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# Quarterly report on the Spanish economy

## 1. Overview

INE has recently released the first Spanish National Accounts data (base year 1995, CNE 95), drawn up using ESA 95 methodology. These figures include changes of both a statistical and conceptual nature, the former being quantitatively more significant owing, among other factors, to the use of new sources and estimation methods, and the latter derived from the application of a methodology which broadens the definition of the concept of economic activity (see Box 1).

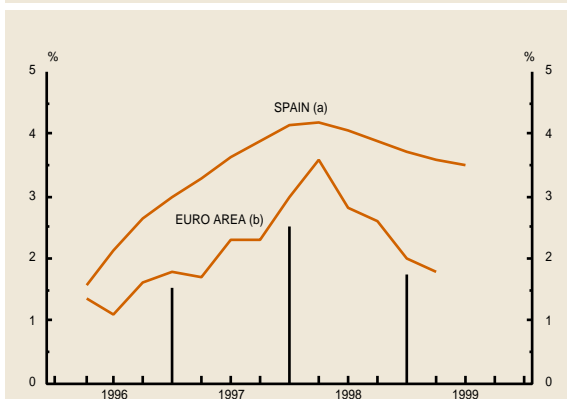
With the release of the new series, INE has laid out its provisional estimate for the first quarter of 1999. Compared with a year earlier, real GDP in this period ran at 3.6 %, in terms of the trend-cycle series, extending the moderate slowdown apparent in the 1998 figures (see Chart 1). The rate of increase of national demand heightened to 5.7 %, while the negative contribution of net external demand reached a new peak, subtracting two percentage points from the growth of real output. The key features of the main components of final demand are as follows: the tendency of final household consumer spending and capital investment to stabilise at very high year-on-year rates; the resilience of investment in construction and the notable weakness of goods exports, despite the progressive growth of the tourism sector; and the response by imports to the firmness of demand, with a slight increase in their growth rate. There is no significant change discernible in the patterns seen last year in the various productive branches, a fresh loss of momentum being witnessed in non-energy industry.

During the first months following the start of Economic and Monetary Union (EMU), the Spanish economy continued to show remarkable buoyancy (among the highest in the euro area) and job-creation capacity. The pattern of growth resides to an increasingly greater extent on domestic demand, while exports have been impacted by the slowdown on international markets. The external deficit thus corresponds to the reduction of the economy's private-sector financing capacity whereas, conversely, public finances have improved appreciably, with a further reduction in borrowing requirements and debt. There has been a sizeable increase in labour costs in the industrial and services sectors, despite having moderated during the first quarter of the year. And this, combined with the ongoing recovery in intermediate input prices on international markets (the rise in energy prices is already feeding through to the consumer price index), might shape a setting less conducive to sustaining the economy's stability and competitiveness.

The second quarter of 1999 has seen confirmation of the improved economic situation of

CHART 1

Gross domestic product



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

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

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

the external environment of the euro area. Significant contributing factors here have been the continuation of a sustained rate of economic activity without inflationary pressures in the United States, the gradual recovery in the level of output in the United Kingdom and more favourable figures from Japan. As regards the emerging market economies, the end of the crisis in the south-east Asian countries and the improvement in the Russian economic situation reinforce the recovery in the external setting. However, some of the main Latin-American countries continue to be affected by the consequences of the Brazilian crisis, despite the fact this country has performed much better than expected.

The economic situation of the euro area has likewise improved in the period to date in 1999. On the data available, it may be asserted that the slowdown in activity in the area reached a trough at the end of 1998 and that a moderate expansion has been under way since the early months of the current year, with consumption and investment running at sustained rates. The recovery already perceptible on foreign markets will undoubtedly be one of the key factors for the consolidation of this process.

On the prices front, continuing moderate growth rates have been the general norm, despite the fact that the rise in oil prices on international markets is passing through to energy goods prices, the growth rates of which have turned positive. Nonetheless, the slowdown in the prices of other HICP components has once

more placed the inflation rate for the area as a whole below 1 % in June.

Monetary and financial conditions in the euro area generally remained accommodating during the second quarter of 1999, given weak growth prospects without significant risks for price stability. Against this background, the Governing Council of the ECB decided at its meeting on 8th April to cut the interest rate on its main refinancing operations by 50 basis points, to 2.5 %. This gave rise to reductions in interest rates along the entire yield curve in April.

Subsequently, the improvement in the economic outlook for the euro area as from May, underpinned partly by a more optimistic international setting, prompted upward movements in euro-area interest rates which were more intense in the longer-dated terms. As a result, the interest rates on long-term debt stood at higher levels than those at end-1998, and the rates on 6- and 12-month interbank deposits regained the levels reached before the reduction in the Eurosystem's benchmark rates in April. During the second quarter the ongoing depreciation of the euro against the dollar continued, although there was a turnaround as from mid-July as economic prospects for the euro area improved and firmed. The progressive pick-up in economic activity has also been reflected in the euro-area monetary and credit aggregates which, on information to May, have been relatively expansionary. Specifically, M3, the Eurosystem's reference monetary aggregate, grew slightly over 5 % in April and May compared with a year earlier, while M1, incorporating the most liquid assets, ran at over 11 % year-on-year. Likewise, financing to the private sector was highly buoyant, posting a growth rate of 10.5 % in the twelve months to May.

The information available at the time of this report going to press shows that the high growth rates of the Spanish economy continued to moderate in the second quarter of the year. The national demand indicators generally point to a stabilising of or reduction in such growth rates. The signs are clearest in the case of capital investment; though it continues to evidence great buoyancy, it is nonetheless affected by the relative slackness apparent in manufacturing industry, given the persistently unfavourable results in foreign sales. The favourable expectations about developments in foreign markets have not yet passed through to goods exports, the April figures for which are considerably adverse (1). The changes apparent in the interna-

(1) The May figures were released after the cut-off date for this report, but do not alter this assessment. Imports remain buoyant.

**Main changes incorporated into Spanish National Accounts (base year 1995)**

The Spanish National Accounts series (base year 1995, CNE 95) recently released by INE have two important new features: the re-basing of the accounts and the implementation of the new ESA 95 (European System of Accounts 1995) methodology. The aim of both these features is to enhance adaptation of the National Accounts to changes in the actual economic situation. Differences between the CNE 95 and CNE 86 estimates are due to two types of factor (1), of a statistical and conceptual nature. Statistical changes arise with all re-basing processes and are the outcome of the use and adaptation of new statistical sources and of the application of new estimation methods. The conceptual changes in this case are linked to the application of the new National Accounts methodology. INE has provided a quantitative estimate of the impact of the statistical and conceptual changes on the level of GDP and of the main demand components at current prices for the year 1995 (see adjoining chart). The statistical changes have been of greater significance in quantitative terms, while the conceptual changes have mainly affected gross capital formation, owing to the widening of the concept. Overall, the level of GDP has increased 4.4% in the base year.

As regards GDP developments in the period 1995-1998, in constant pesetas, the new CNE has entailed a minor upward revision of growth rates in 1997 and 1998 (and a downward one in 1996). From a quarterly standpoint, one of the new features of CNE 95 is the presentation of series of the main aggregates in terms of gross seasonally adjusted data, in addition to the trend-cycle data, which were already published previously. Comparison of the quarterly profiles between CNE 95 and CNE 86, in terms of data at constant prices and in terms of trend-cycle, is given in the adjoining Chart. It can be seen that the contribution of national demand heightens in the new estimates (owing to the progressive acceleration of investment, while spending on final consumption is on a rising trend until the last quarter of 1998) and the contribution of net external demand is ultimately more negative at end-1998, since the slowdown in imports during the year is less marked.

The main addition in the labour market area is the estimation of various employment concepts, whereas under the previous system only equivalent employment was estimated, which entails measuring jobs in homogeneous terms. Under CNE 95, the set of variables relating to the use of the labour factor are as follows: employment (including all people – wage-earners and self-employed - engaged in productive activity); jobs (number of contracts, whether explicit or implicit, between an individual and a resident institutional unit for engaging in work in exchange for remuneration); hours worked (overall figure of hours actually worked by employees in the economy); and full-time-equivalent jobs (total hours worked divided by the average full-time working day). So far, INE has only released data on jobs and full-time-equivalent jobs, the latter being the variable comparable with the former National Accounts employment variable. The new information on employment has meant an upward revision of the level per the CNE 86 figures: comparison between these and the new series of full-time-equivalent jobs reveals an average difference, for the period 1995-1998, of 230,000 jobs.

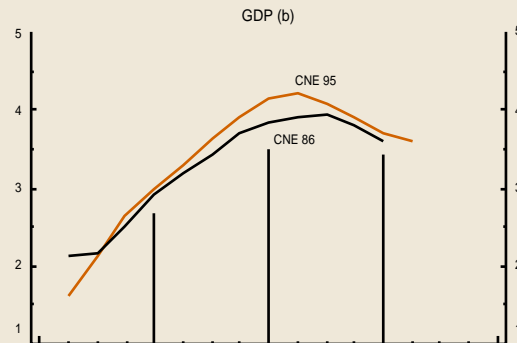
With regard to the measurement of GDP from the income standpoint, the most significant changes are the loss of the share of the surplus in nominal GDP and the increase in the weight of employee compensation, which is largely due to the broadening of the concept of wage-earner in the new accounts. Further, the share in GDP of taxes net of subsidies has also increased, owing largely to a stricter definition of subsidies. The rates of change of employee compensation are similar to the previous ones, while the surplus has grown more sharply than with the CNE 86 data, except in 1998, when there was greater growth both of employee compensation and of average employee compensation under the new accounts.

(1) See "Contabilidad Nacional de España 1995", INE, *Boletín Trimestral de Coyuntura*, June 1999.

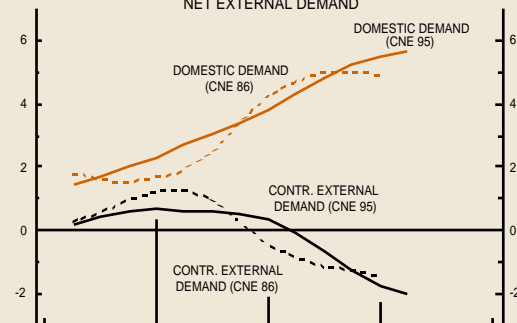
**Comparison between CNE 95 and CNE 86 figures**

DIFFERENCES IN GDP AND DEMAND-AGGREGATE LEVELS, 1995 (a)

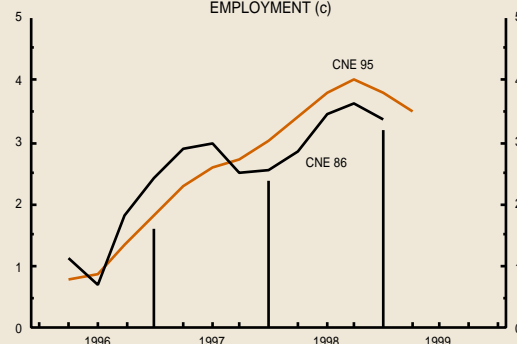
	Total change	Statistical changes	Conceptual changes
Final consumption expenditure	3.0	2.0	1.0
Gross fixed capital formation	10.3	6.0	4.3
Exports of goods and services	-0.6	-0.8	0.2
Imports of goods and services	0.8	-0.2	1.0
GDP	4.4	2.9	1.5



DOMESTIC DEMAND (b) AND CONTRIBUTION OF NET EXTERNAL DEMAND



EMPLOYMENT (c)



Source: Instituto Nacional de Estadística.

(a) As percentage of CNE 95 over CNE 86. GDP at current prices.

(b) Percentage change on same quarter a year earlier, calculated on the basis of constant-price series. For the CNE 95 series, the rates of change are based on the trend-cycle component.

(c) Percentage change on same quarter a year earlier. For the CNE 95 series, the rates of change are based on the trend-cycle component.

CHART 2

**Confidence indicators**

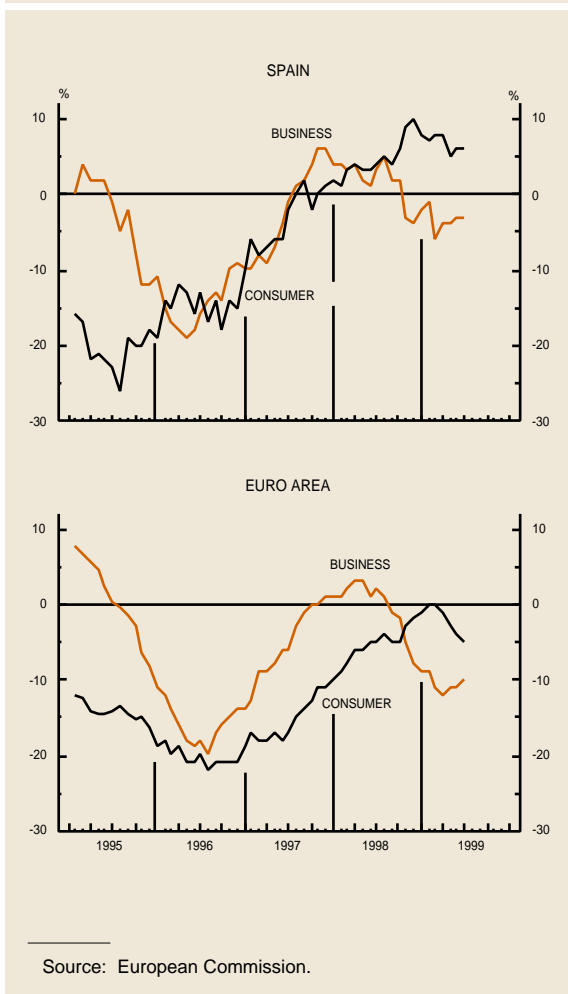


CHART 3

**Harmonised indices of consumer prices**

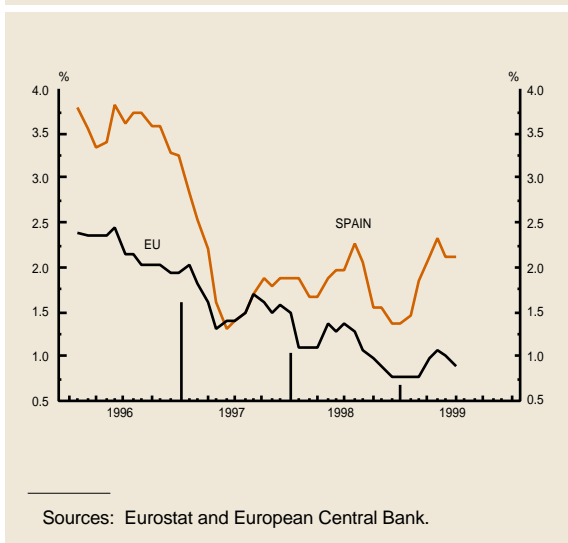
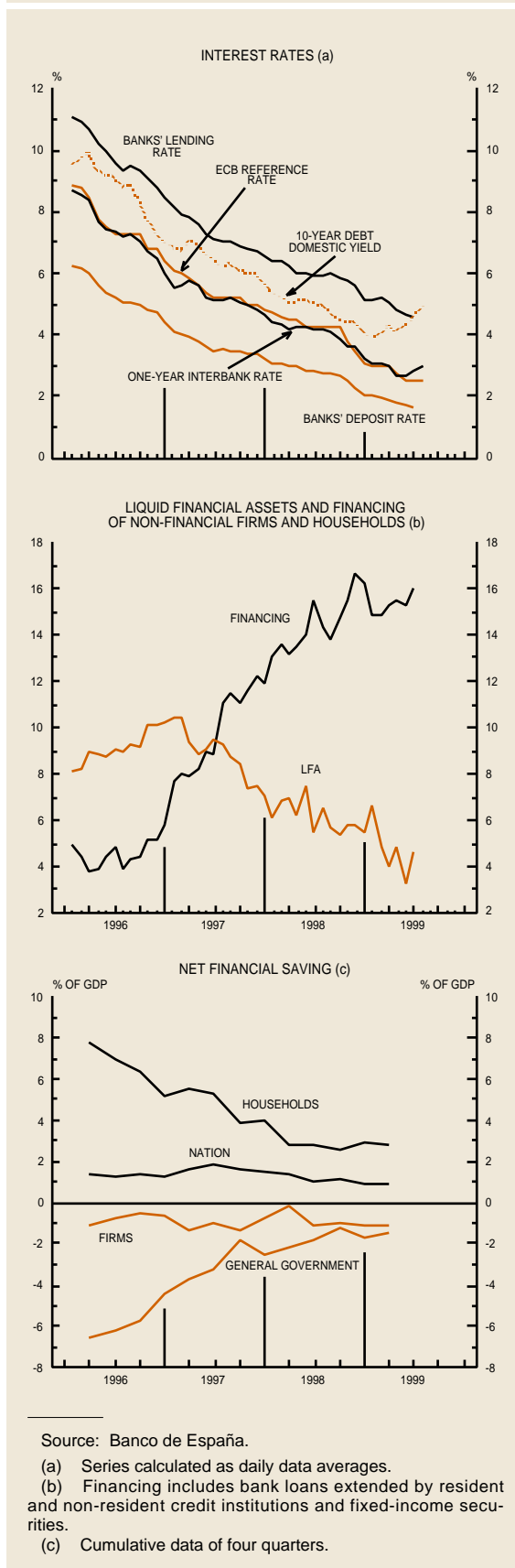


CHART 4

**Financial indicators of the Spanish economy**



tional outlook will no doubt ultimately affect exports and contribute to improving business expectations. Turning to household spending, some indicators have slipped back slightly, in step with consumer confidence levels (see Chart 2). However, other expenditure segments, especially car sales, remain very resilient, as do house purchases. As a result, investment in the construction sector has perhaps been the sole demand component whose year-on-year growth rate has not fallen during the second quarter.

If these trends hold, the year-on-year growth rates of national demand for the second quarter of 1999, measured on the basis of the trend-cycle series, could be around 5.5 %. Imports, for their part, continue to show notable vigour, in step with that of demand. Accordingly, even if the slowdown in exports were to touch bottom (taking into account the excellent tourism revenue results), net external demand would once again subtract about two percentage points from real GDP growth, leaving its growth rate at approximately 3.5 %.

The trend of the employment indicators in the second quarter is in line with the behaviour of the various productive branches, and a tendency towards deceleration is also apparent. The case of employee compensation is somewhat similar and this, combined with the slight rise in productivity, is slackening the growth rate of unit labour costs, which remains considerably higher than that in other euro-area countries. The greater relative pressure exerted by costs, against a background of strong demand growth, is reflected in the inflation differential between the Spanish economy and the euro area as a whole, measured on the basis of the respective HICPs (see Chart 3). The spread in the services component has stabilised at almost two points so far in 1999 (it was one point in 1996), and is widening considerably in the case of goods, where it stands above one point after

having been virtually zero over the two previous years.

Regarding the State deficit figures, the results in the first half of the year have been very favourable. The rate of increase of expenditure, once adjusted for the factors distorting its comparison, is in line with the targets set, while the growth of revenue is above budget.

Lastly, from the financial standpoint, the second quarter has been marked by a gradual pass-through of the cuts in monetary policy interest rates to bank lending and borrowing interest rates in Spain which, especially in the case of lending, have fallen to very low levels. Conversely, long-term yields have risen significantly, in step with the situation of the area as a whole, whereby the slope of the yield curve has increased. The relative easiness of bank financing conditions in Spain has continued to encourage households and non-financial firms to take on debt, which has grown at a high rate, while it has detracted from the attractiveness of liquid financial assets in favour of other higher-yielding and riskier assets and of real assets.

Specifically, financing to households and firms in the form of bank credit and fixed-income securities retained a rate of expansion of 16 % year-on-year in the second quarter, similar to that recorded at end-1998 and significantly higher than the growth rate of nominal expenditure in the economy (see Chart 4). Liquid financial assets held by households and firms posted a year-on-year rate of less than 5 % at the end of the second quarter, more in keeping with economic activity. On the information for the first quarter from the financial accounts, net household financial saving can be seen to have held on the slowing course begun in 1995, which is consistent with the strong growth of bank credit to this sector. This did not affect the nation's net financial saving insofar as general government saving increased and corporate saving held constant.

## 2. The external environment of the euro area

The improvement in the worldwide economic situation initially discernible in the opening months of the year progressively firmed during the second quarter of 1999. Among the industrialised countries, highlights included the prolongation of the sustained growth phase in the United States, the start of a fresh pick-up in the United Kingdom and the unexpected increase in GDP in Japan in the first quarter. In turn, inflation has held at low levels, despite the fact that oil prices on international markets have continued on an upward course since February.

As regards the emerging market economies, events so far in 1999 have confirmed the end of the crisis in the south-east Asian countries, some of which, such as Korea, are already posting positive growth rates. Likewise, the economic situation in Russia has shown signs of improving in recent months.

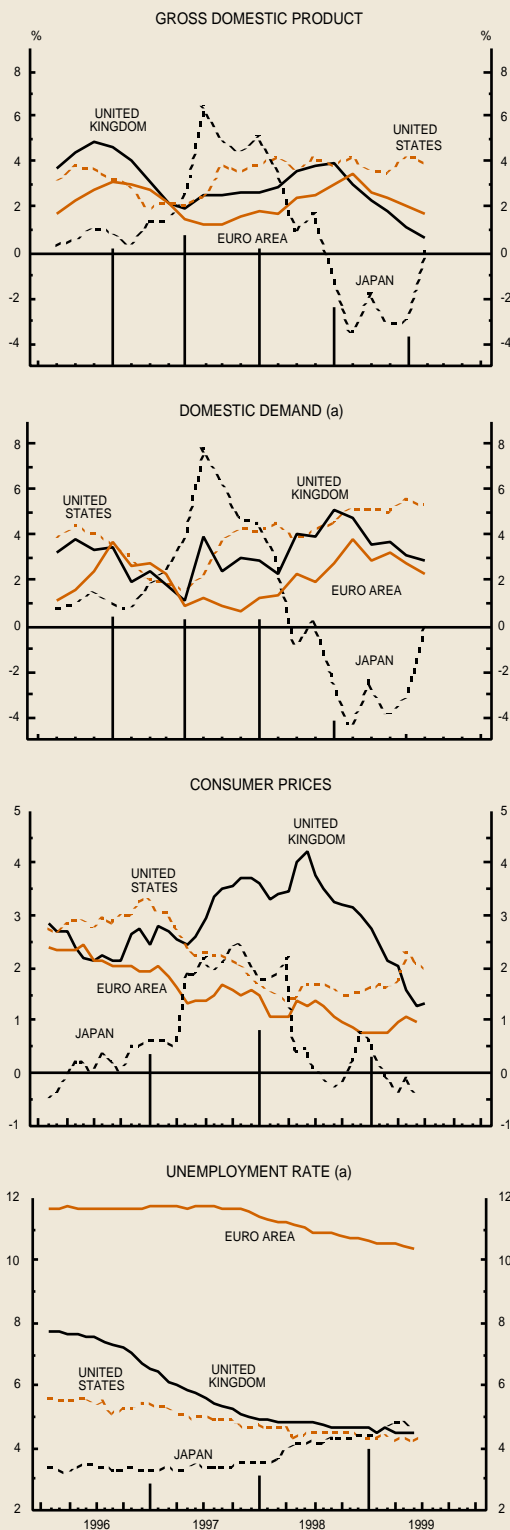
In Latin America, the main conditioning factor of the economic situation of the area continues to be the fall-out from the Brazilian crisis. That said, its effects on international financial markets were less than expected and its consequences have been confined predominantly to the Mercosur countries. Against this background, the economic recession affecting the Brazilian economy is proving less intense than forecast, inflation has risen very moderately following the devaluation of the real and the fiscal adjustment policies implemented suggest that the fiscal targets set for 1999 will be met. Argentina is the Latin American country that is being most affected by the Brazilian crisis owing to their close trade links (30 % of Argentine exports are to Brazil). Nonetheless, insofar as the recovery in Brazil firms in the coming months, the knock-on effect this will exert on the area in general and on the Argentine economy in particular could improve the economic outlook for the area.

The US economy has continued growing at a sustained pace during the second quarter, at a similar year-on-year rate to the previous three months (4 %). On the indicators available, the composition of growth would have been similar to that of the first quarter, with highly buoyant domestic demand (see Chart 5) and a negative contribution of the external sector. The loss in competitiveness entailed by the strong appreciation of the dollar (7 % between January and July in real effective terms against the developed countries) along with the slackness of foreign markets accounts for the unfavourable performance of exports. And this, combined with a greater demand for imports, is translating into an ongoing widening of the trade and current-account deficit since the beginning of the year. Thus, the negative trade balance built up in the



CHART 5

**Main macroeconomic indicators**  
**Percentage change on previous year**



Sources: Banco de España, national statistics and Eurostat.

(a) As a percentage of the labour force.

first five months of the year was 30 % higher than for the same period a year earlier.

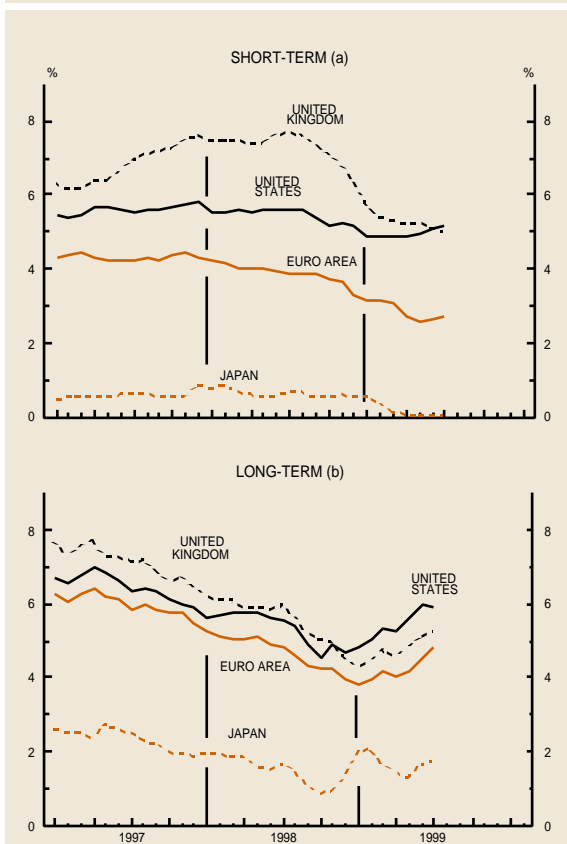
The unemployment rate held at between 4.2 % and 4.3 % of the labour force in the second quarter. Despite surging activity, consumer prices continue to grow at very moderate rates. The rise in inflation in April (to 2.3 % on 12 months earlier), essentially as a result of the increase in the prices of energy products, did not continue in the following two months. Thus, in June, the 12-month growth rate of prices was 2 %, a rate which rises to 2.1 % if energy and food prices are excluded from the general index.

In Japan, GDP grew 0.1 % in year-on-year terms in the first quarter of 1999 (1.9 % on the previous quarter), clearly above forecast. This result, which broke with the falling trajectory of Japanese output since the fourth quarter of 1997, was associated with an appreciable and unexpected improvement in domestic demand, both on the side of private consumption (which increased 0.8 % year-on-year) and of private investment (the rate of decline of which was substantially lower than in previous quarters). The indicators of activity available for the second quarter do not yet offer a clear and robust signal that the economic recovery has continued. But the previous rate of decline of industrial production has moderated, construction appears to have touched bottom and the latest quarterly survey of business expectations shows an improvement as far as the major manufacturing firms are concerned. The unemployment rate dipped to 4.6 % in May, although the level of employment has continued to fall. Consumer prices and producer prices have continued to grow at negative 12-month rates (-0.4 % and -3.4 %, respectively), denoting the persistence of deflationary pressures. In the external sector, the loss of competitiveness entailed by the appreciation of the yen in the second half of 1998 (25 % in real terms against the industrialised countries between August 1998 and January 1999) is being reflected in a significant reduction in the Japanese trade and current-account surpluses.

Turning to the EU economies not currently members of EMU, mention may be made of the moderate and gradual path of economic recovery in the United Kingdom, a pattern perceptible in the positive course of the latest indicators of activity available. In the labour market, unemployment has fallen to 4.4 % of the labour force in June. Moreover, this has been accompanied by a clear moderation of inflation: the 12-month increase in retail prices, excluding mortgage interest payments, was 2.2 % in June (2.7 % in March), below the 2.5 % target set. The favourable course of wages and the apprecia-

CHART 6

Interest rates



Source: Banco de España.

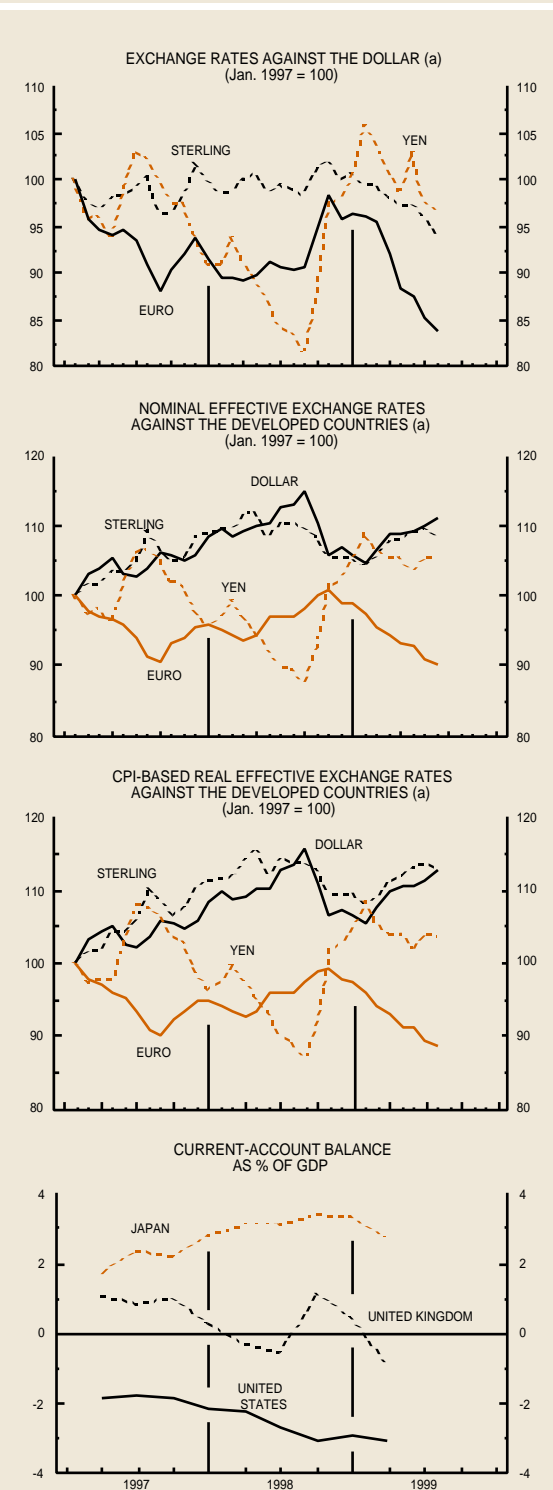
- (a) Three-month interbank market interest rate. Euro area: until December 1998, weighted average of the 11 euro area countries. In 1999, three-month EURIBOR.
- (b) Ten-year government bond yields. Euro area: weighted average of the 11 euro area countries.

tion of sterling are among the factors that explain the fall in UK inflation.

With respect to economic policies, fiscal consolidation has continued in the main Anglo-Saxon economies. In the United States, the federal surplus in May stood at \$24 billion and it is foreseen that the positive balance at the end of the current fiscal year will be slightly higher than programmed; on different forecasts, general government net lending would be between 1 % and 2 % of GDP. In the United Kingdom, the entrenchment of a higher growth rate in the coming months might help hold the budget deficit below 1 % of GDP in 1999. On the contrary, in Japan, public borrowing requirements for the current year might, in principle, stand at around 8 % of GDP, although the possibility of a new expansionary fiscal package being introduced in the last quarter of the year might ultimately raise this figure.

CHART 7

Exchange rates and current-account balances



Sources: Banco de España, BIS and national statistics.

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



As regards monetary policy, the US Federal Reserve raised its federal funds rate by 25 basis points to 5 % on 30th June. This measure was unveiled as a means of forestalling future inflationary pressures, given the high economic growth rate, the low level of the unemployment rate and the rise in the price of energy commodities. Nonetheless, the increase in the official interest-rate was accompanied by the announcement by the Federal Reserve that it would maintain a neutral bias in the implementation of monetary policy in the coming months. That has contributed to moderating expectations of additional rate increases in the immediate future. By contrast, the Bank of England once more cut its base rate on June 10th (for the fourth time since the start of 1999) by one quarter of a point, to 5 %, in view of the slowdown in the inflation rate so far this year. Finally, in Japan, the monetary authorities have kept official intervention rates stable and at levels close to zero.

Turning to the money and financial markets, three-month interest rates in the United States edged up in the period between April and July (see Chart 6). The increase in long-term interest rates over this same period was on a greater scale, rising to stand at around 6 % as from mid-June. In the United Kingdom, the fall in short-term rates which followed a fresh cut in the official interest rate was accompanied by a slight increase in 10-year rates, which stand at over 5 %. Lastly, in Japan, while the shorter-dated interest rates remained unchanged and

close to zero, 10-year government bond yields rose once more to 1.7 %. On the securities markets, there was a generalised upward trend which was somewhat more notable in Japan's case further to its improved economic results. The behaviour of stock market indices has been somewhat more volatile in the United States. Indeed, since mid-May, the upward trend has been checked, although the indices are still at very high levels.

Finally, on the foreign exchange markets, the dollar has continued rising against the main currencies (see Chart 7). The dollar appreciated by 5 % against the euro between April and July (15 % since the start of the year). However, since mid-July, the euro has tended to regain ground against the dollar, whereby in the last fortnight of July it stood at above 1.06 dollars per euro. In relation to the yen, the dollar appreciated by somewhat over 1 % between April and July. Nonetheless, the strength of the Japanese currency once the increase in GDP in the first quarter was disclosed has prompted interventions on the foreign exchange markets. These involved not only the Bank of Japan but, on occasions, also the ECB and the Federal Reserve, who sought to prevent an additional worsening in competitiveness from weakening the possibility of economic recovery in Japan. Lastly, between April and July, the dollar appreciated by almost 3 % against sterling. The appreciation of the dollar in this period against the developed countries was 2 % in nominal effective terms.

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

#### 3.1. Economic developments

On the information available, economic activity in the euro area in the first half of 1999 has progressively recovered following the slow-down seen during 1998. This performance is in response to the gradual improvement in the area's main export markets, especially if it is borne in mind that the crisis of the emerging market economies was one of the main reasons for the reduction in the rate of output of the euro-area countries. In the second quarter, the unemployment rate for the area as a whole fell very slightly and inflation stood once more below 1 % in June, despite the upward bias induced by the rise in energy prices.

The National Accounts figures for the first quarter of 1999 (2) suggest that economic activity in the area underwent a turnaround in this period. Thus, although the year-on-year growth of GDP (1.8 %) was somewhat lower than the related rate in the previous quarter (2 %), the quarter-on-quarter rate of change (0.5 %) was two-tenths of a point up on that of the fourth quarter of 1998, thereby turning around the downtrend evident in these quarterly rates since end-1997. The rise in domestic demand was the driving force behind growth, and all its components posted significant increases. In year-on-year terms, private consumption grew by 2.8 % and gross fixed capital formation by 3.2 %. The change in stockbuilding, after having reached very high levels in 1998, subtracted 0.8 percentage points from GDP growth (see Chart 8). Finally, the contribution of net external demand remained negative, albeit in a lesser proportion than in previous quarters. Exports grew by 0.4 % compared with a year earlier, while imports increased by 2.3 % (1.3 % and 4.6 % in the previous quarter, respectively).

As regards the individual results for the euro-area economies, the degree of diachrony among the six countries for which information is available lessened in the first quarter of 1999: the highest national GDP year-on-year rate was that of Finland (3.9 %), while the lowest was that of Germany (0.8 %). Greater convergence has been achieved owing, above all, to the recovery in those economies, such as Germany and Italy, whose level of output had been markedly impacted by the international crisis, given its greater degree of exposure to developments on foreign markets. Nonetheless, the increase in the GDP of these two countries in the

(2) The estimate of GDP for this quarter combines mixed methodological criteria according to the countries involved. Most have calculated their figures in accordance with ESA 95 criteria while others have continued to take ESA 79 as their basis.

TABLE 1

## Euro area. Qualitative indicators

	1989-1998	1998	1998			1999		1999					
			Q2	Q3	Q4	Q1	Q2	JAN	FEB	MAR	APR	MAY	JUN
<b>MONTHLY SURVEY (NET REPLIES):</b>													
Industrial confidence	-8	0	2	-1	-5	-10	-11	-8	-11	-12	-11	-11	-10
Order books	-18	-4	-1	-4	-11	-19	-20	-15	-19	-22	-19	-20	-20
<i>Foreign orders</i>	-20	-5	-3	-5	-15	-23	-24	-19	-24	-27	-24	-23	-24
Stocks	11	8	7	8	10	14	14	13	14	14	14	14	13
Construction-													
sector confidence	-22	-19	-22	-13	-15	-9	-7	-9	-9	-9	-7	-8	-6
Order books	-30	-25	-28	-19	-21	-17	-14	-19	-18	-15	-13	-16	-12
Retailer confidence	-7	-2	-4	-1	-3	-3	-4	0	-4	-6	-1	-3	-9
Consumer confidence	-14	-5	-5	-5	-2	0	-4	0	0	-1	-3	-4	-5
<b>Economic sentiment index (1985 = 100)</b>	<b>101.2</b>	<b>104.0</b>	<b>104.9</b>	<b>104.4</b>	<b>103.7</b>	<b>104.1</b>	<b>103.9</b>	<b>104.4</b>	<b>104.1</b>	<b>103.9</b>	<b>104.1</b>	<b>103.8</b>	<b>103.8</b>
<b>QUARTERLY SURVEY:</b>													
Capacity utilisation (%)	81.8	82.6	81.9	83.7	82.8	81.9	81.9						

Source: European Commission.

first quarter remained below that of the average for the area.

The indicators of activity in the euro area during the second quarter tend to corroborate the fact a recovery is taking place. The area-wide economic sentiment indicator drawn up by the European Commission, though it fell slightly in average terms in the second quarter, has tended to stabilise and is holding at historically high levels. However, a certain dichotomy persists between business and consumer confidence (see Table 1). On one hand, business confidence has picked up from the trough reached in March, largely in response to the recovery of orders, especially those from foreign markets. Likewise, production expectations have been growing since February. In the construction sector, too, the confidence indicator has tended to rise slightly. On the other hand, consumer confidence has continued falling, although it is still at historically high levels and purchasing intentions have increased. In any event, other consumption indicators (car and retail sales, among others) continued to reflect sustained growth.

The information available for the euro-area countries points in the same direction. Of particular relevance are the improvement in the business climate in Germany and the upward revision of official forecasts of German GDP growth for the year as a whole. That contributes to reaffirming the prospects of recovery in the common monetary area in the second half of

the year. Likewise, the ongoing pick-up in the external environment, combined with the gain in competitiveness of the euro against the developed countries since the start of the year (9%), will be conducive to the contribution of the external sector to growth in the area becoming less negative. Most uncertainty over growth currently turns on whether the adjustment of stocks observed in the first quarter continues or not in the coming months, given their highly volatile nature and the measurement problems involved.

The euro-area labour market continues to be influenced by the loss of momentum of activity in 1998. Employment has thus been growing at falling rates since the middle of last year, which prevents unemployment from declining at a greater pace. Between March and May, the unemployment rate has held stable at around 10.3% of the labour force.

Prices have remained stable throughout the second quarter despite the increase in oil prices, which have risen 75% since February. The 12-month growth rate of the HICP for the area, after having risen to 1.1% in April, stood at 0.9% in June. In explaining the price performance it should be borne in mind that, although the prices of energy products have climbed most significantly, their upward impact on the general index has been offset by the decline in the prices of services and, most especially, of food. As a result, the differential between services and goods inflation has narrowed from 1.4

percentage points in January to 0.9 points in June (see Chart 9).

Country by country, convergence between national inflation rates has increased, as witnessed by the fact that their degree of dispersion, measured by the difference between the maximum and minimum values, has moved from 2.3 percentage points in January to 1.9 percentage points in June. However, analysis of the differences between the national growth rates of services prices (services being the most inflationary component of the HICP in all the countries) gives very different results: the differential here widened by 0.6 percentage points between January and June.

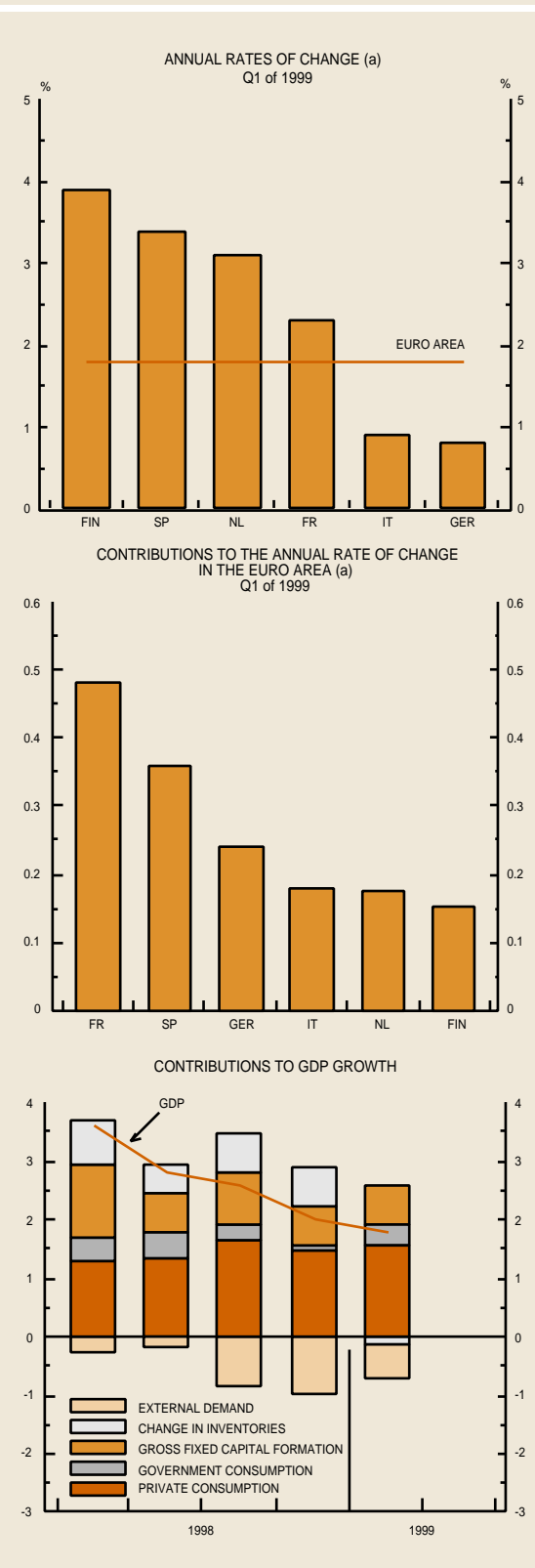
In the near future, there are certain risks that area-wide inflation may trend upwards, albeit without jeopardising price stability. Such risks are associated with various factors. First, the course of oil prices which, after a slight correction in May, have grown most significantly in recent weeks, it seeming unlikely that they will fall substantially in what remains of the year. Next, the behaviour of non-energy commodity prices, which have also been on something of a rising trend. Further, the possibility of wage settlements agreed on at the beginning of the year in certain countries not being offset by gains in productivity and passing through to final prices. And finally, the cumulative depreciation of the euro since the start of 1999.

Since May, the ECB has published the external accounts of the area as a whole. Thus, on provisional data, the euro-area current-account balance in the first five months of 1999 ran a surplus of EUR 18.5 billion (EUR 19.4 billion in the same period in 1998). The trade balance over this same period was EUR 34.1 billion, 9.5 billion lower than in 1998. In the services balance, payments exceeded receipts by EUR 3.5 billion. And the income and current transfers accounts also ran deficits (of EUR 1.1 billion and 11.1 billion, respectively).

In the budgetary area, no additional headway in budgetary consolidation is expected in the area as a whole in 1999, particularly in view of the fact that the final 1998 outturn was better than expected (see Table 2). On the estimates available, the cyclically adjusted balance would remain unchanged in relation to 1998, while the actual deficit would show a slight reduction, as a result mainly of a fall in the interest burden. The composition of the growth of actual output so far in 1999, in particular the strength of private consumption, proves favourable for tax revenue. In any

CHART 8

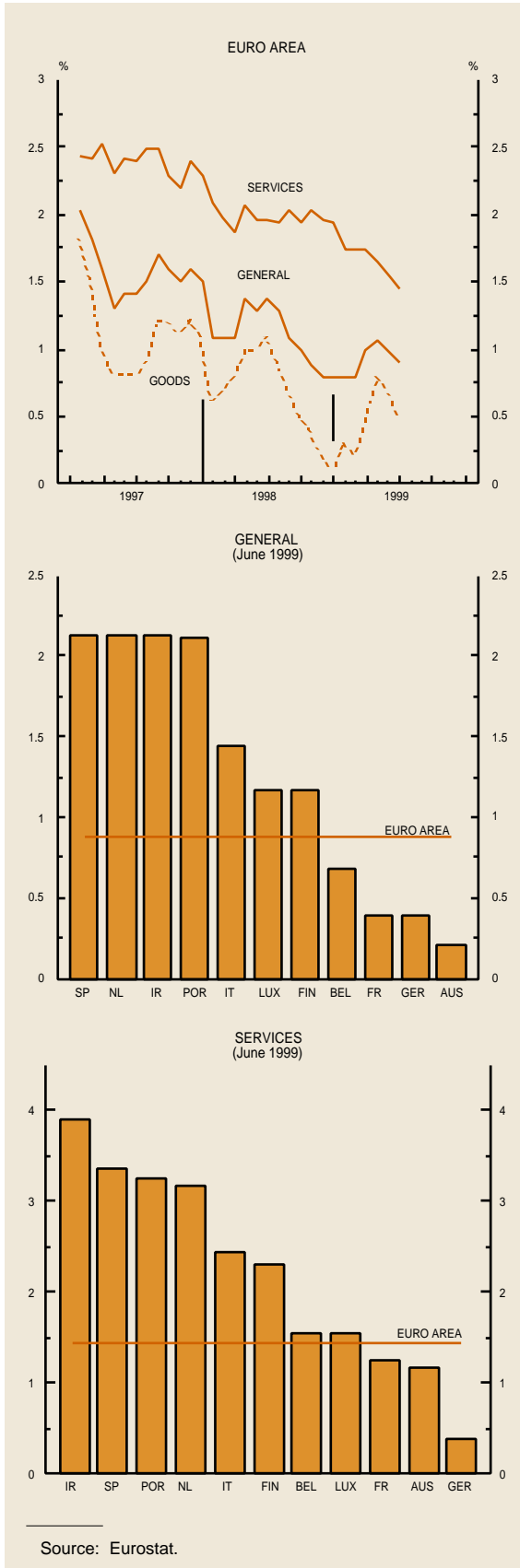
GDP in the euro area



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

CHART 9

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



event, this overall evaluation masks differing situations in the countries of the area, as can be seen in Table 2.

As regards fiscal programming for the coming years, two countries, Germany and Italy, have disclosed their medium-term plans. The German government has unveiled the guiding principles of its federal budget for the year 2000 and of its fiscal strategy up to the year 2003. The authorities envisage a broad range of measures, with further details pending. For next year, a 1.5 % cut in federal spending has been announced, which would offset the foreseen reduction in the tax burden, placing the federal deficit at 1.2 % of GDP. The Italian government has, in its Document on Economic and Financial Programming for the period 2000-2003, confirmed the deficit targets of the Stability Programme for the next two years, although these would be attained with a primary surplus lower by the order of half a percentage point of GDP. It is envisaged achieving budgetary equilibrium by the year 2003, mainly through the control of current primary expenditure.

In a setting in which fiscal policy is geared to achieving medium-term targets (through positions close to budgetary equilibrium under neutral cyclical conditions), the possibilities of a counter-cyclical use of fiscal policy are governed by the closeness to or distance from such targets. Moreover, the positions of the various countries along the business cycle differ. For those further ahead in the cycle, both considerations make it advisable to adopt a particularly tight fiscal policy stance, so as to prevent inflationary pressures emerging and to entrench the progress made towards the medium-term targets. Conversely, in the countries in which the slowdown in economic activity has been sharper (tending to coincide with those with a more unfavourable structural position), there is scarcely any scope for the built-in stabilisers to contribute to sustaining activity.

**3.2. Monetary and financial developments**

Monetary and financial conditions in the euro area were generally accommodating during the second quarter of 1999, against a backdrop of relatively weak growth prospects, without significant risks for price stability. However, the configuration of these conditions underwent significant changes during the period under consideration.

As indicated in the preceding «Quarterly Report», the economic situation in the euro area at the outset of the year was marked by relatively pessimistic growth expectations and by a very

TABLE 2

**General government financial balances of the euro-area countries  
(as a % of GDP)**

	1994	1995	1996	1997	1998	1999 (b)
Belgium	-4.9	-4.0	-3.1	-1.9	-1.3	-1.3
Germany	-2.6	-3.3	-3.4	-2.7	-2.1	-2.0
Spain	-6.2	-7.1	-4.5	-2.6	-1.8	-1.6
France	-5.8	-4.9	-4.1	-3.0	-2.9	-2.3
Ireland	-1.5	-2.1	-0.3	1.1	2.3	1.7
Italy	-9.2	-7.7	-6.6	-2.7	-2.7	-2.0
Luxembourg	2.7	1.8	2.8	2.9	2.1	1.1
Netherlands	-3.8	-4.0	-2.0	-0.9	-0.9	-1.3
Austria	-5.0	-5.1	-3.7	-1.9	-2.1	-2.0
Portugal	-6.0	-5.7	-3.3	-2.5	-2.3	-2.0
Finland	-6.6	-4.6	-3.1	-1.2	1.0	2.4
<b>MEMORANDUM ITEM:</b>						
Euro area						
Primary balance (a)	0.3	0.7	1.3	2.5	2.4	
Overall balance (a)	-5.1	-5.0	-4.1	-2.5	-2.1	
Public debt	70.8	74.8	76.1	75.4	73.6	

Source: ECB (to 1998).

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

(b) National stability and convergence programmes.

low inflation rate. Against this background, the Governing Council of the ECB decided at its meeting on 8th April to cut the interest rate on its main refinancing operations by 50 basis points to 2.5 %, simultaneously reducing the rates on its standing lending and deposit facilities to 3.5 % and 1.5 %, respectively, from 4.5 % and 2.5 % (see Chart 10). This cut in the official Eurosystem rates was greater than expected by the markets and gave rise in April to reductions in interest rates along the entire yield curve.

Bearing on the external environment in the second quarter were expectations of an interest rate hike by the Federal Reserve. As previously mentioned in this Report, this rise finally took place on 30th June. Further, certain signs of recovery in the pace of activity were discernible in the euro area as from May. These factors led thereafter to upward movements in euro-area interest rates, which were sharper in the longer terms. As a result, long-term interest rates were at higher levels than those in place at end-1998.

As regards the shorter-term interest rates, those on interbank deposits rose as from the six-month maturity (see Chart 11). On the latest information available, the six-month EURIBOR stood, as of 20th July, around 35 basis points above the average level reached in May, whereas the increase in the case of the 12-month EURIBOR was 41 basis points. Conse-

quently, the slope of the EURIBOR curve has increased significantly in recent weeks, with the difference between the 12-month and one-month EURIBOR widening from 11 basis points in May to 23 basis points in June and to 43 basis points as of 20th July. By contrast, the rates on three-month and shorter-term interbank deposits have scarcely altered during the same period.

Longer-term interest rates have also increased significantly in recent months. Here, the first increases were seen in the opening months of the year; in February and March there were rises in the yields on ten-year bonds from the minimum level, below 4 %, observed in January. In any event, this course of events intensified as from May and, at present, rates stand at around 5 %, more than one percentage point above the levels at the outset of 1999. As a result of these movements, the long-term interest rate spread over the United States narrowed, especially after 30th June, when the Federal Reserve decided to increase its intervention rate and the upward trajectory of US long-term rates moderated. Thus, the US/euro area spread narrowed in the first half of July to around 115 basis points, after having stood at over 140 basis points in May and June.

Initially, the upward movement in interest rates in the euro area and the narrowing of the



CHART 10

**ECB interest rates and euro exchange rates**

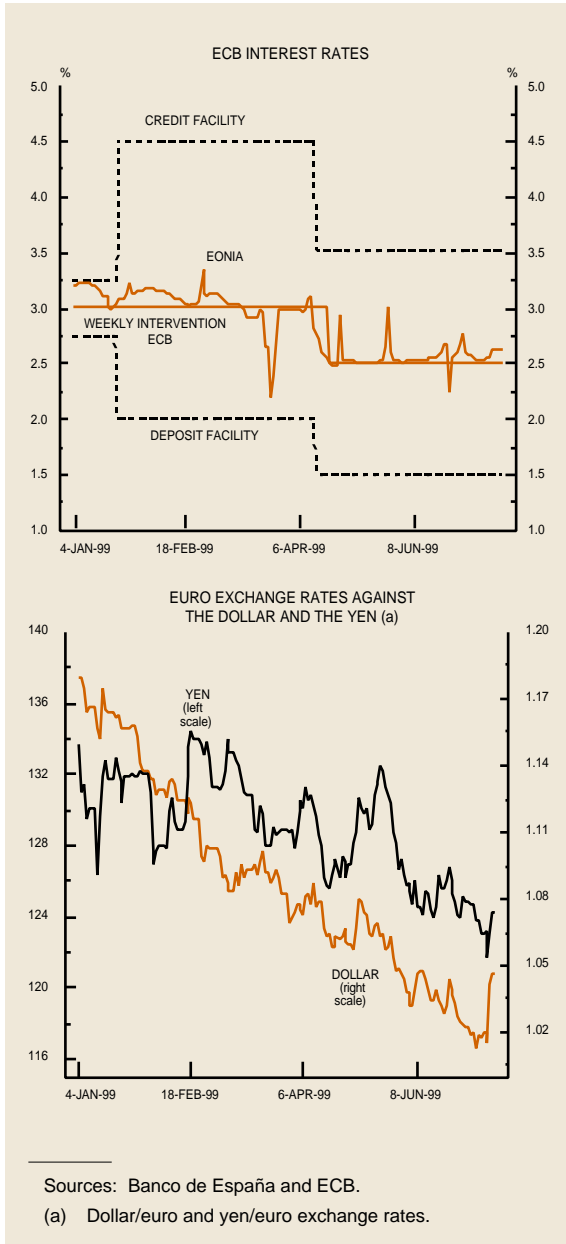
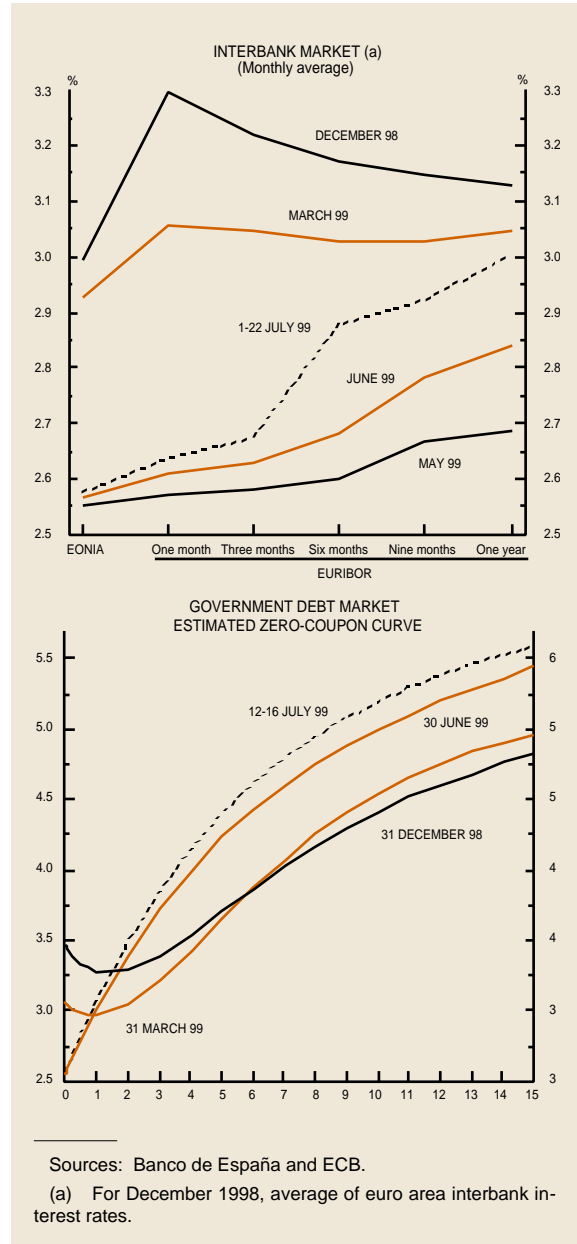


CHART 11

**Euro area yield curves**



long-term spread over US debt did not check the depreciation of the euro against the dollar during the second quarter. In that period, the exchange rate of the euro weakened by around 5 % vis-à-vis the US currency, running up a maximum cumulative depreciation of 12 % in relation to the average exchange rate in January. However, in mid-July the exchange rate of the euro stabilised, embarking thereafter on a process of appreciation up to the time of this report going to press for (see Chart 10).

As regards retail bank interest rates, the lower part of Chart 12 shows that, until May, the

rates on retail bank lending to households and firms continued falling, reflecting with something of a lag the decline in market interest rates in previous quarters.

Despite the rise in long-term interest rates during the second quarter, there was, as on other international stock exchanges, a certain improvement in equity markets in the euro area owing to the more favourable economic outlook for the zone. From March to 15th July the Dow Jones Euro Stoxx index rose by around 8.5 %, with a concurrent reduction in its volatility in relation to the pattern of previous months.

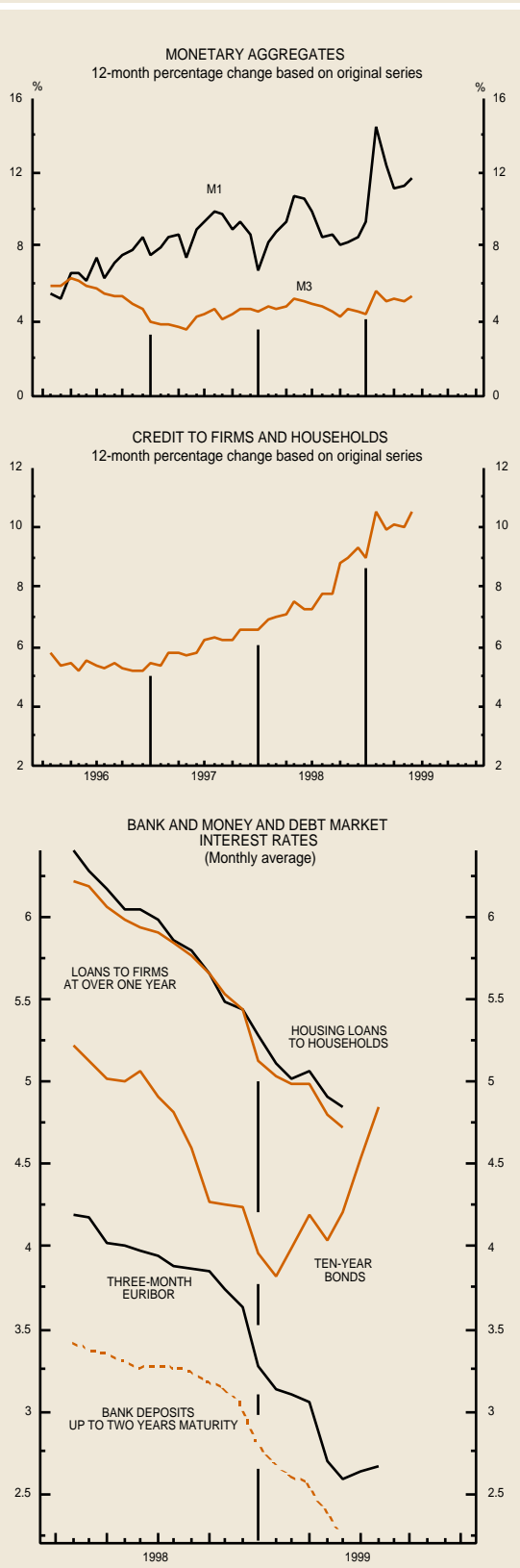
The brighter economic outlook and the low levels of short-term interest rates have also been reflected in the monetary and credit aggregates. On information to May, the behaviour of these aggregates has been relatively expansionary (see Chart 12). The benchmark monetary aggregate (M3) grew by around 5 % in April and May compared with a year earlier, and its moving average over the last three months stood at 5.2 %. This was essentially due to the strong growth of the demand for sight deposits which, after decelerating in March, gave signs of renewed vigour in April and May. M1 posted year-on-year growth of over 11 % in these two months. Among the other financial assets included in M3, only the demand for shares in money market funds showed great resilience, growing at around 15 % in May compared with twelve months earlier.

Turning to the counterparts of M3, the high growth of financing to resident sectors in the euro area continued, rising to almost 8 % year-on-year in May. This reflected the strong expansion of financing to households and non-financial firms, which grew 10.5 % in May compared with twelve months earlier, and very moderate growth of financing to general government (1.2 %). The behaviour of the longer-term liabilities not included in M3 was generally fairly stable, with year-on-year growth of around 5 %. The difference between the growth of credit, on one hand, and of M3 and other liabilities, on the other, was financed by means of a reduction in the net external asset position of MFIs.

With respect to monetary policy implementation during the second quarter, the liquidity provided by the Eurosystem through the main refinancing operations (75 % of the total) and the longer-term operations (25 % of the total) meant that the overnight interbank interest rate, EONIA, held at between 2.5 % and 2.6 %, around 30 basis points below the average levels in March. The pro rata percentages applied by the Eurosystem at its main refinancing operations remained very small throughout the second quarter and, in particular, in recent weeks, where the allotment ratio has varied between 4 % and 7 %. The net liquidity provided by the Eurosystem in the third, fourth and fifth reserve maintenance periods, corresponding to the second quarter, amounted to EUR 175.5 billion, 167 billion and 176.7 billion, respectively, which sufficed to meet institutions' liquidity requirements in respect of minimum reserves and the effect of autonomous factors. These factors entailed, on average, a net absorption of liquidity for the respective amounts of EUR 74.4 billion, 65.8 billion and 74.8 billion.

CHART 12

Monetary and credit aggregates and interest rates in the euro area



Sources: Banco de España and ECB.

## 4. The Spanish economy

### 4.1. Demand

As indicated in the "Overview" of this report, INE has, with the publication of the Quarterly National Accounts (QNA) provisional data for the first quarter of 1999, re-based the National Accounts (CNE 95) incorporating ESA 95 methodology. The new data exhibit significant changes as regards the course of certain economic aggregates. Specifically, the new information reveals much more pronounced growth in national demand in the second half of 1998 than that previously estimated. GDP, however, has continued to show a gently slowing profile since mid-1998, as reflected under the former accounting methodology, since the contribution of net external demand has become much more negative since the third quarter of 1998.

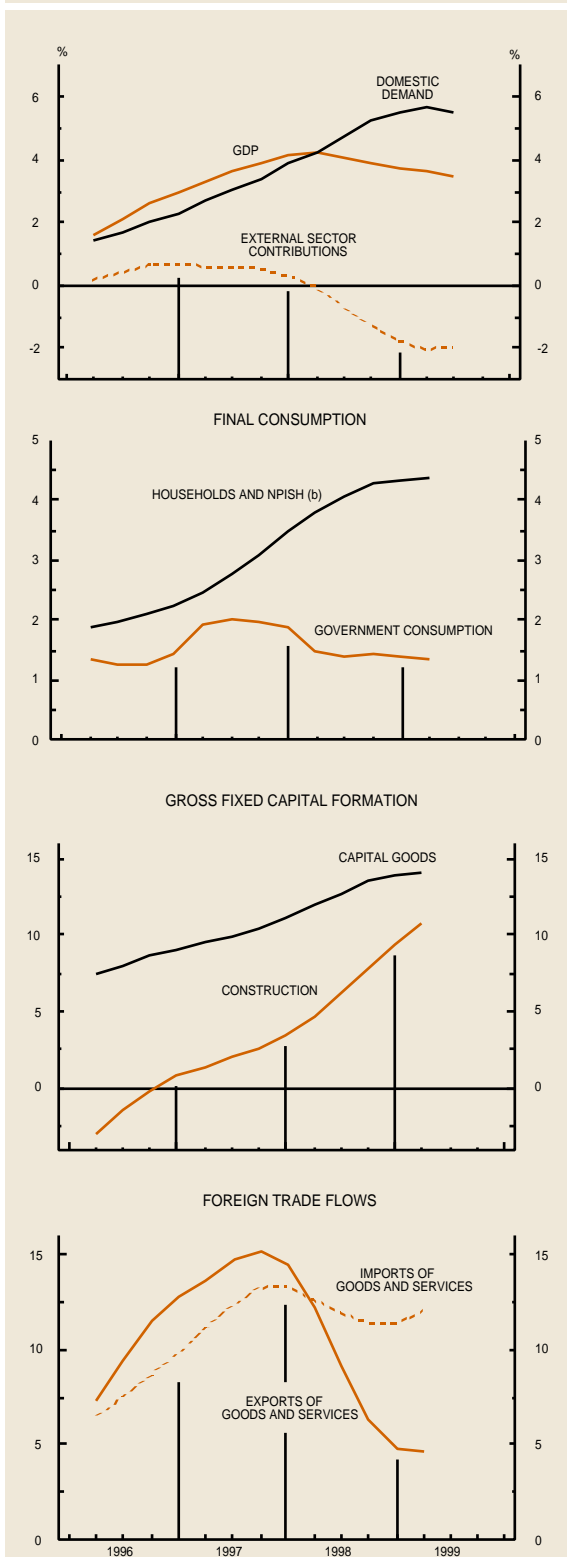
According to this new information, national demand posted real growth of 5.7 % in the first quarter (3) of 1999 compared with four quarters earlier, slightly up on the figure for the fourth quarter of 1998, for which year average growth was 5 % (see Chart 13). The growth rates of all the national demand components, except general government final consumption spending, intensified in the first quarter of 1999. There was a notable acceleration in construction spending, while household final consumption spending and capital investment recorded a rate of increase one-tenth of a point higher than in the previous quarter. Net external demand became more contractionary in the first quarter of the year, subtracting two percentage points from real GDP growth. This result reflects the acceleration in imports, in line with the strength of domestic demand, and a further weakening in exports.

The economic information available for the second quarter of 1999 indicates that the previous acceleration in national demand, in year-on-year terms, has not continued. Indeed, it is estimated that this variable recorded a slightly lower growth rate in this period than in the first quarter of the year, since both national final consumption expenditure and gross capital formation decelerated, although they once more posted high real rates of increase. On the partial information currently available, the negative contribution of external demand to real GDP growth is estimated to have held at first-quarter levels, as a result of (as yet) very limited headway by exports, whereas imports continued to

(3) Unless otherwise indicated, the rates of change of the QNA referred to in this section are those defined in trend-cycle terms; INE also publishes gross and seasonally adjusted data.

CHART 13

Main macroeconomic aggregates (a)



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

be boosted by the resilience of the economy's final demand.

Drawing on the latest consumption indicators, the pattern of behaviour of this variable was close to that of the preceding quarter, although it embarked on a slight slowing trend. Chart 14 shows that, although the index of apparent consumption of goods and services, calculated on as yet limited information, has tended to stabilise in terms of its growth rate and in relation to the previous quarter, the rate of increase of the goods component in the second quarter of the year has moderated. This is the result of the loss of momentum of the food component and of the aggregate of durable goods. Behind the slowdown in this latter component has been the set of durable goods other than those intended for private transport, since car purchases remain very buoyant. Indeed, the expansiveness of the index of apparent consumption of transport goods is matched by the indicator of new car registrations, which has advanced further in the second quarter. The retail sales index showed growth of 0.5 % in real terms in April and May compared with the same two-month period a year earlier, far below the figure of 3.2 % observed in the first quarter. Nonetheless, this slowdown has not been confirmed by the retail trade survey indicator, the improvement in which in the second quarter has been underpinned by greater optimism in respect of the current situation of this type of business.

Since the sectoral accounts estimated under CNE 95 methodology are not yet available, it is a particularly complex task to approximate the course of household disposable income for 1999. Nonetheless, the indicators of some of the components of this aggregate confirm that income has continued running at high growth rates, since the still-significant increase in employee compensation (despite the mild slowdown in employment) has added to the expansionary effect arising from the personal income tax reform. The other determinants of private consumption – wealth and interest rates – also attest to the buoyancy of expenditure, since their favourable performance during 1998 and the lag with which these variables act on household decisions are an additional spur to consumption growth in 1999. The ongoing optimism characterising household expectations is also conducive to spending decisions materialising. In fact, although the consumer confidence indicator has dipped slightly in the second quarter, its level remains positive and high. The slight fall in the indicator has come about as a

result of surveyed opinions about both the current and future situation of the country, while its other chief component parts exhibited more stable behaviour. However, the recent deterioration in price and employment expectations should also be highlighted, as that might boost precautionary household saving.

On QNA estimates, the real year-on-year increase in general government final consumption spending was 1.4 % during the first quarter of 1999, in step with the moderation of this variable in 1998. This growth rate remained virtually unchanged during the second quarter of 1999 owing to the trend of public-sector employee compensation. Conversely, public-sector net purchases of goods and services and fixed capital consumption exhibited somewhat higher growth rates.

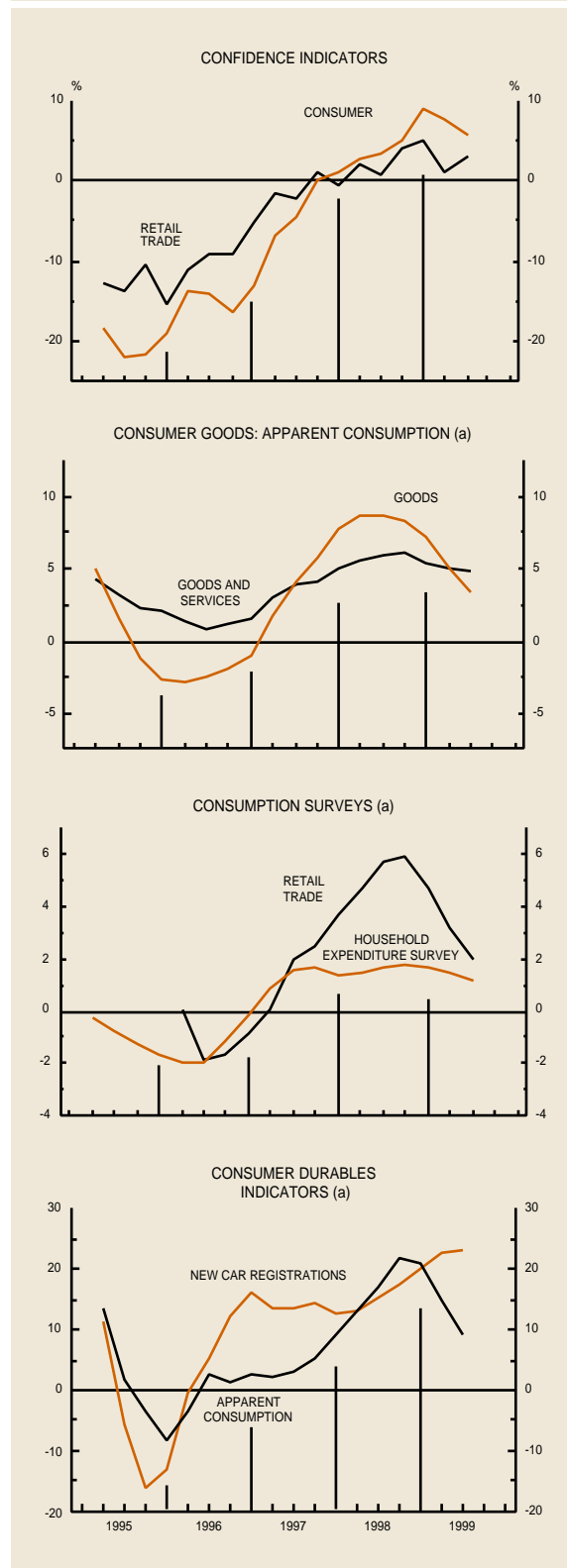
The real increase in gross fixed capital formation in the first quarter of 1999 was 11.9 % year-on-year, thereby prolonging the acceleration in this aggregate since 1996. Underpinning this acceleration was the buoyancy of construction spending and the high growth of investment in capital goods. In the second quarter of the year, the information available indicates this demand component may have run at a somewhat lower rate of increase than that of the previous quarter, owing essentially to the estimated course of investment in capital goods.

Among the available indicators of the behaviour of capital investment in the second quarter of the year is the apparent investment index. This decelerated in April, in tow to the lower growth of the domestic production of capital goods, while the buoyancy of imports heightened, climbing 26.3 % in the first four months of the year (see Chart 14). Component by component, both the index of apparent investment in transport equipment and those of other capital goods reflected the slowing profile of the aggregate index, although transport equipment stood at comparatively higher growth rates. Nonetheless, according to the MINER monthly business survey, expected orders for industry as a whole remained in April and May on the rising trend initiated in mid-1998, and the business confidence indicator in the capital goods sector has improved following its deterioration in the first quarter of the year (see Chart 15).

The slight moderation in the investment process in the second quarter of 1999 would appear to be related to the slowdown in final demand, since the remaining basic determinants of productive investment have held on the

CHART 14

Private consumption indicators

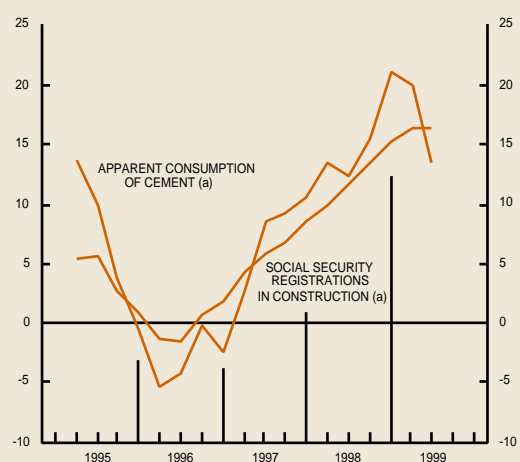
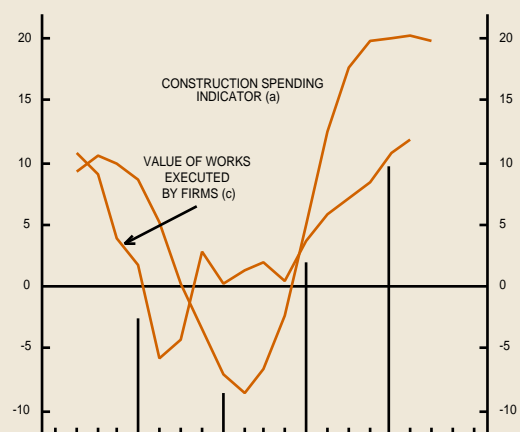
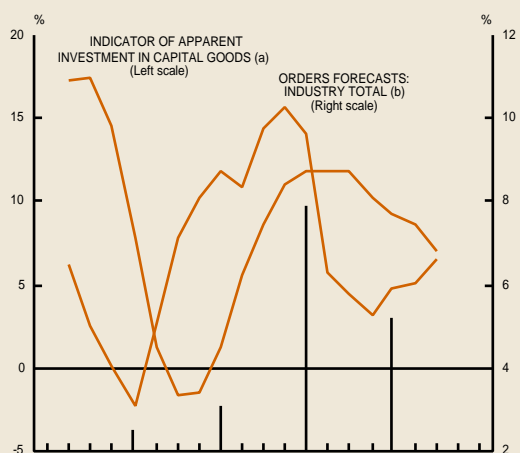


Sources: Instituto Nacional de Estadística, European Commission, Dirección General de Trabajo and Banco de España.

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

CHART 15

Gross fixed capital formation indicators



Sources: Ministerio de Industria y Energía, Oficemen, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

- (a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.
- (b) Trend level.
- (c) Obtained from the quarterly construction industry survey and deflated by the construction costs indicator. Four-quarter rate of change based on original series.

favourable line of previous quarters. According to quarterly figures from the Banco de España Central Balance Sheet Office, the profit and loss accounts of non-financial firms continued to benefit in the first quarter of 1999 from the interest rate cuts in previous quarters, albeit to an increasingly less intense degree. Moreover, corporate returns on both net assets and equity held at considerably high levels. The improvement in self-financing sources, reflecting the increase in profits, and the favourable conditions in which firms may resort to borrowed funds have both upheld vigorous investment activity. On data drawn from the industrial sector, investment priorities are focused on increasing plant capacity, and capacity utilisation is indeed holding at high levels. Improving production process returns is, according to responses in the half-yearly investment survey conducted in autumn 1998, also one of the main aims of investment.

On QNA data, investment in construction continued to gain momentum during the first quarter of 1999. In year-on-year terms its growth rose to 10.7 %, with the national demand component posting a sharper acceleration in this period. Information from the construction indicators during the second quarter suggests that, although their related growth rates remain high, the process of acceleration has tended to halt.

Among the coincident indicators of construction, the buoyancy of apparent consumption of cement (which grew 17.7 % year-on-year in the period from April to June, compared with 19.3 % during the first quarter) is compatible with a trend deceleration, as shown in Chart 14. The force of new social security registrations in the construction sector continued in April and May, with average year-on-year growth of 16.5 %, very close to the figure of 16.3 % for the first quarter of 1999. In line with this employment performance, registered unemployment in construction underwent an average fall of 22.3 % during these months, compared with a year earlier, again similar to the previous-quarter figure of 22.9 %. Lastly, the construction-sector business climate indicator, released by the European Commission with data to June, has weakened in recent months.

An alternative assessment of the behaviour of investment in construction during the second quarter can be obtained drawing on the leading indicators in previous quarters. In this respect, public tenders, recorded on the basis of their publication in the Official State Gazette (BOE), grew 29 % during the second half of 1998.



However, the latest data on this variable, relating to the first quarter of the current year, reveal a slide. There has been an average fall of 19.9 % year-on-year, with a more marked decline in the civil engineering works component. Should this fall become entrenched, it could affect the present buoyancy of public works and, therefore, construction in the medium term. Foreseeably, however, the start-up of the Major Infrastructure Programme in the near future should sustain the buoyancy of public construction in the medium term.

The leading indicators of private-sector building (such as the number of square metres to be built included in municipal permits) showed sizeable increases during 1998 which, in general, have continued in the opening months of 1999. Further, the determinants of housing investment appear to substantiate significant growth in this variable. In this connection, the favourable performance of employment, low interest rate levels, the lengthening of mortgage loan repayment terms and the cumulative gains in financial wealth, among other factors, may be cited. Set against these factors, the rise in house prices might exert a restraining influence on spending, although the ongoing buoyancy of the supply of housing makes it foreseeable that price pressures should not heighten significantly.

The trend of investment in construction, estimated on the basis of the aforementioned leading indicators, is concisely depicted in the middle section of Chart 15 in the form of the spending indicator. The results obtained for this indicator confirm the great buoyancy of construction in the second quarter of the year that the other indicators had signalled.

The contribution of stockbuilding to GDP growth in the first quarter of the year was positive of the order of one-tenth of a point, half that of the previous quarter. The information available for the second quarter shows that this contribution continues to be positive. Drawing on the survey findings by the European Commission, the declared proportion of firms in this period with higher-than-wanted stocks was slightly lower than in the preceding quarter.

The negative contribution of net external demand to GDP growth continued to intensify in the first quarter of 1999. This was due to the marked weakness of goods exports and the high growth rate of imports, underpinned by the strength of domestic demand. The information available for the second quarter is as yet very incomplete; it refers to the merchandise trade

and balance of payments figures for April (4), and does not show significant changes from the trends observed in the first quarter. That said, in view of the determinants of goods exports, this aggregate may be expected to pick up as from the summer. Indeed, the improvement in the international setting, in general, and in the EU, in particular, coupled with the strong depreciation of the euro against the dollar, should make – if it has not done so already – for an improvement in exports. In any event, the poor April export figure, combined with the strength of tourism receipts and with a sustained growth rate for imports similar to that of the first quarter of the year (in line with the estimated trend of final demand), suggests, overall, that the negative contribution of net external demand to GDP growth will have held in the second quarter at around the levels of the preceding quarter.

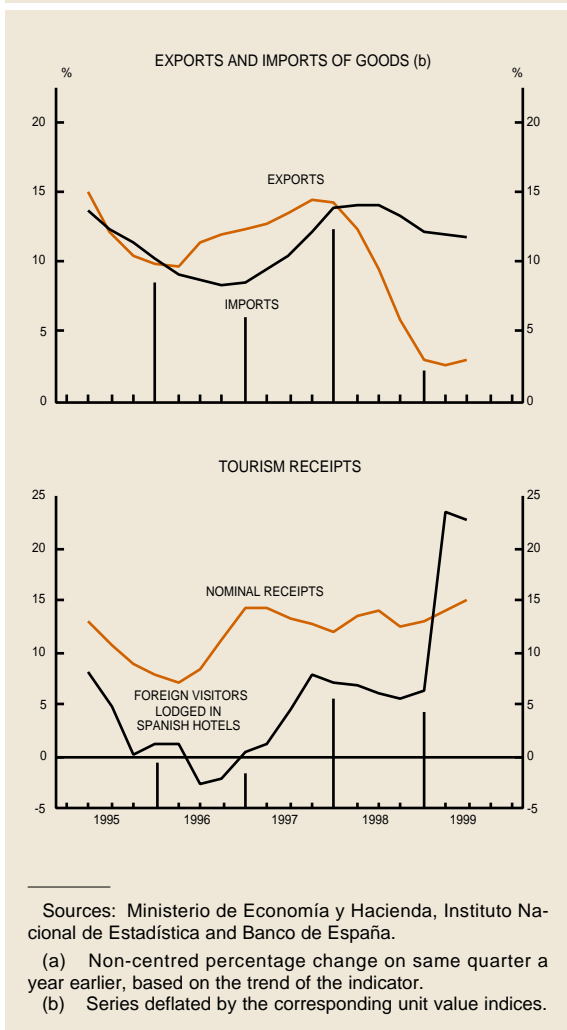
According to official Customs figures, goods exports, after resuming a positive growth path in real terms in the first quarter of 1999, were once more very depressed in April, falling by 4.8 % in real terms. Consequently, their real cumulative growth in the January-April period was only 0.8 %. The considerable slackness of sales to the EU and the sharp fall in exports to non-Community markets were behind this result. Given the variability marking these flows, assessment of the only figure available for the second quarter requires caution. The trend depicted in Chart 16 would seem to point to the persistence of very slack exports which, nevertheless, might have touched bottom in the spring, in step with the trend of its determining factors. Taking the different product groups, sales of capital goods alone remained buoyant (with a real growth rate of 14 %) over the first four months of the year, despite their recent slowdown. Meantime, there were falls in the remaining components, notably so in non-food consumer exports, influenced by a loss of competitiveness of certain consumer manufactures vis-à-vis third countries. Likewise, sales of non-energy intermediate products continued to be affected by the decline in demand from those countries most beset by the international financial crisis.

Conversely, the expansionary behaviour of real-terms tourism receipts over the course of 1999 has continued. In the Balance of Payments, tourism receipts grew by 13 % in nominal terms to April. Similarly, both tourist arrivals

(4) The aggregate foreign trade data for May were published after this report had gone to press. The figures confirm the strength of goods imports and the low growth of exports.

CHART 16

Foreign trade (a)



and the number of foreign visitors staying in hotels were most buoyant during the first five months of the year (10.2 % and 19.4 %, respectively), the high growth rates of the first quarter being repeated in the April-May period. In terms of countries of origin, there was a sizeable increase in tourists from Britain and a pick-up in numbers from other European countries, such as Germany, Italy or the Netherlands. Contributing to the strength of the tourism performance has been the high level of European consumer confidence and cheaper costs for tourists from non-EMU countries, owing to the depreciation of the euro.

In real terms, goods imports grew at a rate of 14.5 % in April compared with the same month a year earlier, prolonging the high growth rate exhibited throughout the first quarter of the year. For the first four months of 1999, the related increase was 11.7 %. Component by com-

ponent, the strength of capital goods purchases and of non-food goods in 1998 has continued during the first four months of 1999, in step with the vigour of domestic demand. Consumer imports of food, for their part, ran on a moderately quickening course, the outcome of the poor results of the latest fruit and vegetable harvest and from the fall in the prices of these products on international markets. Meantime, there was a moderate increase in non-energy intermediate goods, in line with the slowdown in industrial activity. The volume of intermediate energy goods imports continued to run at high growth rates as a consequence of ongoing stock replenishment at the main Spanish refineries, and the pace has not slackened despite the strong upward trend in the price of crude witnessed since April. Lastly, tourism expenditure grew by 15.6 % in the first four months of the year, on a par with the previous vigour of this variable, which is the result of Spanish households' greater purchasing power.

4.2. Output and employment

As can be seen from the behaviour of domestic demand and external demand in the second quarter of 1999, Spanish GDP is estimated to have slowed mildly during this period compared with a year earlier, thus prolonging a trend apparent since the start of 1998. Hence, after increasing by 3.6 % in the first quarter, GDP is estimated to have risen by around 3.5 % in the second quarter. This rate is a significantly high one and has been accompanied by substantial employment creation. From the standpoint of the productive branches, output developments have been compatible with further moderation in the growth rates of value added in the industrial branches, while construction and services have shown greater stability. The number of full-time-equivalent jobs grew by 3.4 % in the first quarter of the year (5), below the average rate recorded in 1998. And the indicators available for the second quarter of 1999 coincide in signalling a further deceleration in this variable, albeit less marked than the previous quarter. That would be conducive to a recovery in the rate of increase of apparent labour productivity, which has been at very low rates in recent quarters (see Chart 17). Collective bargaining results confirm the slowdown in wages compared with 1998, with settlements running close to consumer price growth. Yet there are signs that the process of deceleration

(5) The QNA employment data referred to hereafter relate to the trend-cycle series of full-time-equivalent jobs.

of compensation has run its course. Lastly, the CPI posted 12-month growth rates of around 2.2 % during the second quarter, rising slightly from the floor recorded in the last quarter of 1998.

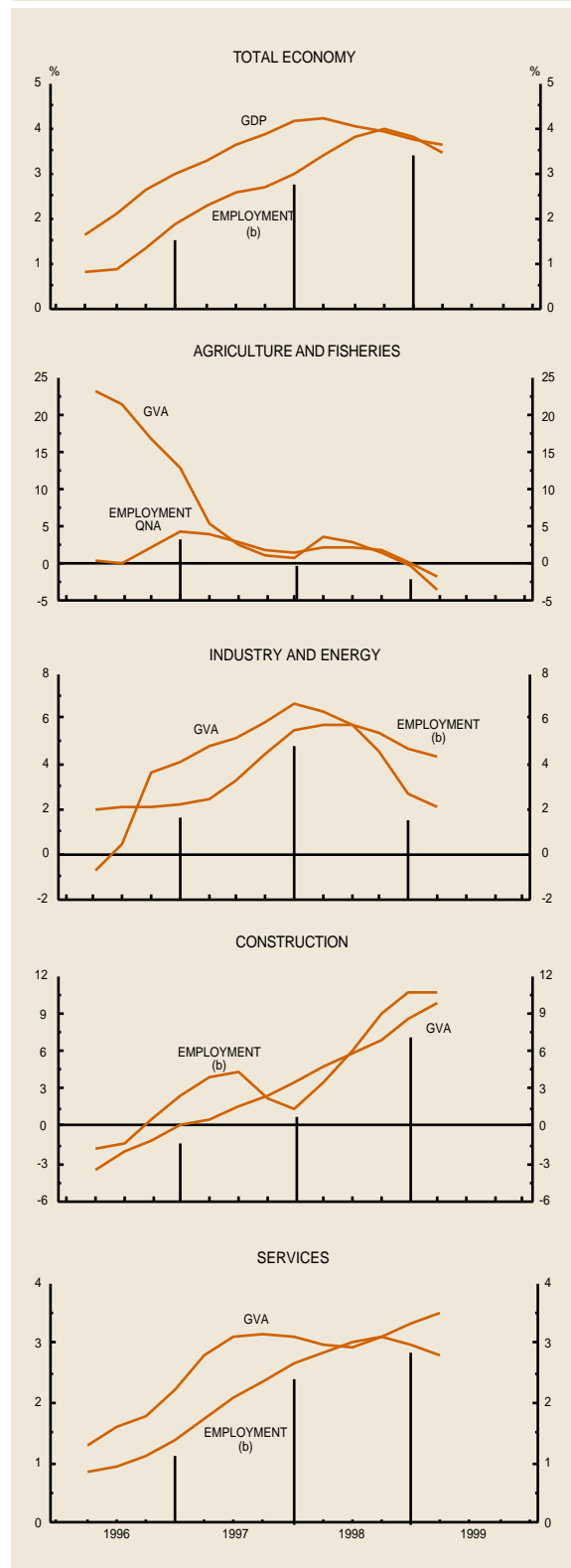
The ongoing slowdown in primary activity since early 1998 steepened in the first quarter of 1999; compared with a year earlier, it fell by 3.7 % in this period according to QNA figures. Largely behind this loss of momentum has been bad weather, specifically scant rainfall, as from the second half of 1998, the effects of which will also be felt in output in this branch in the second quarter of the year. The lack of rainfall has intensely affected the dry farming cereal and beet harvests, as well as olive and wine production. It has also had a bearing on livestock farming output, where the resulting reduction of pasture has begun to affect cattle and sheep. The economic information relating to the second quarter of 1999 is very limited and generally confirms the depressed state of value added in this branch. Indeed, both registered unemployment in the agricultural sector in the second quarter and the manufacture of products for agriculture in April and May have shown signs of slowing, while the number of social security registrations in the branch has held fairly stable.

Value added in the energy branches recovered in the first quarter of 1999, halting the progressive deceleration witnessed since late 1997. The information available for the second quarter of the year, however, would not seem to point to a prolongation of this favourable performance. According to the Industrial Production Index, the energy branch, despite this being the most buoyant activity in the first five months of 1999, with cumulative year-on-year growth of 3.5 %, was also that which slowed to the greatest extent in this period. This loss of momentum was extensive to all its components, notably solid fuel production, which fell by 8.7 % to May.

The ongoing loss of steam in industrial activity since early 1998 continued into the first quarter of 1999, albeit in a slacker fashion. The economic data available for the second quarter tend to confirm the deceleration scenario observed at the start of 1999, although there are signs that the process could be coming to an end. The non-energy component of the Industrial Production Index increased by 2.6 % year-on-year in the period spanning April and May, though this figure falls substantially if adjusted for calendar effects, thereby extending the flatness of the previous months. Nonetheless, the qualitative business climate indicator ceased, in

CHART 17

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



Source: Instituto Nacional de Estadística.

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

(b) Number of equivalent full-time jobs.

the second quarter of the year, to move on the sharply deteriorating line it had followed since mid-1998. And adding to this is the expected recovery in exports to the EU and to those economies most affected by the recent international crisis, as indicated in the section on demand. Consequently, there are factors providing scope for regeneration which may boost industrial activity in the coming months.

A more itemised analysis of the various industrial branches reveals different behaviour among them. The slowdown in train in the metal working industry since the second quarter of 1998 intensified in April and May, with cumulative year-on-year growth of 0.8 % being recorded to May. Notable within this branch were the heavy falls in the first five months of the year in the production of electronic equipment (excluding computers), office machinery and shipbuilding. Conversely, the growth of activities included under the production and transformation of non-energy products and the chemical industry increased in April and May, running at a cumulative year-on-year rate of 2.6 % in the latter month. This broke the slowing trend it had been exhibiting over the past twelve months. It was the result of favourable developments in the chemical industry, the non-metallic mineral industry and the extraction of non-metallic, non-energy minerals. The other manufacturing sectors also began to pick up as from March, recording cumulative year-on-year growth of 1.5 % in the first five months of the year. A clear distinction should be drawn under this latter group of activities between those immersed in recession (leather, footwear, clothing and textiles) and those showing signs of recovery, such as cork and furniture, rubber transformation and the production of food, beverages and tobacco. There appears to have been a turnaround in this latter industry from the negative growth rates recorded in the opening months of the year, which were largely brought about by the poor yield of olives intended for olive oil production.

Value added in construction advanced at a year-on-year rate of 10.2 % on QNA estimates in the first quarter of 1999, in line with its vigorous expansion since early 1996. Underpinning this continuing buoyancy has been the vigour of civil engineering works and overall building, both for residential and other purposes. As earlier discussed in the section on demand, the information available for the second quarter of 1999 confirms the sustained high growth rate in this activity, but without indicating an additional acceleration.

Growth in the services branches climbed to 3.5 % in the first quarter of 1999, two-tenths of a point up on the previous quarter. This was due to the acceleration in both the market and non-market services components. The limited information available for the second quarter of 1999 points to flat growth in the value added by market services, the outcome of counteracting and offsetting movements in the various associated components. The ongoing deceleration in branches such as distribution (drawing on the retail trade sales index in April and May) would be offset by the growing buoyancy of the transport sector (as shown by the employment indicators, with information to May) and by the excellent performance in recent months in the hotel and catering trade, since the indicators on hotel and overnight stays have advanced strongly in the first five months of the year.

The new QNA have, for the first time, provided employment data calculated in terms of jobs and jobs equivalent to full-time posts. According to these data, the lower growth rate of economic activity in the first quarter of 1999 was accompanied by less buoyant employment, albeit at high levels. The number of full-time-equivalent jobs rose by 3.4 % in this period, compared with the same quarter of 1998, prolonging the deceleration that began in the third quarter last year. This lesser figure was scarcely reflected in dependent employment (this group has expanded significantly with the definition of the new re-based National Accounts — CNE 95), which has held at a stable and high rate of increase since the second half of 1998, running at a year-on-year rate of 4.4 % in the first quarter. The numbers of self-employed, after having picked up slightly in 1998, declined by 1 % in the first half of the current year.

Drawing on the Labour Force Survey (EPA), the main employment indicator available, there was a substantial acceleration in the number of employed in the first quarter of 1999. This was in contrast to the QNA data for this period and to the information provided by other indicators. In effect, the data provided by the EPA survey for this period should be interpreted with caution, since they have already incorporated certain changes in the design of the survey (6). These changes no doubt provide for a better measurement of employment and unemployment levels, but they have tem-

(6) See "La evolución del empleo durante el primer trimestre de 1999", *Boletín económico*, June 1999.



porarily affected the rate of change of the main variables analysed and it will be necessary to bear them in mind when interpreting them. With regard to unemployment, the jobless rate estimated under EPA for the first quarter stood at 17 % of the labour force. In the case of registered unemployment, there was a sizeable fall of 13.8 % in this same quarter compared with the same period a year earlier. The rate of decline of registered unemployment began to show signs of slowing during the second quarter, though it ended this period nonetheless posting a fall of 13.3 %. The number of social security registrations also showed something of a slowdown in the second quarter, when it increased by 5.5 % over the same period in 1998, two-tenths of a point less than in the first quarter. The data available therefore point to an increase in employment in the second quarter lower than that in the preceding three months. The slight deceleration in output, along with the moderate loss of momentum of employment, would have entailed a mild recovery in apparent labour productivity, after its growing at rates close to zero in the previous quarters.

By type of employment contract, and qualifying the first-quarter data accordingly, the EPA survey showed a notable increase in wage-earners with permanent contracts in this period, more than double the growth in temporary contracts. That is in line with the rising profile of permanent contracts registered by INEM (the Spanish National Employment Office), and it has placed the proportion of temporary to permanent employees at 32.6 % in the first quarter, eight-tenths of a point below the level in the same period in 1998. Regarding employment by branch of activity, the EPA information for the first quarter of 1999 largely coincides with that drawn from QNA. Of note is the decline in employment in agriculture (–2 % according to QNA), in step with the trend of gross value added in this branch. The loss of steam in industrial activity, for its part, was accompanied by only a mild moderation in the rate of increase of jobs (up to 4.3 %) – owing to a strong decline in self-employment –, which is indicative of a fall-off in apparent labour productivity in this branch. In construction, the most buoyant activity, employment retained the vigour it had shown at end-1998, the number of jobs increasing by 10.6 %. As to services, net jobs increased by 2.8 %, slightly down on the previous quarter. The slowdown affected market services to a lesser degree than non-market services; jobs in the former grew by 4 %, while in the latter they increased by scarcely 0.4 %.

### 4.3. Costs and prices

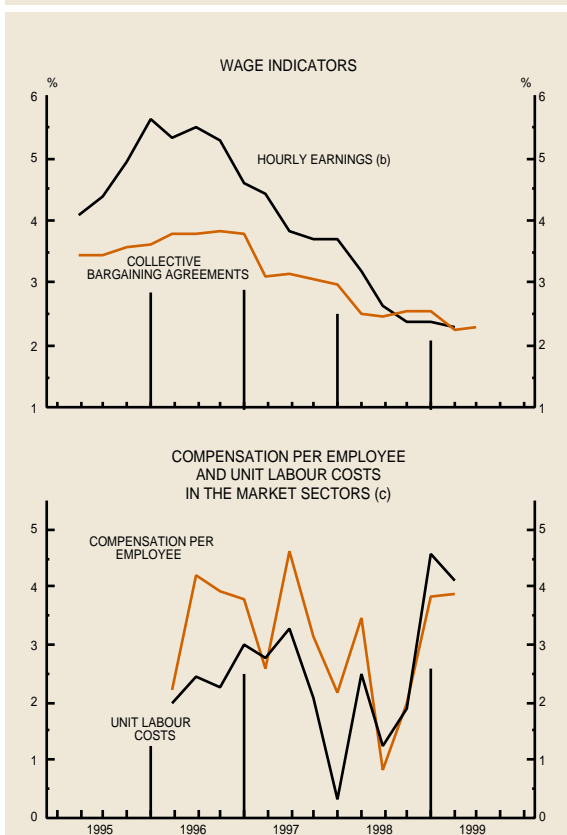
With the new re-based National Accounts (CNE 95), quarterly data on employee compensation have begun to be published. These allow unit labour costs (also quarterly) that are compatible with the trend of GDP and of employment to be calculated. According to the new and as yet provisional data, compensation per employee in the economy as a whole increased by 3.8 % (7) in the first quarter of 1999, after having recorded average growth of 2.7 % in 1998. These results show compensation to have been on an accelerating line since mid-1998, and this, combined with the moderation of productivity gains, points to a likewise upward trend in unit labour costs (ULCs) in the economy as a whole. Indeed, the estimated increase for ULCs in the first quarter of 1999 is 3.7 %. The use of gross data QNA series softens somewhat the growing profile of compensation per employee and of costs, showing a slowdown in both magnitudes in the first quarter of 1999. In any event, this accelerating path is not perceptible in the indicators available on wage developments during 1998 and early 1999, although the use of disaggregated information from these indicators (specifically, from the wage survey), with criteria and weights closer to those of National Accounts, do allow a closer approximation to the growth rates of compensation estimated under QNA.

The wage survey data relating to industry and services in the first quarter of the year (the latest received) and collective bargaining agreements signed in the period to June would indicate the continuation of moderate wage growth rates (see Chart 18). According to the wage survey, the increase in average hourly earnings in terms of basic pay was 2.3 % during the first quarter of 1999, one-tenth of a point less than in the fourth quarter of 1998. Nonetheless, in terms of total earnings, there was a rise in this rate to 2.6 %. Wage-earners with shorter working days joining the labour market have made for a lower increase in average monthly earnings (1.8 % in terms of basic pay). By branch of activity, the biggest increase in average hourly earnings in the first quarter was in construction (3.9 %), following the acceleration seen during the previous year. In industry and in services the increase was 2.3 %, although in the former branch the trend was an accelerating one while in the latter the increase was less than in the fourth quarter of the previous year.

(7) Unless otherwise indicated, the rates mentioned are those calculated using the trend-cycle series.

CHART 18

**Developments in wages and labour costs (a)**



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

- (a) Percentage change on same quarter a year earlier.
- (b) Basic pay.
- (c) Gross QNA data.

Wage settlements under collective bargaining agreements recorded to 30th June (indicating the potential result for the whole of the year) ran at 2.3 %, three-tenths of a point down on 1998 and only marginally above the expected increase in consumer prices (2.1 % according to the official Budget forecast). Across the various branches of activity, there are scarcely any differences. The highest settlements correspond to agriculture (2.6 %), followed by services (2.3 %) and by industry and construction (2.2 %). Comparing these figures with the increases in hourly earnings per the wage survey shows that, although the growth rates are similar in aggregate terms (denoting wage drift close to zero), there has been a notable increase in wage drift in construction, while in services its sign is negative.

On the basis of the foregoing interpretation of wage indicators, the slowdown in compensa-

tion per employee and in ULCs inferred by the gross QNA data in the first quarter of 1999 may be estimated to have continued in the second quarter, more markedly so in the case of ULCs owing to the bigger increase in productivity. Nonetheless, the persistence of higher growth rates for ULCs than for prices might adversely affect the economy's competitiveness if the favourable course of other costs (such as import costs) were to turn around and cease to offset the rises in labour costs. Prior to a joint analysis of prices and costs, the following paragraphs briefly discuss how the main price indicators have trended.

Most of the indicators of prices in the Spanish economy were very stable in the second quarter of the year, after having deteriorated in the first quarter. The 12-month growth rate of the CPI stood at 2.2 % in June, unchanged on the March figure (see Chart 19). Meantime, the 12-month growth rate of the sub-index that excludes fresh food and energy prices (IPSEBENE by its Spanish name) held stable in June at 2.5 %. Component by component, processed food prices posted a year-on-year increase of 2.4 % in June, five-tenths of a point above the related March rate. Unprocessed food, which follows a much more variable trajectory, slowed during the second quarter, offsetting its upward course in the opening months of the year. This process might, however, be inverted in the near future if the drought were to result in a shortage of certain foodstuffs. The prices of industrial goods increased between March and June, as a result of the ongoing acceleration in energy prices, the annual growth rate of which moved from -2.9 % to 1.6 % in this period. The price cuts in electricity and gas rates, further to the urgent legislative measures to liberalise and heighten competition, have been unable to counter the effects of the rise in the oil price on international markets. The 12-month growth rate of non-energy industrial goods prices has, for its part, held at 1.5 %. Finally, services prices were running at 3.5 % year-on-year in June. The 12-month growth rate of these prices has risen and fallen by the odd tenth of a point since March, as a result of the price of tourist services, which has followed a somewhat different pattern than that seen in 1998. Nonetheless, the year-on-year rate of this heading was still 9.4 % in June.

The harmonised index of consumer prices (HICP) remained more or less stable between March and June at a rate of 2.1 %. However, the moderate trend of the HICP in the euro area as a whole has prompted a slight widening of



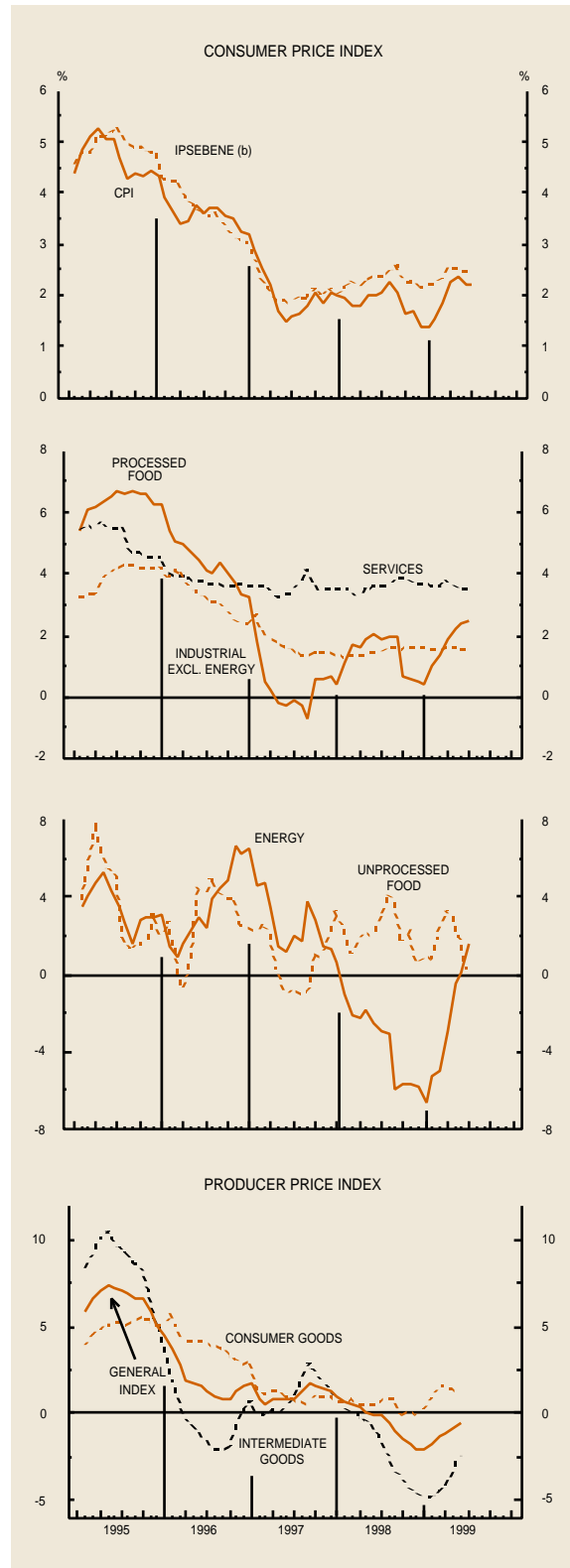
the inflation differential with this area, which stood at 1.2 percentage points in June. Regarding the different components, there is a perceptible improvement in the services differential, which is still very wide, and an opening up of the inflation gap in the case of food (see Chart 20).

There has been a certain deterioration in the producer price index in recent months, although its rate of change on a year earlier has remained negative. The year-on-year rate of the general index stood in May at  $-0.5\%$ , against  $-1.2\%$  in March. This performance was marked by the course of the prices of intermediate energy goods, whose rate of change was  $-1.8\%$  in May, having been  $-5.2\%$  at the end of the first quarter. The producer prices of consumer goods stabilised at a rate of  $1.3\%$  in year-on-year terms, following a deterioration in the opening months of the year, while capital goods prices also stabilised at around  $0.5\%$ . The prices at source of agricultural produce remained on a rising path in the opening months of the year (the latest figure for the index of prices received by farmers corresponds to February), reflecting dearer olive oil and fresh fruit. Other more up-to-date information has shown price rises to have slackened in subsequent months, though they could worsen as a result of the drought. Lastly, the 12-month growth rate of the import unit value index remained negative in April, although its rate of decline moderated over the course of the first four months of the year. This result is evident both in the case of non-energy products (due to the acceleration of non-food consumer goods prices) and energy goods.

By combining the information provided by the prices and costs indicators, within the accounting framework of the input-output tables of the Spanish economy, representative indicators of the price formation process and, residually, of the trend of operating margins (see Chart 21) can be obtained. In the first quarter of 1999, the latest period for which full information is available, the final prices of non-financial firms accelerated moderately. This reflected the greater proportion of products intended for the domestic market (where moderate increases in final prices are being recorded), as opposed to the weakening of exports (the prices of which have fallen). Variable costs also accelerated slightly, whereby unit operating margins tended to stabilise, after having widened considerably in 1998. Elsewhere, the rises in labour costs, in line with the behaviour of ULCs calculated with QNA data, were offset by the fall in intermediate

CHART 19

Price indicators (a)  
Spain



Source: Instituto Nacional de Estadística.

(a) Percentage change on same period a year earlier, based on the original series.

(b) Index of non-energy processed goods and services prices.

CHART 20

**Price indicators**  
**Differentials vis-à-vis the euro area (a)**



Source: Instituto Nacional de Estadística and Eurostat.

(a) Calculations based on percentage change on same quarter a year earlier of the original series.

costs, which have continued to reflect the substantial reductions in train in the prices of imported intermediate goods.

By branch of activity, the differential behaviour of prices and margins in manufacturing and in services continued. In manufacturing, final prices declined strongly, associated both with the course of domestic prices and, especially, with the prices of products intended for export. Meantime, the growth of variable costs, driven by labour costs, outstripped that of prices. Accordingly, there was a fresh squeeze on operating margins. In services, prices tended to quicken in the first quarter, running at far higher growth rates than those of costs. As a result, the gross operating margin per unit of output continued to widen.

**4.4. State budget**

The State cash-basis budget stood at ESP 1,006 billion in the first half of the year, 10.8 % up on the same period a year earlier. This rate of change is below that forecast in the State Budget for the year as a whole (27.6 %) (see Table 3). The increase in the cash-basis deficit was due to the rise in expenditure (9.5 %) outstripping that in revenue (9.4 %), contrary to the budgetary forecast of a small reduction in revenue (0.5 %) and a slight increase in expenditure (1.2 %). Nonetheless, the growth rates for the first half of the year have been temporarily influenced by certain exceptional effects. These are particularly significant in the case of expenditure, which has been affected by the concentration of interest payments in the opening months of the current year. The removal of these effects would result in an improvement in the cash-basis deficit both overall and in relation to the first half of 1998.

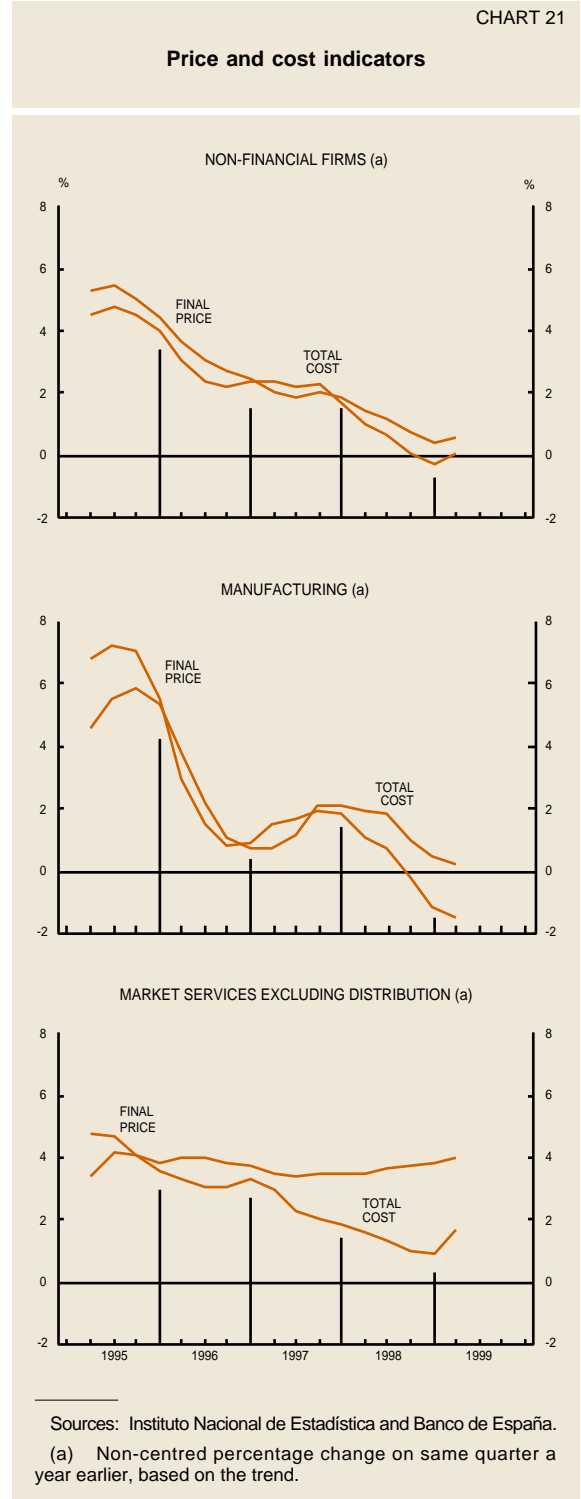
In National Accounts terms, the State budget deficit stood at ESP 1,274 billion in the first half of the year, 6.4 % up on the same period in 1998. Expenditure climbed 10.4 %, in line with the rise according to the cash-basis criterion, while revenue rose 11 %. The result for the first six months of the year, once the aforementioned calendar effects have been taken into account, is compatible with the annual budget deficit target set by the Government in the Stability and Growth Programme. The behaviour of the revenue and expenditure items in the second quarter is discussed below. Cash-basis data are used since it is these that are available

at the time of this report going to press (see Table 3).

The growth rates of both taxes and other net revenue were higher than budgeted in the second quarter, although a slowdown in relation to the first quarter was apparent. The high growth of direct taxes (13.6 %) in the first six months of the year, in contrast to the forecast decline (0.3 %), was due in particular to the sound performance of personal income and corporate income tax revenue (7.9 % and 47.7 %, respectively). In the case of personal income tax, regard should be had, first, to the fall in revenue from employment income, associated with the cut in average withholding rates applicable since February; and further, to the ESP 145 million of revenue from the Autonomous (Regional) Governments and Social Security Funds in respect of employment income withholdings from previous years (the related amount last year was ESP 30 million). If this latter effect were removed, the growth rate of personal income tax revenue would be 3.9 %, slightly lower than budgeted (4.2 %). Corporate income tax revenue was favourably affected by lower tax rebates and by the revenue from withholdings on property leasing and on capital gains arising from mutual funds. Capital gains arising from privatisation, however, had a negative effect if compared with the previous year.

Indirect taxes grew 13 % in the first half of the year. All the taxes comprising this heading were highly buoyant. The related growth rates were far greater than initially budgeted, owing largely to the behaviour of consumption and imports. The growth of VAT, at 16.1 %, was particularly significant, although the fall in rebates in relation to the previous year had a bearing on this rate. Once this effect is removed, however, the resulting growth rate remains higher than budgeted (9.9 %). In the case of excise duties, there were increases in the taxes on hydrocarbons and specific means of transport, and on electricity, which includes one month more than in 1998. Also of note among other indirect taxes was that on insurance premia. The behaviour of this latter levy is, like that on specific means of transport, warranted by the expanding trend of car sales.

Finally, the cumulative rate of change of other net revenue in the second quarter drew closer to that initially budgeted. The decline in revenue relating to State profits and dividends was due to the fact that the increase in dividends and shares in the profits of the Banco de España did not offset lower privatisation proceeds



during the year. Of the remaining items of other net revenue, only current transfers showed a positive growth rate. Fees and charges and other revenue fell by 13.3 % in the first six months, the result of lower revenue in connection with public debt issuance premia, and capital transfers declined by 9.7 %, owing to the altered timing of EU transfers.

TABLE 3

State Budget outturn

PTA bn and %

	Outturn	Budgeted		Outturn	Outturn		
	1998	1999	Percentage change	Outturn	1998	1999	Percentage change
	1	2	3=2/1	JAN-MAR	JAN-JUN	JAN-JUN	7=6/5
			Percentage change	Percentage change			
			1999/1998	1999/1998			
			3=2/1	4	5	6	7=6/5
<b>1. Revenue</b>	<b>17,534</b>	<b>17,445</b>	<b>-0.5</b>	<b>23.0</b>	<b>8,372</b>	<b>9,158</b>	<b>9.4</b>
Direct taxes	7,457	7,431	-0.3	35.8	3,378	3,839	13.6
<i>Personal income tax</i>	4,992	5,201	4.2	24.9	2,834	3,059	7.9
<i>Corporate income tax (a)</i>	2,324	2,082	-10.4	—	463	683	47.7
<i>Other</i>	140	149	5.7	137.2	82	96	17.9
Indirect taxes	7,015	7,524	7.3	14.7	3,499	3,954	13.0
VAT	4,373	4,807	9.9	17.8	2,231	2,591	16.1
<i>Excise duties</i>	2,391	2,463	3.0	7.0	1,149	1,233	7.3
<i>Tariffs</i>	132	133	0.8	16.6	61	67	10.4
<i>Other</i>	120	120	0.7	26.8	58	63	8.8
Other net revenue	3,063	2,490	-18.7	20.9	1,495	1,366	-8.6
<b>2. Expenditure</b>	<b>18,649</b>	<b>18,867</b>	<b>1.2</b>	<b>19.2</b>	<b>9,280</b>	<b>10,165</b>	<b>9.5</b>
Wages and salaries	3,053	3,132	2.6	0.4	1,519	1,525	0.4
Goods and services	388	340	-12.4	14.7	195	227	16.5
Interest payments	3,334	3,042	-8.8	51.6	1,782	2,183	22.5
Current transfers	9,906	10,411	5.1	10.5	4,811	5,204	8.2
Investment	898	945	5.3	36.3	476	582	22.2
Capital transfers	1,071	997	-6.9	-4.3	498	444	-10.9
<b>3. Cash-basis deficit (3 = 1 - 2) (b)</b>	<b>-1,114</b>	<b>-1,422</b>	<b>27.6</b>	<b>-3.1</b>	<b>-908</b>	<b>-1,006</b>	<b>10.8</b>
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Revenue	17,316	—	—	17.4	8,014	8,898	11.0
Expenditure	18,550	—	—	19.2	9,211	10,172	10.4
<b>Net borrowing (-) or lending (c)</b>	<b>-1,234</b>	<b>-1,164</b>	<b>-5.6</b>	<b>29.3</b>	<b>-1,198</b>	<b>-1,274</b>	<b>6.4</b>

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

(a) The January-June 1999 outturn includes all non-resident corporate income tax revenue.

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

(c) The Budgeted figure is the Central Government figure drawn from the Spanish Finance Ministry's response to the Excessive Deficit Procedure questionnaire. Further, the January-June outturn figures do not include the gross operating surplus, owing to the lack of information to date, although this shortcoming does not affect the net borrowing figure.

Expenditure, for its part, also slowed in relation to the first quarter. Nonetheless, all the related captions, except wages and salaries and capital transfers, showed higher growth rates in the first six months than those budgeted for the year as a whole. The growth rate of interest payments (22.5 %) has, as discussed earlier, been influenced by the different public-debt maturity calendar. This effect will be removed in the second half of the year, whereby the growth rate of expenditure relating to this item will draw closer to the decline initially budgeted (8.8 %). Such a decline is warranted by the greater expenditure arising in 1998 in connection with the early redemption of debt, with the effects derived from the interest rate cuts in train since 1995 and with the primary surpluses recorded in recent years. The most significant overruns came about in purchases of goods and services and real investment, with somewhat over 60 %

of the related budgetary appropriations having been used up in both cases. For purchases of goods and services, a decline of 12.4 % -as opposed to the increase of 16.5 % in the first half of the year- was budgeted. In the case of real investment, the forecast rate was 5.3 %, in contrast to the actual rate to June (22.2 %). The growth of current transfers has also been greater than budgeted. Yet it should be borne in mind that such transfers include those intended for Social Security Funds and the Regional (Autonomous) Governments, which grow as a result of the State assuming the cost of health-care and of the transfer of responsibility for non-university education to the Aragon, Balearic Islands and La Rioja regional governments. Capital transfers fell by 10.9 % in relation to the first half of 1998. This decline was attributable to the delay in payments to RENFE (the State Railway Company) and to the fall in transfers intended

**Social security budget outturn**

On budget outturn data to April, the Social Security System showed a surplus of ESP 640 million, ESP 175 million (37.5 %) greater than that recorded in the same period a year earlier. This result is a notable improvement on the budgetary forecast for the year as a whole, which had predicted a reduction in the deficit of ESP 48 million in relation to the 1998 Budget.

This performance was due to growth in revenue of 9.1 % to April (above the budgetary forecast of 6.2 %), which outpaced the 5.8 % increase in expenditure. Revenue relating to social security contributions climbed 8.1 %, three percentage points more than initially budgeted. The rise was due, above all, to the favourable trend in social security registrations, mainly under the general regime. The other major source of revenue, current transfers from the State, also posted an increase over two points bigger than the budgeted figure.

The growth of expenditure during the first four months of 1999 matched the budgetary forecast for the year as a whole. The greater-than-budgeted increases in consumption-related expenditure (especially purchases of goods and services) were offset by the lower growth of benefits-related expenditure, essentially contributory pensions and prescriptions (this is included under the «Other» heading in the adjoining table). On the contrary, temporary disability benefits increased strongly, in contrast to the initially budgeted reduction.

With regard to INEM (the National Employment Office), information is available on social security contributions to March and unemployment benefits to May. In these respective periods, the former grew by 11.7 % compared with a year earlier, and the latter fell by 4.8 %. The sound performance of employment explains these developments. Lastly, social security rebates relating to job promotion increased by around 65 % in the first quarter.

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

ESP bn and %

	Budgeted			Outturn		
				JAN-APR		
	1998 (c)	1999	% change	1998	1999	% change
<b>1. Revenue</b>	<b>12,731</b>	<b>13,519</b>	<b>6.2</b>	<b>4,399</b>	<b>4,801</b>	<b>9.1</b>
Social security contributions	8,596	9,032	5.1	2,763	2,987	8.1
Current transfers	3,998	4,327	8.2	1,597	1,766	10.6
Other	137	160	16.5	39	48	20.9
<b>2. Expenditure</b>	<b>12,850</b>	<b>13,589</b>	<b>5.8</b>	<b>3,934</b>	<b>4,161</b>	<b>5.8</b>
Wages and salaries	2,038	2,144	5.2	719	761	5.8
Goods and services	1,211	1,281	5.7	400	433	8.3
Current transfers	9,417	9,959	5.8	2,777	2,926	5.4
Benefits	9,357	9,896	5.8	2,752	2,900	5.4
<i>Contributory pensions</i>	7,477	7,892	5.6	2,119	2,221	4.8
<i>Temporary disability</i>	519	505	-2.8	125	143	14.7
<i>Other</i>	1,361	1,499	10.1	508	535	5.3
Other current transfers	60	64	5.9	25	26	5.9
Other	184	205	11.6	38	41	9.2
<b>3. Balance (3 = 1 - 2)</b>	<b>-119</b>	<b>-71</b>	<b>-40.4</b>	<b>465</b>	<b>640</b>	<b>37.5</b>

Sources: Ministerios de Economía y Hacienda y de Trabajo y Asuntos Sociales, and Banco de España.

(a) Only data relating to the System, not to the entire Social Security Funds sector, are given. This is because the figures for other Social Security Funds for the year 1999 are not available.

(b) Transfers to Regional Governments to finance the health-care and social services responsibilities they have assumed have been distributed among the various expenditure captions on the basis of the percentages resulting from the General Government accounts for 1995 (the latest year available).

(c) The budgetary reference takes the budget for 1998 as the basis for comparison, since the outturn for last year is not yet available.

TABLE 4

**Balance of payments: summary table (a)**

EUR m

	JAN-APR 1998	JAN-APR 1999
	Receipts	Receipts
<b>Current account</b>	<b>54,547</b>	<b>56,634</b>
Merchandise	32,944	32,475
Services	12,450	14,083
<i>Tourism</i>	7,156	8,086
<i>Other services</i>	5,294	5,997
Income	3,978	4,754
Current transfers	5,175	5,322
<b>Capital account</b>	<b>2,636</b>	<b>1,972</b>
	Payments	Payments
<b>Current account</b>	<b>53,976</b>	<b>57,993</b>
Merchandise	36,816	39,317
Services	7,696	8,685
<i>Tourism</i>	1,231	1,423
<i>Other services</i>	6,465	7,262
Income	6,231	6,750
Current transfers	3,234	3,240
<b>Capital account</b>	<b>228</b>	<b>334</b>
	Balance	Balance
<b>Current account</b>	<b>571</b>	<b>-1,359</b>
Merchandise	-3,872	-6,842
Services	4,754	5,398
<i>Tourism</i>	5,925	6,663
<i>Other services</i>	-1,170	-1,265
Income	-2,253	-1,996
Current transfers	1,941	2,082
<b>Capital account</b>	<b>2,408</b>	<b>1,638</b>

Source: Banco de España.

(a) First provisional results.

#### 4.5. The Spanish balance of payments and capital account

According to Balance of Payments data, the overall current and capital account ran a surplus of EUR 279 million in the first four months of 1999, EUR 2,699 million less than in the same period of the previous year (see Table 4). This result was essentially due to the notable widening of the trade deficit in this period, which reflected the weakness of goods exports. Neither the excellent performance of tourism operations nor the improvement in the other current-account balances were able to offset such weakness. Specifically, the surplus on current transfers widened slightly thanks to the bigger increase in flows from the EU (the EAGGF-Guarantee Fund). Likewise, the income deficit underwent a correction, as a consequence of the buoyancy of receipts, particularly those relating to the private sector, which have benefited from the expansion of assets in this sector. Conversely, the capital-account balance deteriorated considerably in the January-April period compared with a year earlier owing to delays in receiving the structural funds assigned to Spain under the Community budget.

As earlier indicated in section 4.1, the non-availability, to date, of the accounts of the institutional sectors using the new ESA 95 methodology means the breakdown of resident-sector saving and investment flows cannot be appropriately assessed. However, it may be inferred from the comments made in this section that the ongoing weakness of the economy's financing capacity would, in part, be offset by lesser general government borrowing requirements. That said, it might also have been reflected in a deterioration of the sectoral balances of households and firms, as a consequence of the continuing forceful expansion of non-residential investment and private productive investment.

for mortgage interest relief. Lastly, in connection with wages and salaries, the resulting growth rate was lower than budgeted (0.4 % compared with 2.6 %).



## 5. The financial markets and flows of the Spanish economy

In the financial sphere, the second quarter was marked in Spain by the gradual pass-through of the reduction in official interest rates to very short-dated interest rates and to bank rates. The latter, and lending rates in particular, have fallen to very low levels. By contrast, yields on Spanish bond markets have increased significantly, following the pattern in the euro area.

The favourable credit conditions have meant that the high rate of expansion of financing to the private sector of the economy has continued. In year-on-year terms, it is estimated to have grown at around 16 % in the second quarter. The increase in longer-dated interest rates relative to short rates has detracted from the attractiveness of liquid financial assets in favour of other higher-yielding and riskier instruments. The reflection of this has been an estimated year-on-year growth rate of liquid financial assets of slightly below 5 % as of the end of the second quarter, a figure more in keeping with the trend of economic activity.

### 5.1. Interest rates and the financial markets

As in other European countries, there has been a significant increase in Spanish bond market yields since May, and this has intensified in recent weeks. The increase has been particularly marked in the case of 10-year bonds, the latest yield on which has been around 5 %, the same as that a year earlier and almost one point above the end-1998 level.

Evidently, the foregoing has affected the primary markets for public debt. After a temporary period in April and May when Treasury yields declined slightly, in June, and above all at the tenders held in July, interest rates were revised upwards. Hence, the yield on one-year Treasury bill issues regained in July its first-quarter level, at around 2.9 %, while the yields on 18-month bills stood above 3 %. With regard to medium- and long-term bond issues, this turnaround has had a more pronounced effect. Specifically, at the June tender, the rate at issue on 10-year bonds was 38 basis points up on the previous month's level, and at the July tender the marginal rate additionally increased by almost half a percentage point to 5.1 % (see Table 5).

Notable on the private fixed-income markets was the increase in trading on the AIAF (Spanish Securities Dealers' Association) market in the period January-June 1999. A volume of EUR 216 billion (ESP 36 trillion) was traded in this period, almost threefold the traded volume in the same period a year earlier. The greater

TABLE 5

**Domestic interest rates and financial markets (a)**

	1998				1999		Memorandum item: July 1999
	Q1	Q2	Q3	Q4	Q1	Q2	
<b>RETAIL BANK RATES:</b>							
Deposit synthetic rate	3.02	2.79	2.67	2.06	1.90	1.66	...
Lending synthetic rate	6.20	5.93	5.80	5.15	5.02	4.54	...
<b>TREASURY RATES:</b>							
12-month Treasury bills (b)	4.01	4.05	3.67	2.95	2.94	2.75	2.95
3-year government bonds	4.32	4.35	3.96	3.54	3.51	3.29	3.92
10-year government bonds	5.14	5.05	4.75	4.32	4.40	4.59	5.09
<b>SECONDARY MARKETS:</b>							
6/12-month Treasury bills	4.05	4.06	3.64	2.88	2.91	2.68	2.78
10-year government bonds	5.09	5.02	4.47	4.08	4.25	4.60	4.90
Yield spread over German <i>bund</i>	0.18	0.22	0.43	0.20	0.22	0.25	0.22
Commercial paper	4.12	4.30	3.82	3.21	3.09	2.89	2.94
Private-sector bonds	5.06	4.96	4.35	4.29	3.93	4.18	...
Madrid Stock Exchange General Index (c)	40.49	39.66	8.72	37.19	-0.12	4.22	0.76

Source: Banco de España.

(a) Average daily data of last month in quarter.

(b) Marginal interest rate.

(c) Cumulative percentage change in index since start of year. Latest data available: July 23rd 1999.

buoyancy of this market has been due in part to the surge in securitisation funds following the sizeable issues of these bonds on the primary market, linked in the main to the mortgage market. It has also been partly attributable to the pick-up in the commercial paper market, the result, to some extent, of the change in taxation on this product since early 1999, which has entailed the elimination of the withholding on account on transfers by legal entities. Yields in this trading segment continue to be closely aligned to the interbank market for 12-month deposits, at around 3 %. Lastly, mention should be made of the increase in trading in private medium- and long-term securities (bonds and notes). The continuing differential vis-à-vis public debt, against a background of low interest rates, may have helped boost the demand for these securities.

In line with developments on the secondary market, bond issues on the primary market have retained the buoyancy shown since end-1998, although a lower volume of securities issues has been evident during the second quarter of 1999. That said, during the first half of the year private securities issues amounted to EUR 2.7 billion, 85 % of which related to securitised bond issues.

With regard to equities, national securities markets continue to be prone to relatively high volatility, which may be checking equity investment. Following the fall-off in February and

March, there was a modest recovery during the second quarter associated with the improved economic outlook for Europe. Thus, overall, the Madrid Stock Exchange General Index rose 4.2 % in the first six months of the year, somewhat below the related rises on the main European exchanges.

Turning to bank interest rates, the overriding effect in the second quarter was the feed-through of the cut made to the Eurosystem's official rate in April to transactions with customers. The cut was more marked in lending than in deposit operations. Thus, the synthetic rate on lending transactions stood, in the second quarter, at around 4.5 %, against 5 % in the first quarter of 1999, a reduction similar to that in the official rate (see Table 5). The already low level of deposit interest rates meant that such rates fell to a lesser extent in the second quarter. Even so, the synthetic rate on deposits was revised downwards by 25 basis points, to 1.7 % in June. In any event, attention should be paid to the potential effect on bank interest rates of the change in trend in recent weeks of financial market interest rates.

**5.2. Financial flows in the economy as a whole**

Information from the financial accounts for the first quarter of 1999 reflects the absence of

TABLE 6

**Saving and financial position**

	FINANCIAL SAVING AS A % OF GDP (Cumulative data over four quarters)							
	Average 1988-1992	Average 1993-1997	1997	1998				1999
				Q1	Q2	Q3	Q4	Q1
Financial saving of the nation	-2.6	0.5	1.5	1.3	1.0	1.1	0.9	0.9
Non-financial firms and households	-0.2	4.9	3.2	2.6	1.7	1.5	1.8	1.6
<i>Non-financial firms</i>	-3.9	-0.8	-0.7	-0.2	-1.1	-1.0	-1.1	-1.1
<i>Households</i>	3.7	5.7	3.9	2.8	2.8	2.6	2.9	2.8
Credit institutions (a)	1.4	0.7	0.6	0.7	0.8	0.6	0.6	0.5
Institutional investors (b)	-0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1
General government	-3.8	-5.4	-2.5	-2.2	-1.8	-1.2	-1.7	-1.4

	FINANCIAL POSITION AS A % OF GDP (Fourth-quarter data)							
	1992	1993	1994	1995	1996	1997	1998	1999 (d)
Financial position of the nation	-16.6	-19.0	-19.3	-18.1	-17.7	-18.1	-19.4	-18.3
Non-financial firms and households	39.5	47.8	52.8	59.1	68.4	77.2	86.4	86.0
<i>Non-financial firms (c)</i>	-17.2	-16.3	-13.6	-11.0	-6.8	-4.9	-0.5	-0.2
<i>Households</i>	56.7	64.1	66.3	70.1	75.3	82.1	86.9	86.3
Credit institutions (a) (c)	12.4	14.0	12.9	12.1	12.8	14.3	14.3	14.4
Institutional investors (b)	-1.1	-1.2	-1.0	-0.9	-0.6	-0.5	-0.6	-0.6
General government	-35.0	-42.0	-46.1	-50.3	-52.6	-52.0	-50.0	-49.2

Source: Banco de España.

(a) Defined according to the 1st Banking Directive.

(b) Insurance companies, collective investment undertakings, and securities-dealer companies and securities agencies.

(c) Shares excluded from liabilities.

(d) First-quarter data.

significant changes in the economy's financial flows during the first three months of the year compared with the last quarter of 1998. As can be seen in Table 6, there has been a reduction in private-sector net saving and a firming of the trends indicated in the previous "Quarterly Report", which showed lower net household financial saving, especially when compared with past data and, specifically, with a similar economic boom such as the period spanning the years 1988 to 1992. The trends that may be extrapolated on the basis of the information available for the second quarter of the year confirm the deterioration in net household financial saving insofar as the pace of acquisition of financial assets has been much more moderate than that of borrowing. The tendency towards lower household saving has not had a significant bearing on the nation's financial saving, which remains at around 1 % of GDP at the end of the first quarter (calculated in cumulative terms over the last four quarters). This is because there has been a progressive improvement in general government saving, to -1.4 % of GDP in the first quarter of 1999. Further, non-financial firms' debt has held stable at around -1.1 % of GDP in the first quarter.

In terms of the net financial position, defined as the difference between total financial assets and liabilities, the trend of net financial saving has meant, first, a slight decline in the case of households, in contrast to the continuous rise recorded in the past; and further, an increase in the financial position of firms, which have progressively shored up their finances in recent years.

The information covering the period to April on the Balance of Payments financial account reflects a continuation of the trends recorded in 1998. At the same time, there has been a perceptible turnaround in net capital flows compared with those in the same period a year earlier. The balance on the financial account thus showed net capital inflows amounting to EUR 1,856 million in the first four months of 1999, compared with net outflows of EUR 1,610 million in the same period in 1998 (see Table 7).

Purchases of foreign assets (capital outflows) remained very buoyant in the opening months of 1999. Direct investment posted high growth in the January-April period, substantially up on that recorded in the same period a year

TABLE 7

## Balance of payments on financial account

EUR m

	1997	1998	JAN-APR	
			1998	1999
<b>BALANCE ON FINANCIAL ACCOUNT</b>	<b>-2,775</b>	<b>-1,188</b>	<b>-1,610</b>	<b>1,856</b>
<b>CHANGE IN LIABILITIES VIA-À-VIS EXTERNAL SECTOR</b>	<b>34,479</b>	<b>65,681</b>	<b>25,405</b>	<b>24,859</b>
<b>Direct investment (a)</b>	<b>5,621</b>	<b>10,152</b>	<b>3,809</b>	<b>2,553</b>
<b>Portfolio investment (b)</b>	11,068	15,354	-1,662	8,946
General government	9,952	4,125	-6,067	5,783
Other resident sectors	1,183	8,469	2,199	863
Credit system	-67	2,760	2,206	2,300
<b>Other investment</b>	<b>17,790</b>	<b>40,176</b>	<b>23,258</b>	<b>13,360</b>
General government	21	866	76	152
Other resident sectors	544	4,319	2,298	3,682
Credit system	17,226	34,991	20,884	9,526
<b>CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR</b>	<b>37,255</b>	<b>66,870</b>	<b>27,015</b>	<b>23,003</b>
<b>Direct investment</b>	<b>10,970</b>	<b>16,507</b>	<b>3,837</b>	<b>5,371</b>
Other resident sectors	9,844	14,756	3,432	5,293
Credit system	1,126	1,751	405	78
<b>Portfolio investment</b>	<b>14,377</b>	<b>40,985</b>	<b>10,874</b>	<b>21,020</b>
Other resident sectors	10,049	29,873	9,441	13,965
Credit system	4,328	11,112	1,433	7,055
<b>Other investment</b>	<b>1,555</b>	<b>21,625</b>	<b>13,629</b>	<b>10,103</b>
General government	331	388	163	-19
Other resident sectors	12,392	17,668	9,133	1,012
Credit system	-11,168	3,569	4,333	9,110
<b>Reserves</b>	<b>10,352</b>	<b>-12,248</b>	<b>-1,325</b>	<b>-13,491</b>

Source: Balanza de Pagos. Banco de España.

(a) Includes portfolio investment in unlisted shares.

(b) Includes direct investment in listed shares.

earlier. This was the outcome of intense investment by Spanish firms abroad, especially in Latin America. Portfolio investment doubled in the first four months of the year and, in this connection, the acquisition of securities by Spanish credit institutions was notable. Under other investment, there was a slight increase in resident deposits abroad, albeit far lower than that in the same period a year earlier. Finally, the reduction in reserve assets is largely attributable to the unwinding of currency swap transactions entered into the previous year and to the transfer of Banco de España reserves to the ECB at the outset of 1999 (and which, in exchange, gave rise to assets of the same order being classified under other investment).

As to capital inflows, the related volume between January and April 1999 was similar to that in the same period a year earlier, although a high proportion of the change in foreign liabilities has been channelled this year through the purchase of general government securities. Also of note is the high flow of financing obtained by the private sector abroad; in the first

four months of the year, it was only slightly below the total financing extended by non-resident institutions throughout the whole of 1998. Moreover, as in recent years, Spanish credit institutions increased their foreign debt, meaning that national financial saving continues to be insufficient to cover residents' sizeable foreign asset purchases.

### 5.3. Financial flows of households and non-financial firms

As discussed in the previous section, the net financial saving of the private sector as a proportion of GDP fell in the first quarter, and it is estimated that it may fall further in the April-June period. This is the outcome of household financial saving being lower and that of non-financial firms holding stable. The private sector's lower net financial saving can be explained by the strong increase in its financial liabilities, set against more moderate growth in its financial assets (see Table 8).

TABLE 8

**Financial assets and liabilities of households and non-financial firms**

	Latest- quarter balance (a) (b)	Four-quarter % change					
		1998				1999 (b)	
		Q1	Q2	Q3	Q4	Q1	Q2
<b>HOUSEHOLDS AND NON-FINANCIAL FIRMS:</b>							
<b>Total financial assets</b>	<b>1,270.5</b>	<b>14.9</b>	<b>14.0</b>	<b>10.5</b>	<b>12.9</b>	<b>10.2</b>	<b>11.4</b>
Liquid financial assets	545.6	6.9	5.5	5.3	5.4	4.0	4.7
<i>Cash and cash equivalents</i>	253.9	10.5	7.7	10.2	14.6	14.6	16.8
<i>Other liquid financial assets</i>	291.6	4.5	3.9	2.0	-1.1	-3.3	-4.0
Other financial assets	724.9	22.8	22.4	15.4	20.0	15.5	17.1
<b>Total financial liabilities</b>	<b>863.8</b>	<b>10.3</b>	<b>12.7</b>	<b>12.3</b>	<b>13.3</b>	<b>15.5</b>	<b>16.9</b>
Bank financing plus fixed-income securities	543.5	13.1	15.4	14.8	16.2	15.3	16.0
<i>Credit from resident credit institutions</i>	440.3	14.2	16.7	15.9	15.8	14.4	15.5
Other financial liabilities	320.3	5.7	8.3	8.2	8.4	16.0	18.4
<b>HOUSEHOLDS:</b>							
<b>Total financial assets</b>	<b>806.6</b>	<b>15.2</b>	<b>11.7</b>	<b>6.9</b>	<b>10.5</b>	<b>6.4</b>	<b>8.8</b>
Liquid financial assets	453.6	6.5	4.4	4.7	3.6	2.0	3.7
<i>Cash and cash equivalents</i>	191.2	7.6	4.9	6.5	8.9	10.6	14.0
<i>Other liquid financial assets</i>	262.4	5.8	4.1	3.6	0.4	-3.1	-2.8
Other financial assets	353.0	30.8	24.1	10.6	21.9	12.7	16.2
<b>Total financial liabilities</b>	<b>360.3</b>	<b>11.7</b>	<b>12.2</b>	<b>12.0</b>	<b>13.4</b>	<b>16.0</b>	<b>18.3</b>
Bank financing plus fixed-income securities	250.4	16.8	17.4	16.5	18.3	18.6	20.0
<i>Credit from resident credit institutions</i>	226.8	17.6	18.2	17.2	19.1	19.4	20.9
Other financial liabilities	109.9	2.2	2.4	3.3	3.6	10.5	14.6
<b>NON-FINANCIAL FIRMS:</b>							
<b>Total financial assets</b>	<b>463.9</b>	<b>14.1</b>	<b>18.6</b>	<b>17.5</b>	<b>17.5</b>	<b>17.6</b>	<b>16.3</b>
Liquid financial assets	92.0	8.9	11.2	8.7	14.8	15.1	9.9
<i>Cash and cash equivalents</i>	62.8	22.3	18.1	24.7	35.4	28.8	26.0
<i>Other liquid financial assets</i>	29.2	-5.7	2.4	-9.7	-13.5	-4.5	-13.7
Other financial assets	371.8	15.6	20.7	20.0	18.2	18.3	18.0
<b>Total financial liabilities</b>	<b>503.4</b>	<b>9.3</b>	<b>13.1</b>	<b>12.5</b>	<b>13.2</b>	<b>15.2</b>	<b>15.9</b>
Bank financing plus fixed-income securities	293.1	10.3	13.9	13.5	14.6	12.7	12.8
<i>Credit from resident credit institutions</i>	213.5	11.0	15.4	14.7	12.7	9.6	10.3
Other financial liabilities	210.4	7.9	11.8	11.1	11.2	19.0	20.5

Source: Banco de España.  
 (a) EUR billion.  
 (b) The data for the second quarter of 1999 are provisional estimates.

Monthly monitoring of the set of most liquid financial assets, and of bank financing, has already shown the different course of household and corporate financial assets and liabilities over recent months. Yet, as Chart 22 shows, liquid financial assets have trended much more moderately than total assets. It is thus estimated that total household and corporate financial assets have grown by around 11 % year-on-year in the second quarter, outpacing the growth rate for the previous quarter but lower than the end-1998 figure of 13 %. By contrast, liquid financial assets (which include, along with cash and cash equivalents, other financial assets such as time deposits, repos, banks securities and shares in fixed-income mutual funds)

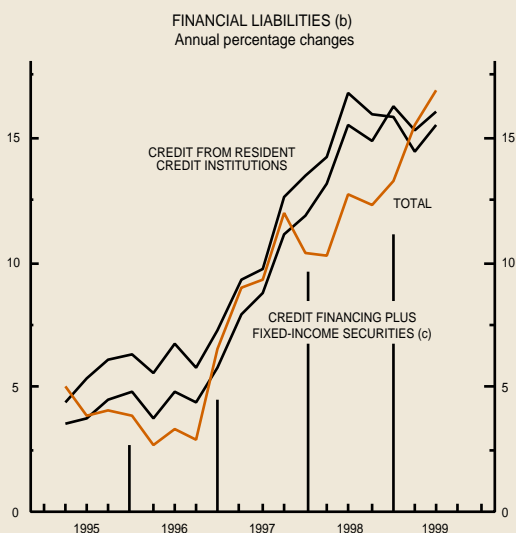
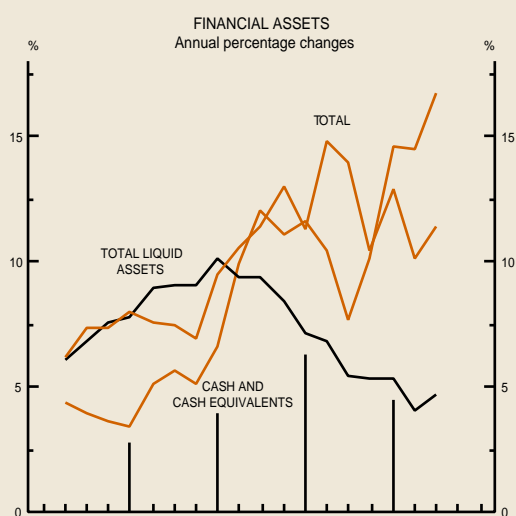
have grown by around 5 %, slightly below the rate posted at the end of 1998. Under this subset of financial assets, it is cash and cash equivalents which have most accelerated during the second quarter, most probably as a result of the lower opportunity cost of holding such instruments.

Turning to financial liabilities, a certain acceleration – to a year-on-year rate of almost 17 % in June – is apparent in what had already been a markedly expansionary course in the previous quarters. Given the more provisional nature of the information available on certain financial liabilities, such as inter-company loans, it would be advisable to pay more attention to the debt ag-



CHART 22

**Non-financial firms and households (a)**



Source: Banco de España.

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

(b) Excluding shares.

(c) Excluding trade credit.

gregate made up of bank credit and fixed-income securities. Analysis of this financing variable reveals that in the second quarter there has not been an acceleration such as that seen in estimated total liabilities, although the high growth rate (16 %) of financing extended to the private sector seen in previous quarters has firmed.

**5.3.1. Financial flows of households**

The trend of financial flows during the first half of 1999 shows that households' lesser sav-

ing capacity has become entrenched at below 3 % of GDP. This result is the outcome of the growth rate of lending operations stabilising somewhat, albeit with fluctuations, while debt levels have been on a rising course that has become significantly more marked as the year has unfolded. Moreover, unlike in 1998, the effect of the rise in the price of certain financial assets scarcely offsets the moderation of financial flows, given the uncertainty and volatility that have characterised stock markets throughout the first half of 1999. As a result of the foregoing, the increase in household net financial worth has been negligible (see Chart 23).

The more moderate growth rate – compared with previous years or with that of financial liabilities – of household financial assets may be partly due to the low return on traditional saving instruments, which encourages consumption and investment in real assets. Indeed, the indicators of activity and prices in the construction sector show considerable buoyancy, as highlighted in the previous section of this Report. The greater volatility of domestic stock markets and the fall in prices on debt markets might also be acting as a deterrent to financial-asset acquisitions, favouring instead consumer and housing spending.

As regards the most recent trend of total household financial assets, their growth stood at close to 9 % year-on-year in the second quarter. The low level of interest rates has meant that the demand for financial assets continues to focus on the more liquid instruments (whose opportunity cost has fallen significantly) and those with a lesser degree of liquidity, but which may offer a greater return in exchange for bearing a greater risk. Hence, the assets with the highest growth rates are cash and cash equivalents, which were expanding at an estimated year-on-year rate of 14 % in the second quarter, and assets with a limited degree of liquidity, such as shares and fixed-income securities. In contrast, the group of liquid assets other than cash and cash equivalents, i.e. time deposits, repos and shares in fixed-income mutual funds, showed negative growth rates in the first two quarters of 1999, insofar as the additional return offered would not appear to offset their lesser liquidity.

It is estimated that household equity holdings expanded moderately in the first half of 1999, reflecting the absence of a clear price trend in this market. In any event, there was a muted rise in equity prices in the second quarter, the result of brighter economic prospects, and household equity purchases may have been higher. Moreover, there have been sever-

al public offerings of shares early in the third quarter, the demand for which by the public has been most sizeable.

Regarding financial liabilities, there was an estimated progressive acceleration during the second quarter to a rate of 18 %, building on the rapid growth profile of the last nine months. Specifically, bank credit (the most relevant instrument and that on which the most accurate information is available), extended both by resident and non-resident institutions, increased at a rate of 20 % in the second quarter compared with a year earlier. This suggests that the low level of lending interest rates, good economic prospects and the increase in disposable income arising from the reduction in personal income tax withholdings have prompted intense indebtedness by households.

Quarterly information drawn from summary bank balance sheets regarding the end-use of credit extended to individuals (a concept that does not exactly match that of households as analysed in this section) shows that house-purchase loans are continuing to grow at a brisk pace, having run at a rate of close to 20 % during the first quarter of 1999. Likewise, there has been a significant rise in credit for consumer durables, which increased at a rate of over 40 % in the first quarter.

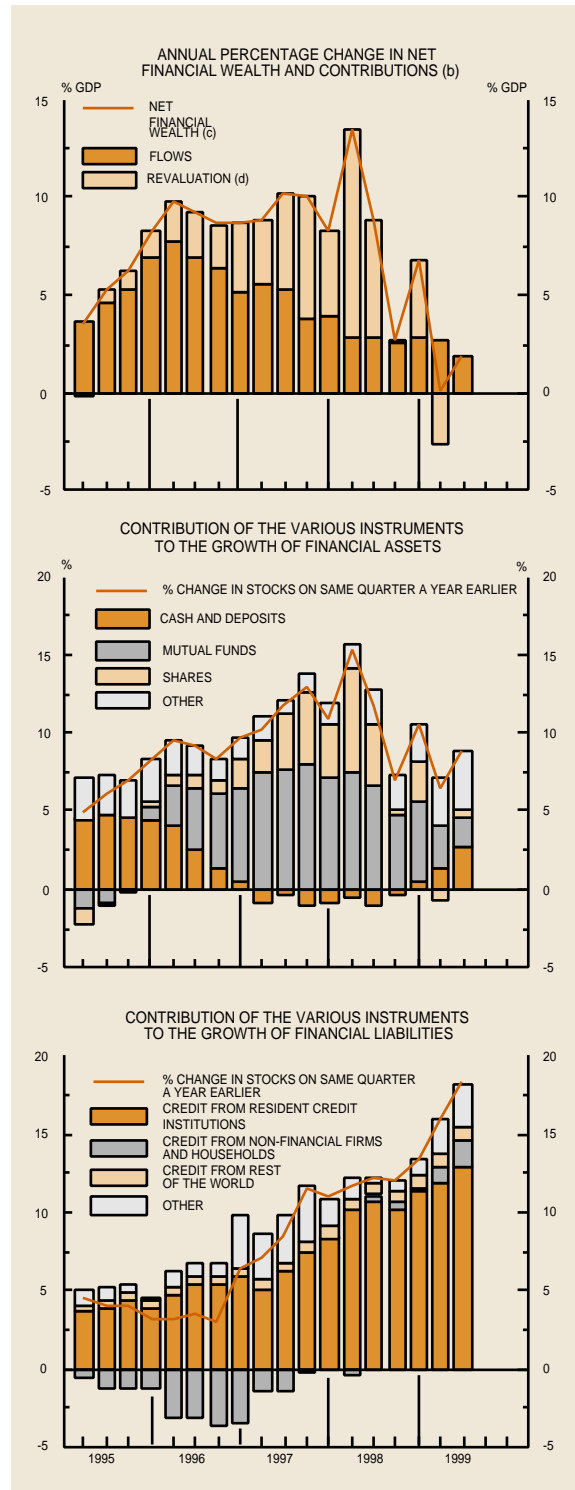
5.3.2. Financial flows of non-financial firms

Firms' financial flows have shown a greater balance between the growth of financial assets and liabilities than was the case for households, which has made for continuing stable net financial saving. To some extent, this might be due to the greater ease with which firms can finance their investment drawing on their own resources during cyclical upturns, when their profit and loss accounts are more favourable, without having to resort to external borrowing. Indeed, the growth rate of firms' financial assets has outpaced that of liabilities in recent quarters.

Estimated total financial assets grew by 16 % during the second quarter. As with households, this is the result of the strong growth of cash and cash equivalents (26 %) and of assets not considered liquid. Under the latter, claims on firms and households (so-called inter-company loans) and on the rest of the world continue to contribute strongly to the growth of firms' financial assets, as can be seen in Chart 24. In connection with this latter component, there has been something of a moderation in deposits held by non-resident institutions, while direct investment abroad has retained the buoyancy of

CHART 23

Households (a)

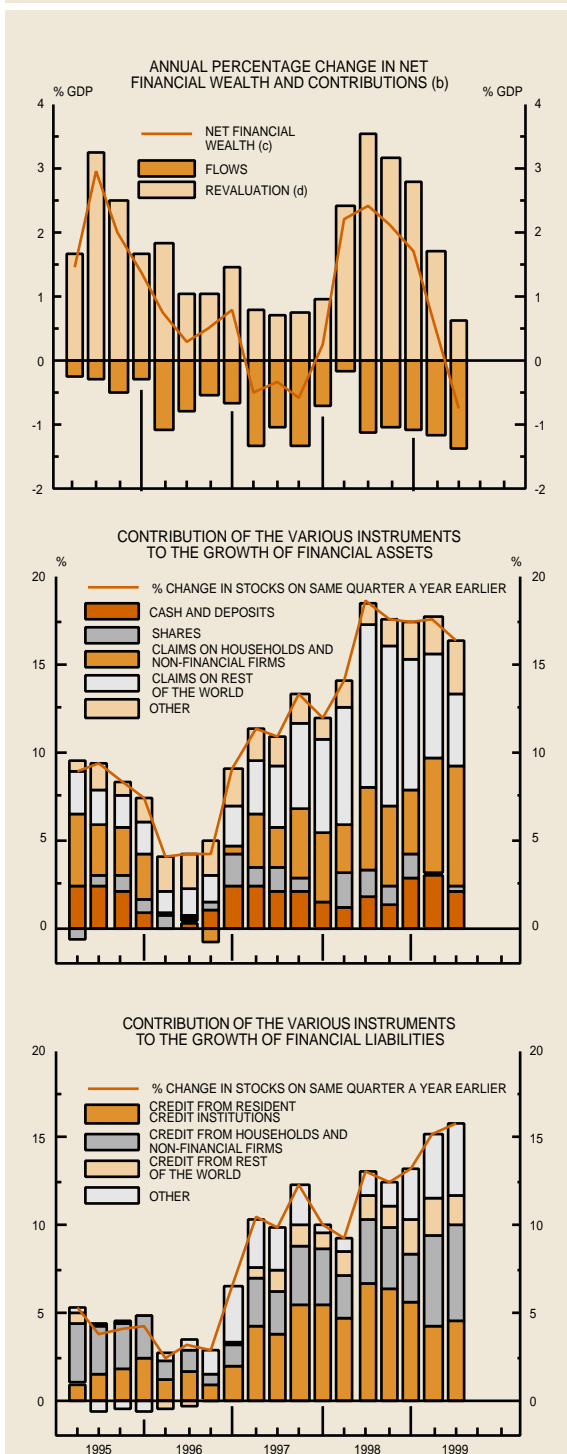


Source: Banco de España.

- (a) The data for the second quarter of 1999 are provisional estimates.
- (b) Cumulative flows and revaluation data to the fourth quarter.
- (c) Calculated using an estimate of the assets valued at market prices.
- (d) Difference between the change in the stock and the flow.

CHART 24

Non-financial firms (a)

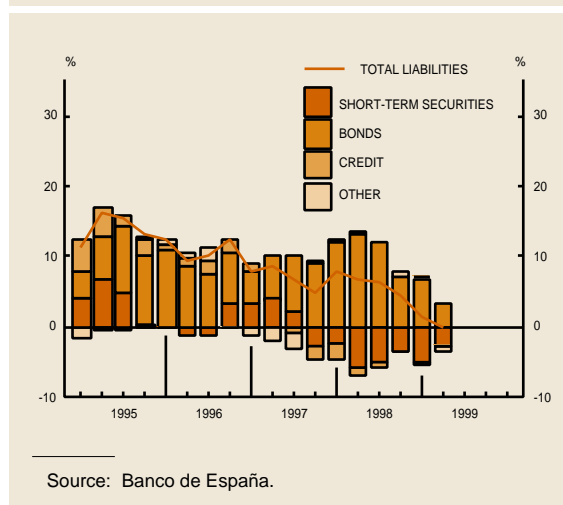


Source: Banco de España.

- (a) The data for the second quarter of 1999 are provisional estimates.
- (b) Cumulative flow and revaluation data to fourth quarter.
- (c) Shares are not included in liabilities. Calculated using an estimate of the assets valued at market prices.
- (d) Difference between the change in the stock and the flow.

CHART 25

Growth of general government liabilities  
 % change on same quarter a year earlier  
 and contributions



previous quarters, with the quarterly growth of average flows running at around EUR 2.5 billion over the past year.

The estimated trend of financial liabilities during the second quarter has been marked by a slight acceleration in growth to 16 % year-on-year. In terms of the contribution to growth of these liabilities, the breakdown by instrument has changed somewhat. Whereas bank credit remains the main source of financing, its contribution to the growth of total corporate financing has been on a declining course since mid-1998. The alternative sources of financing, such as inter-company loans and foreign financing, have contributed significantly to the overall financing obtained by this sector.

Lastly, the information available on the end-use of bank credit extended to firms during the first quarter indicates that financing to the services sector and to industry is holding at year-on-year growth rates similar to those at the end of last year, around 16 % and 11 %, respectively. However, credit to the construction sector has moderated significantly to 12 %, down from 17 % at end-1998.

5.4. General government financial flows

In the first quarter of 1999, overall general government net financial saving improved further, moving from -1.7 % of GDP at end-1998 to -1.4 %. The information available for the second quarter suggests this improvement may have continued.

The falling trajectory of financing requirements during recent quarters has run parallel to the ongoing deceleration in the growth rate of general government financial liabilities (see Chart 25). As to the coverage by instrument of these requirements, the lengthening of the maturity of financial liabilities has continued via the substitution of medium- and long-term bonds for short-term fixed-income securities.

Over the course of the first half of the year, the net issuance of public securities on the primary markets totalled EUR 6.5 billion, adding to which was an increase in foreign currency financing of EUR 950 million. Since the resources raised on the securities markets exceeded actual financing requirements, the volume of general government financial assets has risen. Specifically, the balance of general government deposits in the Banco de España has increased by EUR 6 billion in the first half of the year.

Turning to State securities placements, there was a negative net issue of Treasury bills in the April-July period of EUR 4.1 billion. Notwithstanding, this amount marks something of a recovery compared with the strong contraction in issuance activity the previous quarter, which saw most of the redemptions for the present year. The cumulative reduction in the outstanding balance of Treasury bills in the year to date amounts to EUR 11.3 billion. This reduction is concentrated in the 18-month segment, while in the 12- and 6-month segments, maturing instruments have generally been rolled over. With regard to bond tenders settled in the April-July period, the related gross issue exceeded EUR 11.6 billion, the ensuing distribution being close to that of the maximum issuance targets set. However, the amount of net financing finally raised was scant, as a result of the redemptions in this period.

28.7.1999.