
Quarterly report on the Spanish economy

1. Overview

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

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

TABLE 1

Gross domestic product (a)

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

Source: Instituto Nacional de Estadística.

(a) Year-on-year trend rates of change. 1986 constant pesetas. Provisional figures.

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

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

In the euro area, economic growth in the third quarter of 1998 (2.4 % in year-on-year terms) stood at appreciably lower rates than in the first two quarters. Further contributing to the slowdown, which was, as stated, largely due to

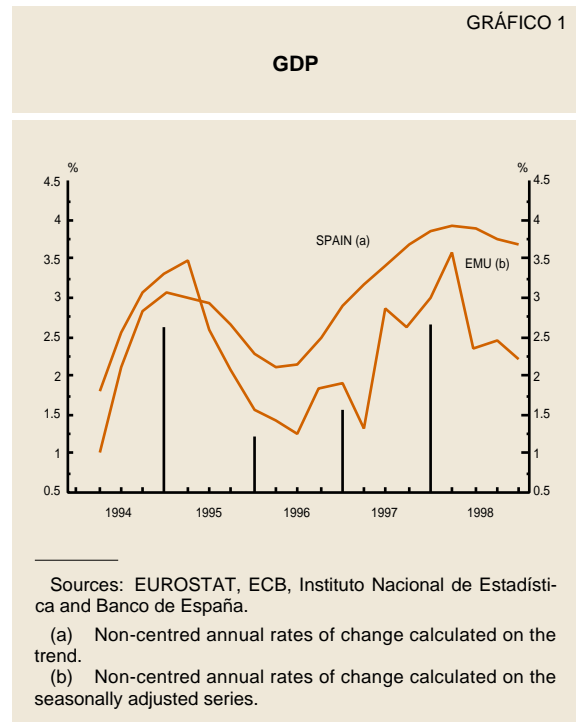
the sluggishness of the foreign sector, was the behaviour of stockbuilding. The related indicators attest to the deterioration in business confidence, although consumer confidence remains at very high levels, whereby the continuing strength of private consumption may, for the moment, be anticipated.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

The Spanish economy ended 1998 with a growth rate clearly higher than that recorded on average in EMU (see Chart 1). The negative contribution of real net external demand to GDP growth increased, as exports are being affected

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

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

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



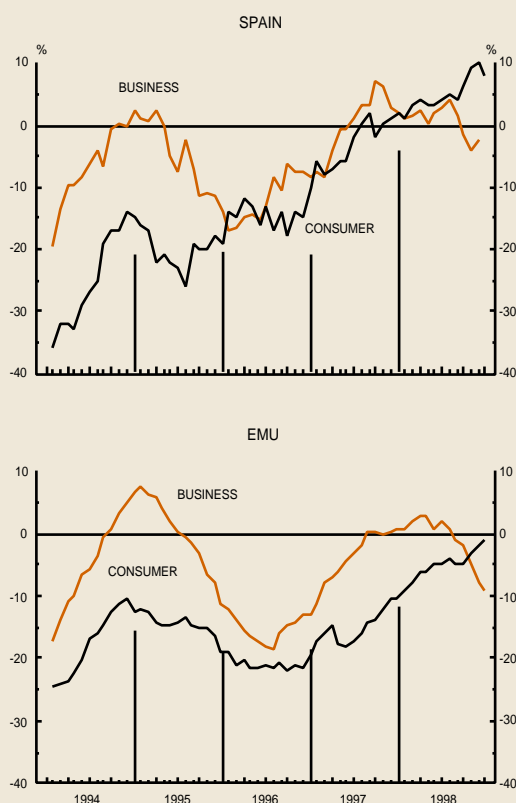
trend of export is spreading to the EU area. On the information available, in which high erraticism is evident, it is estimated that total exports of goods and services in 1998 are running at a real growth rate of around 7 %, over six percentage points below the related rate a year earlier. As to capital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

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

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

CHART 2

Confidence indicators



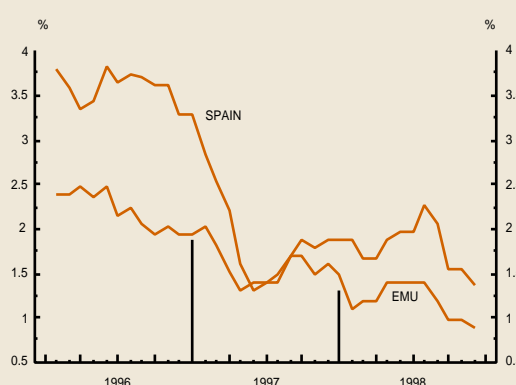
Sources: European Commission and Ministerio de Industria y Energía.

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

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

CHART 3

Harmonised indices of consumer prices
12-month percentage change



Source: EUROSTAT and Instituto Nacional de Estadística.

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

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

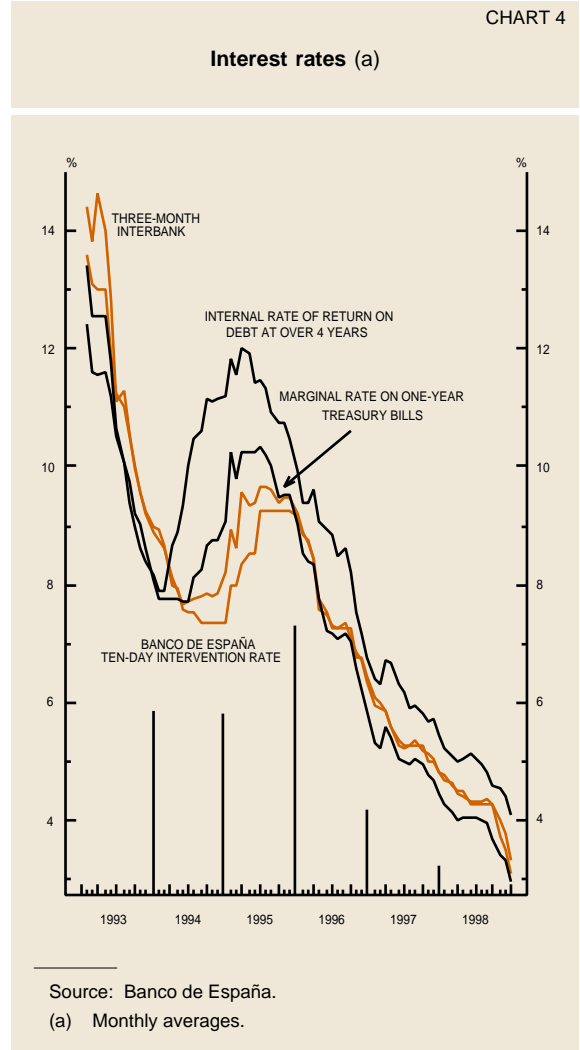
In December, the increase in the Harmonised Index of Consumer Prices (HICP) was 1.4 %, half a percentage point up on prices across EMU. Analysis of the main components with data to November shows that, although growth rates are identical in the goods aggregate (0.3 %, somewhat higher than that of industrial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

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

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

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

The ongoing convergence of interest rates has seen the Banco de España cut 1.25 points off its intervention rate in the final quarter of 1998. The effects of this on money and financial markets are equivalent to those recorded in other euro-area countries (see Chart 4). Regarding monetary and credit developments, the pattern in the Spanish economy was also



similar to that seen for the euro area as a whole. The broad monetary aggregates ended the year with moderate annual growth rates (6.5 % for ALPF and 1 % for ALP). The narrow aggregates, such as M1 and M2, showed more intense growth rates (around 14-15 %). Financing to households and firms increased at a rate of higher than 16 per cent in 1998, driven by the ongoing process of interest rate cuts, the improved economic outlook and, specifically, favourable employment developments.

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

2. The external environment of the euro area

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

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

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

Regarding developments in the US economy in the fourth quarter, the available indicators show very diverse behaviour. Private consump-

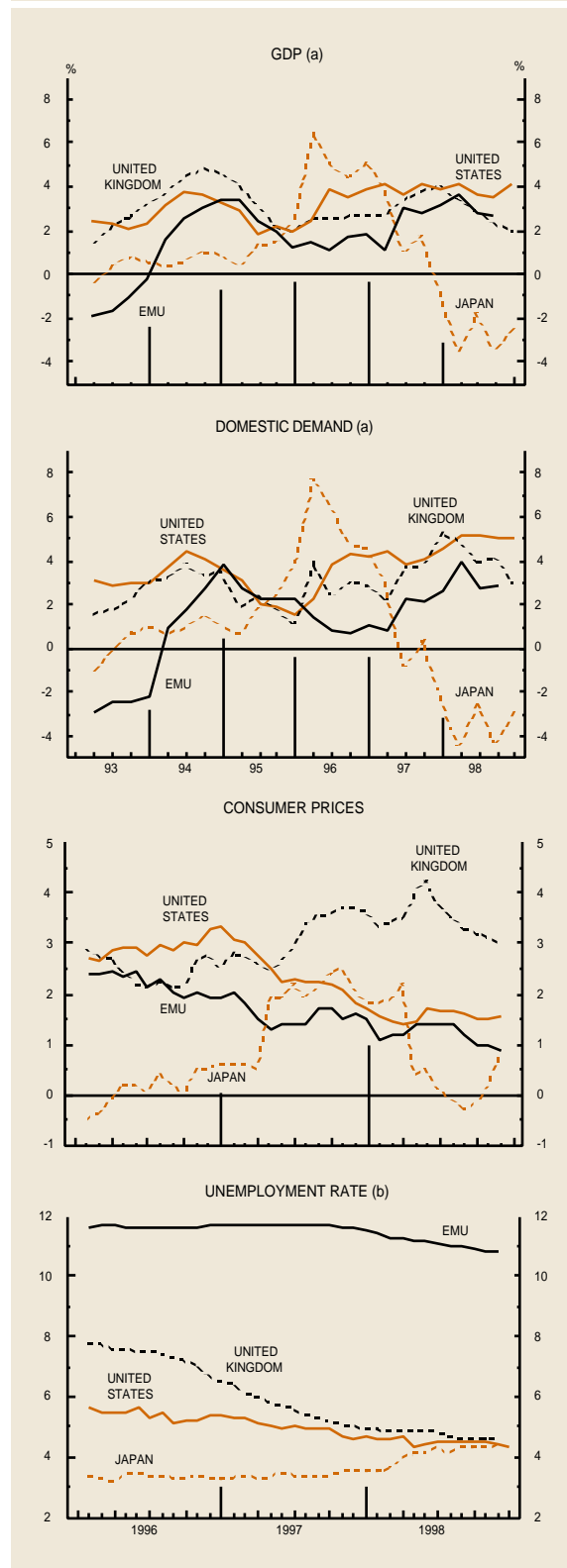
tion and investment have continued growing at sustained rates, while industrial production and other supply-side indicators have shown a slowdown in productive activity, in response to the contraction in external demand. On provisional figures, US GDP in the fourth quarter may have grown at a year-on-year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

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

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

CHART 5

Main macroeconomic indicators
Percentage change on previous year

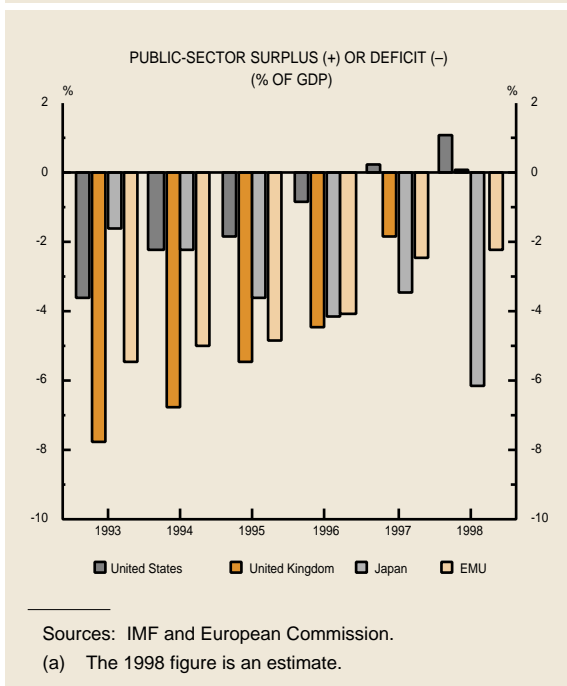


Sources: Banco de España, national statistics and EURO-STAT.

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

CHART 6

Public finances in the main economies (a)



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

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

In the United States, the budgetary consolidation drive and the favourable contribution of this economy's cyclical conditions mean that fis-

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

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

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

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

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

The exchange rate crisis in Brazil

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

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

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

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

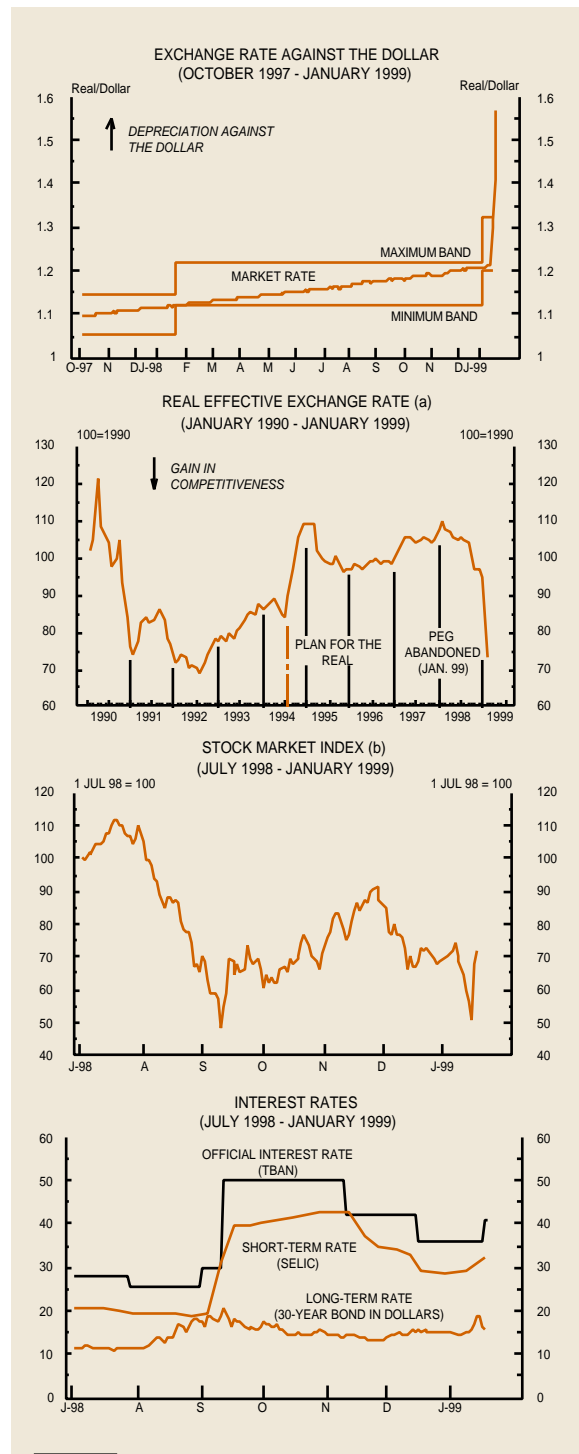
The annual depreciation by the real against the dollar in nominal terms did not suffice to offset the unfavourable price differential for Brazil prevailing in the period from 1994 to 1997, despite the efforts made in this area. As a consequence, the inflation-adjusted exchange rate index of the Brazilian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

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

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

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

Brazil: main financial indicators



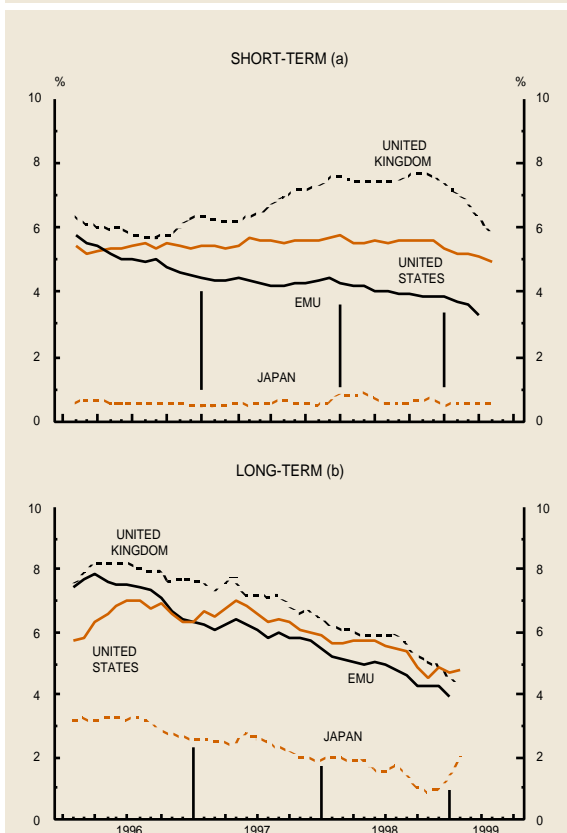
Sources: JP Morgan, Reuters and in-house compilation

(a) The real has been the Brazilian currency since July 1994. January 1999: estimated on the basis of the nominal depreciation of the real.

(b) Sao Paulo Stock Exchange index (BOVESPA).

CHART 7

Interest rates



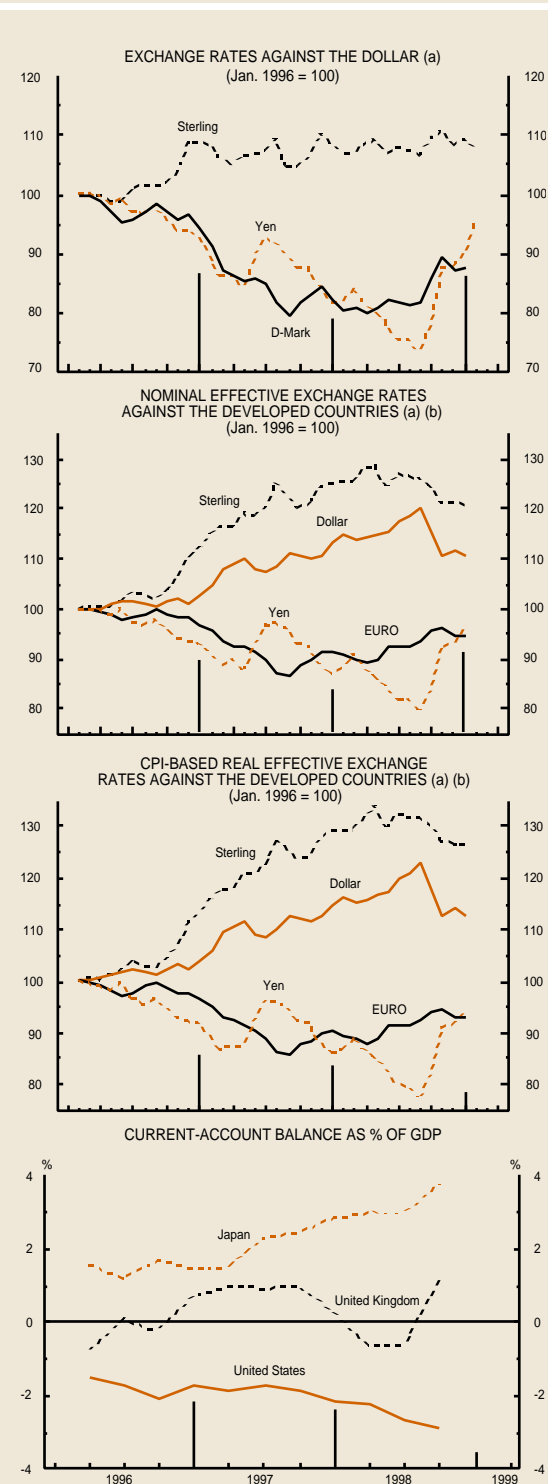
Source: Banco de España.
 (a) Three-month interbank market interest rates. January 1999: average data to the 15th.
 (b) Ten-year government bond yields. January 1999: average data to the 15th.

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

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

CHART 8

Exchange rates and current-account balances



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

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

3.1. Economic conditions in the euro area

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

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

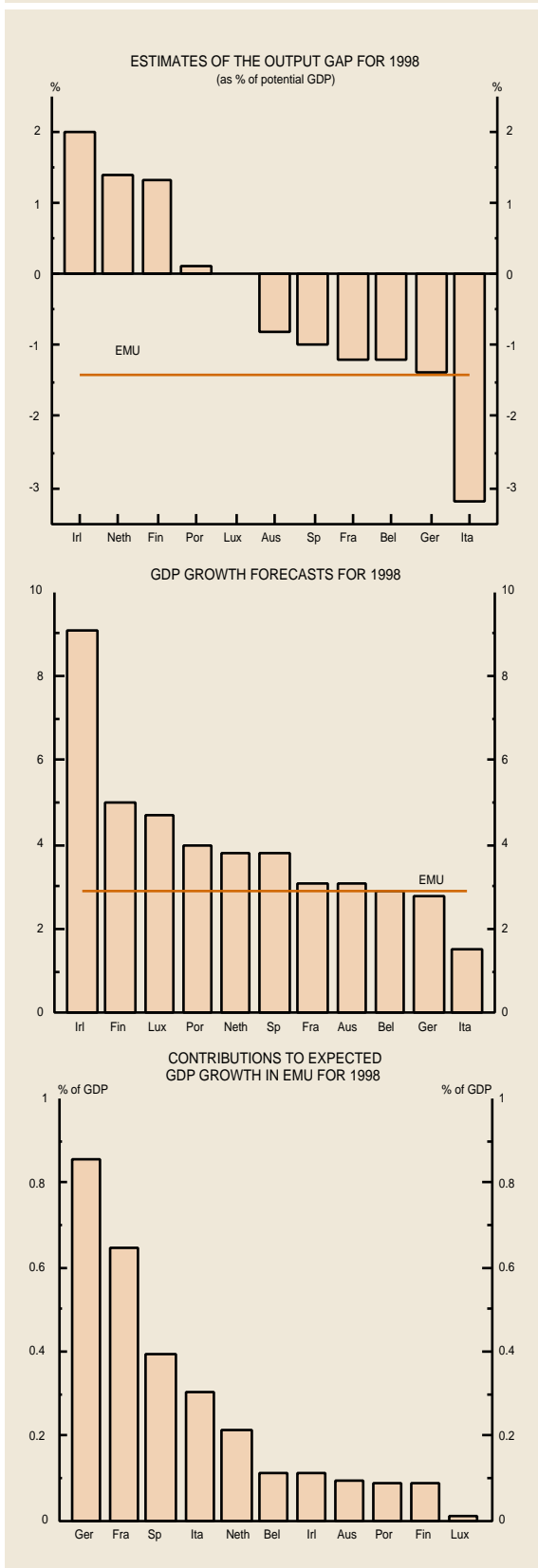
In the first half of 1998, domestic demand was unusually strong. Of particular note was the buoyancy of investment, underpinned by the area's financial stability and low interest rates (see Chart 7). From the third quarter, the negative contribution of the external sector has been accompanied by a reduction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

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

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

CHART 9

Output gaps and GDP in EMU



Source: OECD (December 1998)

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

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

With regard to the area's competitiveness vis-à-vis its main trading partners, the nominal and real effective appreciation in 1998 of the EMU members' currencies has brought about a partial correction of the depreciation against sterling and the US dollar in 1997 (see Chart 8). The effective exchange rate of the euro is thus trending at present towards the average of recent years. According to foreign trade data, the trade surplus declined in September 1998 by €1,600 million (23 %) compared with the same month a year earlier. In the third quarter, the trade deficit fell by 4.6 % in year-on-year terms, reflecting a modest increase in the value of exports (0.9 %) and somewhat higher growth in imports (1.8 %). The cumulative trade surplus in the first three quarters of 1998 was up 0.3 % on the same period in 1997.

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

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

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

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

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

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

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

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

CHART 10

**Harmonised Indices of Consumer Prices
12-month percentage change**

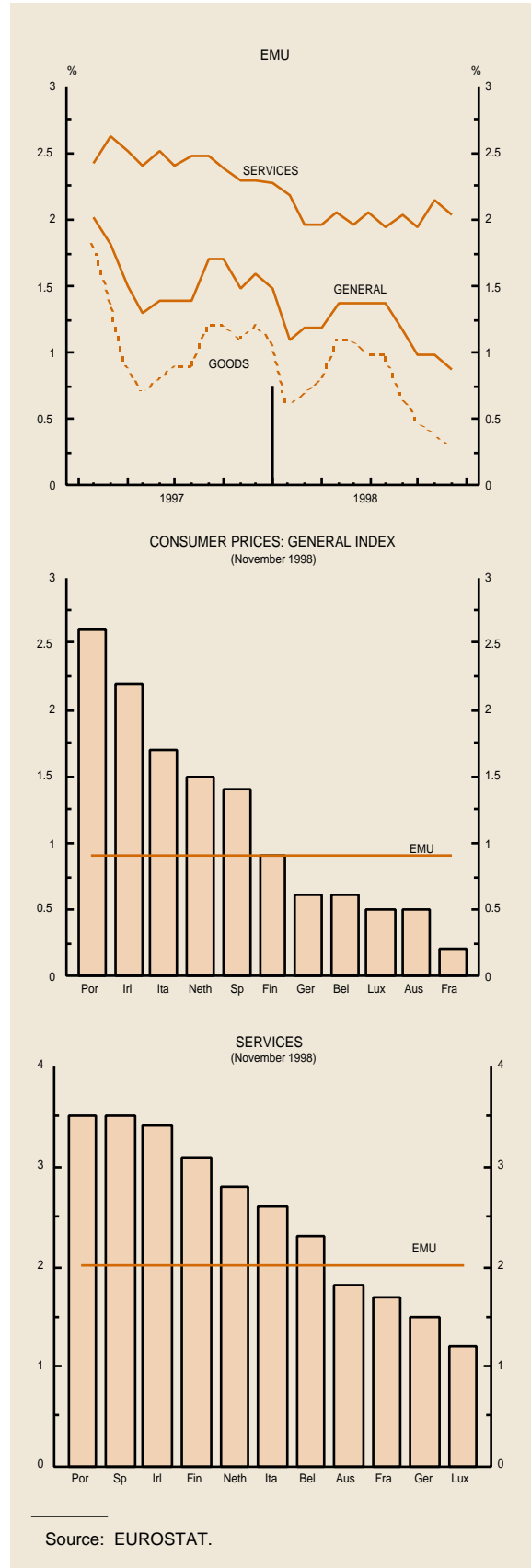


TABLE 2

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

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

Sources: European Commission and ECB.

(a) Estimate.

(b) Deficit (-) / surplus (+).

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

This situation underscores the unavoidable need for resolute progress in the consolidation of public finances. Broadly, budgetary guidelines for 1999 and the stability programmes drawn up by each country are consistent with this objective. Nonetheless, the degree of ambition regarding attainment of this objective and the margin for manoeuvre with which it is intended to endow fiscal policy in the medium term diverge from country to country. Moreover, the improvement expected for 1999 will continue partly to draw on the favourable effects of the low level of interest rates and the inertia of the business cycle. Along with the improvement in overall balances, budgetary plans in the short

and medium term are generally pursuing a reduction in the share of revenue and expenditure in GDP and, in particular, the restructuring of these two categories. A common feature on the revenue side is the proposed tax reforms. These are generally aimed at easing the direct tax burden on companies and households (in particular the lower-income brackets) in order to enhance the efficiency of the labour market. The resulting forgone revenue would be partly offset, in some cases, by higher indirect taxes. On the expenditure side, greater priority is to be given to public investment and to active labour market policies.

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

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

TABLE 3

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

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

Source: European Commission.

(a) Estimate.

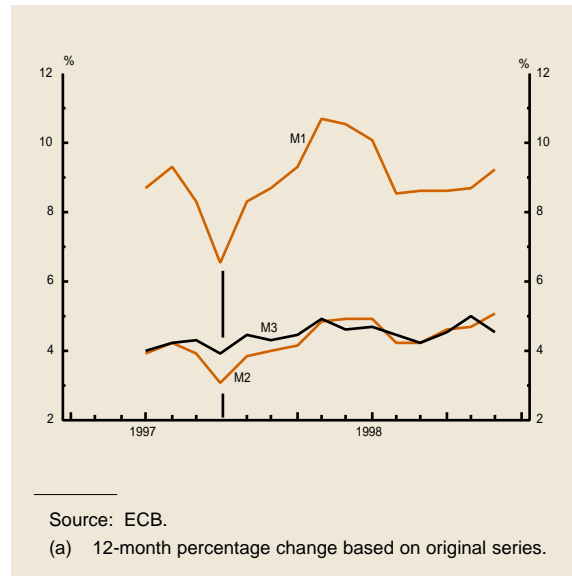
have been determined by the prior convergence of numerous European countries' interest rates towards the levels of the core countries with lower rates. At the end of 1998, the intervention rates of the countries that were to initiate the Third Stage of Economic and Monetary Union (EMU) stood at 3 %,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

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

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

On the information available, the recent growth of M3 is compatible with the reference value established. With data to November, the centred three-month moving average of its year-on-year growth stood at a rate of 4.6 % in September and of 4.7 % in October. The growth of the monetary aggregates in the euro area has been essentially driven by the rate of economic expansion and by the opportunity costs of holding assets considered liquid as opposed to other alternative assets. In the area as a whole, the broad monetary aggregates ran, ac-

CHART 11
Monetary aggregates in the euro area (a)



ording to the information available to November 1998, at a lower rate of expansion than the narrow aggregates (2). As Chart 11 shows, the year-on-year growth of M1, which includes only cash and overnight deposits, held at levels close to 9 %. M2, which further includes time deposits up to two years and deposits redeemable at notice up to three months, trended more modestly in a very similar fashion to M3.

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

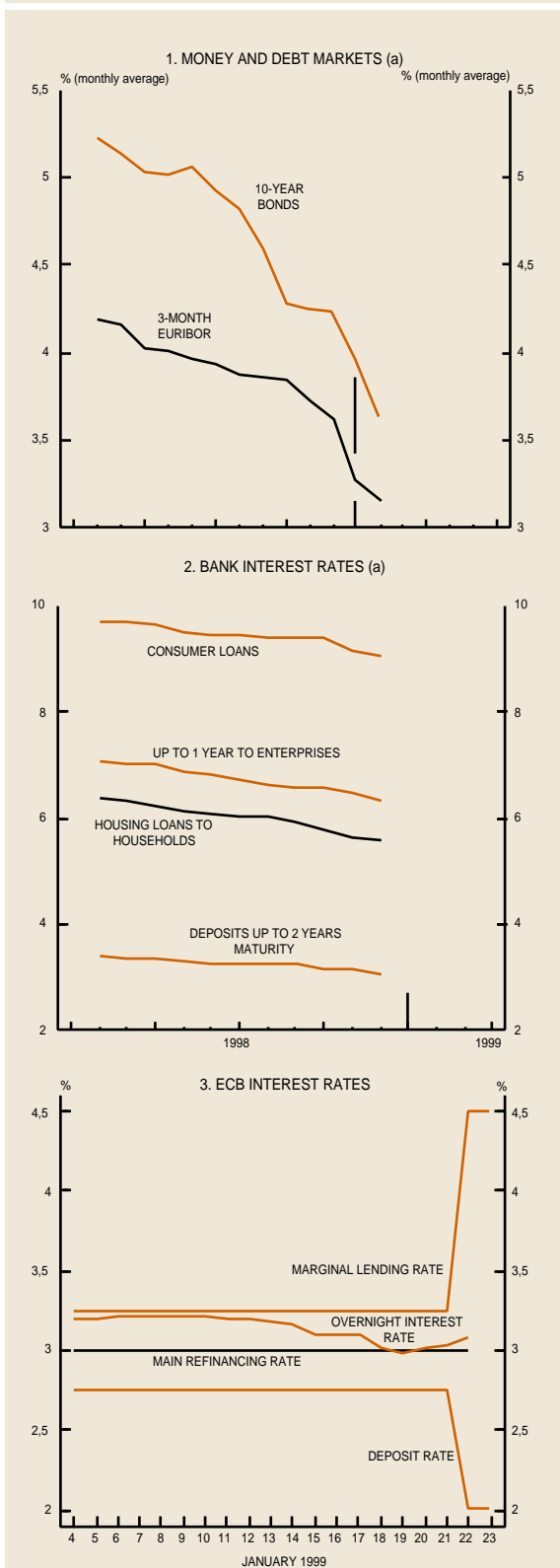
The remaining non-monetary liabilities of monetary financial institutions (MFIs) (3), such as deposits and securities at over two years

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

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

CHART 12

Interest rates in the euro area



Sources: Banco de España and ECB.

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

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

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

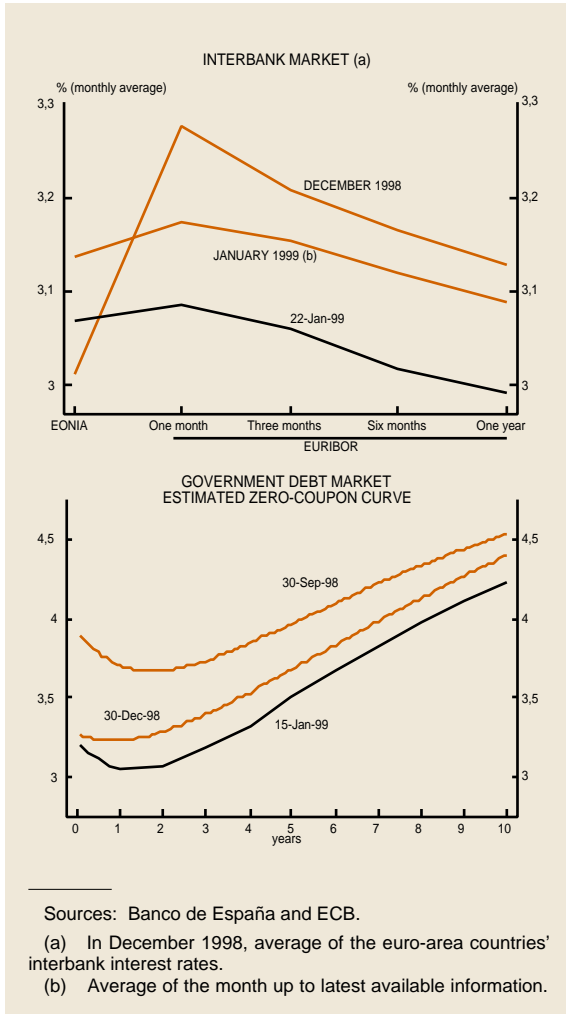
The growth rate of the financing extended by MFIs in the euro area to residents is in contrast to the continuing slowdown in lending by these institutions to general government. In November, loans to general government fell by 1.5 % year-on-year and the outstanding balance of debt issued by the sector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

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

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

CHART 13

Euro-area yield curves

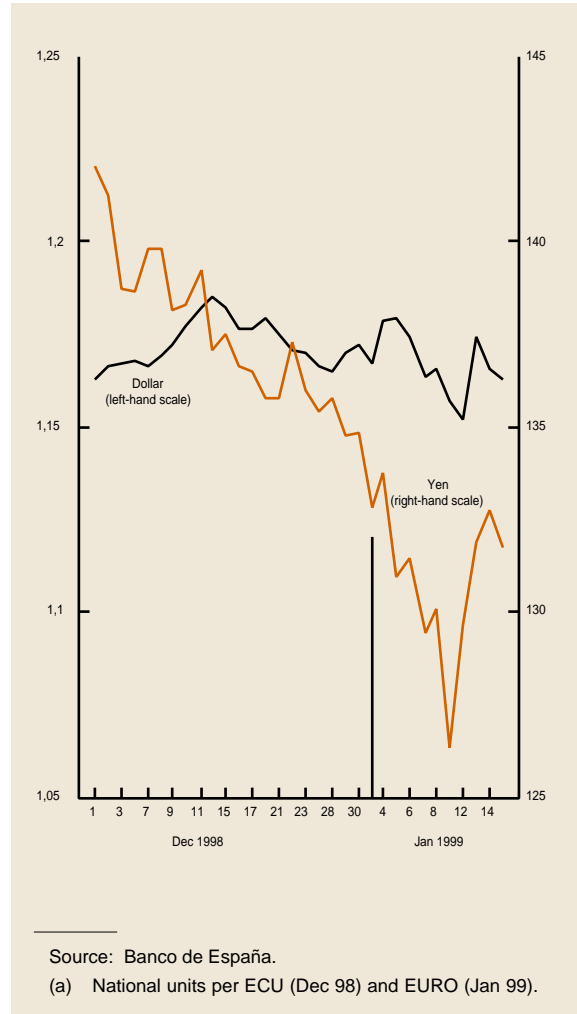


associated with the greater volatility generated by the recent turbulence on international financial markets. In any event, these movements translated into downward shifts of the yield curve in the euro area in January, highlighting the credibility enjoyed by the initial monetary policy measures implemented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

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

CHART 14

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



and Japan, since in recent months short-term interest rates in Europe have fallen more than in these two countries.

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

Monetary and financial conditions at the start of the Third Stage have been largely influenced

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

The first four tenders for the main refinancing operations were allotted on 7th, 13th, 20th and 27th January. These tenders were executed at a fixed rate of 3 % and were settled with high rationing levels (16 %, 8.5 %, 10 % and 10 %, respectively). Given that the type of tender and adjudication procedure used (fixed-rate and high rationing) involved a change from previous national practices for the credit institutions of certain countries (Spain among them), there

was significant use of both the marginal credit and deposit facilities. This situation has subsequently been corrected, and resort to the standing facilities is proving exceptional.

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

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

4. The Spanish economy

4.1. Demand

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

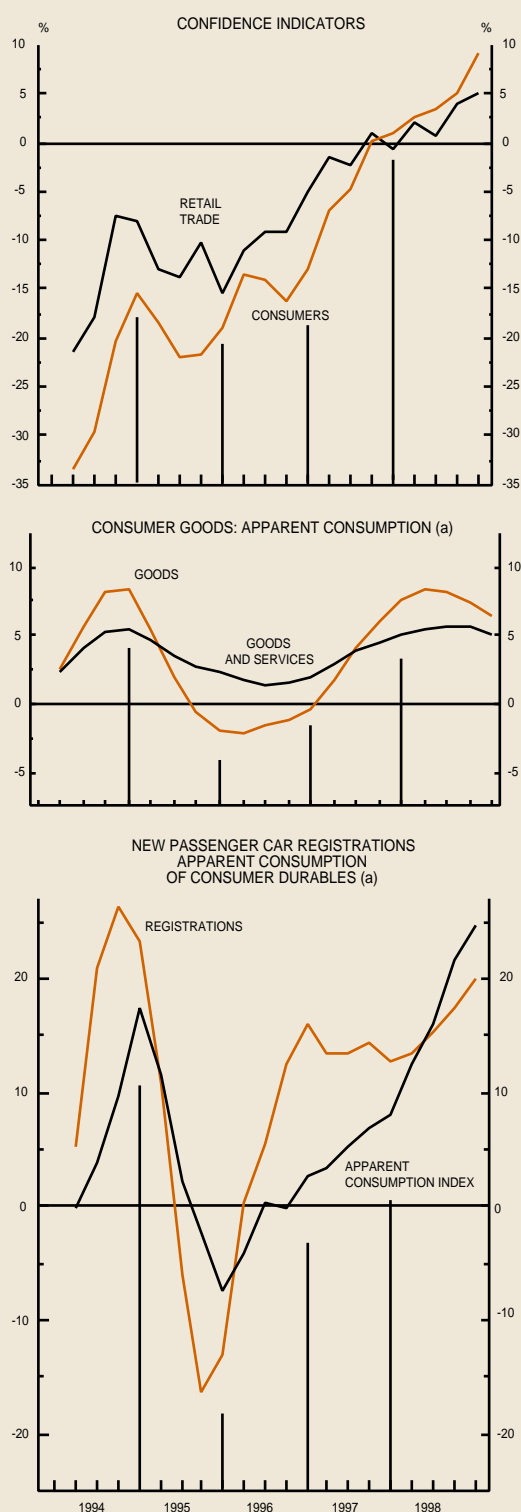
On the economic data available at present, it is estimated that national demand resumed a high real growth rate in the fourth quarter, higher indeed than that of the previous quarter, with growth for the year on average standing at 4.4 %. This performance in the closing months of 1998 is a result of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

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

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

CHART 15

Private consumption indicators



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

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

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

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

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

The moderation seen in capital investment during 1998 is closely tied to the containment of

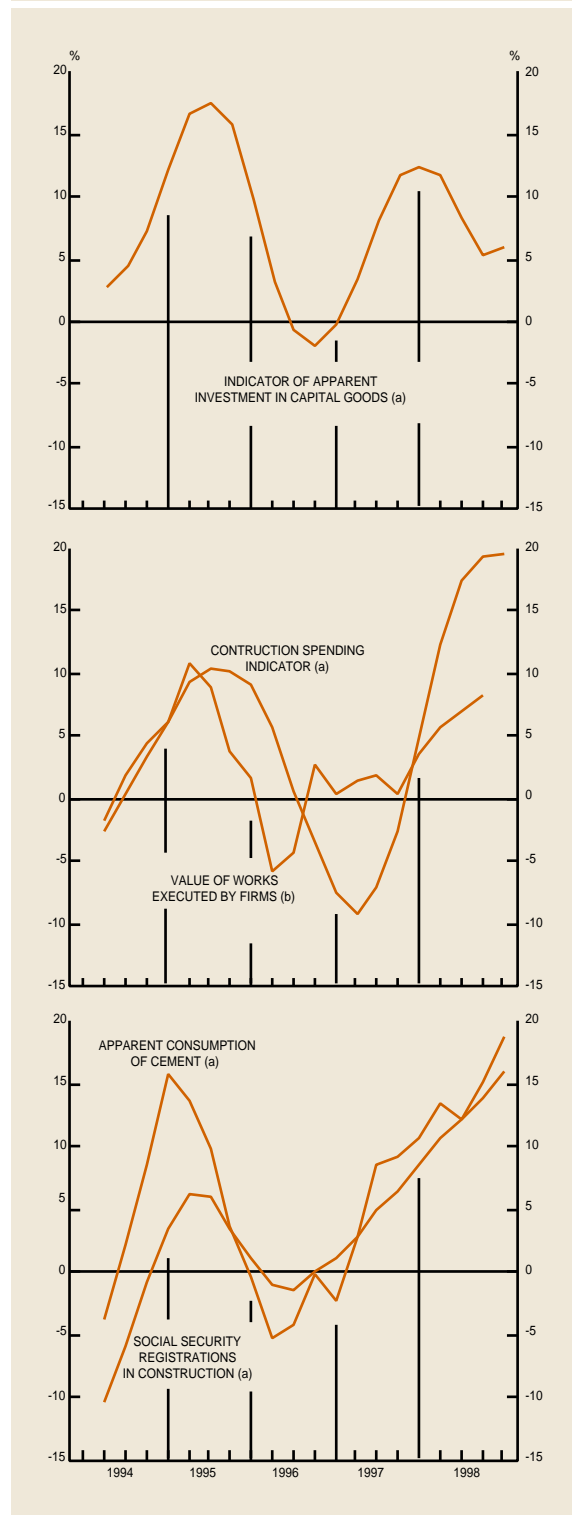
the growth rate of final demand, arising from the progressive weakness of exports, which has translated into a sizeable decline in foreign orders. Notwithstanding, capital spending was the most buoyant component of demand on average in 1998, with an estimated growth rate of around 12 %, higher than that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

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

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

CHART 16

Gross fixed capital formation indicators



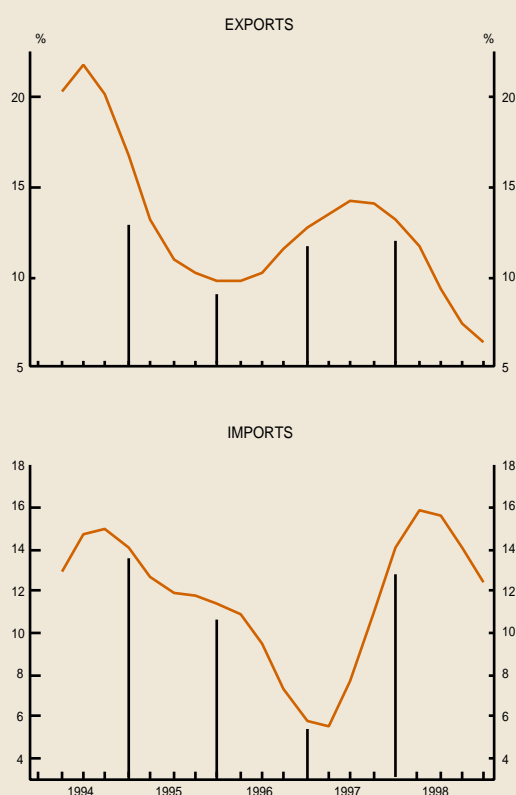
Sources: Ministerio de Fomento, Oficemen and Banco de España.

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

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

CHART 17

Foreign trade in goods (a)



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

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

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

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

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

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

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

The breakdown of exports by geographical area reveals a sharp decline in sales to countries directly affected by the crisis. Specifically, exports in recent months to Latin-American and east European countries have been very depressed. And this has compounded the sizeable decline since the start of the year in exports to Japan and other south-east Asian countries. The collapse of the Russian economy and its effects on other economies in the region and the growing instability of the Latin-American economies account for this result. Sales to the United States have flagged substantially in recent months as a result of the

downward course of the dollar. Overall, exports to non-EU countries fell by 3.9 % in nominal terms in the first eleven months of the year, in contrast to the 24.2 % increase on average in 1997. As regards exports to the EU, the drastic slowdown in October and November will foreseeably be temporary. That said, the export growth path had already slackened in the preceding months (after gathering notable steam at the start of the year), in step with the prevailing moderation in EU economic activity during the second half of the year. Consequently, the cumulative growth in the first eleven months of 1998 stood at 12.1 %, slightly down on the figure of 14.5 % in 1997. Notable at a more detailed level is the strength of exports to France. Sales to Germany showed similar growth rates to those in 1997, and those to Italy have slowed.

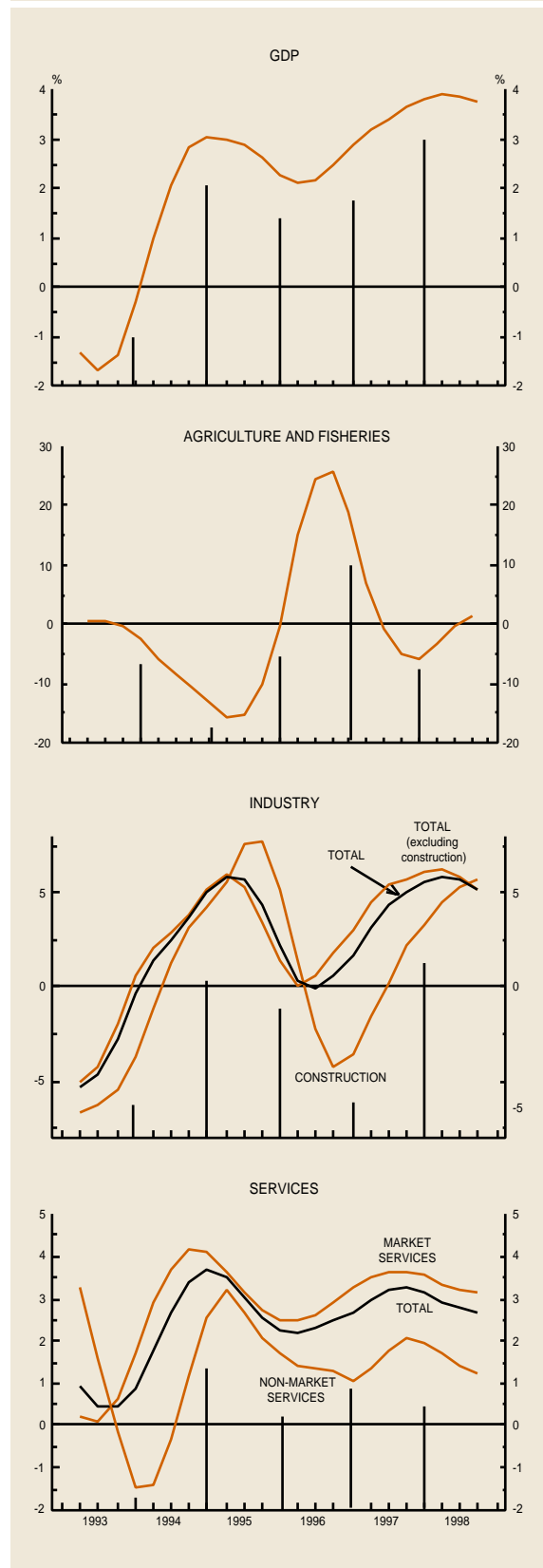
In terms of product groups, the growth rates of all components of exports have slowed as the year has unfolded. The deceleration in sales of non-food consumer goods and, in particular, of cars has been to the fore. However, exports of capital goods continue to show very high real growth rates.

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

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

CHART 18

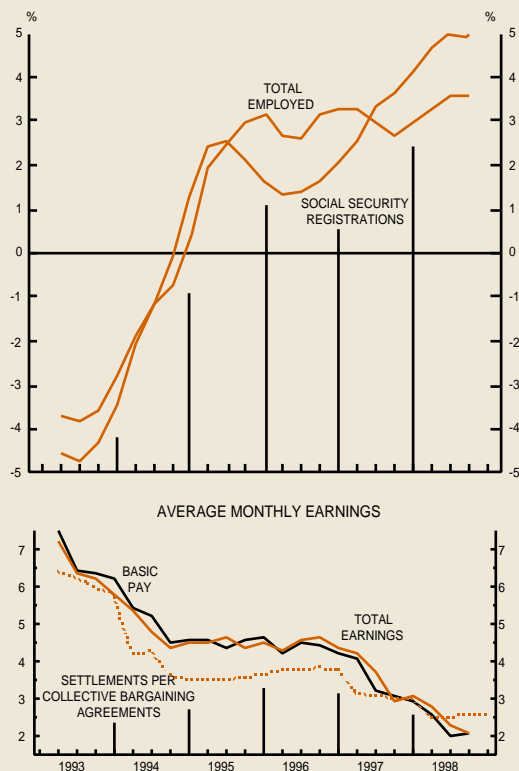
Gross value added by branch of activity
Rate of change



Source: Instituto Nacional de Estadística.

CHART 19

**Employment and wages (a)
Percentage change on year ago**



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

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

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

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

4.2. Output, employment, costs and prices

During the fourth quarter of 1998, the year-on-year growth of real GDP remained high, though slightly down on the previous quarter, at 3.8 % on QNA estimates. From the standpoint

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

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

Gross value added in industry ran at a year-on-year rate of 5.1 % in the third quarter of 1998, seven-tenths of a percentage point below the rate at the end of the first six months. The marked buoyancy of this variable thus continued, although its growth rate was on a moderating trend, as was the case in the first half of the year. The as yet incomplete data for the fourth quarter show similar behaviour, although the November figures, if confirmed in the coming months, might signify a turnaround. The industrial climate indicator stood in October and November far below the levels of the previous months. This was the result of flagging orders

(especially those from abroad) and the increase in stock levels. The industrial production index posted a year-on-year rate of 2.4 % on average in October and November, signifying an increase of 3.6 % when adjustments are made for calendar effects, one percentage point below the related figure in the third quarter of the year. A disaggregated analysis of the industrial production index on the basis of industrial groupings shows that the additional loss of momentum in October spread to all components. Indeed, the production of consumer goods showed a growth rate of 4.6 % on average in October and November, calculated using the series adjusted for calendar effects, compared with 5 % the previous quarter, mainly as a result of the trend of the non-food component. As for the production of capital goods, the sharp loss of momentum between the second and third quarters moderated substantially, even though it continued to slow. Lastly, the production of intermediate goods increased by 3 % on average in the last two months, compared with 4.1 % the previous quarter. Set against the background of this slowdown in industrial activity, production surveys for the following three months showed a substantial improvement in November, and there was also a rise in expected orders. These data have been confirmed by the November industrial production index.

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

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

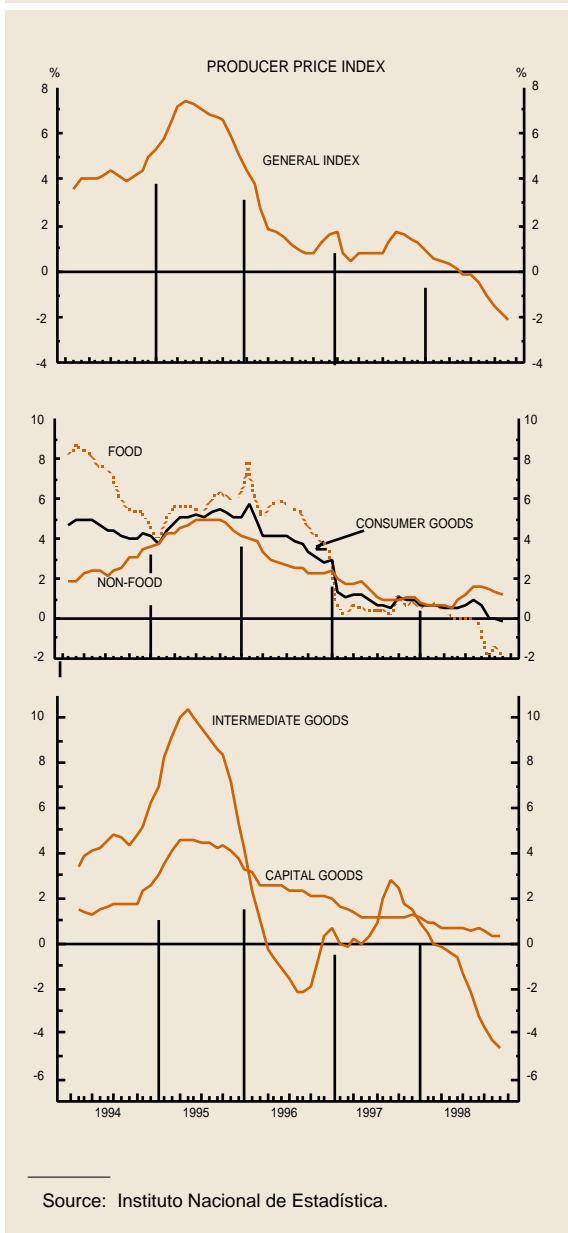


essentially on employment, trade and tourism indicators, does not seem to point to a further slowdown.

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

CHART 21

**Producer price index components
12-month percentage change**



months of decline. This pattern was again apparent in the initial EPA figures for September, including data from August to October, although in a less buoyant context for total employment. This is because the figures appear to indicate that the rate of job creation might have reached a plateau in the second half of 1998, in step with the trend of activity. Specifically, the year-on-change in the labour force totalled 447,000 people in September, which translates into a year-on-year rate of 3.5 %, slightly below that observed in the third quarter (3.6 %). Set against this, Social Security registrations showed greater strength as from September, increasing in the fourth quarter as a whole at

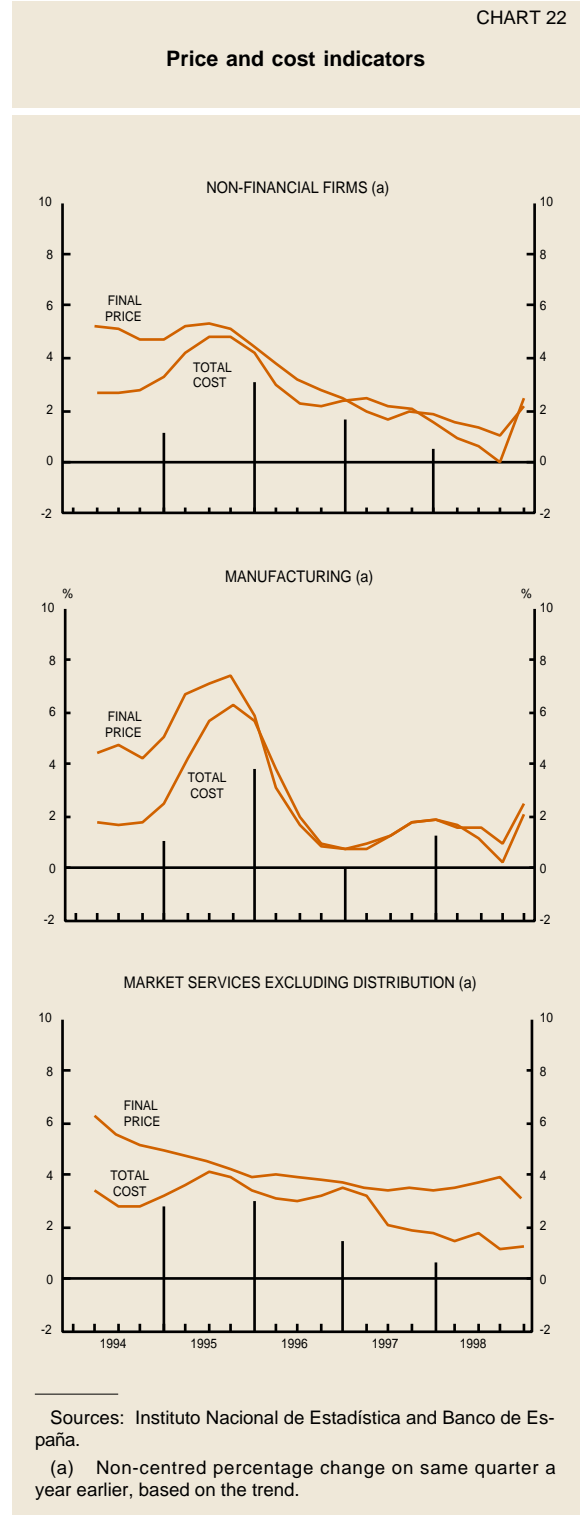
rates higher than those seen during the summer. As regards unemployment, and according to EPA figures, the joblessness rate fell by three-tenths of a point in the third quarter of 1998 to 18.6 %, holding at this level in the months covered by the initial EPA figures for September. The reduction in the number of unemployed has worked through to the registered unemployment figure compiled by INEM (the National Employment Office). In the fourth quarter, the rate of decline of registered unemployment intensified, with an average reduction of 283,000 people in the number of jobless: the resulting negative rate of -13.6 % is clearly greater in absolute terms than that seen in previous quarters.

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

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

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

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



ly, the 12-month growth rates of the HICPs in November were 1.4 % in Spain, and 1 % and 0.9 % in the EU and EMU, respectively.

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

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

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

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

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

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

4.3. Balance of payments

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

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

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

TABLE 4

Balance of payments: summary table (a)

PTA bn

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

Source: Banco de España.

(a) Provisional.

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

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

The surplus on the current transfers account increased by PTA 143 billion over the first eleven months of the year in relation to the same period a year earlier. This was due to the increase in transfers received by the private sector, under the European Agricultural Guid-

ance and Guarantee Fund heading, while public-sector transfers relating to the European Social Fund stabilised at the same levels of the previous year. Payments, for their part, increased under all captions, except in that earmarked for the VAT Resource.

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

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

TABLE 5

Balance of payments on financial account

PTA bn

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

Source: Balance of Payments. Banco de España.

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

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

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

vate-sector lending and deposit operations, of both a financial and non-financial nature.

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

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

TABLE 6

**Financial account
January-October 1998**

PTA bn

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

Source: Balance of Payments. Banco de España.

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

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

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

Lastly, as can be seen in Table 6, the sectoral breakdown of cross-border financial flows shows significant differences in the period elapsed in 1998. The credit system and general government have exerted net demand for foreign financing for large amounts (almost PTA 4 trillion and the case of the credit system and PTA 1.5 trillion in the case of general govern-

ment). Conversely, the other resident sectors (which include, among others, households, firms and other financial institutions such as mutual and pension funds) continue to finance, in net terms, the rest of the world, both via direct and portfolio investment and through loans and deposits abroad.

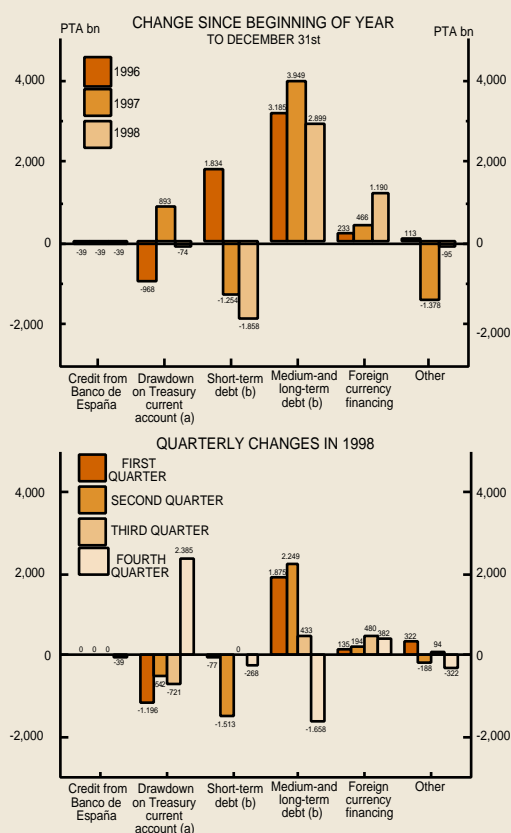
4.4. State Budget outturn and financing (5)

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

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

CHART 23

**State financing:
Breakdown by instrument**



Source: Banco de España.

- (a) (-) increase in credit balance; (+) decrease in credit balance.
- (b) Effective values.

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

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

In the period January-November, the rate of increase of revenue accelerated in relation to the first nine months of the year. This was due to the pick-up in direct tax revenue, the rate of decline of which eased to -1.5 %, and, to a

lesser extent, to the favourable performance of indirect tax (13.1 %). However, other net revenue underwent a slowdown, although continuing to grow at high rates (27.7 %). Thus, the increase in tax takings and in other net revenue stood, in November, above the level envisaged in the projected outturn for the year as a whole.

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

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

TABLE 7

Budget: outturn and financing

PTA bn and %

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

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

(a) This is the cash-basis deficit as defined by IGAE (National Audit Office).

(b) Effective values.

(c) Includes coined money, deposits and loans, and peseta- and foreign-currency-denominated loans assumed.

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

Turning to expenditure, its cumulative rate of change to September was -0.2 %, below the projected outturn (0.7 %), but far removed from the initially budgeted figure (-2.9 %). In fact, all items under expenditure, except that relating to wages and salaries, showed higher rates of change to November than those budgeted for the year as a whole. The differences between the growth rates of expenditure to November and those included in the projected outturn for the year as a whole are essentially due to capital expenditure (real investment and capital transfers) which has, to November, advanced well below budget. As to current expenditure, both wages and salaries and goods and services stood below the projected outturn. In the case of wages and salaries, payments to current employees grew by only 1.1 %, while pension and social security payments ran at 3.2 % and 7.9 %, respectively. Goods and services increased by 1.3 % (rising to over 8 % if the effects of Royal Legislative Decree 12/1996 are removed), above the figure initially budgeted for the year as a whole. Interest payments fell by -6.8 %, in which connection it should be borne in mind that this year a credit extension for PTA 210 billion has been authorised for the purposes of early redemption and debt conversion. Finally, expenditure on current transfers fell by

0.9 %, which becomes an increase of 5.5 % once the effects of the transfer of the personal income tax rate structure to the Regional (Autonomous) Governments are eliminated. It should be remembered that one of the biggest volumes of transfers is to Social Security Funds to finance INSALUD (the Spanish health service). This item showed an increase of close to 10 % to November, the result of the ongoing assumption by the State of health care expenses, to be culminated in 1999.

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

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

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

In this bearish setting, the Treasury cut its rates at issue considerably. However, redemp-

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

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

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

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

trillion in the longer-dated issues (15- and 30-year bonds).

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

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

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

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

CHART 24

Yield curve

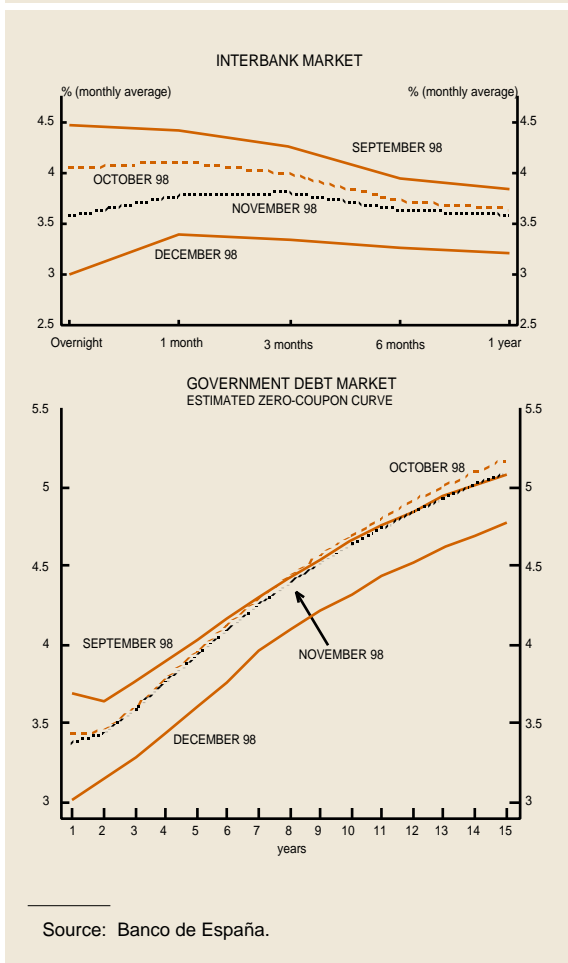
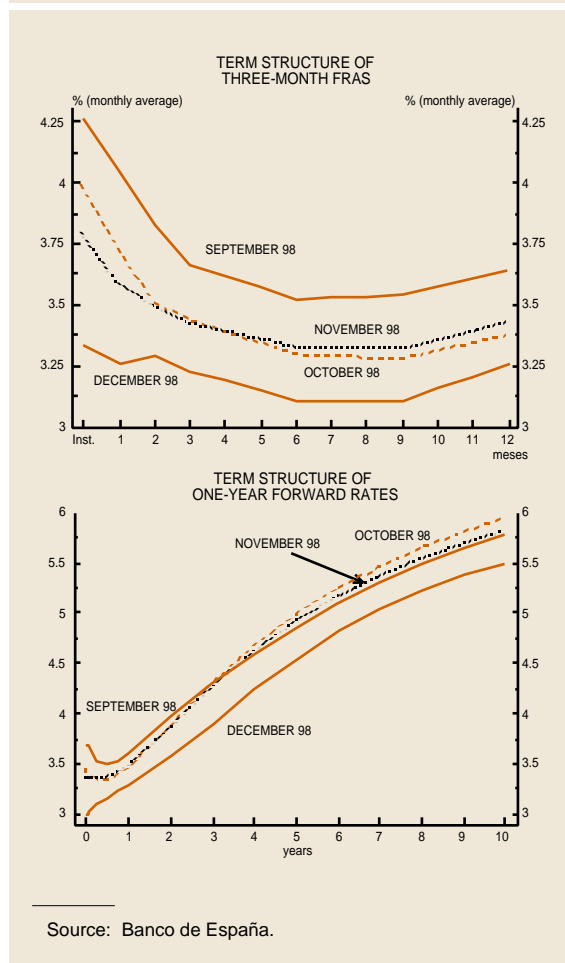


CHART 25

Forward rates



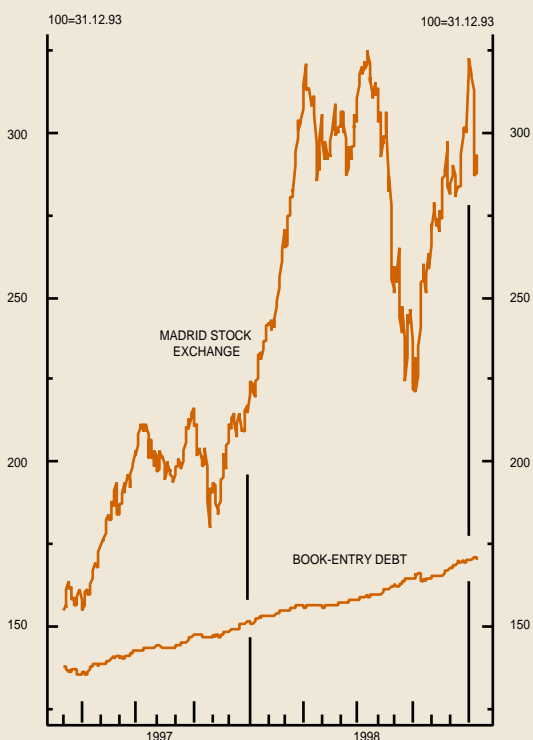
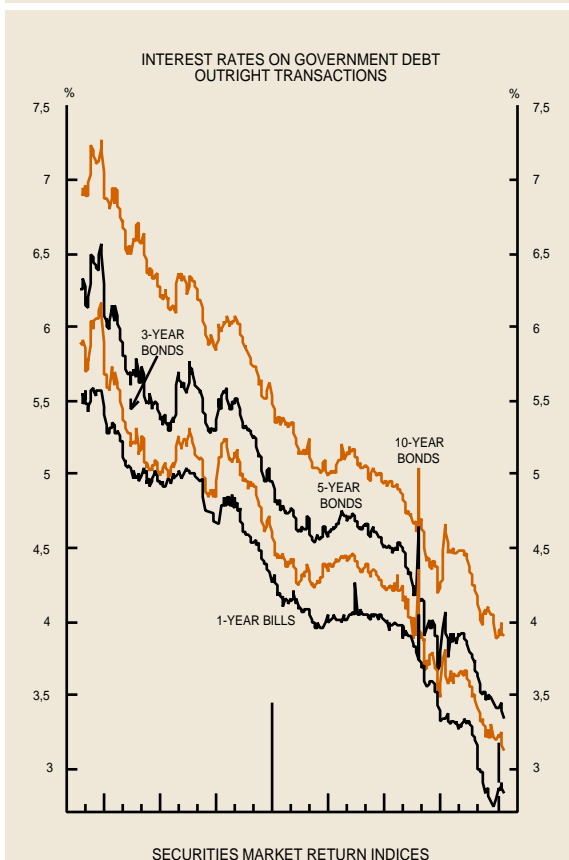
4.5. Monetary and financial developments

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

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

CHART 26

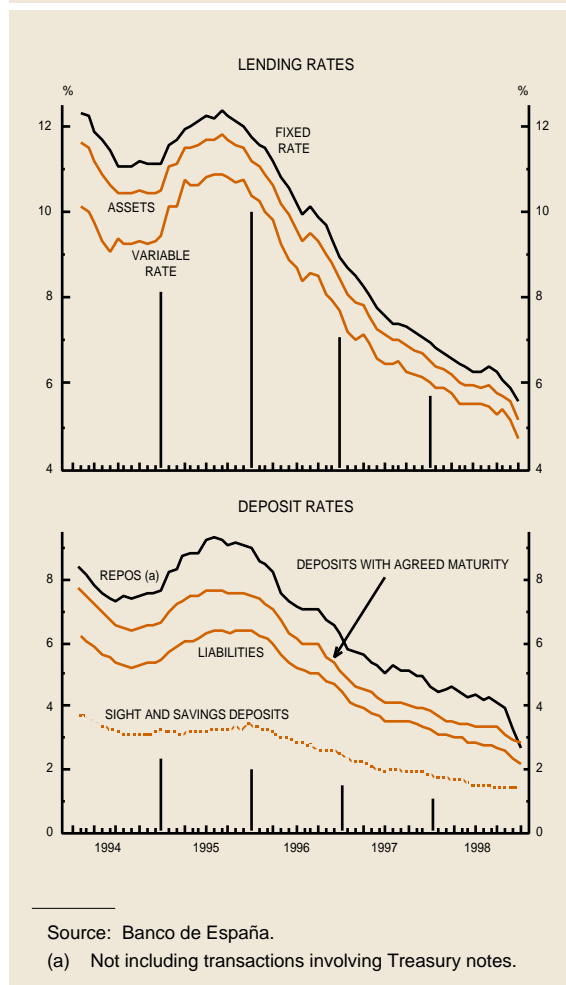
Interest rates and yields on securities markets



Source: Banco de España.

CHART 27

Synthetic bank and savings-bank interest rates

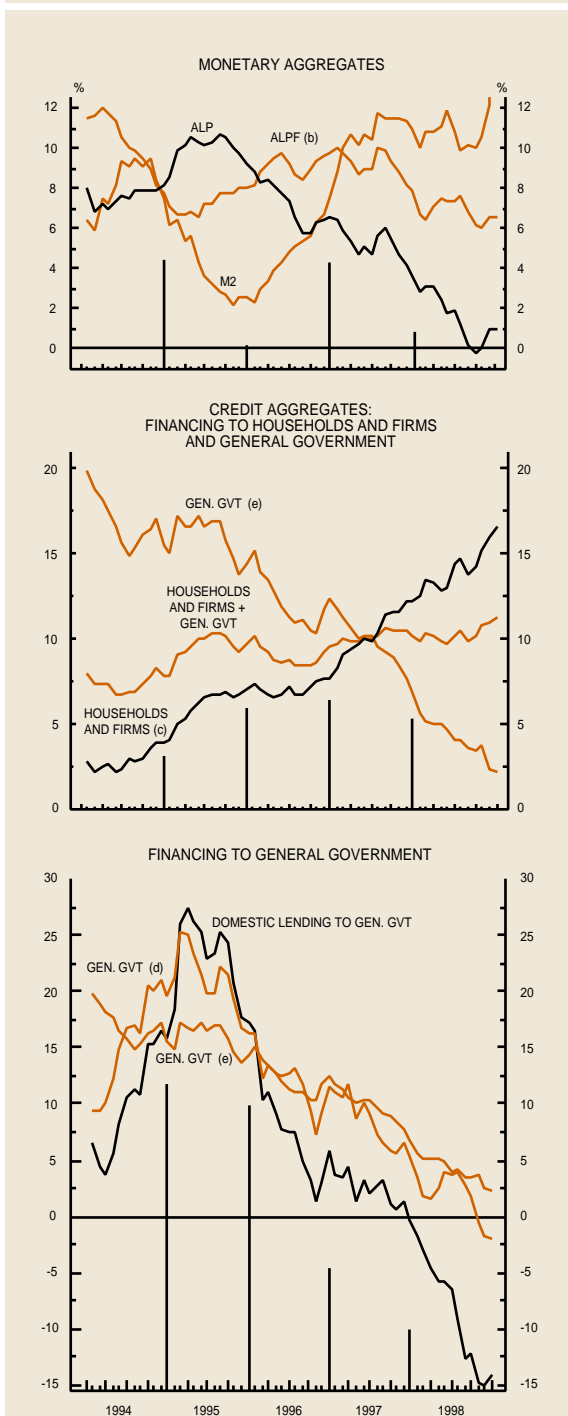


the time of this report going to press at levels slightly higher than that of the ECB weekly intervention rate, which has held unchanged at 3 %.

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

CHART 28

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



Source: Banco de España.

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

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

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

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

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

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

TABLE 8

Monetary and credit aggregates (a)

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

Source: Banco de España.

(a) Four-quarter rate of change of end-quarter series, except mutual funds and debt portfolio, which reflect year-on-year changes in billions of pesetas.

(b) Domestic lending plus outright medium- and long-term debt held by the public plus foreign direct financing.

(c) Domestic lending plus commercial paper plus foreign direct lending.

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

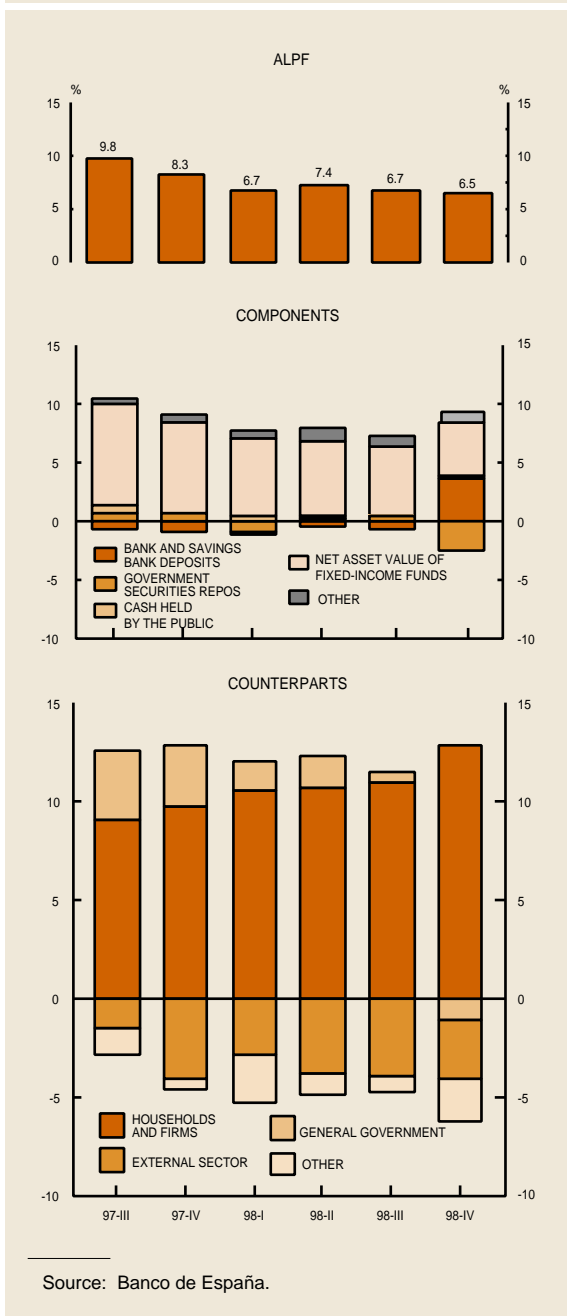
The Madrid Stock Exchange general index, after recording an annual low at the beginning of October, rose by 35 % in this quarter, on a similar trend to that recorded from the beginning of the year (see Chart 26). This rising trend continued during the first week of January, following the start of Monetary Union. Subsequently, however, as a result of the Brazilian crisis, there was a sizeable downward correction in prices. Finally, in the days

before this Bulletin went to press, the announcement of the merger between Banco de Santander and Banco Central Hispano prompted an appreciable recovery in price levels.

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

CHART 29

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



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

In the last quarter of the year there has been a certain acceleration in the growth rates of both the broad and narrow monetary aggregates compared with previous months. Behind this behaviour, perhaps, is agents' preference to have a portion of their wealth in more liquid positions. Thus, the absence of inflationary pressures, along with the stock market crisis in the summer and the fiscal measures approved

by the government (reduction of the tax withholding on deposits and favourable treatment for time deposits at over two years), might be prompting a change in the general public's preferences towards deposits. The growth of time deposits during the quarter, after the decline seen in recent years, and the sustainedly high rate of expansion of sight and savings deposits, appear to confirm these facts. Moreover, the new tax regime for mutual funds (withholdings on account for capital gains and the disappearance of the adjustment coefficients) appears to have affected greatly money market funds. The net asset value of the latter fell significantly in December as a result of redemptions made so as to take advantage of the tax arrangements in force in 1998.

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

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

The ALP aggregate expanded in the period October-December at rates somewhat higher than in the previous quarter. This placed its year-on-year growth rate at 1 % in December; however, that is still two percentage points below the rate posted at the start of the year. Analysis of the ALP components shows that the

higher growth rates of the aggregate during the quarter were due to the sizeable growth of bank and savings-bank deposits. The latter exhibited a growth rate of 7.2 % year-on-year in December, five percentage points up on that at the end of the previous quarter.

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

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

With regard to the counterparts of ALP, the growth rate of domestic credit to households and firms increased in relation to the third quarter, rising to 16.2 % year-on-year in December. That signifies an increase of three percentage points since the start of the year (see Chart

29). These data show that the reductions in interest rates are having a clearly expansionary effect on the demand for credit by households and firms.

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

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

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