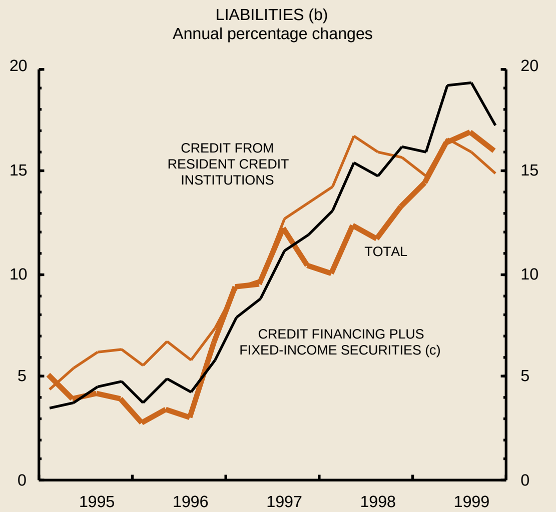
In the third quarter of 1999, the net financial saving of the non-financial private sector fell by four-tenths of a percentage point from the previous quarter - to 0.7 % of GDP – a similar decline to that in the second quarter of the year. According to estimates based on the provisional information available on certain asset and financial liability items, in the last quarter of 1999 the fall in the financial saving of the private sector seems to have come to an end. The rate of investment in financial assets is expected to have recovered and the assumption of new liabilities to have moderated.

As regards financial assets, there has been a certain recovery in recent quarters in the rate of growth of the private sector's financial investments. As at end-1999, the year-on-year rate of growth may be almost 15 %. As seen in Table 7

CHART 23

Non-financial firms and households (a)





Source: Banco de España.
(a) The data for the fourth quarter of 1999 are provisional estimates.
(b) Excluding shares.
(c) Excluding trade credit.

and in Chart 23, growth rates vary considerably from instrument to instrument. While so-called liquid financial assets have grown at a year-on-year rate of 5 %, both cash and cash equivalents (the most liquid assets, which include cash and sight and savings deposits) and those financial assets not considered liquid (consisting, among others, of equities) have displayed very high rates of growth. In this respect, the strong expansion in cash and cash equivalents, which are especially linked to immediate spending decisions, and in other assets that are illiquid, but capable of giving rise to significant increases in the financial wealth of agents, through rises in their prices on financial markets, gives the impression that the current growth in the financial investments of households and firms can finance a continued expansion in demand, with some ease.

The information on the private sector's financial liabilities confirms this assessment, since various financing aggregates have been growing at high rates. The only sign of let-up is that the ongoing expansion of the indebtedness of households and non-financial firms reached a high in the third quarter of 1999. Thus, although it continued at very high rates, there was a slight slowdown in late 1999. In terms of the credit aggregate for which most information is available – namely financing to the private sector through bank credit and the issuance of fixed-income securities – its growth is estimated to have stood at around 17 % at end-1999, two percentage points lower than the growth rates in the second and third quarters of the year.

5.3.1. Financial flows of households

In the third quarter of 1999 the gradual decline in the net financial saving of households continued. This decline began in 1995 and has accompanied the recovery in economic activity and the easing of financial conditions. In the present period of economic recovery, which dates back to 1995, the net financial saving of households has on average been 4 % of GDP, very similar to the rate in the period 1987-1991, the previous phase of expansion of output. However, at the peak of the previous cycle the low reached by saving (2 % of GDP in 1988) was higher than the level in the third quarter of 1999 which will foreseeably be surpassed by the year-end. This may be due to a more optimistic perception by households of economic prospects, to more expansionary financial conditions and, even, to the accumulation of a significant level of financial, and also real, wealth, which is encouraging borrowing and spending. In this respect, it should be recalled that while in the last economic cycle the net financial wealth of households was around 60 % of GDP, in the third quarter of 1999 this percentage was 85 % of GDP.

This rise in wealth is particularly significant if it is taken into account that it occurred during a period of strong growth in indebtedness. This means that there have been large capital gains, particularly favoured by the decline in interest rates, which has been reflected in rises in the prices of certain financial instruments (especially equities).

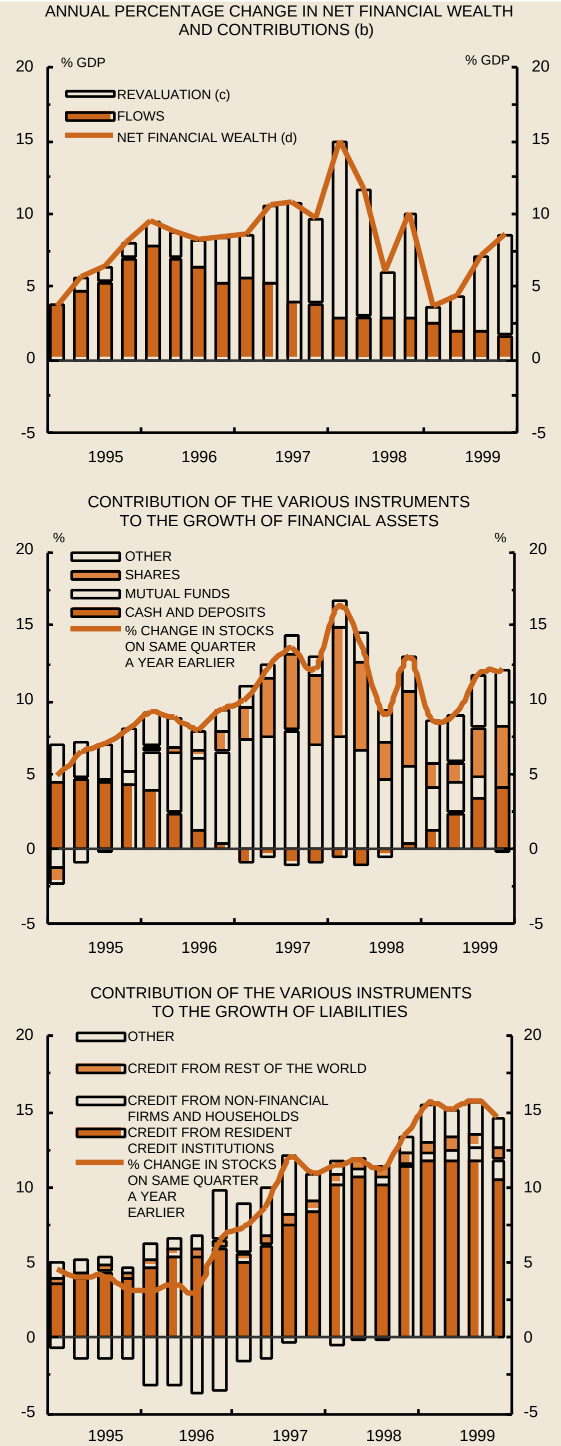
In the final quarter of 1999, the financial wealth of households recovered as a consequence of the rise in stock markets. As a result the same may have been the case in 1999 as in the previous two years, when most of the increase in the financial wealth of households was not due to new flows of saving, but to an increase in the price of the financial assets acquired (see Chart 24).

When households' financial assets and liabilities are analysed separately, it is seen that in 1999 there was a slight slowdown in the rate of growth of assets, while the rate of assumption of new liabilities was higher than in 1998. The most expansionary component of assets in 1999 was that made up of the least liquid financial assets (such as equities, shares in equity and international mutual funds and insurance products) which grew at rates of over 20 %. Although stock market expectations were not optimistic during much of 1999, savers continued to display a predilection for assets which, albeit with a greater risk, are capable of offering a higher return by way of compensation. A certain recovery has been detected in the growth rate of liquid assets in the final quarter of 1999, which may be due to the fact that the spread between long- and short-term interest rates fell during that period. Within liquid assets, cash and cash equivalents have continued to post the highest growth rates. The end-1999 rate was foreseeably over 14 %, in contrast to the year-on-year expansion in 1998 of less than 9 %.

The most dynamic component of household liabilities was bank credit, estimated to have grown at a year-on-year rate of 16 % in the fourth quarter of 1999. There was thus a slight slowdown in the rate of expansion of this form of indebtedness, since at the end of 1998 the growth rate was over 18 %. In any case, household indebtedness continues to grow at a rapid rate, and to represent a growing proportion of both GDP and household disposable income. The decline in interest rates between 1995 and 1999 made it possible for this increase in indebtedness to take place without an increase in financial costs. In terms of use, and on the basis of the latest information received, for the period to the third quarter of 1999, housing credit remained highly buoyant, while credit for the acquisition of durables moderated notably, to a year-on-year rate of 11 %, after more than two years of very high growth. The other financial liabilities of households, consisting essentially of trade credit, have grown at more moderate rates, although it should be pointed out that the importance of this component is small and the information available to estimate it less reliable.

CHART 24

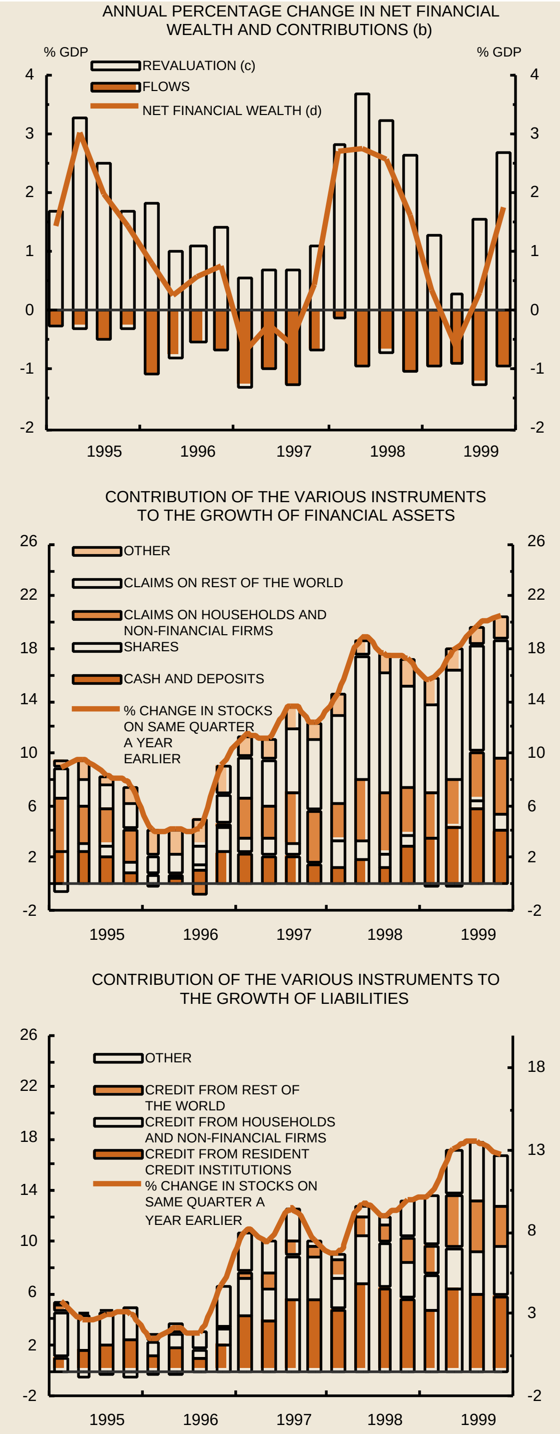
Households (a)



Source: Banco de España.
(a) The data for the fourth quarter of 1999 are provisional estimates.
(b) The flows and revaluation are cumulative data for the latest four quarters.
(c) Difference between the change in the stock and the flow.
(d) Calculated using an estimate of the assets valued at market prices.

CHART 25

Non-financial firms (a)



Source: Banco de España.

(a) The data for the fourth quarter of 1999 are provisional estimates.

(b) The flows and revaluation are cumulative data for the latest four quarters.

(c) Difference between the change in the stock and the flow.

(d) Shares are not included in liabilities. Calculated using an estimate of the assets valued at market prices.

5.3.2. Financial flows of non-financial firms

The net financial saving of non-financial firms fell in the third quarter of 1999 to -1.2 % of GDP. Unlike in the case of households, the current level of firms' net financial saving is not low in comparison with the equivalent stages of previous economic cycles. For example, in the period 1988-1991 the average net financial saving of non-financial firms in Spain was -3.6 % of GDP, while in recent years it has been around -1 % of GDP. The reasons for this include the lower investment requirements of Spanish firms in comparison with the period of rapid modernisation in the second half of the eighties and the more decisive orientation of Spanish firms towards investment abroad. Such investments require sufficient financial resources, whether these come from retained earnings or borrowing, but in principle they do not affect net financial saving since they involve a simultaneous rise in the stock of financial assets held by firms.

In terms of their financial assets and liabilities, in the second half of 1999 the firms displayed very expansionary behaviour. The rate of growth of their financial assets was around 20 % while their financial liabilities grew at around 17 %. The most dynamic component of financial assets was the acquisition of foreign assets, especially foreign equities. The purchase of external assets accounted for almost half of the increase in the financial assets held by firms (see Chart 25). Liquid instruments have also displayed very high rates of expansion, which may be indicative of the firms' healthy cash situation.

The rate of assumption of new liabilities by firms accelerated to the third quarter of 1999, to a year-on-year rate of growth of almost 18 % but, as in the case of households, it is estimated that this rate may have moderated slightly in the fourth quarter of the year. The most important and fastest growing item of liabilities was bank borrowing and the issuance of fixed-income securities. In the third quarter of 1999 this item grew at a year-on-year rate of over 20 %. Within this component, the most dynamic instrument was credit from abroad, which has been one of the main channels used by Spanish firms to finance their heavy foreign direct investment. The information on the destination of the credit shows that the year-on-year rate of growth of credit to the industrial sector and services fell in the third quarter of 1999, while credit to construction activity sustained an upward path throughout the year.

5.4. General government financial flows

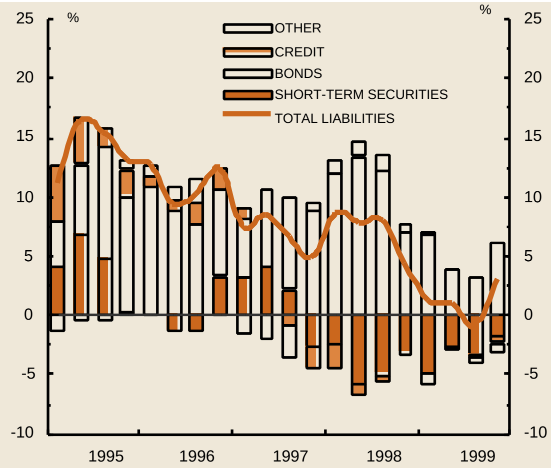
As mentioned in previous sections, the cumulative general government deficit during the four quarters to the third quarter of 1999 stood at 1.3 % of GDP. This is well below the average level for the period 1996-1998 of 3.5 %, and also one-tenth of a percentage point below the forecast for this variable contained in the year-2000 budget law of 1.4 % of GDP at end-1999.

The lower general government financing requirements are reflected in the stock of financial liabilities. The rate of growth of this stock has been falling, reaching a negative year-on-year rate of -0.9 % in the third quarter (see Chart 26). However, a certain rise in the rate of growth of liabilities is estimated for the fourth quarter of 1999. With regard to the composition of financing by instrument during 1999, fundraising was focused on the issuance of medium- and long-term securities (EUR 23 billion in net terms) to the detriment of short-term liabilities, the outstanding stock of which fell to around EUR 7 billion. As a result, the percentage of total outstanding liabilities corresponding to bonds stood at 64 % at end-1999, as against 59 % at end-1998. At the same time as changing the maturity structure of its debt, the State capitalised on the interest rate situation in 1999 to reduce the future financial cost of debt, by replacing liabilities issued in the past at higher rates of interest with securities yielding lower returns. This strategy led to the exchange of EUR 5.5 billion of medium and long-term debt.

The pattern of issuance at the January State tenders has been similar, with net issuance of almost EUR 2.8 billion in bonds and EUR –729 million in Treasury bills.

CHART 26

Growth of general government liabilities



Source: Banco de España.

With regard to financial assets, it is estimated that the heading of cash and transferable deposits, which includes the general government deposit with the Banco de España, increased during 1999 by around EUR 3.5 billion. However its behaviour over the year was not uniform. Thus, in the first and third quarters the balance of this heading fell, while a large increase is estimated for the fourth quarter. The growth of these deposits depends largely on the use made by the Treasury of the deposit held with the Banco de España, as this can be used to cover any mismatch between the Treasury's liquidity requirements and the net financial funds raised in the primary markets.

28.1.2000.

Spanish financial markets and intermediaries

In recent years, the Banco de España Economic Bulletin has been paying increasing attention to Spanish financial markets and intermediaries. Clearly, they have always played a central role in the transmission mechanism of monetary policy decisions, both when these decisions were taken by the Banco de España and now that the Eurosystem determines the monetary policy for the euro area centrally. Also, the monitoring of financial markets and intermediaries is essential to promote the stability of the financial system (a function assigned to the Banco de España by statute) and to identify the degree of competitiveness of an industry whose relative weight in the Spanish economy is growing.

The aim of this article is to give an overview of the main recent developments in the markets for financial products and services and of the behaviour of the main intermediaries acting in such markets. Given the notable changes in the Spanish financial system as a consequence of the start of Stage Three of EMU, and the data currently available, the analysis focuses on the first three quarters of 1999.

The article is divided into two parts. Part 1 analyses the developments in financial markets, distinguishing between fixed-income, equity and derivative markets. For each market, the analysis focuses on the prices and the main developments in the primary and secondary markets. Part 2 analyses the behaviour of the main financial intermediaries, distinguishing between deposit money institutions and other important intermediaries, such as mutual funds, pension funds and insurance companies.

1. THE SPANISH FINANCIAL MARKETS

In 1999, important changes affected the Spanish money and securities markets. First, the existence of a single monetary policy in the euro area and the fixing of the irrevocable exchange rates between the euro area currencies meant that the interbank deposit markets of the countries making up this area were now fully integrated (1) and that the spread of yields on government debt in the area held at low and stable levels. Second, since the beginning of 1999, the cash and securities accounts for the trading, quoting and settlement of transactions in the Spanish markets have been redenominated in euro. These changes have coincided with the entry into force of the reform of the Se-

(1) In fact, it is no longer possible to speak of a Spanish money market. The relevant geographical area for this purpose encompasses the countries that make up the euro area.

curities Market Law (Law 37/1998), which adapts Spanish law to various Community directives and completes the process of opening up Spanish markets to external competition, by enshrining the principle of the right of establishment and the freedom to provide investment services in EU countries. These reforms have helped to increase competition in euro area markets and have thereby stimulated the transformation of the Spanish markets to adapt to the new environment. This is the background to the reforms to the book-entry debt market and the changes made in the Spanish derivatives markets, both of which will be analysed below. In short, all these changes have taken place within the more general process of increasing integration of European financial markets, consolidating a trend that had already been apparent in the past (see Box 1).

Against this background, the most prominent developments in relation to the prices of Spanish financial assets in 1999 were the halt to declining interest rates in fixed-income markets and the moderation of the upward trend in equity prices. As for quantities, the boom in private fixed-income markets was notable. This was the extension of a trend that began in 1998, whereby public-sector issues have been gradually losing weight in favour of those made by private companies.

1.1. Fixed-income markets

1.1.1. Yields

In 1999, the decline in yields on public debt markets, which began in 1995, came to a halt (see Chart 1). This turning point was first apparent at the medium and long maturities, where yields began to rise as from February, while yields on short-term debt continued to trend downwards until the middle of the year, in step with the interest rates negotiated in the euro area interbank deposit market.

The upward movement in long-term yields was apparently the result, at first, of the pull exerted by US debt prices, which had been falling since October 1998. The prices of US debt seem to have been hit initially by the return of flows which had fled higher-risk assets during the summer-1998 financial crisis and, later, by fears that the vigorous growth in the US economy would lead to inflationary pressures and a tightening of monetary policy. However, given the different cyclical position of the euro area countries, some of whose economies showed signs of economic slowdown at the beginning of the year, the movements in US debt yields were not completely passed through to euro area debt. As a result, the spread between US and euro area debt widened to 170 basis points in May 1999 (see Chart 1), the highest level since 1989 if German debt is taken as the benchmark.

During the first few months of the year, the downward path of short-term yields, like that of interbank-deposit-market rates, was driven initially by expectations of an easing of monetary policy in the euro area and subsequently by the 50-basis-point cut in the Eurosystem's intervention rates in April, amid slowing activity and risks of deflation in the area.

As from the middle of the year, the rise in medium and long-term yields tended to strengthen, with certain indicators beginning to show increasingly palpable signs of economic recovery in the Euro area. This time, the rise in yields was greater than on the US market and, moreover, tended to extend to the shorter maturities, initially reflecting market expectations of a future rise in euro area intervention rates. At the beginning of November the Eurosystem's tender rate for its main refinancing operations was raised by 50 basis points.

Yields in November 1999, comparing with December-1998 levels, had risen by 30 basis points in the case of three-month operations, by 60 basis points in that of one-year operations and by 120 basis points in that of 10-year debt issues. The slope of the zero-coupon yield curve, measured by the difference between overnight and 15-year rates had widened to 290 basis points, some 100 basis points up on end-1998. In fact, this slope had stood at 350 basis points before the rise in intervention rates in the euro area at the beginning of November (see Chart 1).

The movements in Spanish debt yields followed a very similar pattern to that set by the yields on the sovereign debt of the euro area countries, so that the spreads between the yields on the debt issued by the various countries remained quite stable. Thus, for example, the spread between the yield on Spanish and German debt at the 10-year maturity fluctuated slightly around the 25-basis-point level. The low volatility of such spreads in 1999 is a consequence of the stability of the markets' assessment of the factors which, now that the currency of issuance is the same, determine the size of such spreads. These include the different credit ratings of the national issuers and the differences in the liquidity of the issues.

By contrast, the 10-year yield spreads between the Spanish and US and Spanish and Japanese debt moved significantly. The spread

BOX 1

Financial integration between international stock exchanges in the nineties

Financial markets are understood to be perfectly integrated when there are no barriers to transactions between them, such as taxes, restrictions on the holding of external assets, information costs or any other cost which makes it more difficult to trade between markets than within them. Where two markets are perfectly integrated, it would be possible to say that they are in fact one single market. During the eighties and nineties, primarily as a consequence of the liberalisation of capital movements and, later, the improvements in telecommunications, there is thought to have been an increase in the degree of integration between international financial markets. However, it is likely that they are still not perfectly integrated since certain barriers, such as taxes and, in some countries, restrictions on the holding of external assets, persist.

Measuring the degree of financial integration between two markets is not a simple task since there is no generally accepted problem-free measure. In the past, the degree of integration between two markets has usually been approximated by the correlation between the prices of the assets traded on them. However, a higher correlation is not a necessary or sufficient condition for a greater degree of integration. To appreciate this point one need only observe that assets traded on the same market are not perfectly correlated and, on occasions, their correlation is even lower than those between assets traded on different markets. For example, an average correlation of 0.47 is obtained between the sectoral indices of the US stock exchange in the second half of the nineties, as against an average correlation of 0.54 between the indices of the main world stock markets (1). This evidence might be mistakenly interpreted as indicating that the integration between international stock exchanges is greater than the self-integration of the US stock exchange.

Recently, a new way of measuring the degree of integration has been proposed in the literature, based on the law of one price. This measure estimates the absolute value of the difference between the prices that would be assigned by two markets to two portfolios each consisting of assets traded on a different market but with identical payoffs. A zero value of this measure would mean that there were no arbitrage opportunities between them, while a positive value would indicate the existence of arbitrage opportunities and the absence of perfect integration. The degree of integration will be greater the lower the value of the measure.

In a recent Research Department study (2), the above measure of integration, with some refinements, is applied to three pairs of stock markets (Madrid, New York and Frankfurt) in order to assess whether there has been an increase in the degree of integration between them during the nineties. The application of this measure runs up against certain practical problems that are overcome in this study by the use of two alternative approaches. In both approaches the measure of integration between pairs of markets is computed by considering different sub-market combinations (each made up of a certain number of securities listed on the same market). To facilitate interpretation of the results measures of relative integration are defined, based on the difference between measures of integration between different markets and those obtained for the same market (3).

The adjoining table shows the average value of the estimates of the relative measures of the degree of integration for each of the three pairs of markets studied, distinguishing between the first and second halves of the nineties (4). Three characteristics can be seen in this table: i) the measures are all positive, which suggests that the market included in the study are not perfectly integrated; ii) the value of the measure fell in every case in the second half of the nineties, which could be interpreted as indicating an increase in the degree of financial integration; and iii) comparison of the countries considered suggests that the integration is greatest, in both the time periods considered, between the Spanish and German markets, while the lowest degree of integration is between the Spanish and US markets.

These results have important implications. For example, owing to the reduction in barriers to transactions between markets, greater integration means improvements in efficiency and in the combinations of risk and return available to investors. This can be seen as a counter-argument to those who hold that financial markets are now too vulnerable owing to the greater interaction between them. Another consequence of greater integration between markets is the reduced scope for the successful pursuit of exclusively domestically focused economic policies.

Measures of relative integration between stock exchanges. Averages in basis points (the lower the value the higher the degree of integration)

	1990-1994	1995-1999
Benchmark market= New York		
New York-Frankfurt	12.0	7.0
New York-Madrid	19.1	8.8
Benchmark market = Madrid		
Madrid-Frankfurt	10.7	5.0
Madrid-New York	17.4	7.4

This table shows the averages of the relative integration measures obtained from 10,000 different estimates, based on the same number of combinations of sub-markets each made up of 10 randomly selected assets from each market. In the first two rows the market taken as benchmark to obtain the relative measures is New York, while in the second two rows it is Madrid.

(1) See Ayuso and Blanco: "Has financial market integration increased during the nineties?", Banco de España Working Paper 9923.

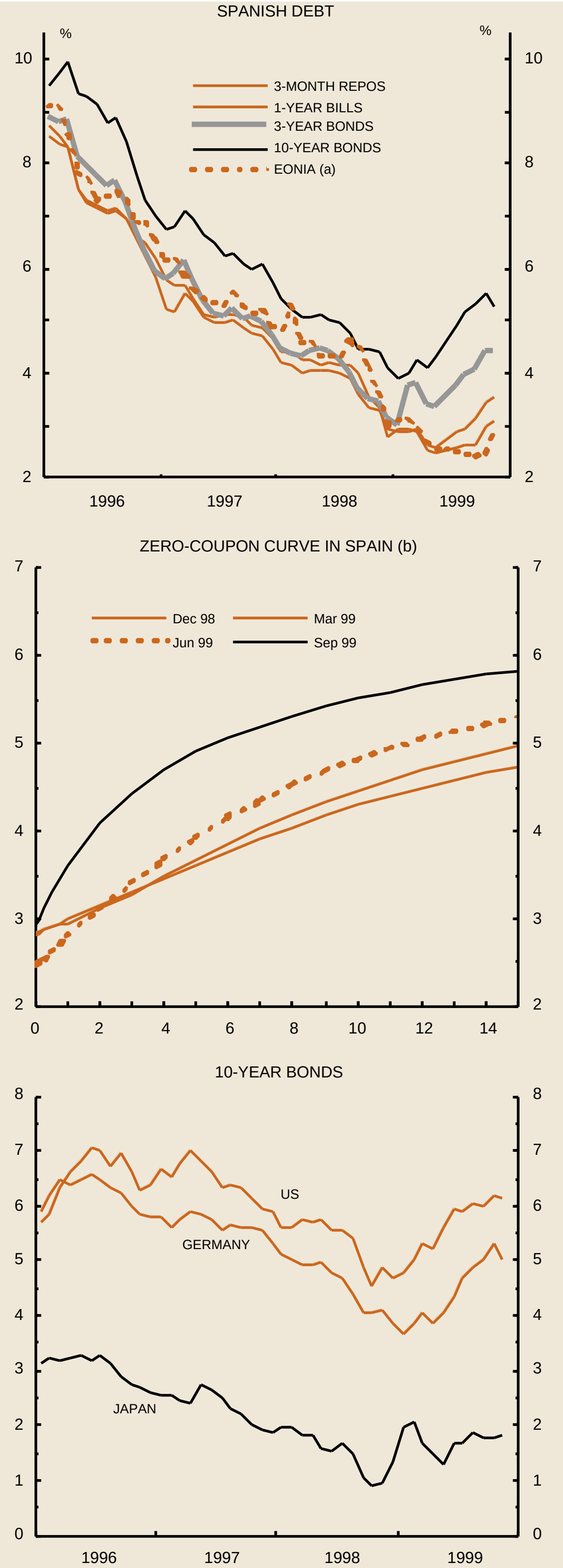
(2) Ayuso and Blanco: "Has financial market integration increased during the nineties?", Banco de España Working Paper 9923.

(3) Although, in theory, the measure of self-integration of a market is zero, problems of estimation may mean that in practice a positive value is obtained.

(4) These results are based on the second approach considered. The results obtained using the first approach are qualitatively the same.

CHART 1

Public debt yields



Source: Banco de España.
(a) Overnight interbank rate to December 1998.
(b) Monthly averages.

between US and Spanish debt, as mentioned above, widened until May, subsequently narrowed to around end-1998 levels in October and widened again slightly in November. It is notable that the volatility of this spread was significantly lower in 1999 than previously, although similar to the historical volatility displayed by the spread between US and German debt. Meanwhile, the spread between the yields on Spanish and Japanese debt was highly volatile. It fell sharply in January, when issuance by the Japanese government was at very high levels. Subsequently, it recovered to the end-1998 level in March, and thereafter continued to widen to reach 350 basis points in November. In short, the above evidence does not conclusively show that the introduction of the euro has led to an increase in the importance of idiosyncratic factors in price formation on international debt markets (a view held by certain authors). Although the volatility of the spread between euro area and Japanese debt has increased, the volatility of the spread between German and US debt has not changed significantly.

As regards the yields on assets issued by private Spanish companies, the available information suggests that the spreads over government debt narrowed in 1999. This would be consistent with the developments in other international debt markets, such as the US market where, after a widening of spreads during the 1998 financial crisis, they have since returned to around pre-crisis levels. None the less, in the Spanish case this result must be treated with caution because, with the information available, which groups all the issues traded by maturity, it is not possible to control for the issuer's credit rating (2).

1.1.2. Primary markets

As regards issuance volumes in Spanish fixed-income primary markets, the trends already seen in 1998 became much more pronounced in 1999 (see Table 1). General government issuance continued to decline, while the upward trend in the issuance of other resident sectors firmed to the point that, in net terms, their volume of issuance in the period January to September 1999 was more than double that of general government. These developments, as discussed below, are explained by a number of different factors. Notable among these are the smaller government borrowing re-

(2) The AIAF market publishes daily the average rates for all the issues traded, distinguishing between certain maturities.

quirement, the inclusion of certain fixed-income securities issued by private firms in the lists of eligible collateral for ESCB monetary policy operations and the new tax treatment applicable to this type of issue.

General government net issuance was positive again in the first three quarters of 1999, having been negative in the final quarter of 1998 due to the high level of redemptions in that period. However, the volume of net issuance was only just over half the level in the same period of 1998. Issuance by the main issuer (the State) continued to be concentrated in the medium and long maturities, so that net Treasury bill issuance was still negative during the first three quarters of 1999. In consequence, the average life of State debt rose from 5 to 5.3 years between end-1998 and September 1999. Territorial government issuance remained moderate in 1999, although the net amounts were higher than in the same period of the previous year. The largest net volumes were in medium and long-term instruments.

As regards issuers other than general government, unlike in 1998, the 1999 boom in the market is not only explained by the buoyancy of securitisation, but also by the fact that growth extended to other issuers and other instruments.

Net issuance by credit institutions in the first three quarters of 1999 was almost three-times as high as in the same period of 1998. The rapid growth in the issuance of this sector partly reflects greater net borrowing as a result of the expansion of credit without an equivalent expansion of customer funds (see Part 2 of this article for a more detailed analysis). The issuance volume of other resident sectors held at a historically high level, although in both the first two quarters of 1999 the net amount was lower than in the final quarter of 1998. Securitisation operations continued to account for a very significant part of the volumes issued by these sectors.

By maturity, the most active segment of private-sector issuance was that of medium- and long-term operations. Notwithstanding this, the growth of short-term operations (commercial paper) was notable, boosted by the more advantageous tax treatment for legal persons, following the elimination, as from the beginning of 1999, of withholdings on their returns. This measure, which has been applied to all book-entry fixed-income securities traded on organised markets, has entailed, in the case of commercial paper, the elimination of withholdings on all transactions. The impact of the change in tax treatment on medium- and long-term debt has been less significant in so far as only coupon payments were previously subject to withholdings (see Box 2).

The effect of all these developments has been a continuation of the rise in the weight of the outstanding securities issued by resident companies in all domestic fixed-income issues. This weight reached 19.5 % at the end of the third quarter of 1999, 3.9 percentage points higher than at end-1998 (see Chart 2). As mentioned above, this is explained by a combination of several kinds of factor, most of which were already active in 1998. On the supply side, the reduction in the public deficit has reduced the State borrowing requirement leaving room for the issues of other sectors. At the same time, various regulatory changes introduced in 1998 have facilitated the issuance of fixed-income securities by private sectors by increasing the flexibility and simplifying and lowering the cost of the issuance process and by widening the range of instruments available. In particular, the introduction of the programme prospectus enables more than one issue to be made without a full prospectus being required for each, and the admission prospectus (3) has been eliminated. In addition, the extension of the regulation of securitisation (4) has introduced greater flexibility into securitisation operations and has widened the range of securitisable assets.

On the demand side, the inclusion of certain fixed-income securities issued by private firms in the lists of eligible collateral for ESCB monetary policy operations has boosted the demand for this type of security from credit institutions. Also, the new tax treatment applicable to the fixed-income issues of private firms (which, as mentioned above, exempts legal persons from withholdings on the returns obtained and brings their tax treatment into line with that of State debt) has stimulated the demand for these instruments. Finally, the greater stability of the Spanish economy and the lower nominal yield on lower-risk assets is another factor helping to stimulate a shift of investment from assets issued by the State towards others with a higher expected return and, in consequence, a greater risk, such as fixed-income securities issued by private firms.

(3) These measures were introduced in Royal Decree 2590/1998 on changes to the legal regime for the securities market, known as the "Omnibus Royal Decree". For further information see "Financial regulation: fourth quarter of 1998", in Economic bulletin, Banco de España, January 1999.

(4) Royal Decree 926/1998 of 14 May. For further information see "Financial regulation: second quarter of 1998", in Economic bulletin, Banco de España, July 1998

TABLE 1

Net issuance of fixed-income securities (a)

EUR millions

	1998	1999	1998	1999		
	Q1-Q3	Q1-Q3	Q4	Q1	Q2	Q3
General government	**13,635**	**7,922**	**-8,571**	**5,230**	**2,407**	**285**
State	12,484	6,336	-9,607	4,011	2,348	-23
Short-term	*-11,846*	*-11,018*	*-2,122*	*-7,277*	*-1,382*	*-2,359*
Medium- and long-term	*24,330*	*17,354*	*-7,485*	*11,289*	*3,730*	*2,336*
Territorial government	1,151	1,586	1,036	1,219	59	308
Short-term	*62*	*107*	*172*	*144*	*43*	*-81*
Medium- and long-term	*1,089*	*1,479*	*865*	*1,075*	*16*	*388*
Credit institutions	**3,753**	**11,198**	**-58**	**4,865**	**2,789**	**3,544**
Short-term	14	6,690	-25	2,103	1,205	3,382
Medium- and long-term	3,739	4,508	-33	2,761	1,584	162
Other resident sectors	**2,885**	**7,352**	**2,884**	**2,398**	**1,041**	**3,914**
Short-term	328	699	72	680	-269	288
Medium- and long-term	2,557	6,653	2,812	1,718	1,309	3,626

Fuente: Banco de España.

(a) Including issues of residents denominated in both domestic and foreign currencies.

All of these trends will foreseeably intensify in the future. The Stability and Growth Pact will lay the foundations for a reduction in the weight of public debt in the financial markets. At the same time, the low weight of securitisation in Spain in comparison with more developed markets, like those in the US and Germany, portends further expansion of fixed-income instruments associated with securitisation operations, in an environment in which economic stability will continue to help steer investors towards higher risk assets. In this context, the agreement between AIAF (Association of Securities Dealers), the stock exchanges and the SCLV (Securities Clearing and Settlement Service) to harmonise the settlement procedures for the fixed-income securities traded on these markets will help to increase the attractiveness of private fixed-income instruments in so far as the costs of secondary market trading will be lower.

Finally, it is worth pointing out that the growing weight of assets issued by the private sector is a general trend that is also discernible in other international markets. After all, a large number of the explanatory factors mentioned above (such as the shift in demand towards higher risk assets and the decline in the State borrowing requirement) are also relevant at the international level. Besides these factors, the available evidence suggests that emerging market issuers have increased their recourse to debt financing on international markets, after their withdrawal following the international financial crisis in 1998.

The available information on world-wide debt issues reveals a high level of activity in these markets in 1999. In the first half of the year the net volume was 30 % higher than in the same period of 1998 and well above the quarterly volumes recorded in recent years. As in the Spanish market, the buoyancy of world debt markets in 1999 was essentially due to the behaviour of the private sector. The information available for the third quarter, relating solely to the international segment (placements outside the issuer's country, generally made simultaneously in several countries), confirms that the world primary debt markets remained buoyant.

With regard to the nationality of the issuers, the growth in the volume of net issuance has been very much across-the-board, although it has been particularly strong in the case of euro area issuers. In the first quarter of 1999 the weight of these issuers in total net issuance was 24 %, a higher proportion than in previous quarters. Nonetheless, US issuers continued to account for the largest proportion of new issues during the same period, with 46 % of the total. By currency, the relative growth in euro issuance is notable. During the first half of the year the amount of net issuance in that currency represented 25 % of the total. This was higher than the recent historical average weight of net issuance in the currencies replaced by the euro (around 16 %). The growth in the weight of euro issuance has also been more apparent in the international segment, where the proportion of net issuance in that currency was 43 % in the first half of 1999 (only 6 percentage points be-

BOX 2

The new tax treatment for financial assets in 1999

New income tax provisions for residents and non-residents and new regulations on withholdings (1) have, since January 1999, transformed the tax treatment and system of withholdings for financial assets held by residents and, to a lesser extent, by non-residents. Owing to the magnitude of these changes and their implications for domestic financial flows and, to a greater extent, for the development of certain Spanish securities markets, this box focuses on the changes in tax regulations and their effects on resident individual (natural person) and institutional (legal person) investors.

As regards tax treatment, the most notable changes can be summarised in three points. First, the taxation of a number of financial assets previously with different tax treatments has been standardised. As from 1999, returns on most financial assets, excluding mutual funds and shares, are taxed as income from capital irrespective of the taxable event concerned (transfer, redemption or payment of interest). As a result, returns on financial assets that were previously taxed as income from capital and capital gains are now taxed exclusively as income from capital.

Second, the distinction between regular and irregular income has been dispensed with, so that the average rates for the taxation of unearned income have been abolished, and all unearned income is taxed at the marginal tax rate. Also, the inflation-adjustment coefficients have disappeared.

Third, a number of reliefs have been established in the taxation of income from capital, ranging from 30 % to 70 % depending on the investment period and the type of asset concerned. In general, a 30 % relief is applied to income from capital if the investment period exceeds two years. In the specific case of life-assurance contracts the exemption is 60 % if the investment period exceeds five years and 70 % if it exceeds eight. The recent interpretation given by the tax authorities to unit-linked (2), whereby they are considered to be life assurance linked to mutual funds, has eliminated many of the uncertainties surrounding the taxation of such assets.

As regards the system of withholdings of personal income tax and corporate income tax the main changes for financial assets can be summarised as follows. First, a 20 % withholding is introduced for all capital gains made on shares in portfolio investment institutions although the calculation must take into account any applicable adjustment coefficients. Also, withholdings on income from capital are reduced for borrowed funds (basically debt instruments and bank deposits) from 25 % to 18 %. Likewise, it is provided (in the law accompanying the 2000 budget) that as from the year 2000 the withholding on dividends will be reduced from 25 % to 18 %. At the same time, income arising from marketable book-entry fixed-income securities traded on official Spanish secondary securities markets and issued after the entry into force of the Royal Decree shall be exempt from withholdings of corporate income tax (mainly institutional investors). This means, for institutional investors, that the systems of withholdings for public and private debt and for Treasury bills and commercial paper have been standardised.

Furthermore, Income obtained upon the transfer of coupon-paying financial assets (mostly coupon bonds) that fulfil the same conditions as established for corporate income tax, i.e. newly issued marketable book-entry fixed-income securities, is exempt from withholdings of personal income tax. Also, although the general 25 % withholding is maintained, it is confirmed that a 25 % withholding shall be applied to income from life-assurance contracts (note that prior to 1999 there existed life-assurance contracts which generated capital gains and were thus exempt from withholdings). Finally, the obligation to make payments on account of income paid with a frequency of less than once a year has been abolished.

These changes to taxation and the system of withholdings have important implications for the development of the Spanish financial markets. First, the standardisation of the taxation of public and private fixed-income assets has given a considerable boost to the trading and issuance of private securities. This expansion has been proportionately greater in the case of short-term securities (commercial paper) than in that of long-term securities (bonds). Second, they have boosted the development of bank time deposits, in particular those at more than two years. With the 30 % relief on the income, the post-tax return has improved for medium-and low-income investors. Indeed, financial innovation is generating banking products linked to indices and other references, enabling investors to obtain a premium over guaranteed interest rates.

Furthermore, the new system of withholdings is a disincentive to the growth of mutual funds, especially money-market funds (FIAMMs). In addition to their low financial return due to the low interest rates on money markets, there is now the tax cost arising from the 20 % withholding on account. Finally, there has been a further expansion in the marketing of unit-linked by banks, savings banks and insurance companies. In practice these instruments enable investors to invest in mutual funds, with the advantage of being able to switch between funds without any tax implications, and also to pay less tax in the medium and long term.

(1) Law 40/1998 of 9 December 1998 and Royal Decree 214/1999 of 5 February 1999; Law 41/1998 of 9 December 1998 and Royal Decree 326/1999 of 26 February 1999 and Royal Decree 2717/1998 of 18 December 1998, respectively.

(2) "Unit-linked" are hybrid financial assets since, although they have the legal form of life assurance, in practice the policy-holder (the investor) can choose between various funds or baskets of funds for his investment and can even change this choice on successive occasions.

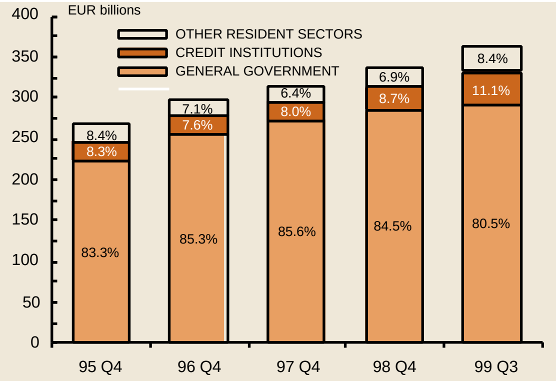
Main changes to the taxation of financial assets

Type of instrument	Classification for tax purposes	Taxable event	Type of income: 1991 & 1996 Laws	Type of income: 1998 Law
BANK DEPOSITS	Discount instruments (at less than 2 years)	Interest	IFC	IFC
	Discount instrument (at more than 2 years)	Interest	IFC	IFC+
GOVERNMENT SECURITIES) (Fixed-income only)	Discount instruments (Treasury bills)	Transfer and redemption	IFC	IFC+
	Coupon-paying instruments (State bonds)	Interest Transfer and redemption	IFC CNW	IFC+ IFC+
PRIVATE FIXED-INCOME SECURITIES	Discount instruments) (commercial paper)	Transfer and redemption	IFC	IFC+
	Coupon-paying instruments (private bonds)	Interest Transfer and redemption	IFC CNW	IFC+ IFC+
EQUITIES	Shares	Dividends Transfer and redemption	IFC CNW+IAC+exemptions	IFC+ CGL
MUTUAL FUNDS	Mutual-fund shares	Dividends Transfer and redemption	IFC CNW+IAC+exemptions	IFC+ CGL
INSURANCE CONTRACTS	Life assurance and unit linked	Income type Capital type	IFC CNW+IAC+exemptions	IFC+reliefs IFC++

IFC: Income from capital.
CGL: Capital gains and losses. Analogous to changes in net-worth (CNW), i.e. increases and decreases in net-worth.
IFC+: There is relief on 30 % of IFC from instruments at more than 2 years.
IFC++: In addition to IFC+, for life-assurance held for over 5 and over 8 years there are reliefs on 60 % and 70 % of the return.
IAC: Inflation-adjustment coefficients.

CHART 2

Debt issues in Spain. Outstanding amounts (a)



Source: Banco de España.
(a) Including issues of residents denominated in both domestic and foreign currencies.

hind the dollar), as against 34 % in 1998 and 24.6 % in 1997.

1.1.3. Secondary markets

Trading volumes on Spanish secondary debt markets have continued to grow in most markets and segments, although with appreciable differences from market to market, partly reflecting the different developments in the various primary markets (see Table 2).

In the book-entry public-debt market there was moderate growth in trading. In spot transactions the overall growth of volumes was particularly strong in the non-market-member segment. As regards instruments, spot bond transactions accounted for a growing proportion of activity while, in line with primary markets, volumes of bill transactions fell in relation to 1998.

These developments in activity on the public-debt market occurred amid structural changes in the market. The rights and obligations of market makers have been extended and, for the first time, non-resident entities are permitted to enjoy this status. These measures aim to increase market liquidity by increasing the extent of market makers' obligations to quote bid and ask prices. Also in 1999, the four screens of the "blind-broker" system were merged into one single screen to which traders have access. In short, these reforms will help to increase the attractiveness of Spanish public debt by making the market more liquid.

In the AIAF (Asociación de Intermediarios de Activos Financieros; Association of Securities Dealers) market, the rise in trading volumes in the fourth quarter of 1998 was consolidated in 1999. In the first three quarters volumes were three times higher than in the same period of 1998. Mortgage certificate and bond transactions continued to account for most of the activity in the market thanks to the buoyancy of securitisation-bond transactions, whose volumes represented around half of all trading on the AIAF market. The increase in activity in this segment is basically explained by the growth in repurchase agreements directly and indirectly related to the counterparties' operations to obtain liquidity for Eurosystem tenders. Such operations have been performed since the fourth quarter of 1998, when certain assets traded on this market became acceptable as collateral for monetary-policy tenders. In addition, since October 1998, the segment has had the benefit of the resolution of the Council of the National Securities Market Commission (CNMV) which made it possible for a new instrument – preference shares – to be listed on the AIAF market. This is a hybrid fixed-income/equity instrument usually issued by subsidiaries of Spanish credit institutions located abroad.

Activity has also been strongly expansionary in the notes segment. This has been a consequence, given the importance of operations to re-place issued securities, of the buoyancy of the primary market and also of the more favourable tax treatment applicable to secondary-market transactions in these instruments.

By contrast, matador-bond trading volumes have fallen as a consequence of the reduction in the outstanding stock of securities, a result of issuers' loss of interest in this market following the disappearance of its main distinguishing element as a consequence of monetary unification.

Unlike in other markets, there was a decline in total fixed-income trading volumes on stock markets. This is attributable to the decline in the segment in which most of the activity of this market is concentrated (that of transactions in territorial-government securities). By contrast, the trading volume for assets issued by private firms increased significantly in relation to 1998.

As a consequence of the developments in primary and secondary markets there have been certain changes in the distribution by type of holder of fixed-income assets issued in Spanish markets. As regards public debt, the most notable aspect has been the increase in the holdings of non-resident investors. As at end-September 1999 they held 25 % of State debt outright, four-and-a-half percentage points

TABLE 2

Trading volumes on secondary fixed-income markets

EUR millions

	1998	1999	1998	1999		
	Q1-Q3	Q1-Q3	Q4	Q1	Q2	Q3
Book-entry public debt market	**10,975,396**	**11,085,283**	**3,138,358**	**3,319,309**	**3,446,815**	**4,319,159**
Spot transactions	1,811,700	1,881,240	511,017	647,331	711,981	521,928
State	1,804,540	1,876,223	506,614	645,349	710,113	520,761
Bills	*74,535*	*64,369*	*25,733*	*22,792*	*18,211*	*23,367*
Bonds	*1,730,005*	*1,811,854*	*480,881*	*622,557*	*691,903*	*497,394*
Territorial government	7,160	5,017	4,403	1,982	1,868	1,166
Forward transactions	19,397	18,207	6,434	7,914	5,991	4,303
State	18,911	17,886	5,777	7,720	5,916	4,251
Territorial government	486	321	657	194	75	52
Repos	9,144,299	9,185,836	2,620,907	2,664,065	2,728,843	3,792,929
State	9,094,942	9,141,275	2,605,111	2,652,753	2,710,737	3,777,785
Territorial government	49,357	44,561	15,796	11,312	18,105	15,144
AIAF market	**19,572**	**60,435**	**23,548**	**18,915**	**17,200**	**24,319**
Commercial paper	5,282	14,916	2,652	2,865	3,565	8,486
Bonds and mortgage certificates	9,407	43,518	19,354	15,423	12,615	15,480
Matador bonds	4,883	2,001	1,542	627	1,020	353
Stock market	**40,043**	**32,451**	**13,105**	**10,574**	**11,114**	**10,763**
State	490	142	113	100	33	8
Territorial government	39,002	30,840	12,789	9,947	10,526	10,367
Other	551	1,470	203	527	554	388

Sources: AIAF, Spanish stock exchanges and Banco de España.

more than at end-1998. There is no information on the distribution of private debt by holder. However, the information available on the placement of fixed-income issues registered with the CNMV also shows an increase in the holdings of non-residents in 1999. These investors increased their holdings from 10 % in 1998 as a whole to 19 % in 1999.

1.2. Equity markets

1.2.1. Price developments

After the high revaluations since 1995, Spanish equity prices in 1999 were characterised until October by the absence of any definite general trend. The Ibex-35 index then stood at around the end-1998 level (see Chart 3) However, as from the beginning of November, there was a clear upward trend, basically led by the telecommunications sector, which took the gain from end-1998 to end-November to 11.4 %.

Price developments in 1999 were the result of a number of opposing factors. Among those with positive effects were the signs of improvement in the international economic environment, visible since the beginning of the year and, later on, the prospects for recovery in the euro area. This change of scenario has had a positive impact on the earnings forecasts of listed companies and, particularly, on those whose profit and loss accounts are most closely linked to the business cycle. This scenario was also supported by the publication of earnings figures that were generally more favourable than initially forecast.

On the other hand, the increase in market interest rates, especially long-term rates, has had a negative impact on stock prices through two channels. First, higher interest rates make equities less attractive relative to fixed income and, second, they have a negative impact on the future earnings of indebted companies by raising their financial costs.

Across firms price movements were very different, reflecting differences in the markets' assessment of the prospects of the sectors to which they belong. Among the sectoral indices of the Madrid stock exchange, the largest rises were in the communications index (up 58 % in the period January-November 1999), mainly attributable to the price of Telefónica which, like that of most other European firms in this sector, soared amid good prospects for the growth of the telecommunications business in the next few years. Another sector whose index rose notably was oil (up 23.6 %), where firms benefited from rising crude prices. The banking sector, with a high weight in Spanish stock markets, also performed better than the general index, although the gains were relatively moderate (15.3 %).

The share prices of firms in the electricity sector fell due to the reduction in tariffs and also due to the increase in interest rates, since these firms have high levels of debt (the electricity index of the Madrid stock exchange fell by 10.8 %). Finally, there were also notable falls in the share prices of firms in the construction and food sectors (–27.3 % in the construction sector index and –18.2 % in that of the food sector).

Spanish indices did not perform as well as those of the main international stock exchanges (see Chart 3). Of these, the best performing was the Tokyo exchange's Nikkei 225, which from end-1998 to end-November 1999 rose by 34 %. Prices in this market were boosted by the improvement in the prospects for economic recovery in Japan, starting from a very depressed situation. The S&P 500 US stock market index rose 13 % over the same period, amid continuation of the current expansion of the US economy at a higher rate than initially forecast. However, the increases in US interest rates and fears of further rises in future moderated the upward trend to some extent. Finally, the broad Dow Jones Euro Stoxx index of euro area stock markets rose by 21.7 %, led by firms in the technology and industrial sectors. In fact, the lower relative weight of this type of firm in the Spanish market indices would partly explain the lower rises in Spanish stock markets. At the same time, the revaluation of technology-sector firms, which has also occurred in the US market, has been notable for its size and for the fact that many of these firms are loss-making, giving rise to doubts as to its sustainability. In Spain, the most striking example has been that of Terra, a subsidiary of Telefónica. Its share price almost quadrupled in less than one month following the IPO in November. In fact, the valuations of these shares suggest that the markets are discounting the existence of high potential profits in the future. Some of these firms will probably never make these profits, especially if certain areas of business, such as the Internet, end up dominated by a few firms. Accordingly, investment in this type of asset involves a very high element of risk.

Another notable aspect of developments in Spanish stock exchange indices was their relatively low volatility during most of 1999, especially when compared with developments during the financial crisis in the previous year. The main exception to this stability was in the middle of January, at the time of the announcement of the widening of the Brazilian real's fluctuation bands against the US dollar.

1.2.2. Primary markets

The supply of equities increased notably during the first three-quarters of 1999, both through capital increases and IPOs (see Table 3). This development was stimulated by the increasing tendency for agents to invest in this kind of security. Given the lower nominal returns on lower-risk assets, agents are tending to shift their investments towards assets with higher expected returns and, consequently, a greater risk.

Capital increases were at historically high levels in the first three quarters of 1999, even exceeding the exceptionally high volumes during the same period of 1998. Non-financial firms raised a large amount of finance in this way, with Repsol's capital increase in July to finance the purchase of the Argentine firm YPF being especially notable.

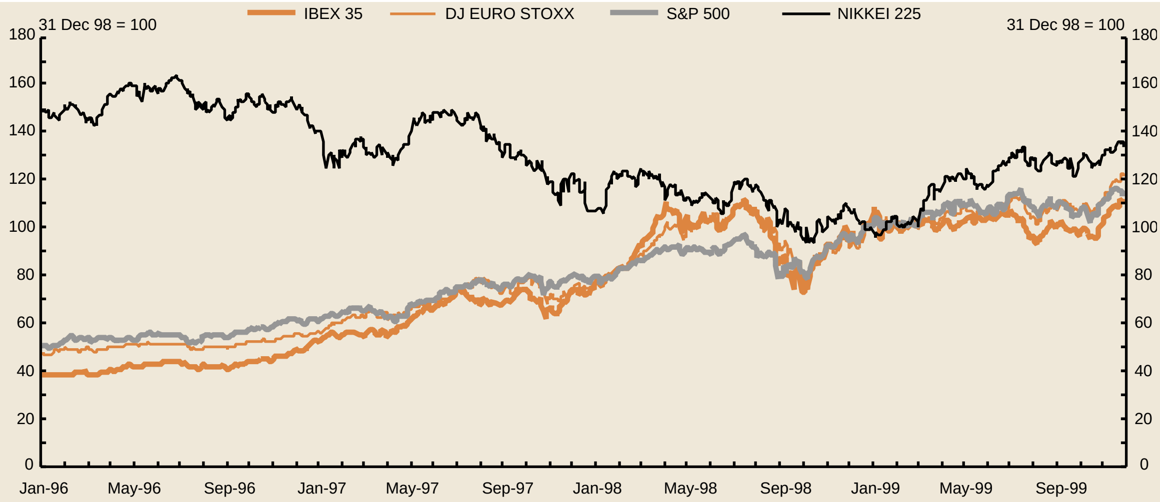
Capital increases in 1999 had the benefit of a more flexible regulatory framework (5), which facilitates and simplifies such operations. As mentioned above, the new regulations have made the issuance formalities less stringent by abolishing the admission prospectus. Furthermore, the new regulations have made it possible to register increases in capital before they are actually carried out and they facilitate and envisage the issuance of several types of shares, including callable and non-voting shares, shares paying preferential dividends and preference shares. However, as yet no firm has used any of these instruments.

In the first three quarters of 1999, the amount of public offerings was below the level in the same period of the previous year (see Table 3), this being attributable to the decline in the number of privatisations. Unlike in previous years, in 1999 the bulk of these operations did not involve the privatisation of state-owned firms, but rather IPOs. Some of these operations had been scheduled for the second half of 1998, but on account of the international financial crisis were postponed until the first half of

(5) The Omnibus Royal Decree and Law 37/1998, reforming the securities market law introduce certain changes in the commercial regulation and financial supervision tending to simplify the issuance of securities. In addition, the Law accompanying the budget completed some of these changes.

CHART 3

Stock market indices



Sources: Madrid Stock Exchange, Bank for International Settlements and Reuters.

1999, including notably those of Ferrovial, Mecalux, Azkar and Parques Reunidos. These operations were generally favourably received by Spanish investors, who have displayed an increasing tendency to invest in equities. IPOs continued in the fourth quarter. That of the Telefónica subsidiary Terra was notable, with purchase orders far in excess of supply and (as mentioned above) very large price rises in the initial trading sessions.

1.2.3. Secondary markets

Trading volumes on the Spanish secondary equity markets continued to grow in 1999 (see Chart 4), although at more moderate rates than in recent years. Moreover, part of the growth in activity in 1999 was attributable to certain exceptional operations, relating to the exchange of shareholdings between the former Banco de Santander and Banco Central Hispano, which were carried out in the second quarter of 1999 off market.

Security loan transactions continued to grow in importance in 1999. At end-September the outstanding amount of such transactions stood at EUR 8.5 billion, 11.4 % higher than at end-1998.

The size and activity of Spanish stock markets is shortly to be increased thanks to the recently created market for Latin American firms. This Madrid stock exchange initiative means that certain firms from Latin American countries can be traded through the Spanish stock market electronic trading system, with settlement through the SCLV.

Finally, as regards the distribution of equities by holder, as in the case of fixed-income markets, in 1999 an increase in the holdings of non-resident investors was discernible. On information to July, the net investment by these investors in the primary and secondary equity markets remained positive in 1999, although at a lower level than in the same period of the previous year. The weight of the activity of these investors in the secondary market increased slightly in the same period, rising from 40 % to 44 %. In addition, the information on the placement of the issues and public offerings registered with the CNMV in the first four months of 1999 shows a significant increase in the proportion placed with non-residents compared with the information for the whole of 1998 (up from 32 % to 55 %). This has been mainly at the expense of the household sector. The smaller number of public offerings in 1999, which usually attract large numbers of small investors, could be one of the main factors behind this development.

1.3. Derivatives markets

The derivatives markets, especially the fixed-income segment, have seen the most rapid transformation following the introduction of the Euro. The integration of euro area money markets and the elimination of exchange risk have entailed an increase in competition between European derivatives markets, as the

TABLE 3

Capital increases and public offerings

EUR millions

	1998	1999	1998	1999		
	Q1-Q3	Q1-Q3	Q4	Q1	Q2	Q3
Capital increases	**8,835**	**9,765**	**616**	**1,141**	**1,327**	**7,297**
Credit institutions	4,839	838	36	128	112	598
Other sectors	3,996	8,927	579	1,013	1,215	6,699
Public offerings	**11169**	**3,377**	**71**	**601**	**1,985**	**791**
Privatisations	10,857	772	0	393	0	379
Other	312	2,605	71	207	1,985	412

Sources: Sociedad de Bolsas and Banco de España.

substitutability of the products linked to the fixed-income instruments traded in these markets has increased substantially. The markets have reacted to this situation by establishing alliances and in certain cases by making changes to their operating structure. In 1998, the German DTB derivatives market joined up with the Swiss SOFFEX market to form the EUREX market. Subsequently, the Spanish, French, Portuguese and Italian markets formed an alliance called Euro-Globex, the European part of Globex, the global network of futures exchanges which also includes the US CME market. The British LIFFE market decided to replace "open-outcry" trading by an electronic system like the one used in the continental markets. More recently, the Council of MEFF (Spanish Financial Futures and Options Market) has resolved to integrate the management of the companies MEFF Renta Fija and MEFF Renta Variable.

In markets trading in equity-based instruments the competition has focused on the launch of new contracts based on aggregate indices for the euro area and other European countries.

The agreement between the markets integrated in Euro-Globex came into effect at the beginning of 1999 for contracts on interbank interest rates. Under the agreement the Spanish MEFF RF market was interconnected with the French MATIF market and MEFF RF members were given access to trading in the 3-month Euribor futures contract, the order book for which is run by MATIF. MEFF RF members continue to settle their transactions through MEFF RF, while their net positions are settled in an account opened with MATIF by a securities-dealer company, MEFF Euro Services, formed for the purpose.

In the middle of the year the agreement was extended to other MATIF products (bon notionnel) and to equity products (pan-European-index futures), although in the latter case the parties to the agreement were MEFF RV and the French market MONEP. From the end of the summer MATIF members have had access to trading in the MEFF RF-notional-bond futures contract.

As regards trading volumes, in 1999 there was a very sharp fall in transactions involving MEFF RF-listed contracts (see Table 4). The explanation for this lies, first, in the fact that market members' activity in three-month Euribor futures carried out through Euro-Globex is not recorded by MEFF RF but by MATIF. However, the cumulative volume of MEFF RF and MATIF interbank-rate futures contracts continued to decline in the period January-September 1999 in relation to the same period of the previous year. The decline in activity in MEFF RF-listed contracts is also attributable to the shift in bond-contract transactions to the Eurex market (see Chart 5). This market has rapidly absorbed the bulk of trading in derivatives on euro area government bonds. MEFF RF reacted to this situation by launching a new contract with an underlying asset made up of a basket of bonds issued by several euro area governments. However, as trading in this new contract did not reach significant volumes MEFF RF's strategy is now focused on marketing products listed on other markets instead of launching its own products. This is the background to the recent agreement between MEFF RF and Eurex whereby MEFF RF members have access through their screens to trading in the Eurex public-debt contract.

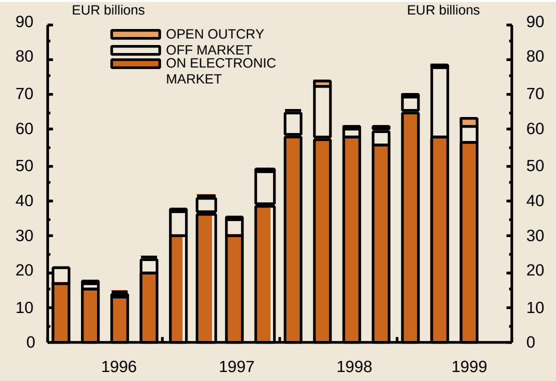
Recent developments in activity in European derivatives markets therefore show the growing concentration of transactions in euro-interest-rate contracts in a single market (see Chart 5).

In the case of interbank-rate contracts this market is the British LIFFE market, while activity in contracts linked to medium- and long-term rates is concentrated in the Eurex market.

As regards activity in equity-based contracts, MEFF RV trading volumes have been more stable. In the first quarter activity grew, but in the second and third quarters the amount traded slowed. As a consequence, the total trading volume in the first three quarters of 1999 was 3.6 % higher than in the same period of 1998. In terms of instruments, the weight of Ibex-35 futures in total trading rose due to a fall in the trading volumes of options contracts on the same index. By contrast, the volumes of transactions in options on individual securities grew in relation to the previous year, although their relative weight in total trading remains very low.

CHART 4

Trading volumes on equity markets



Source: Sociedad de Bolsas.

2. FINANCIAL INTERMEDIARIES

During the first three quarters of 1999, Spanish financial intermediaries conducted their business against a background of vigorous economic growth, low interest rates and the absence of any clear trend in stock market prices. As a result, a strong growth rate in lending was sustained and the growth of the net asset value of mutual and pension funds was lower. The internationalisation of the investment portfolios of pension funds, insurance companies and deposit money institutions likewise continued, as did switching towards higher-risk assets such as private fixed income or equities. Contributing to this re-shaping of portfolios were the greater issues of commercial paper and of other private fixed-income securities, discussed in Part 1 above in which banks participated actively as issuers. Nonetheless, these issues were not so high as to offset the fall in public debt issues, whereby a shortage of negotiable instruments on the domestic market persisted, encouraging investment in other assets of the euro area. This was particularly notable in the case of money-market funds (FIAMMs by their Spanish name), but also in other groups of institutions such as securities funds (FIMs) or deposit money institutions.

The relatively unfavourable trend to October of the prices of financial assets and the recent tax changes (see Box 2) contributed to the pick-up in bank deposits and to the decline in net subscriptions to mutual funds. Notwithstanding, the growth of customers' funds did not suffice to finance the growth of credit. Consequently, deposit money institutions continued to resort to net external financing, essentially interbank borrowing, which increased the net external debit position of these institutions.

Against this backdrop, deposit money institutions' profits in the first nine months of the year continued to grow in relation to 1998. That said, this increase was based exclusively on the favourable course of credit-risk and securities write-downs, whereas net income fell for the first time since 1995.

2.1. Deposit money institutions

Deposit money institutions (banks, savings banks and credit co-operatives) are the main component of the Spanish financial system. Faced with heightening competition with one another, with foreign banks and with other financial entities, these institutions are immersed in an ongoing process of adaptation to the new environment in place as a result of external openness, EMU and technological change. This section reviews the activity of these institutions during the first nine months of 1999 (6). An analysis is first made of the structure of their assets and then of their liabilities, and finally their margins and costs are studied. Annexed to this paper is a comparative analysis of the performance of commercial banks and savings banks, with a somewhat broader time frame. Notably, the two biggest mergers in the sector's history came about or were announced in 1999, giving rise to two groups -BSCH and BBVA- which respectively account for 20 % and 21 % of the sector's total assets.

(6) Other credit institutions, such as specialised credit institutions (SCIs) or the ICO (Official Credit Institute), are not analysed in view of their relative lesser significance and, in the case of the ICO, its specific characteristics. Drawing on 1998 figures, SCIs accounted for 2.4 % of the total assets of credit institutions.

TABLE 4

Trading volumes on derivatives markets (a)

EUR millions

	1998	1999	1998	1999		
	Q1-Q3	Q1-Q3	Q4	Q1	Q2	Q3
MEFF RF (fixed-income)	**1,825,416**	**319,725**	**286,569**	**141,272**	**110,858**	**67,596**
Short-term	987,016	19,939	138,426	13,927	5,181	831
Futures	*940,539*	*19,039*	*137,344*	*13,867*	*4,341*	*831*
Options	*46,477*	*900*	*1,082*	*60*	*840*	*0*
Medium- and long-term	838,399	299,786	148,144	127,345	105,676	66,765
Futures	*794,632*	*299,699*	*145,995*	*127,274*	*105,666*	*66,759*
Options	*43,767*	*87*	*2,149*	*71*	*11*	*6*
MEFF RV (equities)	**427,100**	**441,599**	**129,250**	**161,413**	**145,203**	**134,983**
Ibex 35	422,098	431,640	127,231	159,241	141,459	130,941
Futures	*347,116*	*376,587*	*110,135*	*144,143*	*121,449*	*110,995*
Options	*74,982*	*55,054*	*17,095*	*15,098*	*20,010*	*19,946*
Stock options	5,002	9,959	2,020	2,172	3,744	4,042
MATIF						
Short-term. Futures	3,463,216	2,749,773	600,314	1,201,693	891,088	656,992

Sources: MATIF, MEFF RF, MEFF RV and Banco de España.
(a) The volumes are expressed in monetary units and have been obtained by multiplying the number of contracts traded by their size.

Despite competition from other financial intermediaries, Spanish deposit money institutions' business continued to grow significantly in 1999. Although average total assets (ATA) grew by only 4.8 % in the first three quarters of the year compared with the same period a year earlier (which was below nominal GDP growth for the first time in recent years), the fall in the growth rate was attributable to the decline in foreign bank branches' assets (-15.1 %) and to the effect of bank mergers (7). Without these two effects, the overall growth of deposit money institutions' ATA would not have differed greatly from 1998 (8.6 %).

Since September 1998, seven foreign banks (five of which Japanese) have closed their branches in Spain. Moreover, the activity of some of the branches of foreign banks still in Spain has diminished as a result of their treasury operations being concentrated in other European centres following the arrival of the euro. Further, the merger in October 1998 of Banco Exterior, Banco Hipotecario, Caja Postal and Corporación Bancaria de España entailed the cancellation of interbank operations among the aforementioned institutions, thereby affecting the comparison of the nine-month period in 1999 with the same period in 1998 (8). Both effects had a bearing exclusively on commercial banks, while savings banks and credit co-operatives showed growth in ATA (11.3 % and 10 %, respectively) far higher than that of banks and, in the case of savings banks, higher even than one year earlier.

The overall non-futures off-balance-sheet operations of deposit money institutions (i.e. contingent liabilities and contingent commitments and risks) continued to increase in proportion to the total balance sheet (see Table 5).

2.1.1. Asset structure

On the assets side, credit grew at a notable rate of over 10 % year-on-year for the third consecutive year. The strong expansion was essentially driven by the greater demand arising from lower interest rate levels, the favourable economic outlook and the improved financial position of households and firms in recent years. Offsetting this growth in credit was a significant decline in interbank assets, predominantly in banks. Overall, as a percentage of ATA, interbank assets were lower by more than five percentage points, while credit exceeded 50 % of total assets (see Table 5). Somewhat

(7) Unless otherwise indicated, all the data in this report correspond to the aggregation of the institutions existing at each point in time; consequently, some of the changes may be due to new institutions coming into being or others ceasing to operate.

(8) The merger of BCH and Banco Santander has a lesser effect given that it occurred in April, thereby affecting the 1999 growth rate to a lesser extent.

over half of the decline in interbank assets may be explained by the above-mentioned factors: the merger of Banco Exterior, Banco Hipotecario, Caja Postal and Corporación Bancaria de España, and the reduction in the activity of branches of foreign banks. The rest of the decline was due to the fall in interbank assets vis-à-vis non-resident institutions, which will be discussed in the section on external financing.

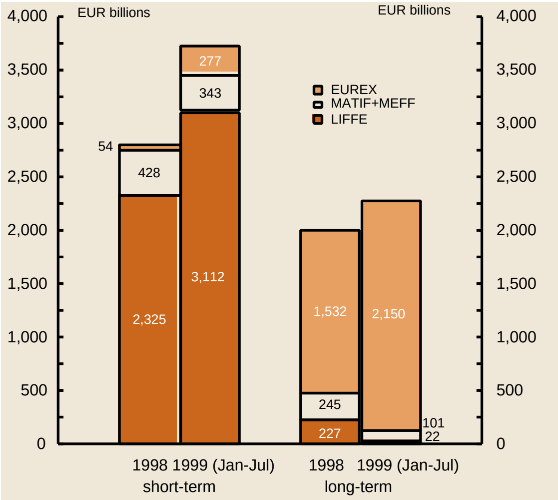
The growth of credit was concentrated in operations with the resident private sector, with a rate of increase of 16.8 % (see Table 6). This growth would rise to 18.7 % if regard were also had to credit in the form of securities purchases (including assets issued by mortgage securitisation funds held by the institutions). Conversely, credit to non-residents and to general government fell in relation to the period January-September 1998. Under credit to the resident private sector, virtually all the items grew notably with the sole exception of credit to other (non-credit) financial institutions and doubtful loans. However, the growth of household consumer credit ran at over 20 % during the first two quarters of 1999, and that of mortgage loans was strong. By maturity, credit at over five years posted the highest growth rates, although the share of floating-rate loans in deposit money institutions' overall lending continued to rise, accounting for 47.6 % of total credit.

As earlier mentioned, both low interest rate levels and the buoyancy of the economy have contributed to the expansion of credit. Other factors (indicated in the 1998 Annual Report) include the improvement in the financial position of households and firms and corporate restructuring. The fall in interest rates in recent years has significantly lessened the interest burden on corporate and household debt, enabling these agents to take on higher levels of indebtedness. In relation partly to the fall in interest rates, the prices of equity instruments have risen strongly over recent years, leading to an increase in the net wealth of households, which account for an increasingly greater proportion of the equity-holding (directly or indirectly) sectors as a whole. Finally, the start of EMU has added renewed momentum to corporate restructuring processes, including the acquisition of companies in Spain or abroad. This, together with the setting up of new firms, spurred by the economy's cyclical position, has no doubt also contributed to fuelling the demand for bank credit.

Against this background of growth in the demand for credit, deposit money institutions continued to cut interest rates on new credit transactions for most of the period under study, in line with the trend of interbank interest rates. The rises recorded in the rates of medium and

CHART 5

Trading volumes on derivatives markets.
Euro-interest-rate futures contracts.
Monthly averages (a) (b)



Sources: Eurex, Matif, Liffe, MEFF RF, MEFF RV and Banco de España.

(a) The volumes are expressed in monetary units and have been obtained by multiplying the number of contracts traded by their size.

(b) The contracts included in each case are the following:
MATIF: Short-term: 3-month Pibor and 3-month Euribor. Long-term: ECU Bond, Euro All Sovereigns, 5-year Matif, 5-year Euro, 30-year E-Bond, Notional Bond and Eurobond.
EUREX: Short-term: 1-month Euromark, 1-month Euribor, 3-month Euromark and 3-month Euribor. Long-term: Schatz, Euro Schatz, Bobl, Euro Bobl, Comi, Conf, Euro Buxi, Jumbo-Pfandbrief, Euro Jumbo-Pfandbrief, Bund and Euro Bund.
LIFFE: Short-term: 3-month Euromark, 3-month Eurolira, 3-month Euribor. Long-term: Bund, Bobl, BTP, Euro Bund and Euro BTP.
MEFF: Short-term: Mibor 90 and Mibor 360. Long-term: 10-year notional bond.

long-term government debt were not reflected in lending rates until after June and July, when they touched bottom. Thereafter, until October (the latest figure available as this report went to press), there were significant increases, although these varied according to the type of instrument and institution. The most marked increases were on unsecured medium and long-term loans, while the increases on mortgage loans remained low owing to the greater relative weight in such loans of floating interest rate instruments, indexed to short-term interest rates. Given the relatively low sensitivity of the demand for credit to changes in interest rates, the recent rise in the cost of credit is not yet expected significantly to affect credit trends.

In real terms, the current growth of financing extended to the non-financial private-sector is running at around 15 %, on a par with the rates recorded at the peak of the previous cycle (1989). Admittedly, there are reasons that may temporarily justify such high credit growth. But if these rates of increase are sustained over a

TABLE 5

Deposit money institutions
Balance sheet structure (a)

% of average balance sheet

	Total (b)		Commercial banks		Savings banks	
	1998	1999	1998	1999	1998	1999
	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP
ASSETS:						
Cash and central banks (c)	1.9	1.8	1.4	1.4	2.7	2.4
Interbank market assets (d)	25.7	20.2	31.8	24.3	15.0	14.1
Loans	46.7	50.2	42.4	45.8	53.9	56.9
Securities portfolio	18.8	19.8	17.6	20.1	21.7	20.0
Fixed-income	*14.7*	*15.3*	*13.6*	*15.4*	*17.4*	*15.5*
Equities	*4.1*	*4.5*	*4.1*	*4.7*	*4.3*	*4.5*
Other assets	6.9	8.0	6.8	8.4	6.7	6.7
LIABILITIES:						
Banco de España and interbank market (e)	29.8	27.2	40.3	37.0	11.6	12.1
Customer funds	55.1	56.3	44.1	45.2	74.5	73.6
Non-bank creditors (f)	*53.4*	*54.1*	*42.7*	*43.4*	*72.0*	*70.6*
Debt securities	*1.7*	*2.2*	*1.4*	*1.9*	*2.5*	*2.9*
Capital	5.8	5.6	5.3	5.0	6.4	6.4
Special funds	2.5	2.6	2.2	2.4	3.1	2.9
Subordinated financing	1.6	1.9	2.1	2.4	0.8	1.0
Other liabilities	5.2	6.4	6.1	7.9	3.6	4.0
OFF-BALANCE-SHEET ITEMS:						
Contingent liabilities	9.6	11.4	12.2	15.0	4.3	5.0
Commitments and contingent risks	14.6	17.1	15.9	18.9	12.5	14.5
Futures transactions	148.3	139.9	213.9	198.6	33.0	47.5
MEMORADUM ITEM:						
Average total balance sheet						
Balance in EUR millions	894,390	936,947	573,331	579,859	292,002	325,139
Annual growth rate	8.5	4.8	8.3	1.1	8.8	11.3

Source: Banco de España.
(a) Data relate to the institutions existing in each period.
(b) Commercial banks, savings banks and credit co-operatives. The data relate to total turnover, which includes banks' foreign branches, but not subsidiaries.
(c) Including cash, central banks (except securities purchases under repos) and Banco de España Certificates.
(d) Including lending to banks (time deposits, securities purchases under repos and securities loans) and securities purchases under repos with the Banco de España.
(e) Including Banco de España and credit institutions (time deposits and securities sales under repos).
(f) Including sales of securities to customers under repos.

prolonged period, they could, in addition to jeopardising macroeconomic stability, result in the future in a loss of quality for certain institutions' credit portfolios.

A second problem arising from strong growth of credit is the need for institutions to seek out the means of financing such credit. Should the growth of deposits prove insufficient, this may lead to balance-sheet mismatches. This aspect is discussed in detail in the following section.

Unlike in 1998, the share of the securities portfolio in the total balance sheet increased in the period of 1999 covered by this report (accounting for almost 20 %), as a result of the notable increase posted in the first two quarters. Deposit money institutions continued to increase their investment in equities. But, moreover, they more than offset the fall in their holdings of government debt over the course of the year with most significant increases in the rest of their fixed-income (private and non-resident) portfolio. This probably reflects these institutions' wish to increase their share in national and international markets, especially in the euro area, and also, possibly, to hold more securities that may be used to obtain liquidity at the Banco de España. Thus, the holdings of bonds of the resident sectors, excluding general government and credit institutions, virtually quadrupled in the 12 months to September 1999, with a year-on-year increase of EUR 7,543 million. Judging by the activity on the primary market, purchases of mortgage securitisation bonds ac-

TABLE 6

Operations with customers

	Year-on-year growth rates					% of total	
	1998	1998	1999			1998	1999
		Q4	Q1	Q2	Q3	JAN-SEP	JAN-SEP
Total loans (a)	**13.7**	**13.4**	**12.2**	**12.4**	**13.4**	**100.0**	**100.0**
Non-residents	25.0	8.4	–1.3	–10.5	–5.8	8.1	6.7
General government	–14.9	–16.3	–10.3	–6.8	–7.1	7.5	6.1
Other resident sectors	16.0	17.0	15.7	16.4	16.8	84.4	87.1
Of which:							
Mortgage loans	*20.2*	*20.1*	*19.4*	*18.9*	*18.2*	*36.8*	*38.8*
MEMORANDUM ITEM:							
Doubtful loans	–25.2	–23.7	–20.5	–18.2	–14.4	2.0	1.4
Variable interest rate loans	23.9	24.6	17.2	16.5	17.6	45.8	47.6
Loans in foreign currency (b)	18.3	4.2	–19.1	–20.8	–15.7	8.8	6.4
Loans + fixed-income portfolio of other resident sectors	15.8	17.3	16.7	17.7	18.7	85.1	88.9
Total loans to other resident sectors (c)	**—**	**17.1**	**12.4**	**14.8**	**13.3**	**100.0**	**100.0**
Other financial institutions	—	40.8	–66.9	–68.2	–58.4	3.1	1.4
Non-financial firms	—	13.5	11.7	16.4	14.4	47.0	47.0
Households and non-profit institutions serving households	—	19.2	19.1	17.7	16.6	49.9	51.7
Consumer	—	*28.5*	*28.4*	*25.7*	*17.7*	*7.9*	*8.7*
Housing	—	*18.8*	*19.0*	*16.1*	*16.5*	*31.0*	*31.9*
Other	—	*14.0*	*12.9*	*16.4*	*16.2*	*11.0*	*11.1*
MEMORANDUM ITEM:							
Up to one year	—	18.7	8.4	12.9	11.8	23.7	23.3
At over five years	—	20.6	19.6	19.8	16.6	57.1	59.7
Total non-bank creditors	**6.5**	**5.0**	**5.4**	**6.2**	**6.6**	**100.0**	**100.0**
Repos	4.2	–8.4	–10.0	–12.0	–17.5	20.8	17.0
Deposits	7.2	8.7	9.5	11.0	12.8	79.2	83.0
General government	*9.6*	*12.8*	*22.9*	*18.1*	*14.2*	*3.0*	*3.3*
Sight deposits	*14.1*	*16.1*	*18.9*	*18.3*	*19.8*	*36.4*	*40.8*
Time deposits	*1.2*	*2.0*	*0.2*	*3.7*	*6.2*	*39.9*	*38.9*
MEMORANDUM ITEM:							
Deposits with agreed maturity ≤ two years	–4.2	–7.2	–6.8	–4.9	–0.3	86.6	75.8
Deposits with agreed maturity > two years	13.8	34.0	67.4	90.7	132.2	13.4	24.2
Non-resident non-bank creditors	11.4	7.3	14.4	16.2	36.1	9.2	10.7
Creditors in foreign currency (b)	30.7	28.4	–8.7	–16.7	–5.3	6.8	5.8
Resident deposits in branches abroad	83.9	56.6	12.9	10.3	–24.3	6.0	5.5

Source: Banco de España.

(a) Includes doubtful loans.

(b) To December 1998, loans/creditors in currencies other than the peseta. As from January 1999, loans/creditors in currencies other than the euro.

(c) Only businesses in Spain.

counted for a significant portion of this increase. The portfolio of fixed-income securities of non-resident credit institutions and of other non-residents showed an increase on 12 months earlier of EUR 14,955 million (84 % at banks). These securities already accounted for 24 % of deposit money institutions' total fixed-income portfolio, although there were notable differences across institutional groupings. For banks, the non-resident fixed-income securities portfolio represented one-third of the total, while for savings banks and credit co-operatives this figure was below 12 %, denoting a highly different degree of activity on international markets.

The item “cash and central banks“ grew moderately, offsetting the decline, owing to redemption, in Banco de España certificates of deposit with an increase in assets at the Banco de España, the result of the higher level of reserve assets demanded by the new reserve requirement set by the Eurosystem. Lastly, other assets grew strongly further to the increase in other (non-interbank) accounts with credit institutions, associated with operating changes in interbank fund transfer procedures among countries, following the start of EMU. This effect tended to soften, being counterbalanced on the liabilities side by growth of a similar amount.

2.1.2. Structure of financing

The structure of deposit money institutions' financing was affected by various factors. On one hand, tax changes and the diminished attractiveness of mutual funds, against a background of low expected returns on financial markets, prompted a significant growth in deposits. On the other, there was the effect of the changes entailed by EMU (new monetary policy implementation framework, single interbank market for the euro area), the need to raise resources to finance the growth of credit, in a context of growing external indebtedness, and the need to resolve the problem posed by the shortage of assets to offer as collateral at ESCB monetary intervention tenders. All these circumstances led to a decline in the funds raised at the Banco de España and on interbank markets, to a greater weight of debt securities issues and subordinated financing and to a notable fall in repos (9).

Deposits grew especially at savings banks and credit co-operatives, but also at banks (7 %, in the first three quarters, at banks, and 15 % and 14 % at savings banks and credit co-operatives, respectively). Under this heading there was notable growth of 19 % in sight deposits (current and savings accounts) and a recovery in deposits with an agreed maturity, where there was a turnaround involving deposits at less than two years and deposits at over two years. The latter were particularly favoured by the recent personal income tax reform and, in a single year, saw their share in total time deposits increase from 13 % to 24 % (see Table 6). Overall, the growth of deposits was assisted by the lesser attractiveness of other investment instruments, such as shares in mutual funds (owing to the less favourable outlook on capital markets) and to the switch by the public to more liquid assets, given the low interest rates prevailing. The tax changes also favoured deposits to the detriment of mutual funds (see Box 2). For the first time, the capital gains arising on the sale of investment funds are now subject to a 20 % withholding, while the corresponding withholding on returns on deposits has been cut from 25 % to 18 %. In addition, returns on deposits generated over a period exceeding two years qualify for a 30 % reduction in the tax base, which was previously not the case.

With regard to the cost of this source of financing, the interest rates on new deposit operations touched bottom in the third quarter of the year, rising slightly thereafter. As in the case of lending interest rates, the rises were sharper and swifter on longer-dated deposits, particularly on deposits at over two years.

The strong growth of non-resident non-bank creditors and the tailing off of the process of cross-border deposit delocation were also noteworthy. In the period from January to September 1999, residents' deposits in Spanish bank branches abroad fell slightly, in contrast to their sharp growth in previous years (in 1998, 53 % of the change in resident creditors materialised in branches abroad). The remuneration of the reserve requirement and the lesser relative significance of the associated tax benefits, in a context such as the present one in which interest rates are very low, would account for this fact.

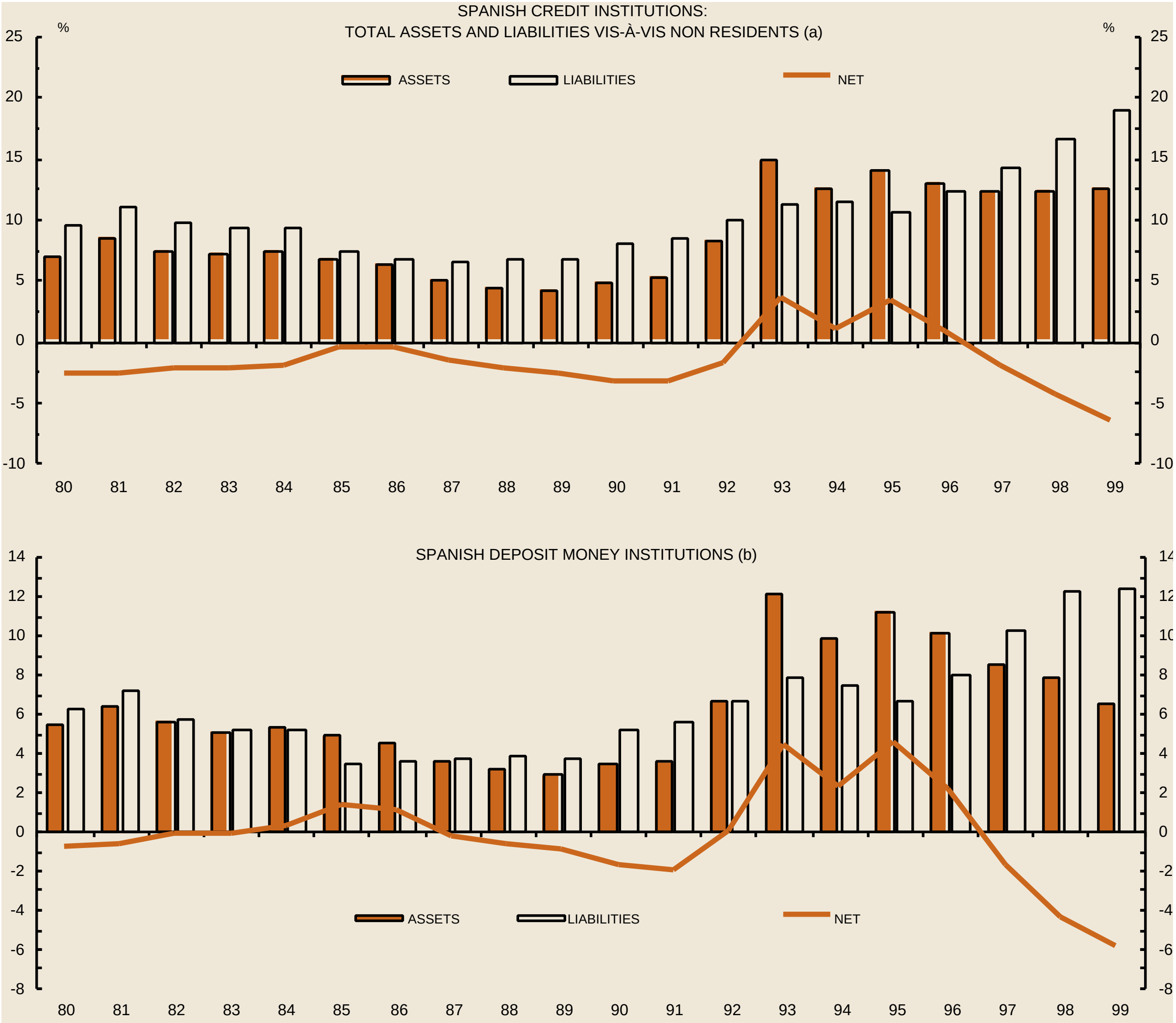
Despite the pick-up in deposits, the notable fall in asset repos (-18 %) meant that resources raised from customers grew but moderately (at around 6 %). The fall in repos was due to fewer issues of government debt, the main instrument used in such repos, to the decline in the demand for repos by mutual funds and to the need for deposit money institutions to hold securities not assigned under repurchase agreements for use as collateral at the Eurosystem liquidity tenders. In past years, banks had been in a situation in which the volume of portfolio securities susceptible to use as collateral was limited. This was due to the fact that the bulk of such instruments had been assigned under repurchase agreements either to the public or to other financial institutions. That had generated certain pressures on money markets, especially in periods in which a high volume of coupon-washing operations were taking place, reducing even further the volume of assets available. To the end of the third quarter, banks increased their holdings of private fixed-income securities and of fixed-income paper issued by non-residents (10), offsetting the fall in the stock of Ban-

(9) In overall terms, the fall in interbank liabilities could again be attributed to the effect of mergers and the diminished activity of foreign branches.

(10) In recent years, the Banco de España has progressively extended the set of assets acceptable as collateral at monetary intervention tenders to include private fixed-income and also equities. Under the new framework adopted by the ESCB, assets issued by non-residents, included in the "Tier 1" and "Tier 2" assets of the corresponding central banks, may also be used as collateral at the Banco de España.

CHART 6

Net position vis-à-vis non residents
(as % of total assets)



Source: Banco de España.

(a) Credit institutions to 1991, inclusive, and MFIs thereafter. The 1999 figure is to October.

(b) To 1996, inclusive, assets and liabilities vis-à-vis non-resident credit institutions. Thereafter, assets and liabilities vis-à-vis MFIs. The 1999 figure is to October.

co de España certificates and of government debt, and reduced repos to the public. Both factors were conducive to an easing of the shortage of securities besetting institutions. Nonetheless, the new system of ESCB monetary intervention tenders has given rise to fresh needs for institutions in respect of available securities.

Although the securitisation of loans enabled the growth of credit on the balance sheet to be reduced, customers' resources continued to prove insufficient to finance the expansion of credit. In the 12 months from September 1998 to September 1999, the main source of resources for savings banks and credit co-operatives lay in their non-bank creditors (66 % and 64 % of the total (11), respectively), while for banks these covered only 23 % of their financing requirements. For banks, the main source of financing was the interbank market (44 %). However, securities issues were relatively significant as an alternative to the interbank market. Securities issues accounted for almost 23 % of banks' total resources and for 13 % of those of savings banks, notably up on previous

(11) Defined as the change in total liabilities minus interbank assets.

periods. Moreover, a significant portion of the growth of non-resident non-bank creditors (most important at banks) corresponded to resources raised via international issues by non-bank subsidiaries domiciled in tax havens. As a result, parent bank figures would be understating the total resort to the capital markets.

Net resort to the interbank market, essentially with non-resident banks, remained important. However, one substantial difference from previous periods was that this did not lead to an increase in interbank liabilities with non-residents, but to a fall in assets. On the liabilities side, deposit money institutions raised the resources they ceased to receive from the Banco de España on the euro-area single money market, while they reduced interbank financing from outside the euro area.

Chart 6 depicts the growth of Spanish deposit money institutions' foreign interbank liabilities, which rose to over 12 % of the total balance sheet in 1998. Such a high level may perhaps explain why banks sought in 1999 to reduce their interbank assets instead of raising their liabilities further. In any event, in net terms, Spanish money deposit institutions' foreign interbank position stood at an historical high. The creation of a single interbank market in the euro area has provided for readier financing of Spanish banks abroad and lessened the significance of the overall net external position. That said, certain risks have persisted. These arise, firstly, from the fact that financing in the euro interbank market is not fully comparable, in terms of liquidity risks, to financing from the Banco de España; and secondly, because the bulk of Spanish banks' net external debit position continues to be with institutions outside the euro area.

Finally, it should be mentioned that capital and reserves scarcely grew, though subordinated financing did. In consolidated terms and with data to June 1999, the BIS ratio (12) for deposit money institutions as a whole stood at 11 %, significantly above the minimum required level (8 %). With regard to capital requirements, a consultative document was published in June this year by the Basel Committee on Banking Supervision proposing an amendment of the 1988 Accord (see Box 3).

2.1.3. Income and costs

In the first three quarters of 1999, and compared with the same period a year earlier, the operating margins of money deposit institutions continued to narrow, despite which profit before tax continued to grow (see Table 7). Once again, this was due to the performance of the items under net income. Specifically, total write-downs fell by 30 % (11 basis points in terms of ATA) as a result, essentially, of the lesser need for provisioning on securities and for country-risk provisioning. Both were relatively high in the first three quarters of 1998 owing to the Russian debt crisis and its repercussions on international stock exchanges and markets.

All three margins (net interest margin, gross margin and net margin) above the profit-before-tax item fell by approximately 10 basis points. Profit before tax, however, grew from 0.98 % of ATA to 0.99 %, whereby the pre-tax return on equity once more grew, rising from 17.1 % to 17.6 %.

The fall in net interest, as a percentage of ATA, was due above all to the continuing narrowing of spreads on lending-deposit operations in pesetas. Although the spread between lending and deposit rates on new credit and deposit operations in pesetas held relatively stable from early 1998 onwards (see Chart 7), margins still continued to fall in terms of return and average cost. This is due to the longer average maturity on loans compared with on deposits and, therefore, to the greater time elapsing before lending - as opposed to deposit - interest rates are updated. The lending-deposit spread on new operations stabilised at around 3 %; thus, unless there was a rise, there would still be room for downward movement in the average return-average cost spread (which reflects all operations outstanding), which stood at 3.5 %.

Commissions relating to the commercialisation of financial products (mutual funds in particular) and overall commissions in general continued to grow considerably (12 %). In the case of the former, however, such growth was clearly below that of the previous years. This was due to the much less expansionary course of mutual funds (see related section). The growth of commissions was checked by lower income on financial operations, as a result of which the gross income margin diminished as a percentage of ATA. Notable under income on financial operations was the negative income (of the order of EUR 500 million) arising on the trading portfolio, in contrast to the positive result of EUR 644 million in the first three quarters of 1998.

Operating expenses grew moderately (2.8 %), but above gross income. Accordingly, the overall efficiency ratio (operating expenses/gross income) worsened by more than one

(12) Own funds as a percentage of risk-weighted assets; the minimum percentage required is 8 %.

BOX 3

Proposals for reform of the Basel Accord on the capital requirements for credit institutions

Last June, the Basel Committee on Banking Supervision (BCBS) published an important consultative document containing various proposals for a new scheme of capital requirements for credit institutions and groups of credit institutions, applicable at the international level, to replace the one currently in force under the 1988 Basel Accord, as subsequently amended (1). The objective of the document is to canvass the opinions of the various sectors involved. These would then serve as the basis for the preparation of definitive proposals in the year 2000, leading to the eventual signing of a new international accord. Accordingly, the proposals are not closed, but rather very much open, with the details of many points still to be elaborated.

The 1988 Basel Accord is the basis for the current legislation on the minimum capital of credit institutions not only in the signatory countries (G 10) but also in many other countries, including those of the European Union and, therefore, Spain, so that its amendment in the near future is a matter of great importance. The purpose of the reform is, while maintaining the positive aspects (the achievement of higher levels of capitalisation of national and international financial systems, the establishment of uniform international rules), to reform those aspects that have been most problematic. These relate, above all, to the inability of the original risk classification system to discriminate adequately according to the true credit risk of each asset, which gives rise to certain perverse effects.

It should be noted, for example, that all credit risks with non-banking firms are assigned a coefficient of 100 % (2), irrespective of the firm's credit quality. This means that loans to firms with a high credit quality are subject to the same capital requirement as loans to firms of doubtful credit quality. At the same time, loans to OECD governments, by the mere fact of OECD membership, are subject to a 0 % coefficient, although the credit ratings of the OECD member countries vary considerably. The situation regarding the requirements for interbank loans is similar. These depend on whether the borrower bank is domiciled in an OECD country. These inconsistencies have resulted in the growing use by banks of regulatory arbitrage operations. For example, loans to higher-credit-quality firms, where the real risk does not correspond to the regulatory capital requirements, are securitised and only the loans with the lowest credit quality within each grouping are kept on the balance sheet. Moreover, it is argued that the current coefficients, by favouring short-term interbank loans over long-term loans, encouraged the high short-term foreign indebtedness of the banks of the Asian countries afflicted by the 1997 crisis, this being considered one of the factors contributing to the Asian crisis.

The proposed new scheme of capital requirements of the BCBS is based on three pillars:

a) the existence of certain minimum capital requirements;

b) supervision of the internal risk control mechanisms of the institutions;

c) a strengthening of market discipline.

As regards the minimum capital requirements for credit risk, three alternatives are proposed, according to the degree of development of the risk control mechanisms of each institution. In general, the BCBS proposes replacing the current scheme, based on the distinction between OECD and non-OECD countries, by a scheme based, to a greater extent, on the credit ratings assigned by rating agencies (such as Standard & Poors, Moody's and Fitch Ibca) to countries and firms (external rating). Alternatively, those institutions which demonstrate sufficient capacity for the purpose would be able to use a system based on their own credit ratings of counterparties (internal rating). Finally, the possibility is anticipated of institutions being able, in future, to use formal credit risk models to calculate their minimum capital requirements. This is not considered feasible in the short term, given the problems that still exist for the assessment of such models.

Changing to a system based on counterparties' credit ratings would certainly help to strengthen the tie between the capital requirements and true credit risk of the institutions, but would not be without problems. A first and obvious problem would be the reliability of the credit ratings and their implications in cases of sudden losses of confidence. For example, the rating agencies have been widely criticised for their inability to anticipate the problems of the Asian countries afflicted by the 1997 crisis and for their over-reaction once the crisis had begun. Against this background, to link the capital requirements of credit institutions to credit ratings could make the system even more unstable. Also, the existence of credit ratings is limited, above all, to large mainly US firms. This raises the problem of what to do about unrated firms. The proposal of the BCBS (which applies a coefficient of 100 % to unrated firms and of 150 % to firms with a low credit rating, may give rise to perverse effects on the bond market and on the incentives facing rating agencies. In any event, given all its problems, the need to change the current system is manifest, so that progress along the lines indicated by the BCBS is necessary.

A more refined measurement of credit risk must be accompanied by the consideration of other risks previously considered implicitly along with the credit risk. It is intended that the reform of the 1988 Accord should not result in an undue decline in the capitalisation of banks, with negative consequences for financial stability. The BCBS therefore proposes that the institutions should be subject not only, as at present, to the minimum capital requirements for credit and market risk, but also to capital requirements for interest rate risk in the banking book, when this is significantly higher than average, as well as for operational risks. The BCBS's June document makes proposals in this respect that are even more tentative.

In any case, irrespective of the degree of success in establishing minimum capital requirements that are truly linked to the real risk of the institutions, the growing complexity of the institution's operations makes it necessary to supplement these measures with what the BCBS calls the second and third pillars. That means promoting both internal and external risk controls, deriving from the market itself. From the viewpoint of internal control of the institutions, the supervisors should require each institution to have an internal risk-control system, supervise its operation and take effective action in the event of risk situations, with the power to require levels of capital above the minimum in the event that the situation of the institution so requires. Finally, market discipline may also play an important role in the promotion of a stable and solvent financial system, for which purpose the BCBS stresses the need to improve the transparency of the institutions. To this end, certain general binding principles could be established.

(1) "A new capital adequacy framework", Basel Committee on Banking Supervision (June 1999).

(2) This means that the general requirement to maintain a minimum volume of capital equivalent to 8 % of risk positions is fully applied. When the coefficient is 20 %, for example, a volume of capital equivalent to 1.6 % (20 % * 8 %) of the risk exposure is required.

TABLE 7

Deposit money institutions
Structure of the profit and loss account

% of average balance sheet

	Total		Commercial banks		Savings banks	
	1998	1999	1998	1999	1998	1999
	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP	JAN-SEP
(+) Interest income	5.80	4.72	5.71	4.64	5.93	4.81
(–) Interest expenses	3.50	2.51	3.82	2.84	2.96	2.02
Net interest income	**2.30**	**2.21**	**1.90**	**1.80**	**2.96**	**2.79**
(+) Net commissions	0.66	0.70	0.67	0.74	0.63	0.64
(+) Income on financial operations	0.14	0.07	0.14	0.06	0.16	0.09
Gross income	**3.10**	**2.98**	**2.71**	**2.61**	**3.75**	**3.52**
(–) Operating expenses	1.99	1.95	1.74	1.73	2.39	2.27
Net income	**1.12**	**1.03**	**0.96**	**0.88**	**1.36**	**1.25**
(–) Write-downs and privisions	0.36	0.25	0.35	0.19	0.41	0.35
(+) Other income	0.23	0.21	0.19	0.15	0.31	0.32
Profit before tax	**0.98**	**0.99**	**0.81**	**0.83**	**1.26**	**1.22**
MEMORANDUM ITEM:						
Average total assets (EUR m)	**894.390**	**936.947**	**573.331**	**579.859**	**292.002**	**325.139**
Growth rates:						
Total assets	8.5	4.8	8.3	1.1	8.8	11.3
Net interest income	5.2	0.5	9.5	–3.6	0.8	4.9
Gross income	5.6	0.7	6.7	–2.3	4.4	4.4
Net income	8.4	–3.0	15.3	–7.6	1.5	2.1
Profit before tax	11.8	6.3	12.7	4.8	11.3	7.8
Profit before tax						
% of capital and reserves	17.1	17.6	15.4	16.6	19.7	19.1

Source: Banco de España.

percentage point, shifting from 64 % to 65.3 %. This deterioration occurred at all groups of institutions, except credit co-operatives. The divergence between operating expenses at banks and at savings banks also persisted. While savings banks continued to pursue their policy of expansion, banks were applying a staff restructuring policy, meaning that the growth of their operating expenses was very low. Nonetheless, the higher growth of ATA at savings banks meant that operating expenses as a proportion of ATA were falling to a greater extent at savings banks than at banks.

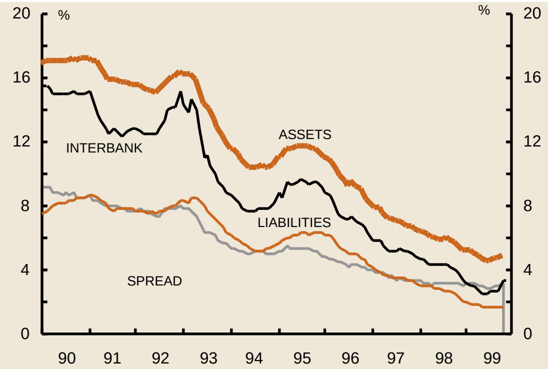
As a result of the foregoing, the net income of deposit money institutions as a whole fell 3 % in the first three quarters of 1999, compared with growth of 8.4 % in the same period in 1998. The sizeable fall in loan and securities write-downs, together with income arising on securities and property sales (accounting for 18 % of profit before tax) and other results meant profits continued growing in 1999, albeit at a lower rate than in 1998.

However, loan write-downs were now standing at very low levels. Moreover, given the maturity of mutual-fund business, such strong growth in commissions as that observed in the recent past would not be foreseeable, and income relating to financial operations was characterised by its erraticism. Consequently, it was likely that banks would not be able in the future to offset fresh reductions in the spread between lending and deposit operations with customers with the foregoing factors, as they had done in the past. That said, they could make use of the strong, unrealised capital gains built up in their portfolios (which accounted for 3.3 % of total ATA)). But, in any event, the offsetting of a potential narrowing in the net interest margin should reside increasingly on the control of operating expenses.

Admittedly, the reduction in write-downs on the credit portfolio was partly due to institutions' improved procedures for monitoring credit risks. But it likewise reflected the strong anti-cyclical character of the default rate and the existence of a regulation on provisions for loan losses requiring that institutions should make provision only as and when debtors incurred delays in respect of their payment obligations. Generally, in the developed countries, credit institutions' provisions for loan losses show a much more stable time profile than in the Spanish case and, at present, a higher level of provisioning. In this respect, the Banco de España recently (13) approved an amendment to Accounting Circular 4/1991. Specifically, it addresses the setting up of a fund for the statistical coverage of loan losses. The aim of the new regulation is that institutions should set aside provisions during periods of buoyant economic activity, in which the cost of provisioning is lower owing to the existence of higher profits, and to which they may resort in periods in which the default rate rises and profits are lower.

CHART 7

Bank interest rates.
Commercial and savings banks



Source: Banco de España.

2.2. Other financial intermediaries

This section analyses recent developments at the so-called institutional investors, i.e. mutual funds, pension funds and insurance companies (14). The weight of this group of institutions in the financial system has progressively increased as a result of very strong growth in recent years, especially in the case of mutual funds. The growth of this type of financial intermediary is playing, and will continue to play in the future, a pivotal role in the development of Spanish capital markets. The high volume of assets they manage means they are key players in such markets. Moreover, they contribute to increasing the range of investment opportunities for the public in general. In this connection, various measures have been introduced in recent months. These are aimed at providing for the development of new vehicles, such as funds of funds and subordinate and principal funds; at adding flexibility to investment opportunities and to the workings of mutual funds investing in government securities and of real-estate portfolio investment institutions; at adapting the regulations governing venture capital companies; and at improving investor-information procedures.

2.2.1. Mutual funds

In terms of collective investment, mutual funds are the most developed segment in the Spanish economy. Indeed, they have reached a significant degree of maturity. The net asset value managed by mutual funds in the first quarter of 1999 amounted to 41 % of GDP, compared with 68 % in the United States or 22 % in the United Kingdom, according to data from the European Federation of Collective Investment Institutions. Other European countries such as Italy or France, in which mutual funds have also grown strongly in recent years, stand at a similar level to Spain, while in Germany or Japan, mutual funds are much more under-developed (less than 10 % of GDP). In relation to bank liabilities, the net asset value of mutual funds in Spain as of September 1999 accounted for almost 40 % of deposit money institutions' total non-bank creditors.

On provisional INVERCO data for September 1999, the net asset value of mutual funds (FIAMMs and FIMs) had grown by only EUR 1.5 billion in the first three quarters of the year. This was the result of a decline of EUR 6.3 billion in FIAMMs and an increase of EUR 7.8 billion in FIMs. This signified a very small increase in the net asset value of mutual funds, after several years' strong and continuous growth (up EUR 41 billion in 1998 and 50 billion in 1997). Indeed, in the third quarter of the year, the net asset value had even fallen (see Chart 8). As regards the other collective investment institutions, the information available from the CNMV (Spanish National Securities Market Commission) for June 1999 highlighted the continuing strong growth rates of the net asset value of open-end investment companies (SIMCAV by their Spanish name) and of real-estate

(13) At the meeting of its Governing Council on December 17th 1999.

(14) Other financial intermediaries such as securities-dealer companies and agency brokers are not considered in this paper since, by virtue of the nature of their activity, the volume of their financial assets and liabilities accounts for less than 1 % of the financial sector's (credit institutions and insurance companies) total financial assets and liabilities.

mutual funds (FIIs), albeit from very low starting points. Conversely, the expansion of the business volume in Spain of foreign collective investment institutions moderated considerably in the first half of the year. Overall, closed-end investment companies (SIMs), SIMCAVs, FIIs and foreign collective investment institutions accounted, in June, for 7 % of the total net asset value of FIMs and FIAMMs.

The scant growth of mutual funds may be attributed both to the small volume of net subscriptions and to the decline in capital gains arising on valuation changes. Several factors contributed to detracting from the attractiveness of investment in mutual funds and in domestic financial instruments in general. These were, namely: the low level of short-term interest rates; the expectations, first, and the realisation, subsequently, of capital losses on fixed-income funds, as a result of the rise in long-term interest rates; and the erraticism of Spanish share prices during the course of the year. Further, as earlier indicated, the onset of 1999 saw a change in the tax arrangements for mutual funds. While not ceasing to be favourable to these funds, the arrangements did make them somewhat less competitive compared with other alternative investments such as deposits or insurance. As a result, and drawing on CNMV data, the volume of net subscriptions to mutual funds fell to EUR 6.7 billion in the first two quarters of 1999 compared with the figure of over EUR 28 billion for the previous year. And, on provisional figures, the volume turned negative in the third quarter. After several years' strong growth, the fall in the volume of net subscriptions is consistent with the degree of maturity attained by the mutual funds sector in the Spanish economy.

As was the case in 1998, the low levels of interest rates on short-term investments and public debt drove investors to demand (and fund managers to offer) funds with a slightly higher risk profile in exchange for correspondingly higher expected returns. Accordingly, there continued to be a net withdrawal of shareholders from FIAMMs throughout this period, while the number of shareholders in FIMs increased. Although the current situation of the equity and long-term bond markets may lead mutual fund shareholders to adopt a somewhat more conservative attitude, a return to the fund structure of some years back -when very short-dated investments in domestic public debt predominated- is not expected. The present structure, which is much more diversified in terms of maturities and risks, is not only more consistent with a medium-term time horizon, typical of fund investors, and with the growth of domestic and euro-area capital markets; it is, moreover, in line with developments on the other European markets.

In the first two quarters of the year, on CNMV data, a notable 42 % of net subscriptions captured by FIMs were for funds described as international according to the new CNMV classification (15). Overall, these funds already accounted in June for 12 % of the total net asset value of FIMs (9.1 % in December 1998). Furthermore, grouping together the types of funds defined by the CNMV on the basis of whether they are pure fixed-income, mixed, pure equity or guaranteed, the bulk of the new resources raised by the funds were invested in mixed funds (72 %), with 20 % routed into pure equity funds and less than 5 % into pure fixed-income funds and guaranteed funds alike (due in this latter case to the decline in fixed-income guaranteed funds). However, in terms of cumulative net asset value as of June 1999, pure fixed-income funds, mixed funds and guaranteed funds each accounted for approximately 30 % of the total net asset value, with the remaining 10 % represented by pure equity funds (8.7 % in December 1998).

Turning to FIAMMs, there was, as is discussed elsewhere in this report, a shift towards international instruments. But this phenomenon was centred on the euro area which, for portfolio risk purposes, is currently on an equal footing with domestic investments. The group of FIAMMs investing more than 5 % of their portfolio in assets not denominated in euros accounted for only 0.3 % of the total net asset value of FIAMMs as of June 1999.

With regard to the breakdown of funds by financial group (banks, savings banks, etc.), there were no significant differences from one group to another in the first two quarters of the year. Consequently, banks retained the leading position in mutual fund-related business, with 63 % of the total net asset value of FIMs and FIAMMs as of June 1999, with savings banks (29 %) following. The possibility of major future growth in unit-linked funds leading to greater participation of insurance companies in the management of mutual funds is limited by the fact that a majority of the insurance companies that offer unit-linked funds are subsidiaries of deposit money institutions. As a result, the management of these funds tends to be entrusted to the corresponding fund manager of

(15) Fixed-income or mixed fixed-income funds with a volume of assets in currencies other than the euro of over 5 %, equity funds or mixed equity funds with a volume of assets in currencies other than the euro of over 30 % and global funds, i.e. those with no defined investment policy and which, therefore, may invest in any market.

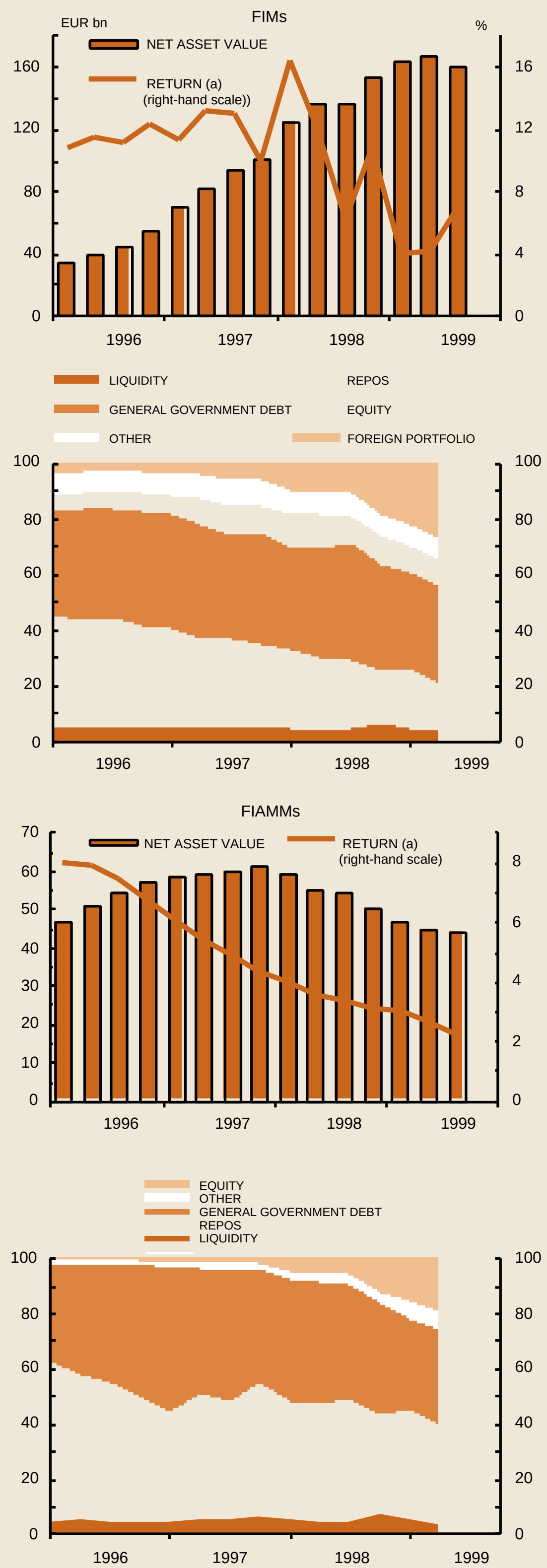
the banking group. International fund managers, who might gain in prominence as a consequence of the demand by shareholders for portfolios that are more diversified internationally, are faced with the problem of competing with the distribution network of national deposit money institutions.

Analysis of the assets in which FIMs and FIAMMs invest the funds raised from shareholders reveal, logically, that these are greatly influenced by the relative performance of the different types of funds. Hence, in recent years, there has been a progressive increase in assets with a higher level of risk and return and in international assets. The process of internationalisation has quickened significantly since the last quarter of 1998 and during the first two quarters of 1999 (see Chart 8). This process is closely connected with the start of EMU. Thus, of the 26.4 % of the total net asset value of FIMs accounted for by the foreign portfolio as of June 1999, 74 % related to euro-denominated instruments. The process was also intense in FIAMMs. Whereas the foreign portfolio accounted for only 1.6 % in December 1997, by June 1999 this figure stood at 19.6 % of the total net asset value (93 % of which in euros). Foreign instruments in euros virtually doubled in the period from January to June in 1999, in FIMs and FIAMMs alike; on the contrary, foreign instruments in currencies other than the euro fell over the same period as a result of an increase in equity and a decrease in fixed income from outside the euro area. This strong rise in assets in the euro area shows Spanish fund managers have adapted rapidly to the risk diversification possibilities offered by EMU (e.g. in equity or in private fixed income) but, above all, it highlights the shortage of negotiable securities on domestic markets. For FIAMMs, for instance, the negative net issues of Treasury bills made it necessary to seek out alternative low-risk short-term assets in which to invest. EMU has offered them the possibility of investing in other countries' short-term government debt securities, free from exchange risk, thereby explaining the strong growth of their foreign assets in euros.

Also notable in connection with the performance of FIMs' portfolio at net realisable value in the first half of the year was the moderate growth of domestic equity (dipping from 10.1 % of the total net asset value in December 1998 to 9.4 % in June 1999). This was in comparison with foreign equity instruments from the euro area and from outside the euro area, which increased by three points as a percentage of net asset value (from 5.6 % to 8.6 %), and the highly significant growth of short-term private fixed-

CHART 8

Mutual Funds



Sources: CNMV, INVERCO and Banco de España.
(a) Cumulative return over past twelve months.

income instruments, the result of the renewed vigour of the domestic market for commercial paper. Conversely, repos continued to decline in absolute terms, as did Treasury bills and long-term private fixed-income instruments. In FIAMMs, repos and government debt also fell and private fixed-income instruments grew.

2.2.2. Pension funds

In December 1998, the net asset value of pension funds accounted for 5.7 % of Spanish GDP, far below the related figure for mutual funds. This underscores the fact that their development in Spain has been much slower than that of mutual funds. Although their level is comparable with that of most of the major European countries such as Germany, France or Italy, it is far below that of countries such as United States, United Kingdom or Netherlands, where the related percentage exceeds 70 % (INTERSEC data).

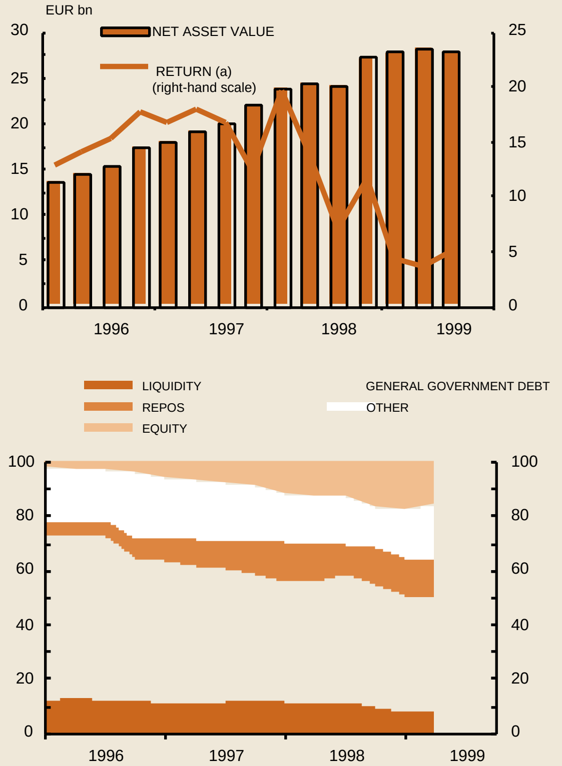
On provisional INVERCO data to September, the growth rate of pension funds also fell in 1999. However, they did so to a lesser extent than mutual funds. In the first nine months of 1999, the net asset value of pension funds increased by EUR 837 million, somewhat less than half the growth recorded in the same period in 1998 (EUR 2,196 million), but somewhat over half the growth of the net asset value of mutual funds in the same period.

Gross (net) contributions in the aforementioned period, estimated drawing on a representative sample of 85 % of total net asset value, amounted to EUR 2,950 (1,010) million. Although there is no comparable information for 1998, comparing the year-on-year growth rate of net asset value (which includes net contributions plus revaluation) with the cumulative return over the past twelve months allows the course of net contributions to be approximated. Under this hypothesis, contributions to pension funds in the first three quarters of 1999 would have fallen slightly, with the heavy decline in returns most accounting for the lower growth of net asset value (see Chart 9). In any event, a considerable portion of contributions to pension funds is concentrated in the final quarter of each year, as a result of which the other quarters may not be sufficiently significant.

With a view to the future, the prospects for pension funds growth remain favourable. In addition to demographic factors and the growth in disposable income to invest, as a consequence of the growth of national per capita income, the recent publication in the BOE (Official State Gazette) of the regulation on the mandatory

CHART 9

Pension funds



Source: INVERCO and Banco de España.
(a) Cumulative return over past twelve months.

"externalisation" of companies' pension commitments to their employees (the transfer of in-house provisions to an external pension fund or insurance company) should be conducive to the continuing growth of employee schemes in the future.

The breakdown of the portfolio of pension funds was along similar lines to that of FIMs. The share of both equity and foreign instruments increased at the expense of government debt, albeit less markedly so than at FIMs (see Chart 9). One particular contrast was discernible in the fact that the relative growth of the foreign portfolio slowed, according to the data available and unlike in mutual funds, in the period under analysis after having run very high in 1998. Foreign assets thus moved from accounting for 16.7 % of the total net asset value in December 1998 to 16 % in June 1999, with a slight decline in the fixed-income foreign portfolio and a marginal increase in the equity foreign portfolio. This was consistent with the developments observed in FIMs' portfolio in currencies other than the euro. Accordingly, it appears that the difference might have been due to the be-

TABLE 8

Insurance companies (a)

	1995	1996	1997	1998
INDICATORS OF ACTIVITY (b):				
Premiums written	1,9	12,1	8,5	8,2
Life	*-4,2*	*20,9*	*16,8*	*7,7*
Non-life	*6,7*	*6,0*	*2,0*	*8,7*
Technical reserves	18,3	18,2	17,3	15,2
Actuarial reserves	*22,5*	*23,1*	*21,8*	*17,1*
Other reserves	*9,5*	*6,4*	*5,0*	*9,0*
Net investments	24,8	19,1	18,2	12,3
STRUCTURE OF GROSS INVESTMENTS (c):				
Tangible invesments	9,2	7,9	7,1	6,3
Loans and credits	2,6	2,1	1,6	1,8
Equity portfolio	5,7	5,4	5,3	5,9
In related companies (d)	*3,3*	*3,5*	*3,1*	*2,9*
Other equity	*2,4*	*1,9*	*2,2*	*3,0*
Fixed-income portfolio (e)	57,7	51,2	51,9	56,3
Deposits (f)	2,6	3,6	4,1	9,7
Indexed securities (g)	—	—	—	0,6
Shares in mutual funds (g)	—	—	—	5,2
Other financial investments	22,2	29,7	30,1	11,2
Investments for the account of policyholders (h)	—	—	—	2,9

Sources: Dirección General de Seguros and Banco de España.

(a) To 1997, rates and ratios refer to the business in Spain of public limited companies, mutual insurance companies and foreign branches; in 1998, to the total business of public limited companies and mutual insurance companies.
(b) Annual % growth rates.
(c) As % of total.
(d) Shares in group and associated companies.
(e) To 1997, included only long-term securities. Short-term securities (Treasury bills) appeared under other financial investments.
(g) Items previously included under other financial investments.
(h) Insurance in which the policy-holder assumes the investment risk (unit-linked funds).

haviour of the foreign portfolio in euros. In pension funds, the lesser volume of funds in absolute terms and the greater liberty to invest in whatsoever instruments lessened the problem of the shortage of negotiable instruments and, therefore, alleviated the need to resort to other fixed-income markets in the euro area.

2.2.3. Insurance companies

The volume of premiums issued by insurance companies has, as a percentage of GDP, grown continuously in recent years. Life assurance has contributed most significantly to this, with mixed products combining insurance elements with saving aspects and, therefore, competing directly with other financial intermediaries. The prospects are for such growth to continue in the future. On EUROSTAT data, the volume of Spanish insurers' premiums accounted for 5.4 % of GDP in 1997, while the related figures for United Kingdom, France, Germany and Italy were 11.7 %, 9.9 %, 6.4 % and 4.2 %, respectively. Specifically, Spain stood above Italy but below the other three countries.

Various events have arisen over recent months that might prove favourable to the insurance business. First, in the tax domain, the personal income tax reforms in place since the onset of 1999 have entailed certain benefits for saving products linked to life assurance (see Box 2). In this same area, the treatment for tax purposes of insurance policies invested in unit-linked funds and whose risk is assumed by the policy-holder has been clarified. Such instruments are considered, under certain conditions, as insurance products and are entitled, therefore, to the related tax benefits and to the possibility of switching funds at no tax cost. Finally, the recent approval of the above-mentioned regulation on the "externalisation" of companies' pension commitments is a further factor that may be conducive to group life assurance policies being taken out.

The short-term economic information on insurance usually appears with some delay. The latest official DGS (Directorate General for Insurance) data are for year-end 1998. Table 8 shows some of the most relevant aspects of activity in this sector. In any event, it should be mentioned that 1998 saw a change in the chart of accounts for insurance companies, along with changes in the scope of the DGS statistics. Consequently, comparisons with previous years occasionally prove difficult.

Taking the total insurance activity of public limited companies and mutual insurers in both Spain and abroad, the volume of premiums issued was EUR 25,651 million in 1998. Of this amount, EUR 12,164 million related to the life sector and EUR 13,488 million to non-life insurance. This volume of premiums signified year-on-year growth of 8.2 %, similar to that in 1997. However, unlike what had happened in previous years, growth was distributed almost evenly between life and non-life business. That meant lower growth in life business and, consequently, in the mathematical provisions and in the stock of investments by insurance companies (see Table 8). In any event, such investments amounted to more than EUR 63 billion, a higher volume than that of FIAMMs and over twice the net asset value of pension funds.

The lower growth of life assurance in 1998 might have been due to the uncertainty surrounding its future tax treatment and to the lesser attractiveness of mixed saving-insurance products, as a result of low interest rates. Some of this uncertainty may have run into the first half of the current year. Nonetheless, in the third quarter there was a very significant pick-up further to which, according to employers' association data for bancassurance firms, premiums issued by their associates (comprising around 60 % of total life business) grew 22 % over the course of the first nine months of the year in relation to the same period a year earlier.

Regarding the breakdown of insurance companies' investment portfolio, the change in the chart of accounts entailed a break in many of the items from 1998 onwards (see Table 8). However, of note were the continuing fall in the relative weight of tangible investments, the growth of the equity portfolio and the relevance acquired by shares in mutual funds (5.2 % of the total) and the growth of investment on behalf of policy-holders. Included under this latter category are investments in unit-linked funds (2.9 % of the total).

22.12.1999.

ANNEX 1

COMPARISON OF THE DEVELOPMENT OF BANKS AND SAVINGS BANKS

The purpose of this annex is to analyse briefly the main differences in the recent development of the two main groups of credit institution in Spain (banks and savings banks). A comparison is made of the changes in the structure and main headings of their balance sheets and in the main components of their profit and loss accounts between 1995 and the third quarter of 1999 (the latest period for which data is available). Broadly, it can be stated that during this period the differences in the productive specialisation of banks and savings banks have not been reduced appreciably, with the latter concentrating relatively more on retail activity. This specialisation is the main factor explaining most of the differences that are discussed in more detail below.

Structure of the balance sheet and its main components

As can be seen in Chart A1, between 1995 and 1998 the total balance sheets of the banks and savings banks, in terms of GDP, grew similarly, with the larger relative size of the former clearly maintained. In 1999, however, while the total balance sheet of the savings banks rose slightly, that of the banks fell by almost four percentage points. The reasons for this fall have already been discussed in detail in the main body of the text.

As regards balance-sheet structure, the main differences between these two groups have traditionally consisted in savings banks' greater specialisation in retail business, with a predominance of loan/deposit activity as against interbank- and wholesale-market intermediation. As a result, the relative weight of loans is much lower in the banks' balance sheet, currently standing at an average of slightly more than 40 % of total assets while in savings banks it exceeds 56 %. Also, the higher relative weight of customer deposits in the balance sheet of savings banks is notable (above 70 % of total liabilities, as against more than 45 % in the case of banks).

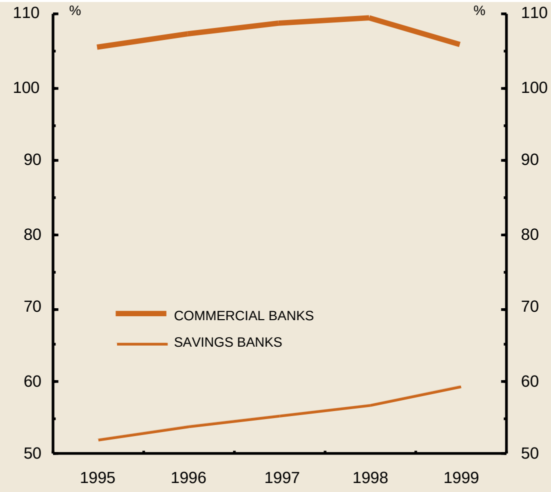
During the period analysed, the differences in the structure of the business of these institutions have only been reduced in relative terms, with a certain increase in the weight of the lending and deposit activity of banks, at the expense of interbank balances. The savings banks, meanwhile, have recorded a continuous increase in the weight of interbank financing, as a consequence of the low growth in their deposits relative to their lending. It should be stressed that the growth in the total lending of savings banks clearly exceeded that of banks in the period analysed. The latter grew at annual rates of around 10 %, and the former at rates between 10 and 17 %.

As can be seen in Chart A2, this strong growth in lending has only given rise to a relative reduction in the differences between the banks and savings banks in relation to the distribution of lending both in terms of risk type and purpose. Despite the significant growth in banks' secured lending and housing loans, loans to finance productive activities and unsecured lending continued to be the main components of their lending. In the case of savings banks, there was also a relative increase in unsecured lending and loans to finance productive activities, although they did not reach the same relative weights as secured lending and housing loans. The strong growth in savings banks' lending to non-residents, at rates of more than 30 % during the period, is notable. This reflects the progressive internationalisation of the activity of these institutions. However, the importance of lending to non-residents by savings banks, at around 1 % of the total balance sheet, is still well below the weight of such lending by banks, at almost 5 % of the total balance sheet.

As already mentioned in the main text, the strong growth rates recorded for lending were not matched by comparable growth rates for deposits. This forced both banks and savings banks to resort to alternative sources of financing to cover the growing gap between these two items. Chart A3 shows how the gap between lending and deposits was financed by the banks and savings banks. The former made greater use of interbank borrowing from non-resident credit institutions, while the latter, although they also used this method, chose to reduce their lending positions with resident credit institutions. It should be stressed that in 1999 the component responsible for the imbalance between the growth of investments and resources was not lending and deposit activity but rather the strong growth in the securities portfolio net of repurchase agreements. The factors explaining these developments have already been mentioned in the main text of the report, but it is worth pointing out the difference in the composition of this increase in the portfolio of the banks and savings banks, since in the former there was an increase in the portfolio of fixed-income securities, particularly those issued by non-residents and, to a lesser extent, a fall in outstanding repurchase agreements, while in the savings banks the reductions in outstanding repurchase agreements and the increase in the equity portfolio were the two items contributing to the growth in the securities portfolio net of repurchase agreements. This could reflect a specific strategy on the part of savings banks. In this respect, it should be noted that the shareholdings of savings banks in non-financial firms rose from 1.35 % of their total balance sheet in 1995 to 2.56 % in the third quarter of 1999, reaching levels similar to those recorded by the banks.

CHART A.1

Total balance sheet as % of nominal GDP

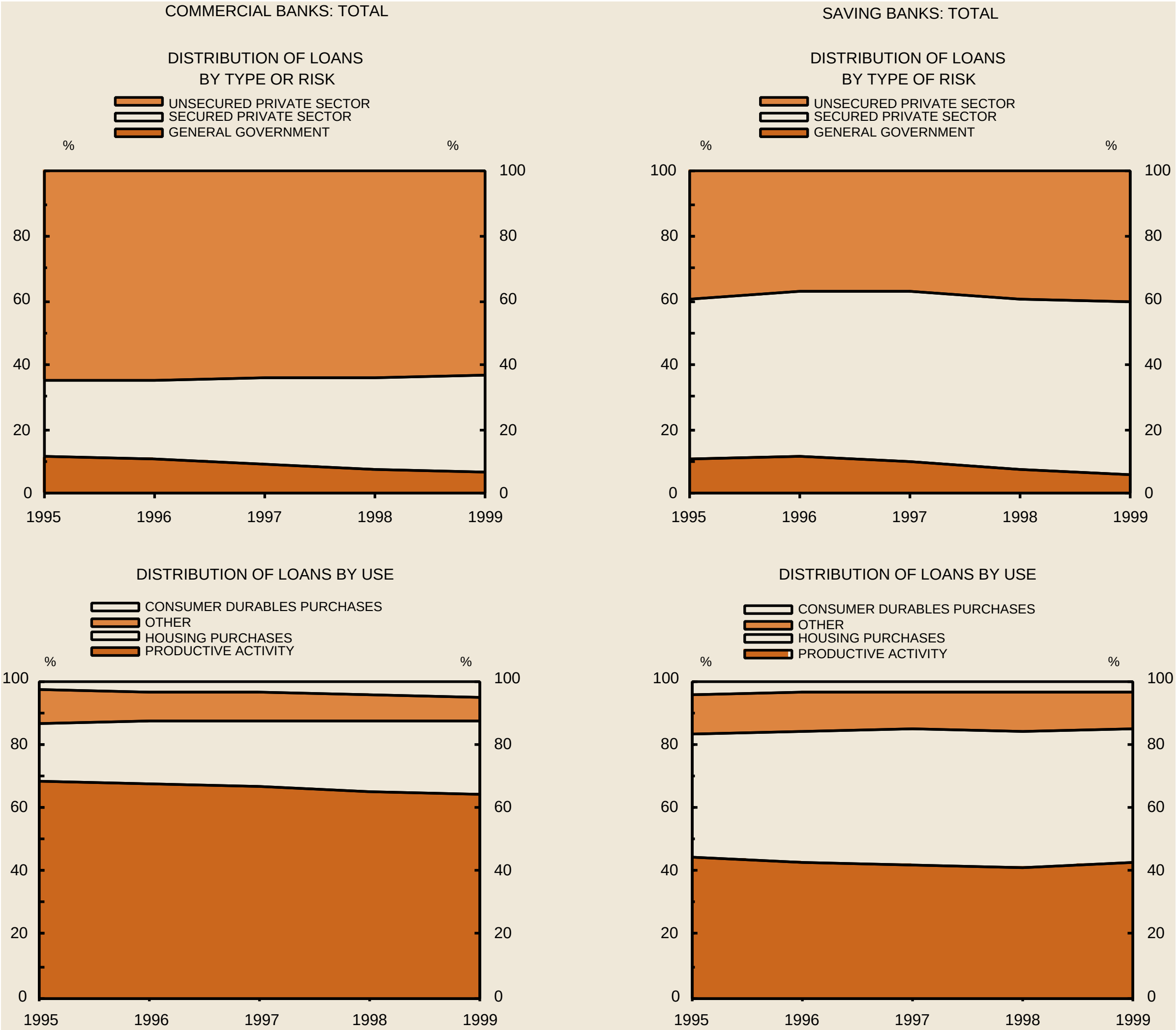


Source: Banco de España.

In any event, a clear result of the widening of the gap between lending and deposits has been a deterioration in the net external position of banks and savings banks, with the deterioration in that of the bank's being greater. There were, however, notable differences in the change in composition of this net external position. In the case of banks, there was a similar deterioration in the position vis-à-vis euro-area residents and vis-à-vis the residents of other countries, although the position vis-à-vis the former deteriorated slightly more than that vis-à-vis the latter in 1999. In the savings banks, in 1999, there was an improvement in the net position vis-à-vis euro-area residents which was offset by a larger deterioration in the position vis-à-vis the residents of other countries. Accordingly, although both groups of institution resorted to foreign borrowing to cover the gap between the growth in their investments and deposits, the composition of this borrowing differs. In the case of the banks funds obtained in the euro area, probably denominated in euro, predominate. In the case of the savings banks, borrow-

CHART A.2

Financing the gap between the flow of lending and the flow of deposits



Source: Banco de España.

ing from the residents of countries outside the euro area, probably denominated in US dollars, predominates. However, although the financing of savings banks could be considered more risky due to the exchange risk involved (assuming that this risk has not been hedged) the amounts of the same are much lower than those of the banks and hardly represent 1.4 % of the total balance sheet.

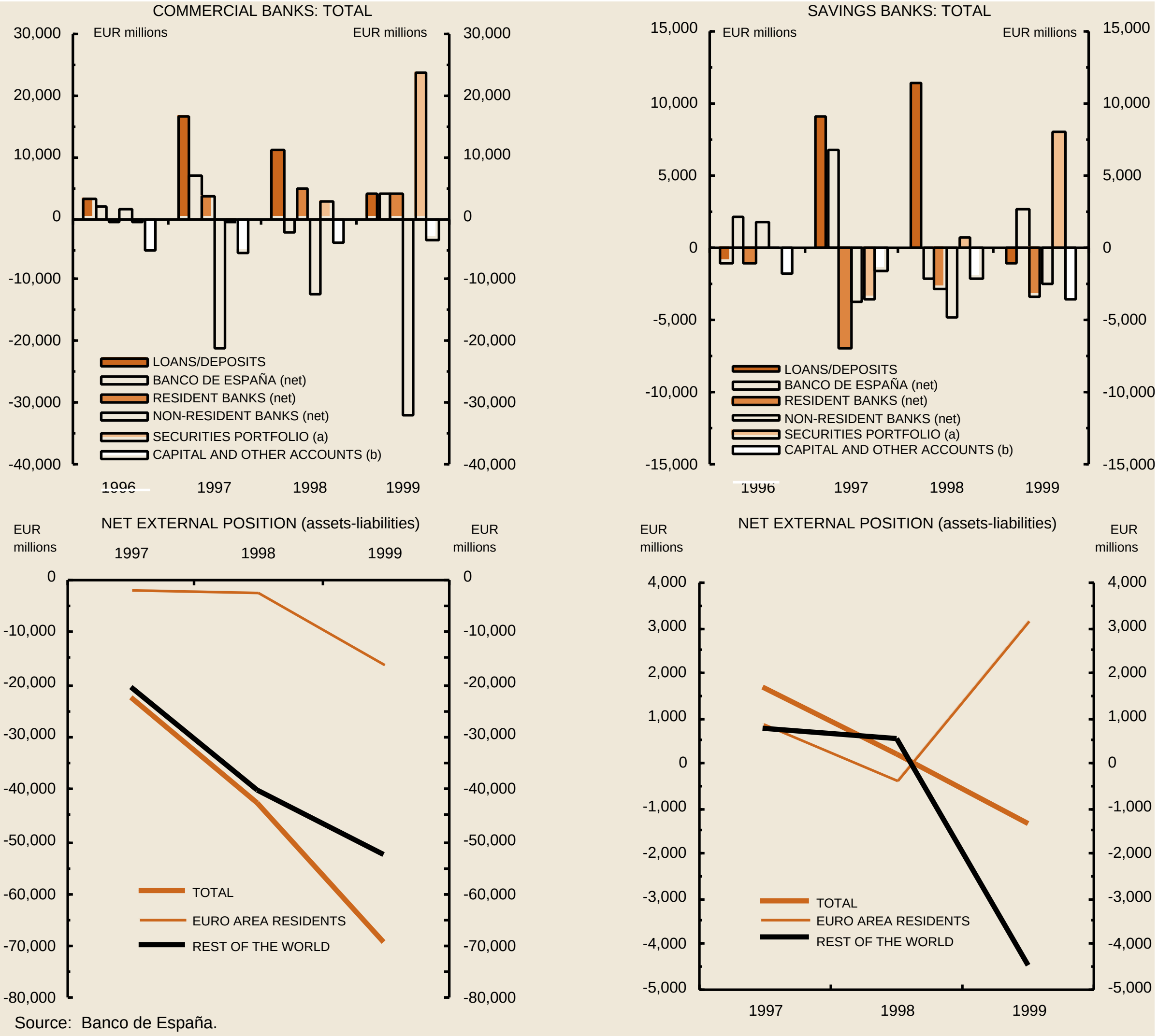
Profit and loss account

Analysis of the main headings of the profit and loss accounts of banks and savings banks showed that the trends in the two groups of institutions in the period analysed were very similar. There was a tendency for operating margins (the gross margin and net interest margin) to fall, which was offset by a relative decline in operating costs and an improvement in the components of the profit and loss account below net income, as mentioned in the report. However, there are certain notable differences between the two groups owing to the different structure of their business.

As can be seen in Chart A4, the margins of savings banks are still higher than those of banks, as a consequence of the greater weight in their business of lending and deposit activity, in which margins are highest. Moreover, in

CHART A.3

Lending activity



Source: Banco de España.

(a) Fixed-income securities of all resident sectors and non-residents, except Banco de España and equities, less sales to the public under repurchase agreements.

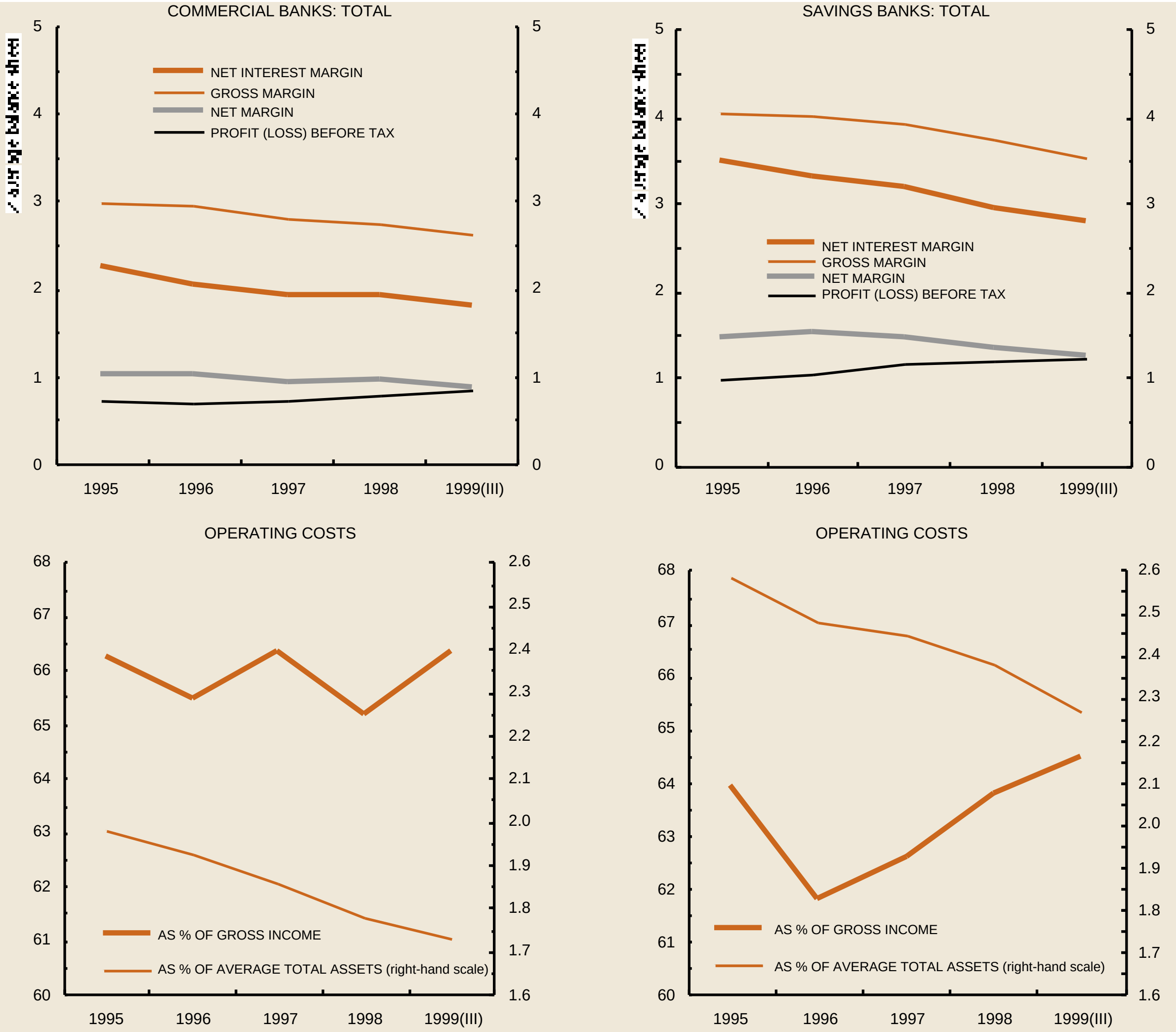
(b) Net of other accounts, own funds and special funds.

the case of savings banks, the margin obtained in this activity is slightly higher than that obtained by banks, probably because of the higher weight in their loan portfolio of loans to individuals which have higher margins than loans to large firms. However, the savings banks are losing this advantage in their margins. During the period analysed the savings banks' margins fell by more than those of the banks: the savings banks' net interest margin fell by 70 basis points, their gross margin by 46 bp and their net margin by 21 bp, while the banks' fell by 46 bp, 38 bp and 13 bp, respectively. Other factors that help to explain these developments include the greater specialisation of the savings banks in lending and deposit activity, which saw the largest falls in operating margins, a larger fall in the margin obtained in the cash operations of the savings banks and the smaller increase in their fees and commissions.

These higher margins in the case of the savings banks in no way reflect a lack of competition or the existence of any kind of segmentation in the markets. As Chart A4 also shows, when operating costs are taken into account, banks and savings banks have much closer ratios. The explanation for these results lies largely in the differences in the structure of the business of the two groups of institution which have been mentioned above. The larger weight of re-

CHART A.4

Margins and operating costs



Source: Banco de España.

tail activity in the business of the savings banks means that the assets managed per employee are lower than those of the banks where, given the higher relative weight of wholesale activity, the volume of assets managed per employee is much greater. The corollary of this is that retail activity has higher margins. Moreover, It should not be forgotten that there is no legal limitation on banks or savings banks preventing them from concentrating on whichever segment (wholesale or retail) they should wish to. Accordingly, in the present highly competitive environment, the productive specialisation mentioned on various occasions in this annex cannot be attributed to the existence of segmentation in this market.

Indeed, although operating costs (as a percentage of the total balance sheet) have fallen continuously both in banks and savings banks, the reduction has been slightly greater in the latter. The main item explaining this difference is communication and data processing costs, so that very possibly the ultimate reason is the lower impact on savings banks of adaptation to the euro and year-2000 compliance. This could be explained by the fact that a significant part of the adaptation has affected shared systems operated by CECA (Spanish Confederation of Savings Banks), which has helped to reduce the costs involved.

It is interesting to note also that the trends in employees and branches have also differed between banks and saving banks. Although the ratios of total assets to branches and to employees have grown similarly in banks and savings banks, there have been notable differences in the way it which these increases have been achieved. In the case of savings banks the increase has been achieved through an expansionary policy that has increased both the number of branches and employees, while in the case of the banks both these variables have been reduced in absolute terms. As is to be expected given their productive specialisation discussed above, the banks still have higher ratios than the savings banks.

Results of non-financial firms in 1998 and in the first three quarters of 1999 (1)

1. INTRODUCTION

At the same time as in previous years, the Banco de España hereby presents the results of the Central Balance Sheet Office Annual Survey (CBA) for the latest completed year (in this case 1998), and those of the Central Balance Sheet Office Quarterly Survey (CBQ) for the first three quarters of the current year (1999).

The annual CBA data for 1998 confirm what was indicated by the CBQ sample of firms in March 1999, and which subsequent information has been confirming, namely that economic growth, based on the healthy performance of final consumption expenditure and on capital investment, firmed in 1998. The slowdown in exports in 1998 was reflected in the activity of the CBA firms belonging to the sectors most open to foreign markets, in particular manufacturing, where value-added actually fell from the fourth quarter of 1998. Against this backdrop, 1999 commenced amid relative business uncertainty, which translated into more moderate growth in productive activity in the first few months of the year than in the previous year. Compared to the same period a year earlier, in the first three quarters of 1999 there was a decline in the rate of growth of the nominal GVA of the CBQ firms. This reflects the effect of the fall in the prices of certain output (charges in the communications sector) and the rise in the prices of certain inputs (of the oil refining sector). Removing these effects, the positive performance of activity in the third quarter continues to be based on the behaviour of demand and on a progressive recovery in the external sector.

As was also anticipated with the presentation of the CBQ data for the fourth quarter of 1998, the CBA results now confirm that growth in productive activity during 1998 was accompanied by strong employment growth in the reporting firms. Personnel costs rose both in 1998

(1) The information published in this article relates to the 5,877 firms which voluntarily sent their data to the Central Balance Sheet Office (the CBA survey) to October 29th, and to the 763 firms which, on average, sent their data to the Central Balance Sheet Office (the CBQ survey) to November 17th 1999. In the first case, the firms reporting to the CBA account for 34.7% of the total activity of the non-financial firms sector (measured in terms of gross value added at factor cost, GVA), while in the case of the CBQ the coverage is 16.2%. The information collected by the CBA is received with a greater delay than that of the CBQ (the lag in publication with respect to the closing date of the accounts is 11 months, as against three in the case of the CBQ), but it is more detailed, while the CBQ information is more up-to-date and summarised. The profiles of the two sources of information are linked, so that the quarterly data satisfactorily anticipate those published subsequently on the basis of the annual information.

TABLE 1

Profit and loss account. Year-on-year performance
(Growth rates 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	1997	1998	98 Q1-Q4 / 97 Q1-Q4 (a)	98 Q1-Q3 (a)	99 Q1-Q3 (a)
	Number of firms / Total national coverage	7716/37.3 %	5877/34.7 %	825/19.7 %	838/20.1 %	763/16.2 %
1.	VALUE OF OUTPUT (including subsidies)	10.0	6.1	2.9	3.7	7.4
	Of which:					
	1. Net amount of turnover and other operating income	9.9	6.7	3.2	4.3	8.6
2.	INPUTS (including taxes)	11.5	5.8	2.2	2.5	11.1
	Of which:					
	1. Net purchases	11.8	3.2	0.6	1.5	12.1
	2. Other operating costs	10.6	10.5	7.0	6.3	12.3
S.1.	GROSS VALUE ADDED AT FACTOR COST	7.0	6.7	4.0	5.5	2.5
3.	Personnel costs	4.0	5.0	3.2	3.8	0.7
S.2.	GROSS OPERATING RESULT	10.9	8.6	4.8	7.0	3.9
4.	Financial revenue	11.3	9.8	15.4	2.3	36.3
5.	Financial costs	–13.7	–8.7	–8.9	–8.3	–7.6
6.	Corporate income tax	21.1	33.6	17.7	17.4	20.1
S.3.	FUNDS GENERATED FROM OPERATIONS	17.2	10.2	8.1	9.2	8.4
7.	Depreciation and provisions	25.3	17.8	–5.3	–3.6	6.9
S.4.	TOTAL NET RESULT (% of GVA at factor cost)	14.9	15.8	19.1	20.0	24.7
PROFITABILITY RATIONS						
R.1.	Ordinary return on net assets (before taxes) (b)	7.6	8.4	8.9	8.9	9.2
R.2.	Interest on borrowed funds/ interest-bearing borrowing	6.7	5.7	6.4	6.4	4.8
R.3.	Ordinary return on equity (before taxes) (b)	8.0	9.7	10.0	10.0	11.2
R.4.	Debt ratio	38.9	39.6	37.3	37.6	36.8
R.5.	Leverage (R.1 – R.2) (b)	0.8	2.7	2.5	2.5	4.5

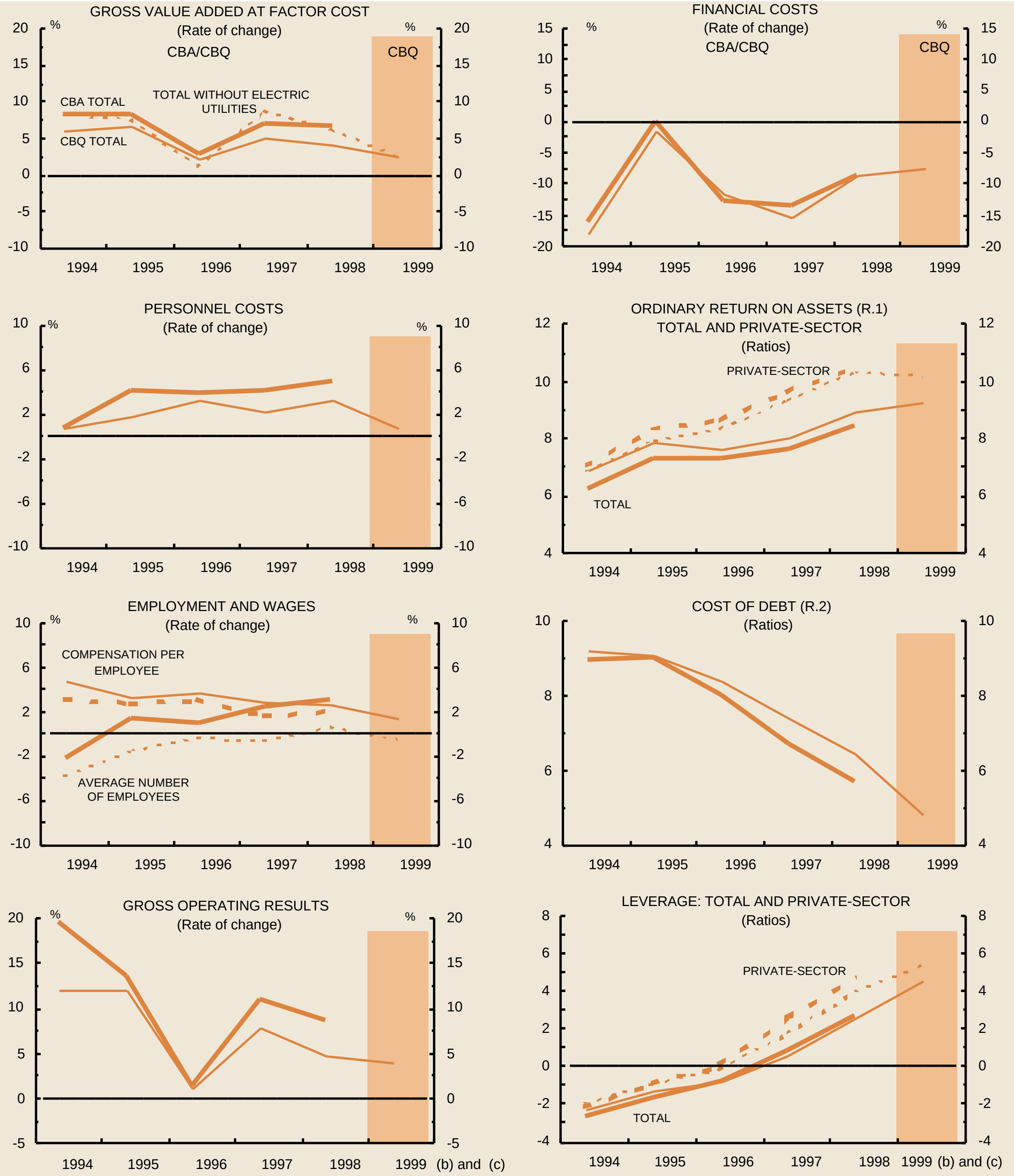
Source: Banco de España.

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

(b) Ratio calculated in accordance with the new methodology explained in this article and in the annual monograph of the Central Balance Sheet Office.

CHART 1

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



NUMBER OF FIRMS

CBA	7.838	8.111	8.019	7.716	5.877	
CBQ	615	722	727	725	825	763

% OF GDP OF NON-FINANCIAL FIRMS SECTOR

CBA	34,6	36,9	38,6	38,0	34,7	
CBQ	18,4	21,5	20,9	20,6	19,7	16,2

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CBQ	18,4	21,5	20,9	20,6	19,7	16,2

CBA data CBQ data

Source: Banco de España

(a) Information available to November 17th 1999 (CBA and CBQ).

(b) The 1994, 1995, 1996, 1997 ad 1998 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) The 1999 data are the average of the three quarters of 1999 in relation to the same period in 1998.

and in the first nine months of 1999, due to the take-off of the creation of both permanent and temporary jobs. As is becoming customary, and as explained in previous editions of this article, this trend is diminished (and in some quarters even reversed) when the quarterly series (obtained from the CBQ) is analysed. This is because the staff adjustment processes in large firms belonging to very specific sectors introduce a significant bias into the CBQ sample, in which they have a disproportionate weight. Employment creation was especially intense in small and medium-sized firms (see Box 1). Average compensation grew at a slightly higher rate than the CPI in 1998, although levels remained relatively moderate in that year and in 1999. It should be taken into account however that the stability of the growth in average compensation is due primarily to the effect on the overall figure of the lower starting wages paid to newly hired workers.

Together the positive developments in activity and personnel costs prompted significant growth in the gross operating result in 1998, which moderated in the first nine months of 1999. The weight of financial costs in the firms' profit and loss accounts continued to fall, in both absolute and relative terms, in step with the decline in interest rates. The negative rates of change in this variable, recorded both in 1998 and in the first three quarters of 1999, explain why financial costs reached their lowest level to date in the series of available data (in 1999 they represented 2.5 % of the whole of the output of the firms analysed, whereas in 1983, when the Central Balance Sheet Office series begin, this percentage was 9 %). The aforementioned reduction is based on the cumulative effect of the passing through of the successive reductions in interest rates to the firms' cost of debt. This has brought the cost-of-debt ratio (interest on borrowed funds or R.2) down to record lows. Favourable business expectations, combined with the cheapness of sources of financing, prompted the firms to increase their indebtedness, both in 1998 and in the first three quarters of 1999, and thereby capitalise on the favourable credit market conditions. However, the debt ratio continued to decline slightly, as a consequence of the increase in equity. This gave rise to a very positive outlook for the sample firms which, in both 1998 and 1999, posted even higher returns [on both net assets (R.1) and equity (R.3)] than in 1997. As mentioned above, this growth in returns was accompanied by a reduction in the cost of debt and, as a result, leverage (R. 5) was positive and rising in both 1998 and the first three quarters of 1999.

In short, the recovery during 1998 in the rates of growth of activity and in returns was accompanied by growth in employment and productive investment in the sample firms, thus confirming what is indicated by alternative sources. The information available for 1999 seems to indicate a similar situation, although two one-off factors (the lowering of telephone charges and the rise in the prices of the oil inputs of the refining industry) had an excessively negative impact on the performance in this period, given the weight of these activities in the CBQ sample. In any event, if instead of analysing the first three quarters of 1999 together, the third quarter is compared with the same period a year earlier (see Box 2 on manufacturing), then a very positive performance is apparent in the latest period too. As a result, the climate of confidence might be expected to hold steady and the current levels of profitability of productive investment, conducive to the creation of employment, to firm.

2. NOMINAL GROSS VALUE ADDED

As mentioned in the introduction, the information obtained by the CBA confirms that business activity grew in 1998 at similar rates to the previous year, consolidating the expansionary path that began in mid-1996. The CBQ information for the first three quarters of 1999 shows a certain continuity in the expansion of productive activity, albeit at a more moderate rate [the rate of change of nominal gross value added (GVA) in this period was 2.5 %; see Table 1 and Chart 1]. The setback suffered by manufacturing at the beginning of the year (already observed in the final quarter of 1998), as a consequence of the instability in foreign markets, and the price developments in certain sectors in the third quarter of 1999 (there was a fall in the final prices applied in the telecommunications sector and an increase in the purchase prices in the oil refining sector), referred to below, were instrumental in this moderation. Analysis of the series of quarter-on-quarter data for 1999, having removed the price effect mentioned above, shows a slightly expansionary profile behind the moderation. In addition, experience would suggest that the CBA data for 1999, which will become available within a year, will show a higher growth rate since, unlike the CBQ, the CBA incorporates the contribution of many small and medium-sized firms. The expansion of business activity continued to be based, both in 1998 and in 1999, primarily on buoyant private consumption and investment. The external activity of the reporting firms, meanwhile, slowed significantly, due to the crisis that has afflicted certain foreign economies. Foreign trade was particularly severely affected in the final quarter of 1998

BOX 1

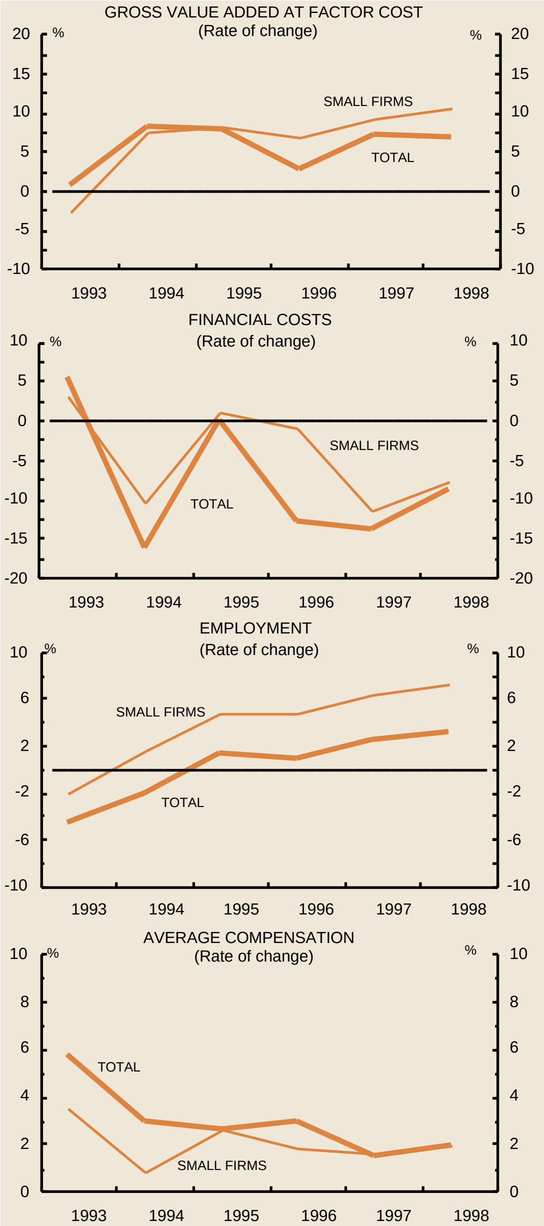
Results of small firms

As in late November 1998, when the annual monograph relating to 1997 and previous years was presented, this box summarises the main features characterising the performance of small Spanish firms in 1998, in relation to the preceding period. This box refers to the tables in the monograph relating to firms with less than 50 employees. The source of these tables is the database maintained by the Central Balance Sheet Office containing the data provided by the Mercantile Registries of Spain (CBBE/RM), which is obtained from the balance sheets filed by firms pursuant to Law 19/1989. Although this database is not as detailed as that of the annual survey of the Central Balance Sheet Office (CBA), it does permit conclusions to be drawn regarding the main magnitudes of the aggregate profit and loss account and the main headings of the balance sheet. As at the closing date of this article data were available for 218,303 firms for 1997 (representing 12.3% of the GVA of non-financial firms) and 38,763 firms for 1998 (2.5%). As can be seen in the adjoining charts, the CBB displays similar profiles to the CBA, although the paths of its main aggregates have more pronounced slopes.

As regards productive activity, GVA grew by 10.7% in 1998, which was above the 9.2% rate recorded in 1997 and consolidates the growth trend announced on the occasion of the presentation of the 1997 results. All the major groupings of activity increased or sustained the rates achieved in 1997, a period in which they had displayed strong growth. Personnel costs grew at high rates as a natural consequence of the increases in employment that have been recorded by small firms on aggregate since 1994 (employment grew by 6.4% in 1997 and by 7.2% in 1998). The growth in employment took place across all the major sectors of activity. The developments in employment and personnel costs together gave rise to growth of 2.5% in average wages and salaries in 1998 for the sample as a whole. As has been becoming usual in the CBA and the CBQ, the sectors with the largest increases in employment were those in which average wages and salaries grew at moderate rates, whereas other sectors, such as manufacturing and the distributive trade, recorded lower employment growth and above-average growth in average wages and salaries. These data also appear to confirm that the hiring of new workers had a decisive effect in the restraint of the average staff costs.

As a consequence of the positive performance of activity, the gross operating result also grew at a strong rate (12.1% in 1998, as against 10.2% in 1997). Financial costs continued to decline and also displayed, in the aggregate of small firms, a gradual reduction in their relative weight, falling by 7.8% in 1998 to represent only 1.8% of the total output of these firms in that period. These developments in the operating surplus and financial costs, combined with those in the rest of the costs and revenues, explains why funds generated grew by 15.6% with respect to the previous year, and why the net result reached 12.5% of GVA in 1998 (an unprecedented level in the series studied by the Central Balance Sheet Office for this aggregate). All this explains why the return on equity, R.3 (the only ratio calculated in a comparable manner in both the CBBE/RM and the CBA), was rising, to reach 10.7% in 1998 for the aggregate of all sectors, and increased across all sectors and sizes.

In short, the results of small firms, according to of this alternative database, confirm the currently favourable condition of the Spanish economy, in terms of activity, employment and profitability. At the same time, since these firms with less than 50 employees are more sheltered from foreign competition, the negative effects of the international crisis were not so apparent as in the case of the large and medium-sized firms.



NUMBER OF FIRMS (a)

CBA	7.336	7.838	8.111	8.019	7.716	5.877	
CBB	29.684	48.499	130.799	173.612	218.303	38.763	b)

% OF GDP OF NON-FINANCIAL FIRMS SECTOR

CBA	32,6	34,6	36,9	38,6	38,0	34,7	
CBB	1,8	3,0	7,5	10,1	12,3	2,5	b)

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

Source: Banco de España
(a) Data available to November 17th 1999 (CBA and CBB).
(b) In the case of the Employment and Average compensation charts, the data correspond to the sub-group of firms reporting consistent employment data (50% of the CBB total).

TABLE 2.a

Value added, employees, personnel costs and average compensation
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 (a)			CBA	CBQ (a)			CBA	CBQ (a)			CBA	CBQ (a)		
	1998	98 Q1-Q4	98 Q1-Q3	98 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	98 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	98 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	98 Q1-Q3
Total	**6.7**	**4.0**	**5.5**	**2.5**	**3.0**	**0.5**	**0.6**	**–0.6**	**5.0**	**3.2**	**3.8**	**0.7**	**1.9**	**2.7**	**3.2**	**1.3**
Total, except electricity sector	**7.9**	**6.0**	**7.8**	**2.3**	**3.4**	**1.1**	**1.2**	**0.3**	**5.5**	**3.9**	**4.4**	**1.8**	**2.0**	**2.8**	**3.2**	**1.6**
SIZE:																
Small	8.2	—	—	—	4.0	—	—	—	7.2	—	—	—	3.1	—	—	—
Medium	10.2	8.2	9.3	6.5	5.7	3.4	3.2	5.0	8.9	6.8	7.3	6.8	3.1	3.2	3.9	1.7
Large	6.2	3.8	5.3	2.3	2.5	0.2	0.4	–1.2	4.3	2.9	3.5	0.1	1.8	2.7	3.1	1.3
OWNERSHIP STATUS:																
Public-sector	5.2	4.5	6.3	4.6	–1.2	0.2	–0.1	1.7	2.1	2.9	3.8	4.9	3.4	2.7	4.0	3.2
Private-sector	6.9	3.9	5.3	2.2	4.1	0.6	0.9	–1.2	5.7	3.2	3.8	–0.5	1.5	2.7	2.9	0.8
BREAKDOWN OF ACTIVITIES BEST REPRESENTED IN THE SAMPLE:																
Manufacturing industries	6.6	6.5	8.9	–1.0	2.0	1.4	1.7	–0.6	5.5	4.8	4.9	2.4	3.4	3.3	3.1	3.1
Production and distribution of electricity, gas and water	0.0	–3.2	–2.8	3.3	–6.0	–6.1	–5.1	–8.6	–2.0	–2.4	–0.7	–7.3	4.3	3.9	4.6	1.5
Distributive trade	14.3	11.5	11.4	9.0	8.4	3.7	3.2	5.8	9.5	6.1	6.2	6.8	1.1	2.3	2.9	1.0
Transport, storage and communications	5.9	4.0	5.8	1.3	–0.8	–1.7	–1.6	–5.6	2.8	1.3	2.4	–3.0	3.7	3.0	4.1	2.7

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 1999 Q1-Q3	Firms increasing (or not changing) staff levels	Firms reducing staff levels
Number of firms	**763**	**448**	**315**
Personnel costs			
Initial situation 1998 Q1-Q3 (EUR millions)	13 078.5	5 789.7	7 288.8
Rate 99 Q1-Q3/98 Q1-Q3	0.7	9.2	–6.5
Average compensation			
Initial situation 1998 Q1-Q3 (EUR)	26 196.9	23 631.7	28 809.5
Rate 99 Q1-Q3/98 Q1-Q3	1.3	0.8	3.6
Number of employees			
Initial situation 1998 Q1-Q3 (thousands)	498	245	253
Rate 99 Q1-Q3/98 Q1-Q3	–0.6	8.4	–9.6
Permanent			
Initial situation 1998 Q1-Q3 (thousands)	*436*	*200*	*236*
Rate 99 Q1-Q3/98 Q1-Q3	*–1.2*	*6.5*	*–8.0*
Non-permanent			
Initial situation 1998 Q1-Q3 (thousands)	*62*	*45*	*17*
Rate 99 Q1-Q3/98 Q1-Q3	*4.4*	*13.3*	*–24.8*

Source: Banco de España.

and in the first few months of 1999. Manufacturing was the sector hit most severely by the fall in exports. Its growth was more restrained (see Table 2.a and Box 2) both in 1998, when its GVA grew by 6.6 %, against almost 11 % in 1997, and in the first three quarters of the current year, when it posted a cumulative negative rate of -1 %. However, in the third quarter the trend changed and its GVA grew. Table 3 provides certain structural information on these variables and confirms that basically it was domestic sales that remained buoyant and sustained the rate of growth of productive activity in 1999. The recent signs of recovery in foreign economies are having a positive, albeit still weak, impact on foreign activity, which can be expected to become greater in the coming months. Imports were much more dynamic than exports, although the available aggregate data for 1998 do not show this clearly, due to the effect of the sharp falls in the price of crude oil that year.

Analysing productive activity by sector, the distributive trade was notably buoyant. The firms in this sector posted the strongest business expansion, both in 1998 and in the first

TABLE 3

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

	CBA		CBQ (a)	
	1997	1998	98 Q1-Q4/97 Q1-Q4	99 Q1-Q3/98 Q1/Q3
Total firms	**7 716**	**5 877**	**838**	**763**
Firms reporting source/destination	7 716	5 877	771	717
	%	%	%	%
Net purchases	**100.0**	**100.0**	**100.0**	**100.0**
SOURCE OF PURCHASES:				
Spain	65.8	65.5	69.2	73.5
Total abroad	34.2	34.5	30.8	26.5
EU countries	*22.3*	*23.8*	*22.9*	*16.9*
Third countries	*11.9*	*10.7*	*8.0*	*9.6*
Net turnover	**100.0**	**100.0**	**100.0**	**100.0**
SALES DESTINATIONS:				
Spain	80.4	79.9	86.1	88.4
Total abroad	19.6	20.1	13.9	11.6
EU countries	*14.6*	*15.1*	*10.4*	*7.6*
Third countries	*5.0*	*5.0*	*3.6*	*4.0*

Source: Banco de España.

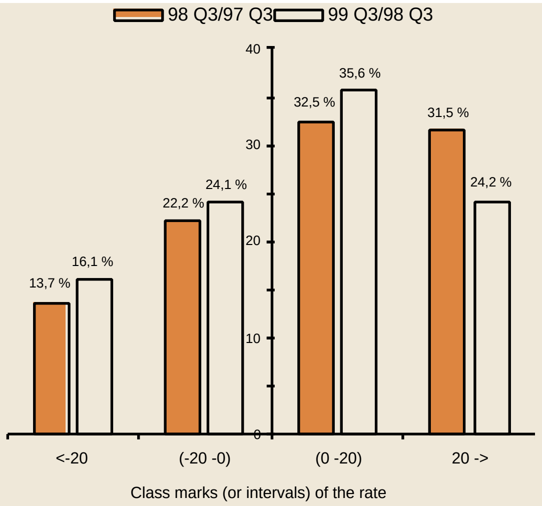
(a) All the data in this column have been calculated as the arithmetic mean of the relevant quarters, including the figure for the total number of firms.

nine months of 1999 (their GVA grew by 14.3 % and 9 %, respectively), due to being the main beneficiaries of the increase in private consumption. The lowest output growth in 1998 was seen in the electricity, gas and water production sector in 1998 (in fact, its value-added was stagnant in nominal terms). The reductions in electricity charges and the changes arising from the liberalisation of the sector (essentially the commencement of operations in the market for electrical energy) explain why the nominal value of this sector's output was flat in 1998 (with a rate of change of 0 %), a year in which the demand for electricity nevertheless grew strongly. In the first nine months of 1999, when the demand for electricity was again highly favourable, nominal output grew, despite the effects of the reduction in charges agreed for 1999. It should be borne in mind that the legal measures adopted to accelerate liberalisation in this sector and in telecommunications (in which there was also a reduction in charges in 1999) have had a short-run effect on the rate of growth of GVA and will probably continue to affect it in future quarters, to the extent that the number of competitors rises and they participate increasingly more actively in both markets. Manufacturing was especially influenced in the second half of 1998 by the fall in foreign activity. This was reflected in the growth of 6.6 % in its GVA, which was significantly below the 1997 rate of 10.9 %. In the first nine months of 1999 the GVA of manufacturing fell, although as the year has elapsed clears signs of recovery have been apparent. Finally, the transport, storage and communications sector grew both in 1998 and in the first three quarters of 1999, although less and less strongly, due to the effect of the price developments referred to above. As regards size, it was the large firms which, both in 1998 and in 1999, saw a slowdown in the growth of their value-added in nominal terms. As for ownership status, the declining relative importance of the public sector and the significant changes that have taken place in recent years make it difficult to draw conclusions from its data.

Chart 2 shows the distribution of firms by the rate of change in their GVA, without any account being taken of their size and weight in the sample. The main conclusion to be drawn from the chart is that there was still a majority of firms in which GVA was growing (in the third

CHART 2

Distribution of firms by rate of change in GVA at factor cost (99 Q3/98 Q3, 98 Q3/97 Q3)



Source: Banco de España.

quarter of 1999 GVA grew in 59.9 % of all firms), although the proportion was lower than in 1998, and their growth rates lower.

3. EMPLOYMENT AND PERSONNEL COSTS

The most notable development in the periods analysed, without a doubt, was the generalisation of the creation of both permanent and temporary employment by the firms of both the annual and quarterly samples. In the case of the annual sample, the 1998 data show net employment growth for the fourth consecutive year. Moreover, the series has a marked expansionary profile (the 1998 rate reached 3 %) that is particularly strong in the case of permanent employment, which grew by 3.1 %, an unprecedented rate in the last 10 years of the annual series. The CBQ, which anticipated this effect for 1998, also confirms that the favourable trend in this item continued in 1999, although in a somewhat more subdued fashion. As is traditional when analysing employment, the preliminary figure provided by the quarterly data (0.5 % for 1998) is completed and corrected with the data published later by the CBA (3 %). The latter covers smaller firms as well which, due to their buoyancy, contribute positively in expansionary times like the present to the creation of employment. Meanwhile, as mentioned above and in previous editions of this article, the existence of certain adjustments in very specific firms and sectors (in the process of being reorganised or liberalised), which are isolated but quantitatively very significant, distorts the CBQ data downwards. This restructuring is concentrated in the electricity, gas and water production and distribution and the transport and communications sectors, and it results in a fall in employment in the CBQ as a whole of –0.6 % in the first nine months of 1999. If the data relating to these firms is excluded then there is clear growth in both permanent and temporary employment. Table 2.a shows that positive, albeit still low, employment growth is obtained (0.3 % in the first three quarters of 1999) merely by removing the electricity sector from the sample. In manufacturing, the rate of change of employment, reflecting the slowdown in the value-added of the sector, fell from 2.0 % in 1998 to -0.6 % in the first three quarters of 1999. Of the sectors shown in Table 2.a, which are the most significant in the quarterly database, the distributive trade was the only one to increase, notably moreover, its workforce (by 5.8 % in the first nine months of 1999, and by 8.4 % in 1998). Personnel costs rose by 5 % in 1998 and by 0.7 % in the first three quarters of 1999, reflecting the behaviour of employment in 1998 and 1999 discussed above.

Average compensation (personnel costs per worker) grew by 1.9 % in 1998, which was higher than the rates of 1.5 % in 1997 and 1.3 % in the first nine months of 1999. In each case this rate is influenced by the differences between the wages of newly hired workers and of existing staff, as can be seen in Table 2.b and as is discussed below. A sectoral analysis of average compensation shows the impact on the total aggregate of the intense generation of employment detected in the distributive trade. This is the sector in which most newly hired workers are concentrated and, consequently, it also has the lowest rate of growth of average compensation, at around 1 %, well below the rate for the rest of the sectors. Finally, it should be pointed out that the costs associated with the major staff adjustments carried out in certain large firms in the first nine months of 1999 have not been reflected in the data discussed. In fact, in the accounting information provided by the CBQ firms, personnel costs usually include compensation for dismissal. However, given the exceptional nature of the adjustments, some firms have opted not to record such compensation under this heading of their profit and loss accounts, setting aside a provision for staff restructuring with a counterpart entry in the balance sheet.

Table 2.b, relating to the first nine months of 1999, shows that in the aggregate of firms which reduced their staff levels (by -9.6 % overall), average compensation grew by 3.6 %, sig-

BOX 2

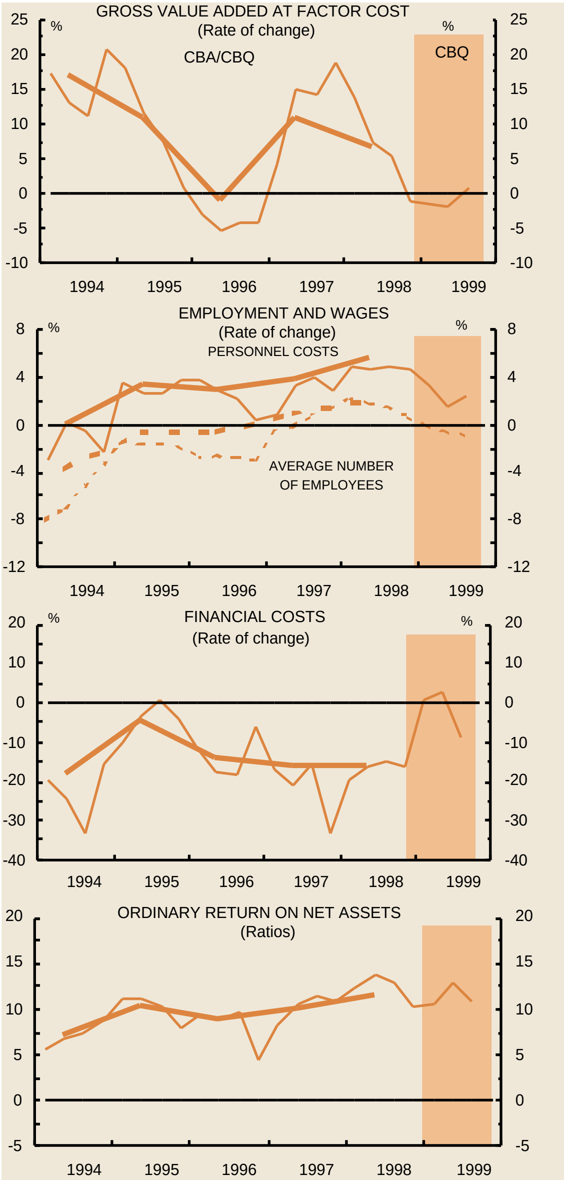
The manufacturing sector

As in previous editions of this article, this box describes the behaviour of manufacturing firms. This sector is well represented in the Central Balance Sheet Office databases and is of great interest for short-term economic analysis. In 1998 developments in the manufacturing sector were positive, as shown by the fact that its GVA grew at a nominal rate of 6.6%, below the 10.9% rate recorded in 1997, as a consequence of the effect of the international crisis on foreign trade in mid-1998. This effect continued into the first quarter of 1999, and a certain change in trend only began to be recorded in the third quarter of 1999, although the sector continued to grow at negative rates (in the first three-quarters its nominal GVA contracted by –1%, whereas in the first two quarters it fell by -1.8%). It is not possible to infer similar falls in activity, as measured by GVA at constant prices, due to the effect on the nominal growth of the oil refining sector, which was severely affected by the rise in the international prices of crude oil inputs (its GVA fell by 21.8% in the first three quarters of 1999). Among the other sectors, that of food and drink and tobacco and transport equipment (in the case of the latter, in line with the growth of new registrations) should be highlighted. These made positive contributions to activity growth, both in 1998 and in the first nine months of 1999, although without managing to offset in 1999 the negative affects discussed above.

In accordance with the developments mentioned above, there was a clear generation of employment in 1998, at rates of 2%. This was interrupted in 1999, for the reasons set out in relation to the growth of GVA in this aggregate (in parallel with the reduction in nominal growth, the workforces of manufacturing firms were reduced by –0.6% during this period). Average compensation grew by 3.4% in 1998 and by 3.1% in the first three quarters of 1999, which was significantly above the rate of inflation. Furthermore, the workforces of the food, drink and tobacco and transport equipment sectors, in which staff adjustment processes were identified, posted larger increases in average compensation.

The continuous reductions in financial costs contributed in 1998 to the 9.2% increase in funds generated. This rate was well above the growth observed in the first three quarters of the present year (1.4%), basically as a consequence of the slowdown in nominal growth. Nonetheless, there was a certain, albeit moderate, recovery in the third quarter (funds generated grew by 4%), permitting an improvement in expectations regarding the year-end. Profitability increased slightly in 1998, to reach 11.4%, the highest level for the last 10 years, which has been sustained in the first nine months of 1999. Moreover, the further reduction in the cost of debt helped sustain leverage in the manufacturing sector at exceptionally high levels, both in 1998 (5.6%) and in the first nine months of 1999 (6.9%). As mentioned in the main body of this article, it is to be hoped that these levels of profitability, which have benefited from a trend in financial costs that is drawing to a close, will not lead firms to relax their control over their costs, given the inflation differential which continues to exist vis-à-vis Spain's European competitors.

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



NUMBER OF FIRMS

CBA	3.127	3.258	3.225	3.202	2.458	
CBQ	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

%OF GDP OF TOTAL MANUFACTURING FIRMS

CBA	37,2	39,3	38,2	38,5	31,7	
CBQ	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

CBA data.
CBQ data.

Source: Banco de España
(a) Information available to November 17th 1999 (CBA and CBQ). The CBQ data are growth rates on the same quarter of the previous year.

TABLE 4

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

	CBA		CBQ			
	1997	1998	97 Q1-Q4 (a)	98 Q1-Q4 (a)	98 Q3	99 Q3
Number of firms	**7 716**	**5 877**	**725**	**825**	**817**	**596**
Personnel costs	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Falling	24.1	20.5	31.8	27.8	26.7	31.2
Constant or rising	75.9	79.5	68.2	72.2	73.3	68.8
Average numer of employees	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Falling	28.3	25.3	50.3	40.2	40.3	37.9
Constant or rising	71.7	74.7	49.7	59.8	59.7	62.1
Average compensation (relative to inflation) (b)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Lower growth	44.0	40.2	41.1	42.1	39.1	50.4
Higher or same growth	56.0	59.8	58.9	57.9	60.9	49.6

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

nificantly above the 1.3 % for the sample as a whole. The 448 firms which created employment in the first nine months of 1999 (58.7 % of the firms) increased their staff levels by 8.4 % (within which the 6.5 % increase in permanent employment stands out). Due to the lower wages paid to newly hired or workers, average compensation in this group of firms only grew by 0.8 %.

Finally, Table 4 shows that in 1998 the percentage of firms in which employment rose increased considerably (almost 75 % of firms, as against 71.7 % in 1997), as was also the case in 1999 (in the third quarter of the year the percentage was 62 %, more than two percentage points higher than in the same quarter of the previous year). As for average compensation, the percentage of firms in which it grew at a higher rate than inflation declined significantly (from 60.9 % in the third quarter of 1998 to 49.6 % in the same period of 1999), with the rise in the price index in 1999 certainly having a significant impact on this result. It should not be forgotten however that, to preserve the capacity to create jobs, it is necessary to constantly monitor upward movements in all the firms' various expenditure items, including their wage costs, and these should be related to, besides nominal indicators, the real variables which justify their growth, i.e. productivity gains.

4. RESULTS, MARGINS AND PROFITABILITY (2)

As a consequence of the paths taken by activity and personnel costs, the Gross Operating Result grew by 8.6 % in 1998, a somewhat lower rate than in 1997 (10.9 %). This rate fell to 3.9 % in the first three quarters of 1999. The slowdown in productive activity in 1999, together with the expansion of employment, is therefore compatible with sustained growth of surpluses, albeit at a lower rate than in 1998.

Financial costs continued to decline in both the periods analysed. In 1998 the fall was 8.7 % and in the first three quarters of 1999 it was 7.6 %. Nonetheless, as pointed out in previous editions of this article, the weight of this item in the

(2) Coinciding with the publication of the annual monograph with the results for 1998 and this article, the calculation of the profitability ratios has been modified, both for the CBA and for the CBQ. The new profitability ratios are more summary indicators, which evaluate the capacity to generate profits, in the absence of extraordinary operations and net capital gains, that is to say, they only take into consideration results arising from ordinary operations. At the same time, the valuation of the tangible fixed assets at current prices has been approximated in the denominator of the profitability ratios, in order to overcome the technical problems arising from balance sheet restatement. The methodological note in the annual monograph (in its printed and CD-ROM versions) provides greater details on these matters.

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 5,877 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	**5877/34.7 %**
		YEAR	1998
1.		VALUE OF OUTPUT (including subsidies)	100.0
	1.	Net amount of turnover and other operating income	119.5
	a.	Other items	–19.5
2.		INPUTS (including taxes)	66.3
	1.	Net purchases	41.8
	2.	Other operating costs	23.4
	b.	Other items	–1.1
S.1.		GROSS VALUE ADDED AT FACTOR COST (1 – 2)	33.7
	3.	Personnel costs	17.6
S.2.		GROSS OPERATING RESULT (S.1. – 3)	16.1
	4.	Financial revenue	2.5
	5.	Financial costs	2.8
	6.	Corporate income tax	1.9
	c.	Othe income included in funds generated	0.0
S.3.		FUNDS GENERATED ROM OPERATIONS (S.2. + 4 – 5 – 6 + c)	13.9
	7.	Depreciation and provisions	12.1
	d.	Other income not included in funds generated	3.5
S.4.		TOTAL NET RESULT (S.3. – 7 + d)	5.3
	e.	Proposed distribution of dividends	3.0
	f.	Retained earnings	2.3
Memorandum item:			
S.5.		SELF-FINANCING (S.3. – e = f + 7 – d)	10.9

TABLE 5

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

	Gross operating result				Funds generated				Ordinary return on assets (R.1) (a)				Leverage (a)			
	CBA	CBQ (b)			CBA	CBQ (b)			CBA	CBQ (b)			CBA	CBQ (b)		
	1998	98 Q1-Q4	98 Q1-Q3	99 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	99 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	99 Q1-Q3	1998	98 Q1-Q4	98 Q1-Q3	99 Q1-Q3
Total	8.6	4.8	7.0	3.9	10.2	8.1	9.2	8.4	8.4	8.9	8.9	9.2	2.7	2.5	2.5	4.5
Total, except electricity sector	11.2	8.4	11.7	2.8	11.7	12.1	14.0	7.8	8.7	9.3	9.4	9.6	2.8	2.7	2.8	4.8
SIZE:																
Small	10.0	—	—	—	15.4	—	—	—	10.2	—	—	—	3.1	—	—	—
Medium	11.9	10.2	12.3	6.2	12.5	10.9	14.8	8.1	11.1	10.5	10.9	11.2	5.0	4.6	4.8	6.8
Large	8.3	4.5	6.8	3.8	9.9	8.0	8.9	8.5	8.1	8.8	8.8	9.1	2.5	2.4	2.4	4.3
STATUS:																
Public-sector	18.8	8.2	12.1	2.7	10.6	33.8	45.8	13.1	0.9	3.1	3.4	4.7	–4.6	–3.3	–2.8	0.5
Private-sector	8.0	4.4	6.5	4.0	10.2	6.3	6.6	7.7	10.4	10.3	10.3	10.1	4.6	3.9	3.8	5.3
BREAKDOWN OF ACTIVITIES BEST REPRESENTED IN THE SAMPLE:																
Manufacturing industries	8.0	9.1	14.8	–4.9	9.2	8.1	13.9	1.4	11.4	12.3	13.0	11.4	5.6	6.7	7.3	6.9
Production and distribution of electricity, gas and water	0.7	–3.6	–3.5	6.8	5.1	–1.0	–1.8	11.2	7.5	8.2	8.0	8.5	2.3	2.2	1.9	3.7
Distributive trade	21.3	19.2	19.0	12.8	20.2	19.6	19.6	13.4	12.3	10.8	10.2	11.7	6.8	4.7	4.0	7.1
Transport, storage and communications	8.6	6.0	8.4	4.0	11.9	14.8	15.0	3.5	7.3	8.0	7.9	8.0	0.9	0.9	1.0	3.0

Source: Banco de España.
(a) Ratio calculated in accordance with the new methodology explained in this article and in the annual monograph of the Central Balance Sheet Office.
(b) The data in these columns have been calculated as the arithmetic mean of the quarterly data.

firms' profit and loss accounts has been reduced very significantly, to represent 2.5 % of total output in 1999 (when in 1983 it represented 9 %). The effects of the changes in the cost of finance and in the amount of debt on the fall in financial costs are as follows:

	99 Q1-Q3/98 Q1-Q3
Change in financial costs	*–7.6 %*
A. Interest on borrowed funds (1+2)	*–10.3 %*
1. Due to the cost (interest rate)	–28.5 %
2. Due to the amount of interest-bearing debt	18.5 %
B. Commissions and cash discounts	*2.7 %*

This table confirms that the reductions in interest rates have continued to be passed through to corporate costs, and that firms are increasingly resorting to external funds to finance new investment, capitalising on the favourable conditions offered in the market. This higher borrowing has been evident since 1998.

The favourable path of net financial charges in both the periods studied enabled funds generated to grow by 10.2 % in 1998 and by 8.4 % in the first three quarters of 1999. At the sectoral level, the highlights were once again the strong increases in the distributive trade's funds generated, with growth of 20.2 % in 1998 and 13.4 % in the first nine months of 1999, and the fall in the growth of funds generated in manufacturing from 9.2 % in 1998 to 1.4 % in the first three quarters of 1999. As was also the case with the activity of the sector, the quarter-on-

TABLE 6

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

	CBQ			
	Ordinary return on net assets (R.1)		Ordinary return on equity (R.3)	
	98 Q3	99 Q3	98 Q3	99 Q3
Total firms	**100**	**100**	**100**	**100**
R ≤ 0 %	19.1	19.1	23.6	22.4
0 % < R ≤ 5 %	16.7	17.9	13.2	14.4
5 % < R ≤ 10 %	16.9	16.4	13.2	11.9
10 % < R ≤ 15 %	13.2	12.3	10.3	11.1
15 % < R	34.1	34.3	39.7	40.2
Number of firms	**838**	**763**	**838**	**763**
MEMORANDUM ITEM:				
Average return	9.3	9.0	10.5	11.2

Source: Banco de España.

quarter profile of the series of data displays a moderate trend towards a progressive recovery.

The ordinary returns on net assets and on equity (calculated using the new method described in a Box 5 of the annual monograph) held at very high levels. In 1998, the return on net assets (R.1) reached 8.4 % for the sample as a whole, the highest level recorded in the annual series since 1989. In the light of the quarterly data available, this level may be surpassed in 1999, when these same results are presented within a year from now (in the first nine months of 1999 this ratio stood at 9.2 %). As already pointed out this growth was accompanied by a continuous reduction in the cost of debt (ratio R.2, interest on borrowed funds), so that leverage (R.5) was again at a record high in the annual series (2.7 % for 1998) and in the quarterly series (4.5 % for the first three quarters of 1999). This is further evidence of the favourable situation of non-financial firms as a whole, and of the favourable conditions existing for investment and employment creation.

Finally, Table 6 enables conclusions to be drawn regarding the distribution of the firms according to their profitability, without any account being taken of their size or ownership status. The most important result is that during the third quarter of 1999, although the percentage of firms posting a positive ordinary return on net assets (R.1) held steady (at close to 80 %), the reduction in the cost of debt (R.2) meant that the percentage of firms earning a positive return on equity continued to increase in that quarter.

In short, 1998 was a positive year for the firms as regards activity, employment and profitability, owing to the favourable performance of domestic consumption and investment. Nonetheless, there was a certain slowdown in the second half of the year, owing to the effects of the International crisis. This negative effect continued to be perceived at the beginning of 1999, although as the year has unfolded there has been a progressive strengthening of manufacturing industries and a certain firming of growth rates. The firms' current levels of profitability are conducive to investment, growth and employment stability.

5. INVESTMENT AND FINANCING

The 1998 results discussed above are based on the information in Chapter II of the annual monograph of the Central Balance Sheet Office, together with the CBQ data for the first three quarters of 1999. This viewpoint gives rise to a very firm-focused presentation. However, there is another accounting approach, based on general economic analysis, which enables balances and aggregates to be obtained that are useful for macroeconomic analysis. This is precisely what Table 7, a summary of the capital and financial account, provides. It is prepared on the basis of the CBA information for 1998, the CBQ information not being sufficiently detailed for these balances to be obtained.

In 1998, the CBA sample firms as a whole were, for the fifth year running, had a positive fi-

TABLE 7

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

	Structure		
Databases	1996	1997	1998
Number of firms / Total national coverage	8073/36.5 %	7716/38.0 %	5877/39.7 %
Year	1996	1997	1998
1. Capital resources	29.9	29.1	32.6
1. Gross saving	26.2	27.9	30.2
2. Net capital transfers	3.7	1.2	2.4
2. Uses of capital	24.4	25.0	24.6
1. Gross capital formation	22.5	23.1	22.3
1. Gross fixed capital formation	20.0	19.3	19.2
2. Change in stocks	2.5	3.8	3.1
2. Other uses of capital	1.9	1.9	2.3
3. Financing capacity (+), borrowing requirements (–) (1 – 2.1 – 2.2 = –4)	5.5	4.1	8.0
4. Net change in liabilities minus net change in assets	–5.5	–4.1	–8.0
1. Securities other than equity	–1.7	–2.2	–5.0
2. Equity capital	–2.8	–0.9	3.3
3. Credit from credit institutions	–6.6	6.2	5.0
4. Credit from abroad	–2.0	0.0	4.2
5. Trade credit and credit between other resident sectors	6.1	–1.3	–6.3
6. Pension funds	0.9	0.6	0.2
7. Other liabilities net of other financial assets	0.6	–6.5	–9.4
MEMORANDUM ITEM:			
Investment in tangible fixed assets (a)	11.5	9.8	9.7

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.

nancing capacity. The strong generation of funds, in the form of a substantial increase in their gross saving, enabled their investment expenditure for the year to be covered, and a surplus over and above this to be generated of 8 % of GVA. All in all, gross fixed capital formation also grew at a healthy rate (6 %). It should be noted that this result, which is unusual up to a point (during cyclical upturns non-financial firms normally need to borrow funds and do not have a positive financing capacity), is largely due to the presence in this sample of: (i) very large firms which, since they commenced their activity some time ago (the telecommunications sector), have already made the bulk of their investment; and (ii) firms belonging to mature and, at least temporarily, saturated sectors (the electricity sector). The financing capacity generated by the firms took the form of large financial investments, both long-term (basically loans to group companies and share purchases) and short-term (basically deposits), in which the capital gains generated by the privatisations carried out during 1998 were placed.

26.11.1999.

Financial regulation: fourth quarter of 1999

1. INTRODUCTION

In the fourth quarter of 1999, the output of new provisions of a financial nature was relatively larger than in previous periods.

As regards the Banco de España (BE), first, the amendment to the general clauses applicable to monetary policy operations to specify certain cases of breach of the obligations arising under such general clauses is highlighted. Second, the rules for payment of the profits of the BE to the Treasury have been published. These maintain the same criteria as laid down in previous legislation, although the rules on the allocation of monetary income of national central banks in the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB) are taken into account.

In relation to credit institutions, first, the accounting standards have been amended to introduce new criteria for the coverage of credit risk in order to provide for levels of solvency risk that will become apparent in the next economic downturn. In this respect, the establishment of a provision for the statistical coverage of insolvency, based on the statistical modelling of the level of risk of each institution based on its historical experience, should be noted. Second, the legislation on capital has been amended to adjust its content to the characteristics and operation of such provision.

Turning to the securities markets, five financial provisions are discussed: first, the incorporation into Spanish law of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems is highlighted due to its importance. Second, certain amendments have been introduced into the legislation on tender offers in order to eliminate certain regulatory costs, without thereby reducing investor protection. Third, a number of rules have been established on the transparency of transactions on official securities markets, in accordance with the minimum requirements laid down in Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field. Fourth the requirements for admission to listing on stock markets have been made more flexible and a special segment has been created for trading the securities of innovative high-technology firms on stock markets. Lastly, the general code and rules of conduct of the securities market have been adapted to the particularities of the portfolio investment management.

The procedures and documents for obtaining authorisation of the incorporation plans for new venture capital companies and their management companies have been regulated.

In the insurance field, certain provisions of the pension scheme and fund regulations have been updated. The existing limit on annual contributions has been raised, new situations that may be assimilated to retirement have been determined and jointly promoted pension schemes under the employment system regulated. Also, the regulation on the application of firms' pension commitments to employees and beneficiaries, known as the "externalisation regime", has been approved.

As regards the taxation of financial assets, two provisions are mentioned. These, among other things, modify the system of withholdings and payments on account for public debt issued by OECD countries and they simplify the procedure for repayment of the withholding on the interest paid on assets held by tax-exempt persons.

Finally, as usual in this period, the State budget for the year 2000 is discussed. The requirements for stability and budgetary rigour arising from Spain's membership of the Euro area are reflected in the budget. As in previous years, a number of fiscal, administrative and social measures have been published along with the budget law, in order to facilitate the fulfilment of economic policy objectives set out in the budget.

2. BANCO DE ESPAÑA: MONETARY POLICY OPERATIONS

The Resolution of 11 December 1998 (1) of the Executive Commission of the Banco de España, partially amended by the Resolution of 23 July 1999 (2), specified the general clauses applicable to the monetary policy operations carried out by the BE from 1 January 1999, in accordance with the guidelines laid down by the ECB.

Recently, this Resolution has been amended by the Resolution of 26 October 1999 of the Executive Commission of the BE (BOE (Official State Gazette) of 7 December 1999), to revise the cases and effects of breach, by the institutions, of the obligations arising under these general clauses.

(1) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 78-82.

(2) See "Financial regulation" third quarter of 1999", in *Economic bulletin,* Banco de España, October 1999, pp. 73-74.

The Resolution of 26 October updates and clarifies certain cases of breach and, in particular, those relating to the use of collateral.

3. MODIFICATION OF THE RULES FOR PAYMENT OF THE PROFITS OF THE BE TO THE TREASURY

The rules for payment of the profits of the BE to the Treasury were laid down in the second additional provision to the 1988 Budget Law 33/1987 of 23 December 1987 (since repealed), which was subsequently incorporated into the Internal Rules of this institution approved by a resolution of the Governing Council of the BE of 14 November 1996 (3).

Later, Law 12/1998 of 28 April 1998, which amends the Law of Autonomy of the BE 13/1994 of 1 June 1994, provided in its second additional provision that the rules for payment to the Treasury of the profits of this institution would be laid down in regulations. This has now been done by the publication of Royal Decree 1746/1999 of 19 November 1999 (BOE of 20 November 1999). This maintains the same rules for payment as in the previous legislation, the convenience and appropriateness of which has long been confirmed, although the rules on the allocation of monetary income of national central banks in the Statute of the ESBC and of the ECB are taken into account.

The BE shall pay to the Treasury the profits earned and recorded in its accounts that are attributable to the latter on the following dates and in the following percentages:

a) On the first business day of November each year, 70 % of the profits earned and recorded to 30 September of that year.

b) On the first business day of the following February, 90 % of the profits earned and recorded to 1 December of the previous year, having deducted the payment mentioned in (a) above.

c) The rest of the profits earned shall be paid when the balance sheet and profit and loss accounts of the BE have been approved by the government upon a proposal from the Ministry of Economy and Finance.

The payments established in (a) and (b) shall be resolved by the Governing Council of

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

the BE, after approval of the relevant profit and loss account. In such resolutions account shall be taken of the possible obligations of the BE to the ESCB under article 32 of the Statute of the ESCB, and in the case of (a) the foreseeable path of the results to the end of the year.

The payment rules established are temporary in nature, being applied, with a criterion of maximum prudence, to the years 1999, 2000 and 2001, until such time as the ESCB takes a new decision under its Statute. Also, the format of the BE's balance sheets and profit and loss accounts shall follow any guidelines and instructions of the ECB that may be applicable.

4. CREDIT INSTITUTIONS: AMENDMENT OF ACCOUNTING STANDARDS

BE Circular 4/1991 of 14 June 1991 (4), which sets out the accounting standards and the formats for the financial statements of credit institutions, has been frequently amended to adapt its content to the changes affecting the credit system in recent years.

Credit institutions are currently enjoying an economic boom, in which a significant role is being played by the minimal weight of the provisions for solvency risk that they must charge to their profit and loss accounts, given the low default rate characteristic of economic upturns. However, as shown by past experience, the loan portfolio may contain hidden potential default risks that will probably be revealed when the business cycle turns down.

As a preventive measure, the Banco de España has, by means of *BE Circular 9/1999 of 17 December 1999* (BOE of 23 December 1999), introduced certain new coverage criteria into the accounting rules to recognise and forestall such risks in the medium and long-term. A *provision for the statistical coverage of insolvency* ("statistical provision for insolvency") has been created and the current treatment of the general provision for insolvency, to cover the total risk, has been redrafted to make it clearer.

This statistical provision for insolvency shall be created by charging to the profit and loss account each year an estimate of the total latent bad debts in the various portfolios classified by level of risk. In this respect, the institutions will estimate the provisions needed using calculation methods based on their own experience of default and on the expected losses for each category of uniform credit risk, taking into account the quality of the different types of counterparties, the security given and its recoverable value, the life of the transaction, if relevant, and the future outlook for the risk based on the foreseeable medium- and long-term changes in the economic situation. An amount shall be set aside quarterly to the provision from the profit and loss account, in accordance with the accounting procedure established in the Circular. If it is wished to make transfers to this provision monthly, similar criteria shall apply, with the appropriate adjustments to the calculations.

The calculation methods shall form part of an appropriate system to measure and manage credit risk, using an historical base spanning a complete business cycle, and must be checked by the Banco de España. As an alternative, BE Circular 9/1999 establishes a system for calculating the transfers to be made to the statistical provision for insolvency which consists in classifying the various loans into six categories or risk groups (no appreciable risk, low risk, medium-low risk, medium risk, medium-high risk and high risk) to which a specific coefficient shall be applied, ranging from 0 % for loans with no appreciable risk to 1.5 % for high-risk loans. Where institutions have their own calculation methods approved by the Banco de España, they may use them, in which case the method specified in the Circular shall only be applied to those risks not covered by the own method.

Transfers shall be made to this provision from the profit and loss account equal to the statistical estimate of the total latent bad debts in the various uniform-risk portfolios (credit risk multiplied by the relevant coefficients) less the net provisions for insolvency made during the quarter. If this amount is negative, it shall be credited to the profit and loss account and debited to the provision, insofar as the available balance of the latter is sufficient.

The Circular also updates the accounting treatment for doubtful assets and the specific coverage of credit risk. As regards single risks, in addition to those specified in BE Circular 4/1991, amounts that have not fallen due under a personal loan with monthly payments shall be classified as doubtful if any payment is more than six months overdue. In all other cases, assets shall be classified as doubtful when payments are more than one year overdue.

The situations in which assets classified as doubtful are reclassified as normal investments are specified and widened. Such reclassification shall take place not only when effective security is provided, but also when it is reasonably

(4) See "Regulación financiera: segundo trimestre de 1991", in *Boletín económico,* Banco de España, July-August 1991, pp. 58-60.

certain that the customer will be able to pay on time and, in both cases, at least the outstanding ordinary interest has been received, without taking into account the default interest. BE Circular 9/1999 also adds that claims on creditors subject to a suspension of payments order shall be reclassified as normal investments when the borrower has paid at least 25 % of the claims affected by the suspension of payments (having deducted any reduction agreed) or two years have elapsed since registration at the Mercantile Registry of the order approving the agreement between the borrower and its creditors, provided that such agreement is being faithfully performed and the trend in the financial and net-worth situation of the firm dispels any doubts regarding full repayment of its debts. The amounts of transactions reclassified as normal investment shall be recorded in the balance sheet for official supervisory purposes until they have been eliminated in a memorandum item known as *"restructured credit".*

As regards credit-risk cover, the requirements have been tightened slightly with the inclusion in the *general scale* of a 3-6 month tranche for assets classified as doubtful, according to the time elapsed from when the first overdue payment in a particular transaction became due. The general scale is thus defined as follows:

Period of default on first overdue payment	Percentage cover
Over 3 and up to 6 months	10
Over 6 and up to 12 months	25
Over 12 and up to 18 months	50
Over 18 and up to 21 months	75
Over 21 months up to write off	100

The coverage percentages and tranches of the reduced scale established in BE Circular 4/1991 are maintained for mortgage loans and financial leasing transactions, in both cases relating to completed residential property, excluding multi-purpose premises and country estates. However, if the amount of the outstanding exposure exceeds 80 % of the appraised value of the residence, the general scale shall apply to the whole transaction. For these purposes, the original appraisal value shall be used if the institution does not have a more recent one available.

The current treatment of the general provision for insolvency, intended to cover the total risks, has been redrafted to make it clearer.

Certain changes have been introduced into the current regulation of country risk that are intended to maintain or strengthen its prudential levels and to provide various technical improvements. The Circular clarifies its scope of application. It now covers, in addition to sovereign risk and transfer risk, the other risks arising from international financial activity which include the other risks that may be covered by export credit insurance (5). There are hardly any changes to the coverage of country risk, although its content is specified, stressing the specific treatment for financial, money or off-balance-sheet support to branches and subsidiary and multi-group institutions resident in countries classified as very doubtful, doubtful or in temporary difficulty.

The Circular has also been used to adapt the current criteria for valuing unlisted shares and other equity to the general provisions of the Chart of Accounts.

Lastly, it should be noted that the BE Circular will enter into force on 1 July 2000 and will thus be fully operative in the second half of the year, although immediate application of its criteria is recommended, in particular, in relation to the statistical provision for insolvency. However, the amendment relating to the valuation of unlisted shares entered into force on 1 December 1999.

5. CREDIT INSTITUTIONS: CHANGES IN THE DETERMINATION AND CONTROL OF THE MINIMUM LEVELS OF CAPITAL

BE Circular 5/1993 of 26 March 1993 (6) represents the final development of the legislation on the capital and supervision on a consolidated basis of financial institutions. Its content has been changed during the years since to adapt it to the new circumstances that have arisen.

For the purposes of calculation of the solvency coefficient, a number of items are deducted from the elements which make up the capital of a credit institution, including the shortfalls in the mandatory specific provisions, with respect to the levels required by accounting standards.

As mentioned in the previous section, BE Circular 9/1999 has established the obligation to create the new statistical provision for insolvency.

(5) Such risks are set out in the Ministerial Order of 12 February 1998 on the State coverage of risks arising from foreign and international trade.

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

Given the characteristics of this provision and the way in which it operates, it was considered desirable to amend BE Circular 5/1993, by means of BE Circular 10/1999 of 17 December 1999 (BOE of 23 December 1999), in order to clarify that any shortfall in this provision should not be included as a deduction from the capital.

Finally, it is necessary to take into account the amount of the statistical provision for insolvency to calculate the net book value of the assets and off-balance-sheet items on the basis of which the insolvency coefficient is calculated. For this purpose it is established that these provisions shall be deducted in proportion to the risks on which their calculation is based, in accordance with the contribution of each to the provision based on its risk profile.

6. PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

The significant increase in the transfers of money funds and securities between the financial institutions of the European Union (EU) and the rest of the world has intensified the concern of the supervisory authorities to establish payment and securities settlement systems which guarantee and ensure the stability of the financial systems in question. Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems was intended to contribute to the efficient operation of cross-border payment and securities settlement arrangements in the EU, by offering a harmonised legal solution. Its main objectives were as follows:

1. To reduce the legal risks associated with participation in payment and securities settlement systems, especially in relation to the finality of settlement, the legal validity of netting agreements and the legal enforceability of collateral security supplied by the participants to cover their obligations.

2. To contribute, through the acceptance of collateral security provided in connection with monetary policy operations, to greater financial stability and to developing the necessary legal framework for the ESCB and the ECB to conduct their monetary policy.

3. To ensure that payments can be made in the internal market without any hindrance whatsoever.

4. To promote greater integration of Community credit institutions in the internal payment systems of other EU Member States, thereby supporting the freedom of movement of capital and the freedom to provide services.

Law 41/1999 of 12 November 1999 (BOE of 13 November 1999) on payment and securities settlement systems, with the same objectives, has been published, in order to incorporate the provisions of the above-mentioned Directive into Spanish law.

Chapter one of the Law establishes its scope, defining the payment and securities clearing and settlement systems *("the systems"),* and *the participants* therein, as well as the collateral security used to ensure the proper functioning of the payment and securities settlement arrangements. The special mention given to the monetary policy operations that have to be conducted by the ECB and the central banks of the EU Member States should be noted here. As regards the participants, these may be credit institutions and investment services companies that are accepted as members of a system and which are liable thereto in respect of financial obligations deriving from its operation. The ECB, the BE, the central banks of the Member States, the international financial organisations of which Spain is a member and the managers and settlement agents of other systems are also entitled to participate in the systems.

Chapter two sets out the rules that apply to Spanish systems and their participants. Systems must be recognised by means of a declaration in a resolution adopted by the government at the request of the institutions participating therein or upon a request by the BE, the CNMV (National Securities Market Commission) or the appropriate regional supervisory body. The requirements that Spanish systems must comply with in order to be recognised are set out. The following are notable:

a) Their purpose shall be the execution and, where appropriate, netting of orders to transfer funds or securities.

b) At least three financial institutions must participate in them. These shall be Spanish credit institutions or investment services companies or financial institutions authorised to operate in Spain, provided that at least one of them has its central administration in Spain.

c) Their general requirements for membership and rules of operation shall have been approved by the relevant supervisory authority (the BE, the CNMV or the relevant body of the Regional (Autonomous) Government) and published in the BOE. Such rules shall determine, inter alia, the time at which a transfer order shall be considered accepted by the system, as well as the establishment of adequate instruments for the control and management of risks.

d) Orders to transfer funds shall be settled through a cash account held with the BE.

e) They shall be managed by the BE or by an entity subject to its supervision or to that of the CNMV or of the competent body of the Regional (Autonomous) Government.

The systems currently existing in Spain are recognised as being subject to this Law, as it is considered that they comply with the requirements laid down thereby, without prejudice to their adaptation thereto within six months. These include: the *SLBE* (the BE Settlement Service), together with the other systems (in other countries) that make up the payment interconnection and settlement system managed by the ESCB; the *Servicio de Compensación y Liquidación de Valores* (Securities Clearing and Settlement Service), managed by the company with the same name and regulated by Securities Market Law 24/1988 and its implementing provisions; the *Stock Market Clearing and Settlement Ser - vices* managed by their respective regulatory companies; the public-debt market *Book-Entry System* managed by the BE; the clearing and settlement arrangements for contracts traded on the *MEFF* (financial futures and options) *equity and fixed-income* markets; and the clearing and settlement system of the *AIAF* (Association of Securities Dealers) f*ixed-income market.*

Chapter three regulates netting and orders to transfer funds and securities. For these purposes, orders to transfer funds and securities are the instructions given by a participant for the purpose of:

a) Placing an amount of money at the disposal of a final consignee, or assuming or discharging a payment obligation as defined in the rules of a system, provided that the instructions for its execution are given by means of an entry in the books of a participant, central bank or credit institution.

b) Transferring title or any other right over one or more securities or derivative instruments, by means of an entry in a register or some other means that evidences the transfer.

The most important aspect of this chapter is the validity and finality of trance for marauders and netting, which, where applicable, will take place between them, they for the participants and third parties. In this way, the transfer orders shall be sent to a system by its participants, when they have been received and accepted, in accordance with the system operating rules, shall be irrevocable. There is no possibility of opposing such transactions, which greatly reduces the possibility of systemic risk.

Chapter four regulates the consequences of finality of settlement in relation to insolvency proceedings that may be brought against a participant. Provided that such proceedings are commenced after the transfer orders have been received and accepted by a system, the shall have no affect whatever on such orders (i.e. the orders shall be clear and settled). The same rules should apply to the collateral security constituted by a participant in favour of the system or of other participants in the event of insolvency proceedings. The beneficiaries of the security, including the monetary authorities, shall be entitled to enforce their security outside the insolvency proceedings (7).

Lastly, Chapter five creates the Interbank Payments Service (SEPI), which will replace the Madrid Clearing House, giving it corporate status and a structure that will enable it to operate with maximum certainty and flexibility. SEPI shall have the sole object of facilitating the exchange, clearing and settlement of orders to transfer funds between credit institutions, been a complementary to the SLBE. Under its corporate objects SEPI may establish such relations with other bodies or entities engaged in a similar activity is, within or outside Spain, as it considers desirable to better performed its functions and assume the management of other systems all services are with similar objects, other than the SEPI.

Supervision of the company shall be carried out by the BE. The latter shall be responsible for authorising, prior to the adoption by the relevant bodies of the company, the company statutes and the amendments, as well as the basic rules of operation of the systems and services that it manages and all other instructions regulating its operations.

7. CHANGES TO THE RULES GOVERNING TENDER OFFERS

The law governing tender offers used to be contained in Royal Decree 279/1984 of 25 Jan-

(7) These exceptions to insolvency law are justified by their main objective, namely to establish the legal and technical instruments considered essential to avoid systemic risk and to ensure the stability of the financial system.

uary 1984, which has been repealed. After various changes a new general framework for tender offers was implemented by Royal Decree 1197/1991 of 26 July 1991 (8), which adapted the previous law to the requirements of legal practice.

Subsequent experience has shown the advisability of making some changes to this Royal Decree to eliminate certain regulatory costs, without thereby reducing the protection of investors in companies subject to tender offers. These changes have been introduced by means of *Royal Decree 1676/1999 of 29 October 1999* (BOE of 30 October 1999),

The percentage or threshold for making a tender offer in cases of indirect acquisition of a significant holding in another company or entity has been changed in order to bring them into line with those established for the same cases in the event of merger (9). As a result, a tender offer must now be made whenever, as a consequence of the acquisition, the holding in the company concerned reaches 50 %, or more, of its capital. The tender offer shall be made within six months following the date of acquisition and shall be for a number of shares enabling the purchaser to obtain at least 75 % of the capital of the company and, in any event, representing at least 10 % of the capital of the company concerned.

With regard to competing bids (10), certain requirements have been changed in order to overcome the excessive rigidity in their regulation and to widen the possibilities for reacting to a tender offer. First, the consideration of a competing bid can be that established in the general legislation (cash, securities, or both). Previously only cash consideration was permitted. Second, in the event that the consideration of the competing bid consists (wholly or partly) of securities to be issued by the bidding company, the acceptance period shall be lengthened in accordance with the general legislation, i.e. it shall be extended, in all cases, to fifteen days from the general meeting of the bidding company at which the increase in capital is approved (11) and, in the event that the acceptance period for the preceding bid terminates on a later date, to such later date.

8. RULES ON TRANSPARENCY IN TRANSACTIONS ON OFFICIAL SECURITIES MARKETS

Royal Decree 629/1993 of 3 May 1993 (12) on rules of conduct for the securities markets and compulsory registrations, implemented by the Ministerial Order of 25 October 1995 (13) and CNMV Circular 1/1996 de 27 March 1996 (14), laid down certain minimum standards of conduct for all persons operating on securities markets, based on EU recommendations and directives, which involved a significant step towards securing the transparency of all participants in such markets.

Subsequently, Law 37/1998 of 16 November 1998, which amended the Securities Market Law 24/1988 of 28 July 1988, established that, in order to increase market transparency, the National Securities Market Commission (CNMV), the BE or the market regulatory bodies should determine, within such limits as may be established by regulations, the information of a public nature on market transactions that it shall be compulsory to disclose.

Pending its implementation through regulations, the CNMV has issued *CNMV Circular 3/1999 of 22 September 1999* on the transparency of transactions on official securities markets (BOE of 1 October 1999), since it is essential to determine the minimum information that must be published on transactions performed on official securities markets (15), in accordance with the minimum requirements laid down in the regulation of securities markets.

The Circular regulates the information of a public nature that stock markets, official futures and options markets and the AIAF fixed-income market must disclose on (both ordinary and extraordinary) market transactions, as well as, where applicable, the orders made on the same.

(8) See “Regulación financiera: tercer trimestre de 1991”, in *Boletín económico,* Banco de España, October 1991, pp. 57 and 58.

(9) In the case of merger, a tender offer must be made when, as a consequence of the merger, the holding in the capital of the company concerned reaches 50 % or more.

(10) Tender offers for securities that have been wholly or partly the subject of a previous bid submitted to the CNMV whose acceptance period has not expired shall be considered competing bids, providing that they fulfil certain requirements.

(11) Previously, as the consideration could only be in the form of cash, the acceptance period was one month.

(12) See “Regulación financiera: segundo trimestre de 1993”, in *Boletín económico,* Banco de España, July-August 1993, pp. 105-106.

(13) See “Regulación financiera: cuarto trimestre de 1995”, in *Boletín económico,* Banco de España, January 1996, pp. 85-86.

(14) See “Regulación financiera: primer trimestre de 1996”, in *Boletín económico,* Banco de España, April 1996, pp. 130-131.

(15) This Circular is not applicable to operations in the government-debt market.

The *stock market regulatory companies* shall publish, in daily turnover bulletins or through other appropriate media, certain information that is set out in the Circular, according to the type of transaction to be performed. The Circular thus regulates the information which must be published on ordinary transactions, both on orders made (or quotations) and on transactions executed; on equity transactions carried out through floor trading; on transactions carried out on the electronic fixed-income market; on special stock market transactions and on extraordinary transactions.

The *regulatory companies of official futures and options markets* shall publish, in real time and for each contract and open maturity and series, where applicable, the cumulative volume for each of the three best bid and offer proposals. As regards transactions executed, the price, volume and time of execution of all transactions carried out during the session shall be indicated and, as regards open positions, the volume thereof.

Finally, with regard to transactions executed on the AIAF fixed-income market, the volume contracted in each issue traded, the latest price and IRR shall be reported in real time, except for short-term assets (promissory notes) for which only the latest volume contracted and IRR shall be published.

9. STOCK MARKETS: CHANGES TO THE REQUIREMENTS FOR ADMISSION TO LISTING

Decree 1506/1967 of 30 June 1967, which approved the Stock Market Regulation currently in force, established that the Ministry of Economy and Finance may change the minimum requirements for the admission of securities to listing on a stock market provided there are circumstances warranting such changes.

Given the increasing tendency of investors to channel their funds into the equity market in recent years, and in order to stimulate the financing of Spanish firms through the securities market, the economic authorities, by means of a Ministerial Order of 19 June 1997 (16), have lifted the requirement for firms wishing to obtain a stock-market listing to have obtained, either in the last two years or in three of the last five years, sufficient profits to have enabled a dividend of at least 6 % of capital to have been paid. The Order requires instead that one of the following circumstances be met: the issuing entity can justify profits in future years on the basis of its business and financial prospects, irrespective of the period elapsed since its incorporation; the issuing entity has been formed as a consequence of merger, spin-off or contribution of a business; or the issuer is in the process of economic realignment or restructuring or privatisation by a public entity.

Recently, with the object of opening up for certain Spanish firms a new channel for obtaining funds in the securities markets, the *Ministerial Order of 22 December 1999* (BOE of 30 December 1999) has made the provisions of the Ministerial Order of 19 June 1997 even more flexible. The justification of future profits has been replaced by a report that the issuing entity must submit to the CNMV on its business and financial prospects, and on its future results.

The two other main requirements for a firm to be admitted to listing remain unchanged, namely a capital of at least ESP 200 million and a minimum level of diffusion of its capital (at least 100 shareholders each holding less than 25 % of the share capital).

10. STOCK MARKETS: CREATION OF A SPECIAL TRADING SEGMENT

A certain type of firm has become particularly prominent on the current economic scene. Such firms belong to sectors at the cutting edge of technology. They are exposed to higher risks, but also have great growth potential. The levels of information and investor protection in these markets need to be increased and adapted to their particular characteristics, as the current legal framework governing the Spanish Securities markets is clearly insufficient.

As a result the *Ministerial Order of 22 December 1999* (BOE 30 December 1999) has been published. This creates a special trading segment called the *"New Market",* in which the securities of firms belonging to innovative high-technology sectors and other sectors offering great potential for future growth will be traded.

The CNMV shall be responsible for establishing the general criteria to determine which firms' securities should be traded on the New Market. It will also establish the listing requirements that these firms will have to fulfil. The stock market will establish the rules for trading and operation of the New Market and will appropriately publish the general and specific information required from the issuing entities belonging to this market segment.

(16) See "Regulación financiera: segundo trimestre de 1997", in *Boletín económico,* Banco de España, July-August 1997, p. 113.

The issuing entities shall report, at least once a year, on the progress and developments in their business, as well as the prospects for the same. Finally, they must mention, in the various information prospectuses and in the periodic public information and in the annual accounts that their securities will be traded on the New Market.

11. GENERAL CODE AND RULES OF CONDUCT IN PORTFOLIO INVESTMENT MANAGEMENT

The preamble to Law 24/1988 of 28 July 1988 on the securities market addressed the need for Spanish legislation to ensure minimum rules of conduct for all persons operating on securities market. The priority aim of these rules was to safeguard investor interests and ensure market transparency at all times. These principles were implemented by means of Royal Decree 629/1993 of 3 May 1993 on rules of conduct in securities markets and compulsory registrations, the objective of which was to contribute to market transparency and to investor safeguards, establishing a general code of conduct to govern relations between institutions operating in the markets and their customers.

However, the considerable growth of portfolio management in Spain in recent years has scarcely been accompanied by the implementation of specific rules for this activity.

In order to adapt the general code of conduct and the associated rules of Royal Decree 629/1993 to the particularities of portfolio investment management, the Ministerial Order dated 7 October 1999 (BOE of 16 October 1999) was promulgated to institute a body of rules of conduct specifically geared to governing relations between portfolio managers and their customers.

Its scope covers investment services companies (17) and Spanish and foreign credit institutions alike (hereafter, institutions) which engage in national territory in activities relating to the discretionary and personalised management of investment portfolios in conformity with the mandate conferred upon them by investors resident in Spain.

In the portfolio management business, institutions must observe certain principles and obligations that are specified in the Order, including most notably: to offer professional advice to their customers; to engage in their business in accordance with the criteria agreed upon in writing with the customer (general investment criteria) under the related contract; to refrain from transacting unnecessary operations aimed at augmenting commissions and without any benefit to the customer; and, in the event of a conflict of interest, to give priority to customers' interests over their own. In this respect, institutions shall inform customers of conflicts of interest that arise in the performance of their business, duly identifying, in the information they regularly send to their customers, the operations, investments or actions where such conflicts arise. They should also inform them expressly of any relationship or self-serving link between the manager or its group and any of the companies in which the customer has an interest in respect of representation for the exercise of the voting rights derived from the shares belonging to said customer.

Relations between customers and their portfolio manager shall be formalised by means of a standard portfolio management contract, as stipulated in the Ministerial Order dated 25 October 1998 (18). These contracts, the standardised model for which shall be approved by the CNMV (National Securities Market Commission), shall be drafted in a clear and readily understandable way. Their content will cover aspects specified in the Order, including most notably the following: a detailed description of the general investment criteria agreed upon by the customer and the institution; a specific, detailed list of the different types of operations that may be conducted, in which, at a minimum, those involving equity and fixed-income securities, other spot financial instruments, derivatives and structured and financed products will all be categorised; an undertaking by the manager to manage the portfolio provided by the customer in a discretionary, personalised manner; and express mention of the Investment Guarantee Fund or of the alternative guarantee arrangements of which the management institution should avail itself if it is a non-resident entity.

(17) Law 37/1998 of 16 November 1998 amending Securities Market Law 24/1988 of 28 July 1988, which transposed Directive 93/22/EEC of 10 May 1993 on investment services in the securities field into Spanish law, introduced the term "investment services companies", similar to that used by Directive 93/22/EEC, to include securities-dealer companies and securities agencies, and portfolio management companies.

(18) This Ministerial Order partially implemented Royal Decree 629/1993 of 3 May 1993 on rules of conduct for the securities market and compulsory registrations, establishing the system of rates which the institutions apply to their customers, the rules they must respect on making available to their customers securities and funds corresponding to the transactions performed, as well as on the delivery of the relevant contractual documents.

Moreover, and irrespective of the causes that may legally or conventionally give rise to the termination of the portfolio management contract, customers shall retain the power at all times to terminate it unilaterally, without prejudice to the institution's entitlement to receive the commissions unpaid on operations performed as of the time of the contract's termination and other contractually agreed expenses. Once the contract has been terminated, portfolio managers shall have fifteen days at most to report the management accounts.

Lastly, once the contract has been terminated, the portfolio managers shall make the assets available to their customers in the form contractually envisaged, after having deducted the amounts due.

12. VENTURE CAPITAL COMPANIES: ADMINISTRATIVE PROCEDURES AND STANDARDISED FORMS

Law 1/1999 of 5 January 1999 (19) established a full, stable legal framework for venture capital companies *(entidades de capital riesgo,* hereafter, ECRs) and their management companies *(sociedades gestoras de las ECR,* hereafter, SGECRs). This provided a foundation for these companies to continue promoting or fostering small and medium-sized non-financial companies so that they should continue engaging in activities relating to technological innovation or other areas through the acquisition of temporary holdings in their capital.

The aforementioned Law empowered the Ministry of Economy and Finance (MEH) to determine, for each type of ECR and having regard to their specialities, the requirements and standardised application forms for authorisation along with the standardised documents that should accompany said application. With this prerogative the MEH issued the Ministerial Order dated 17 June 1999 (20), thereby partially implementing Law 1/1999, it expressly commissioned the CNMV to determine both the requirements and standardised forms, and it stipulated that such documentation should be submitted directly to the CNMV.

By virtue of this authorisation, CNMV Circular 4/1999 of 22 September 1999 (BOE of 16 October 1999) was issued. This Circular regulates the procedures and documentary forms applicable for obtaining authorisation to set up the new ECRs and SGECRs and to amend the management regulations and articles of association of pre-existing companies.

The processing of ECR and SGECR incorporation plans shall be initiated by means of the presentation before the CNMV of an authorisation application, using the forms set out in the annexes to this Circular.

The ECR application shall specify: the data identifying the applicant; an explanatory report of the ECR plan, so as to allow a proper assessment of the purpose and goals of the new entity; a draft prospectus containing the legal and financial elements that will allow investors to form a balanced opinion of the investment proposed; a draft of the management regulation or the articles of association; the career record of the members of the ECR's Board of Directors and of its senior managers, and a questionnaire on standards of integrity to be completed by the aforementioned members. All these data shall be provided and set out in accordance with the forms stipulated by the CNMV and included in the annexes to this Circular.

The application for authorisation for SGECRs is similar to that for ECRs. Presentation before the CNMV of the same documents is required, with the exception of the draft prospectus.

13. AMENDMENT OF PENSION SCHEME AND FUND REGULATIONS

Law 30/1995 of 8 November 1995 (21) on the regulation and supervision of private insurance, and Law 66/1997 of 30 December 1997 (22) on fiscal, administrative and social measures, introduced a series of amendments to Law 8/1987 of 8 June 1987 (23) on the regulation of pension schemes and funds. The amendments related to the legal regime for pension schemes and the financial and actuarial arrangements to which their workings should adapt. Likewise, these regulations provided for the regulatory implementation of certain matters, particularly in relation to capitalisation arrangements, to the calculation of capitalisation

(19) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 100-101.

(20) See "Financial regulation: second quarter of 1999", in *Economic bulletin,* Banco de España, July 1999, pp. 69-70.

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

(22) See "Financial regulation: fourth quarter of 1997", in *Economic bulletin,* Banco de España, January 1998, pp. 90-91.

(23) See "Regulación financiera: segundo trimestre de 1987", in *Boletín económico,* Banco de España, July 1987, pp. 49-51.

funds and technical provisions, and to other limits and aspects of pension schemes.

To address this regulatory implementation, Royal Decree 1589/1999 of 15 October 1999 (BOE of 26 October 1999) has been issued. It updates certain provisions of the regulations governing pension schemes and plans that were approved by Royal Decree 1307/1988 of 30 September 1988.

With regard to funded systems, only the use of financial and actuarial systems of individual funding will be acceptable, excluding the group schemes envisaged in the regulations to date. Hence, the annual cost of each of the contingencies in which the benefit is defined shall be calculated individually for each participant, not permitting the annual amount of the contribution attributable to each participant for these items to differ from the attributed tax borne by said participant.

With regard to the limitation on annual contributions, the ceiling is raised from ESP 1,000,000 to ESP 1,100,000, and may be raised to ESP 2,200,000 for participants aged 52 and over. Likewise, the MEF may update these additional limits as and when the maximum contribution ceiling is altered (i.e. the collection or liquidity of the assets).

Regarding the arrangements for benefits, new situations that may be assimilated to retirement have been determined and the means of collection and recognition of benefit entitlements have been updated. Regarding situations assimilated to retirement, both the termination and suspension of the working relationship of a participant aged at least 52 and entailing a move to unemployment status shall be considered as such provided said participant is registered as unemployed with INEM (National Employment Office) or is in this situation as from that age. In employment schemes, the establishment of such benefits and their recognition may be envisaged for limited periods of time or circumstantially, by virtue of the assumptions stipulated in the Workers' Statute or on the basis of what should have been specified in a group programme of contractual termination or suspension and accepted under collective bargaining.

Further, retirees may only make contributions to pension schemes for the contingency of dying. Nonetheless, retirees that resume work, re-registering with the Social Security system, may contribute to pension schemes with a view to their subsequent retirement.

As to the means of collection and recognition of benefit entitlements, benefits may, as under the previous arrangements, be in the form of capital, income or mixed (combining capital and income).

Mention should be made of the addition of a new section in Royal Decree 1307/1988 to regulate *jointly promoted pension schemes under the employment system (hereafter, joint schemes).* These schemes have to be applied by several companies, whether in a single group or one of companies with fewer than 250 employees.

Regarding joint schemes of a single group, these may be made up of corporations that belong to the group and meet the following conditions:

a) What are involved are companies incorporated in conformity with Spanish legislation and headquartered in national territory.

b) They shall have pension commitments to their employees for retirement contingencies that are susceptible to integration into a pension scheme.

Nonetheless, credit institutions, insurance companies, and securities-dealer companies and securities agencies that should have opted to maintain their commitments in in-house funds will not have to participate in the scheme. And nor will group companies which, as of the date of the group pension scheme being legalised, are promoters of other, previously legalised pension schemes. Once the group pension scheme is legalised, new companies or institutions that subsequently become part of the group may join it.

As regards joint schemes promoted by companies with fewer than 250 employees, the legalisation of these schemes will require that at least two companies be initially involved, with any others with fewer than 250 employees being allowed to participate subsequently, should the specifications limiting the number and characteristics of potential promoters so permit it.

Other noteworthy aspects are the rules common to jointly promoted pension schemes, the composition and working of the control board, the separation of the promoting institutions and the causes of cessation of the schemes.

Lastly, the additional provision of the regulation updates the financial and actuarial hypotheses of relevance for pension schemes, and the transitional provision presents the elements and terms necessary to proceed to the adaptation of pre-existing pension schemes to what is laid down in this Royal Decree.

14. APPLICATION OF COMPANIES' PENSION COMMITMENTS TO EMPLOYEES AND BENEFICIARIES

Law 30/1995 of 8 November 1995 on the regulation and supervision of private insurance crafted the regime governing the application of companies' pension commitments to employees, retirees and beneficiaries (the so-called *externalisation regime),* including the benefits occasioned. At the same time, it amended Law 8/1987 of 8 June 1987 on the regulation of pension schemes and funds along these lines. This regime is of a permanent nature, as it stipulates that the firm's commitments to employees, retirees and beneficiaries should be applied through pension schemes or insurance contracts, and that the coverage of such commitments through in-house funds or similar instruments involving the firm retaining title to the funds set aside shall not be admissible.

Recently, this regime has been implemented by means of RD 1588/1999 of 15 October 1999 (BOE of 27 October 1999). As a result, the Regulation on the application of firms' pension commitments to employees and beneficiaries (also known as the externalisation regime) has been approved.

This regime allows two ends to be met. First, it safeguards firms' pension commitments to employees and beneficiaries in the event of insolvency or financial difficulties for firms. And second, the externalisation of pension commitments off firms' balance sheets allows firms to free resources and focus on their particular business, which will ultimately make for greater national and international competitiveness. Likewise, this process involves transferring the management of pension resources to institutions specialising in financial management and investment, whether pension fund management companies or insurance companies.

Nonetheless, the regime retains an exception – albeit a transitory one – for entities in the financial sector, namely credit institutions, insurance companies and securities-dealer companies and securities agencies (hereafter, financial institutions), since they are engaged in sectors regulated and overseen by a control body, which results in the solvency pursued by the regulation being safeguarded. Furthermore, the habitual business of these institutions does indeed focus on the administration and management of funds and, where appropriate, on the assessment and coverage of risks.

The regulation has four sections.

The first section specifies the scope of the application of firms' pension commitments and the obligation to apply and, where appropriate, adapt firms' pension commitments whether by means of pension schemes, group insurance contracts or both.

The second section sets out the transitional regime for the adaptation of pension commitments by means of pension schemes. Among others, this regime must include the following elements:

a) A rebalancing plan covering the rights in respect of past service corresponding to pension commitments to existing staff and, where applicable, obligations to retirees and beneficiaries.

b) The transfer of existing funds, which shall be carried out within 10 years from the execution or modification of the specifications of the pension scheme, as the case may be, to incorporate the commitments included in the rebalancing plan.

c) Payment of the deficit, within 15 years from execution of the pension scheme or, as the case may be, from amendment of the scheme to incorporate the rebalancing plan.

d) The legal rules, the valuation and quantification of the rights in respect of past service and the obligations to retirees and beneficiaries.

The third section refers to the application of pension commitments by means of insurance contracts, either in the form of a group insurance policy or through the relevant benefit regulations.

Finally, the fourth section implements an exceptional regime for financial institutions. It should be stressed that the regulation maintains a regime of exception for financial institutions that have their pension commitments assumed prior to 10 May 1996 in an internal fund. The following conditions must be met:

a) The pension commitments must arise under a collective agreement or equivalent instrument prior to that date.

b) The financial institution shall have assumed the commitment by that date or, if subsequently, by subrogation as a result of corporate operations.

c) The commitments, as at the entry into force of this regulation, shall be applied by the financial institution through the relevant provisions or book entries, with the responsibility for management of the funds to cover them corresponding to either the financial institution itself or to other financial institutions under insurance transactions or the like.

Also, this transitional regime may be extended to employees from other financial institutions, when the latter assumed pension commitments to the former which they are authorised to cover by means of internal funds. In these cases, if the institution is subrogated to or assumes such commitments, it may in turn cover them with an internal fund, provided that the latter has been authorised to cover its commitments with an internal fund.

Likewise, institutions seeking to come under this transitional regime shall make an application to the Ministry of Economy and Finance before 1 January 2001, submitting the documentation specified in the Royal Decree and fulfilling the conditions laid down here and in the said Regulation.

Finally, they must adjust the fresh pension commitments assumed since 9 May 1996, the pension commitments to staff joining the company after the entry into force of this regulation and the insurance contracts which apply pension commitments to the first additional provision of Law 8/1987 of 8 June 1987 on the regulation of pension schemes and funds.

15. TAXATION OF FINANCIAL ASSETS

The publication of two tax provisions aiming to promote the development and greater liberalisation of markets for financial assets, in line with the other industrialised countries, should be noted:

First, *Royal Decree 2060/1999 of 30 December 1999* (BOE of 31 December 1999) has been published, amending certain provisions of the corporate income tax regulations approved by Royal Decree 537/1997 of 14 April 1997 (24). The following three points should be noted: (i) income from debt issued by the governments of OECD countries and financial assets traded on organised markets in such countries, as well as income obtained from funds of funds and master-feeder funds and the amounts paid by insurance companies to pension funds as a consequence of the insurance of pension schemes are exempted from withholdings; (ii) the obligation on the depositories of open-end investment companies to make withholdings is abolished, and as a result, in the case of the transfer or redemption of their shares, the shareholder shall be obliged to make a payment on account; (iii) the withholding rate generally applicable under the corporate income tax has been lowered from 25 % to 18 %, in line with personal income tax provisions.

Second, the *Ministerial Order of 22 December 1999* (BOE of 29 December 1999) has been published, establishing a new simpler procedure for the refunding of withholdings. In particular, this Order systematises and unifies the withholding procedure applied to the interest on financial assets in the form of book entries that are traded on an official secondary market and held by taxpayers exempt from corporate income tax or the tax on the income of non-residents where income is obtained in Spanish territory through a permanent establishment. This new procedure shall not apply to income from government securities, except for those issued by a local government.

16. STATE BUDGET FOR THE YEAR 2000

As usual in December, the State Budget for the year 2000 has been approved by *Law 54/1999 of 29 December 1999* (BOE of 30 December 1999).

This Budget contains no significant changes from the previous year's, continuing the line of austerity, control of the deficit and budgetary discipline initiated in previous years.

Owing to their importance or novelty, the following aspects should be highlighted:

With respect to financial regulation, the legal interest rate and the delay interest rate for tax purposes are held at 4.25 % and 5.5 %, respectively. Also, the ceiling for the increase in the outstanding stock of State debt during the year is set at ESP 1.71 trillion. This ceiling, 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, upon authorisation from the Ministry of the Economy and Finance, in a limited number of cases.

In the fiscal sphere, with regard to personal income tax, the relevant general and regional tax brackets are adjusted and the coefficients to correct acquisition values are updated to 2 % (percentage inflation rate forecast for the coming year). Also, mechanisms are established to compensate those taxpayers for whom the new regulation is less advantageous than the deductions previously enjoyed for investment and rental of their habitual residence.

(24) See "Regulación financiera: segundo trimestre de 1997", in *Boletín económico,* Banco de España, July-August 1997, pp. 115 and 116.

In relation to corporate income tax, the coefficients to allow for inflation since 1983 are updated, and the amount of the payments on account that entities subject to this tax are required to make is determined. There are no other amendments to the legislation in force in 1999, other than the introduction of an obligation on look-through companies to make advance payments of the tax and, as in the case of personal income tax, the possibility of deducting from the tax base expenditure on the patronage of priority activities and programmes. As regards the wealth tax, the exempt amount (ESP 18 million) and the rate schedule applicable in the event that the Regional (Autonomous) Governments do not approve specific amounts or have not assumed responsibilities in this area are updated.

As regards public spending, the suspension of the possibility of making appropriations, except in certain specific cases, and the prohibition on transferring appropriations from capital to current operations are both maintained, with the same qualifications as last year.

In relation to the Regional (Autonomous) Governments, their percentage shares in State revenue for the five-year period 1997-2001, applicable on 1 January 2000, are fixed, distinguishing between the final percentage shares in the State's territorial revenue under personal income tax and those of the Regional (Autonomous) Governments in general State revenue. Also, as regards the year-2000 financing through shares in State revenue, those Regional (Autonomous) Government's to which the financing arrangements for the five-year period are applicable are distinguished from those that have not adopted the agreement on the financing arrangements.

17. FISCAL, ADMINISTRATIVE AND SOCIAL MEASURES

As usual in recent years, to facilitate the achievement of the economic policy objectives set out in the State Budget for the year 2000, a number of fiscal, administrative and social measures have been adopted. These are contained in *Law 55/1999 of 29 December 1999* (BOE of 30 December 1999).

The Law introduces certain amendments in the area of taxation and to the provisions regulating general government employees, and responds to specific needs in relation to management, organisation and activities of government.

In the fiscal sphere, certain parts of the current personal income tax provisions contained in Law 40/1998 of 9 December 1999 are amended (25). First, compensation paid by general government for personal injury (physical or psychological) suffered as a consequence of the operation of public services is now included under exempt income. Second, the cases in which deductions may be made for investment in habitual residences have been extended to include cases in which taxpayers carry out work and installations to refurbish the same, including the common parts of the building and areas through which passage is necessary to obtain access to the building (previously only the disabled were entitled to these deductions). As regards the calculation of net earned income received at irregular intervals, the Law establishes that the amount of the income to which the 30 % reduction shall be applied may not exceed the amount obtained by multiplying the annual average wage of all personal income tax payers by the number of years over which the income is generated. For this purpose, where the income is clearly obtained irregularly, a period of five years shall be taken.

In general, the net earned income obtained in the year 2000 under the personal income tax self-assessment arrangements may be reduced by 7 %, and by as much as 12 % if the level of staff has been increased during the year 2000.

Certain incentives have been introduced into the corporate income tax, such as the new rules for the deduction for scientific research and technological innovation activities.

With regard to VAT, as from 1 January 2000, the special arrangements for the retail trade whereby tax bases are determined proportionately and their impact on other special VAT arrangements are abolished and the special arrangements for investment in gold are established.

Finally, among the additional provisions, the amendments to Securities Market Law 24/1988 of 28 July 1988 (26) and to Royal Legislative Decree 1564/1989 of 22 March 1989 approving the consolidated text of the Public Limited Companies Law are notable. These amendments regulate *"stock options"* for the first time.

As regards Law 24/1988, the directors of listed companies shall notify the company concerned, the stock markets on which their shares are traded and the CNMV of any acquisition or disposal of stock options over their company's

(25) See "Financial regulation: fourth quarter of 1998", in *Economic bulletin,* Banco de España, January 1999, pp. 105-107.

(26) See "Regulación financiera: tercer trimestre de 1988", in *Boletín económico,* Banco de España, October 1988, pp. 61 and 62.

shares, by whatever means. Also, in addition to the existing requirements, the listing of a company's shares and the appointment of new directors shall require the directors to give details of any stock options they may hold over their company's shares. Finally, the managers of listed companies shall notify the CNMV of any stock options received by way of remuneration. Such notification shall be subject to the rules on the publication of relevant facts (27).

As regards the Public Limited Companies Law, remuneration consisting of shares or stock options or tied to the share price must be expressly envisaged in the articles of association, and shall require a resolution of the shareholders in general meeting. Also, the exercise and disposal by the directors of a listed company of stock options granted before 1 January 2000 (where this is not envisaged in the articles of association) shall also require approval by the shareholders in general meeting. In the case of general managers and the like, approval by the shareholders in general meeting shall be necessary in all cases for the exercise or disposal of stock options granted prior to 1 January 2000.

20.1.2000.

(27) Contained in article 82 of Securities Market Law 24/1988 of 28 July 1988. Issuers of securities are required to inform the public, as soon as possible, of any fact or decision that may significantly affect their prices, although the CNMV may grant exemptions from this obligation should it deem this necessary.

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