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# Quarterly report on the Spanish economy

## 1. Overview

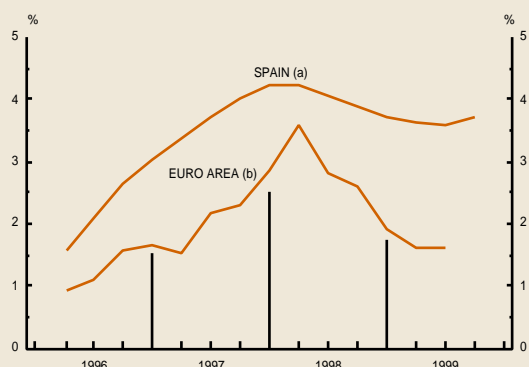
On provisional INE estimates, in the second quarter of 1999 the real sustained rate of growth of Spanish GDP reached 3.6 %, in terms of the year-on-year rate of change of the trend-cycle series. This rate, identical to that in the previous quarter, was somewhat lower than the average for 1998. However, as seen in Chart 1, it was still well above that of the group of countries making up the euro area. The firming of a high year-on-year rate of growth of national demand (5.3 % for practically a year, with notable increases in almost all its components) and the negative contribution of net external demand to the increase in output (which reached 1.7 percentage points) are two of the features characterising recent developments in the Spanish economy. The latest INE data show no significant change in the path of final demand in the first half of 1999, only the vigour of construction investment, which has become its most buoyant component, and some signs of recovery in goods and services exports. However, the real growth rate of the latter continued to depend on the excellent results in the tourism sector. As for imports, their buoyancy rose slightly, in step with domestic spending.

Against this background of sustained growth (the quarter-on-quarter rate of change of the trend-cycle series of real GDP has stood steady at 0.9 % for almost a year and half), there was a considerable increase in employment in the first half of 1999. The largest rises were in those branches with the highest output growth, namely construction and, to a lesser extent, market services, while the rate of growth of output and employment slowed in the other industrial branches and was negative in agriculture. As for prices, the last "Quarterly Report" commented on the expansionary impact the prices of energy products and certain processed food were having on the harmonised index of consumer prices (HICP), as well as on the widening of the inflation differential with euro-area countries.

The international economic situation has shown signs of improvement in recent months. Along with the continued buoyancy of the US economy, there is the recovery in the Japanese economy (with positive real GDP growth for the second consecutive half) and an acceleration in activity in the United Kingdom and in the emerging South East Asian economies. In Latin America, the situation varies significantly across countries, although positive signs are discerned in relation to the Brazilian economy which, owing to its relative size and its trade links with the rest of the area, is particularly important. All the same, the high level of the US stock market and the trade imbalances between the major areas

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.

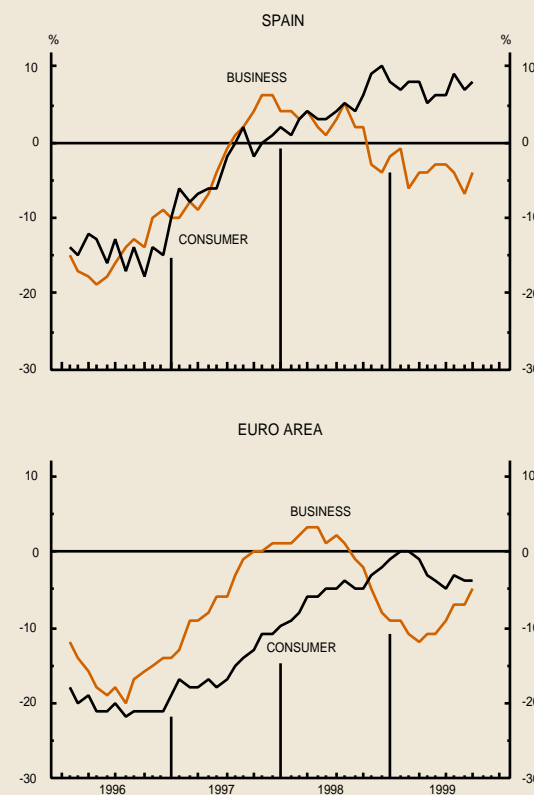
(b) Non-centred annual rates of change calculated on the basis of the seasonally adjusted series.

represent elements of risk. As regards prices, although inflation rates remain moderate in the major economies, the strong increase in oil prices in recent months, together with the pressures discerned in labour markets in certain countries, indicates a certain deterioration in the inflationary outlook, which has prompted a reaction from the US and UK monetary authorities. International financial and foreign exchange markets have remained relatively stable, although there has been a widespread correction in stock market and government bond prices, as well as a significant appreciation by the yen against the dollar.

With respect to the euro area, National Accounts figures for the second quarter indicate a slight pick-up in activity, basically associated with the increase in external demand. Although GDP growth rates for the area as a whole remained modest (1.6 % year-on-year in the first two quarters), they varied considerably across countries. Recent indicators have been consistent with further improvements in activity in the second half of the year (see Chart 2). However, the outlook for the area in the near future depends on the behaviour of the German and Italian economies which, despite recent signs of improvement, continue to grow at rates significantly below the area average. As for prices, the area's inflation rate has stood at relatively low levels during the last few months (see Chart 3), although the rise in oil prices has led to increases in year-on-year rates of growth of consumer prices, which can be expected to continue over the coming months.

CHART 2

Confidence indicators



Source: European Commission.

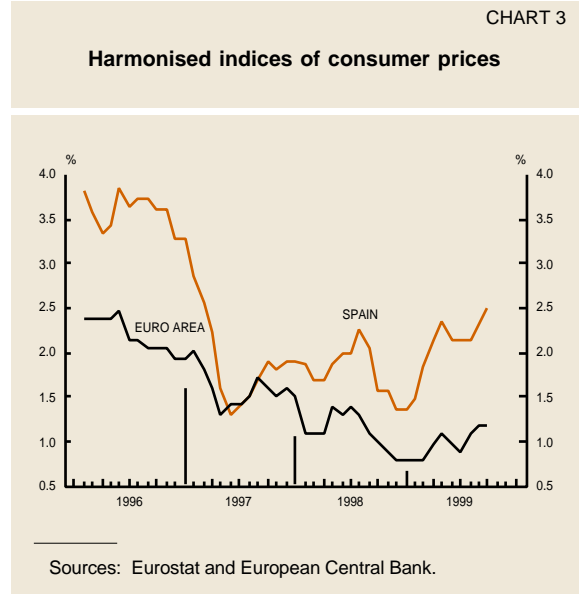
During the third quarter of 1999 the economic environment forming the backdrop to euro area monetary policy changed; the stagnation in economic activity observed at the beginning of the year in many countries of the area gave way to prospects for more favourable growth in the area as a whole. Among other factors, the increased buoyancy of the world economy and the increase in demand and in confidence in European countries – spurred by favourable financial conditions and the exchange rate depreciation – have contributed to this improvement. Thus, although official interest rates were left unchanged in the third quarter, the Eurosystem gradually paid more attention to the risks for price stability posed by faster economic growth. In this context, the significant rise in oil prices has been a further source of concern.

These considerations have prompted expectations of rising interest rates, which have been reflected in a significant increase in yields on medium and long-term debt, and also in an increase – albeit smaller in size and more recent – in money-market interest rates.

Higher interest rates have helped the euro to appreciate notably against the dollar in recent months, thereby recovering part of the cumulative depreciation of the first half of the year. Monetary and credit aggregates behaved in the same way as in the first half of the year, without the change in the direction of interest rates appearing to have moderated their growth. In particular, M3 growth continued at rates above the reference value. The three-month average of the annual growth rates of M3, covering the period July-September, rose to 5.9 %, from 5.6 % in August. The narrowest aggregate, M1, which includes the most liquid assets, displayed much higher rates of growth in September, at almost 13 % on annual average terms. Credit to the private sector has followed a very stable path, with a rate of growth of 10.5 % in September.

Against this backdrop, more conducive to economic growth and to rising prices (the latter being limited so far to the impact of the increases in the wholesale and retail prices of energy products), the rate of growth of the Spanish economy edged up slightly in the third quarter of 1999. On the data available to date, it is estimated that the year-on-year rate of change of real GDP (calculated for the trend-cycle series) was of the order of 3.7 %, which also involves a slight acceleration in terms of quarter-on-quarter rates. This somewhat more expansionary tempo, if confirmed, continues to be based mainly on the behaviour of national demand, which may at least repeat the rate of growth recorded in the preceding quarter. The contribution of external demand is more uncertain. The real rate of growth of exports rose in the period July-August and is expected to continue to do so in the coming months, as anticipated by order books and the expectations of export companies. Their strength will largely depend on the economy's competitiveness. Taking into account that imports remained notably buoyant, the contribution of real net demand to GDP growth in the third quarter will not be very different from that in the previous quarter, although somewhat more negative.

The expansionary performance of the economy over the summer months extended to all the components of domestic demand, with the exception of government consumption, as is confirmed by most of the available indicators. Surveys reflected this favourable climate for households (see Chart 2), whose purchases are being driven by the high growth of real disposable income and by the cumulative decline in real interest rates. In turn, the growth of disposable income stems from the favourable path of employment and the expansionary influence of the reform of personal income tax



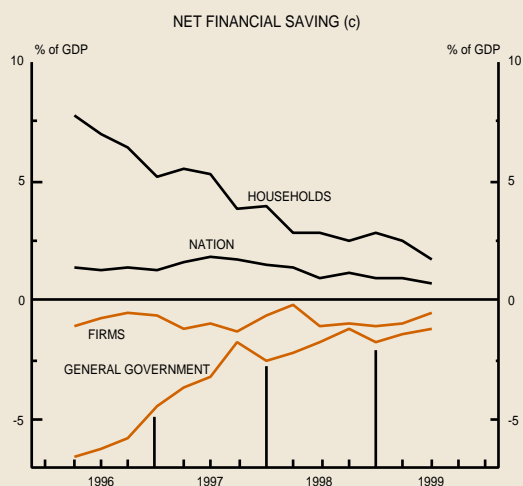
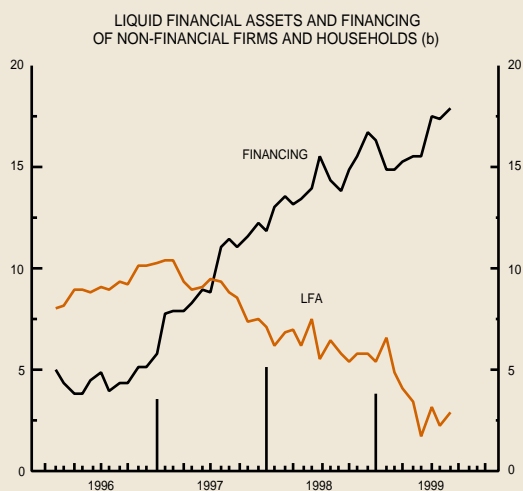
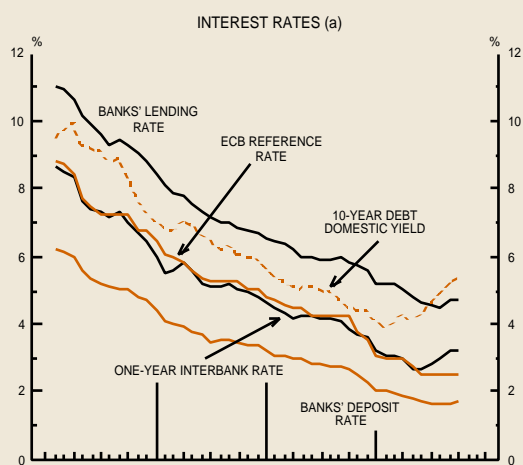
(IRPF) on wage income. These same factors (rising real incomes and low interest rates) help to explain the notable buoyancy of house purchases by households, whose net lending is being considerably reduced by the continued growth in their consumption and investment expenditure. The increase in residential investment, together with the momentum behind public works, is responsible for the expansionary behaviour of gross fixed capital formation in construction and high growth rates also persisted in capital goods investment. The perception by employers of the favourable expectations characterising the international environment has still not been reflected in the confidence indicators (see the aforementioned Chart 2), but the sound corporate results continue to sustain investment in improvements to productive equipment. The latest industrial production index data already show a recovery in activity in the manufacturing branches, and consequently an improvement in their contribution to the growth of value-added is expected in the third quarter of 1999.

Employment indicators continued to show notable buoyancy in the third quarter, although compatible with a recovery in the growth of apparent labour productivity from the abnormally low levels in the preceding quarters. This and the relative stability of wage indicators during the period have permitted a slight cut in the rate of growth of unit labour costs. However, these varied significantly across the productive branches, with unit labour costs in services benefiting most from the favourable path of total costs.

The rise in the CPI in the third quarter of 1999 was due to the impact of energy price in-

CHART 4

**Financial indicators of the Spanish economy**



Source: Banco de España.

- (a) Series calculated as averages of daily data.
- (b) Financing includes bank loans extended by resident and non-resident credit institutions and fixed-income securities.
- (c) Cumulative four-quarter data.

creases. The growth rates of the other components have either stabilised at around their June levels or fallen slightly, as in the case of services, where the growth rate fell by two-tenths of a percentage point over the summer months. In any event, the differential between the growth rates of consumer prices in Spain and in the euro-area countries, measured in terms of the harmonised indices, returned to the June level (1.3 percentage points), the widest since end-1996 (see Chart 3).

The possibility of inflation-adjustment clauses in wage settlements being activated at the year-end, if consumer price growth is less favourable than anticipated, again illustrates the danger of temporary increases in consumer prices, which should drop out of next year's growth rates, being incorporated into inflation expectations and damaging the economy's competitiveness. Accordingly, it is imperative that next year's wage bargaining should take special account of the levels of stability prevailing in the euro area and that the non-monetary spheres of economic policy should actively contribute to the maintenance of macroeconomic stability. The progress made this year in reducing the government deficit has certainly been significant and, in the Draft Budget submitted to Parliament for the year 2000, is programmed to continue. Strict control of public spending growth should allow any further increases in tax revenue, as a consequence of the buoyancy of the economy, to be translated into an acceleration of fiscal consolidation. Budget policy may thereby increase its contribution to the maintenance of medium and long-term stability.

Monetary conditions in the Spanish economy have not changed significantly in recent months. The change in direction of interest rates on financial markets was hardly reflected in the behaviour of economic agents in the third quarter. This is partly because, although interest rates have risen, they remain at historically very low levels, and because the increase in the rate of growth of prices means that real rates have fallen. Similarly, the absence of any significant impact of the increases in interest rates on the economy's financial flows may be explained by the fact that the increase in rates negotiated on the financial markets has only been very timidly passed through to the interest rates applied by financial institutions in their operations with customers, these being the most relevant rates for the spending and saving decisions of households and firms (see Chart 4). Consequently, credit conditions remain very easy, and have continued to drive a strong demand for credit from the private sector, while the financial incentives to save remain limited.

In particular, financing to non-financial firms and households through bank lending and the issuance of fixed-income securities has continued to accelerate in recent months; its year-on-year rate of growth may have stood at around 20 % at the end of the third quarter. As for financial assets, the timid recovery in the rate of growth of the liquid financial assets of non-financial firms and households could be interpreted as the result of an increase in the yield offered by some of these instruments. Nonetheless, the attractiveness of financial assets as a whole is well below the levels of recent years and this stimulates both consumption and in-

vestment in real assets, and discourages saving.

These recent developments in financial flows reflect the continuation of a process in the last few years whereby the strong growth in household indebtedness to banks is leading to a progressive reduction in their net financial saving and, as a result, a reduction in national net financial saving. In this respect, the lower net borrowing of general government and firms only partly offsets the effect on national saving of the lower net financial saving of households.

## 2. The external environment of the euro area

World economic activity in the third quarter confirmed the positive signs observed in the first half of the year. There was a general improvement in the main industrialised countries, marked by the sustained buoyancy of the US economy, signs that Japan is emerging from recession and rapid economic recovery in the UK. These favourable developments in the international environment took place against a background of moderate inflation, despite the strong rise in the price of oil in the year to date (more than 100 % between January and October) and the tightening of the labour market in certain countries.

In the first nine months of 1999, economic activity in the United States sustained the brisk pace that has prevailed for several years (see Chart 5). Admittedly, the annualised quarter-on-quarter growth rate of GDP for the second quarter (1.9 %, against 3.7 % in the previous quarter) reflected a certain slowdown. Yet, according to the available indicators, this has not continued in subsequent months. Thus, industrial production shows a gain in momentum in the manufacturing sector, associated with the increase in exports stemming from the upturn in world demand. Likewise, consumption indicators suggest that the slowdown in this component of demand in the second quarter may have been temporary, with the continued decline in the saving ratio being sustained. However, the construction sector, which is particularly sensitive to interest rate rises, remains subdued (1).

Despite the pick-up in exports, the strength of domestic demand in the United States continued to boost imports and to generate a growing trade deficit. In the first eight months of the year the trade deficit on current account exceeded 200 billion dollars, 36 % up on the same period of 1998. The well-known gap that still exists between the buoyancy of domestic demand in the United States and in the rest of the world (see Chart 5) means that no significant correction of the US current-account deficit, which is forecast to reach 3.5 % of GDP this year (2.7 % in 1998), is foreseeable in the short term. This progressive deterioration of the external balance and in the private-sector saving ratio continues to represent a significant point of vulnerability in the pattern of US growth.

As regards inflation, consumer and industrial prices rose significantly in September, taking

(1) The figures for GDP growth in the third quarter (4.8 % in annualised quarter-on-quarter terms) were released when this bulletin had already gone to press. They confirm the trends mentioned and the continued buoyancy of this economy.



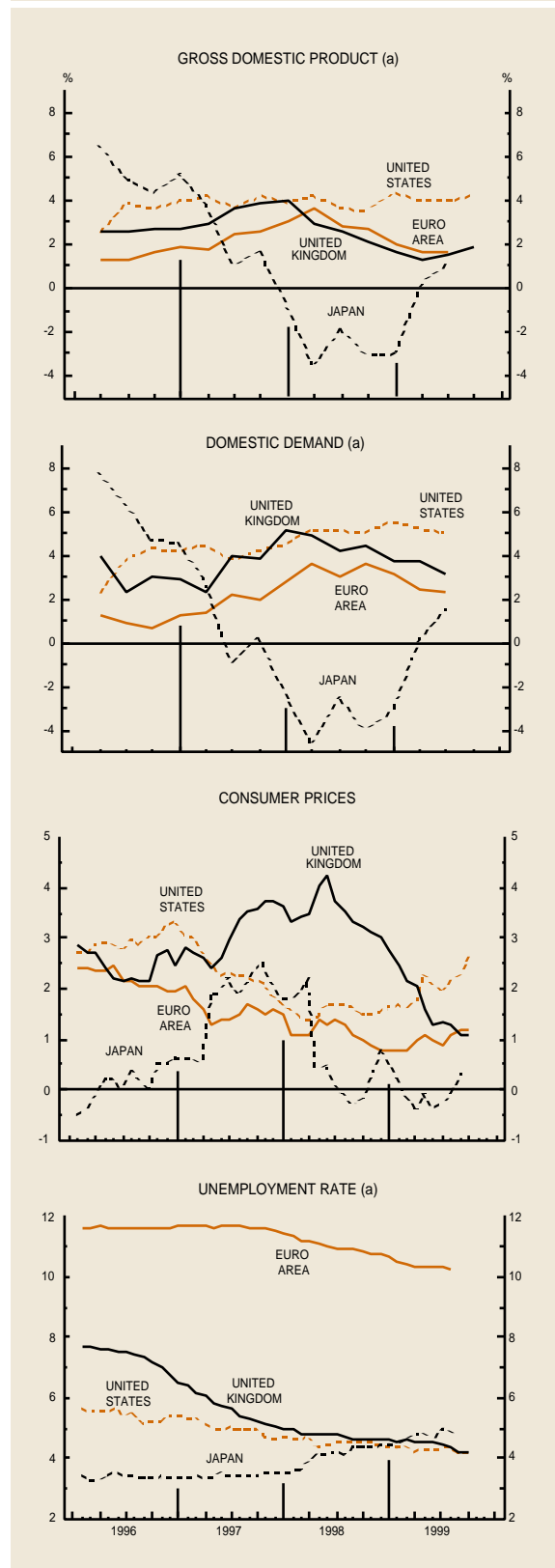
their twelve-month growth rates to 2.6 % and 3.2 %, respectively (see Chart 5). The increase in oil prices and its incipient impact on production costs in manufacturing were the main factors responsible for this outcome. The CPI, excluding the energy and food components, accelerated slightly, to 2 % (1.9 % in August). Signs of supply shortages are beginning to be seen in the labour market, with the unemployment rate still at very low levels (4.2 %). Thus, hourly wages rose somewhat in September (although in year-on-year terms they are still growing at between 3.5 % and 3.8 %), against a background of high productivity growth.

In Japan, second quarter National Accounts data confirmed the improved economic situation. GDP rose by 0.2 % in quarter-on-quarter terms, which was 1.1 percentage points up on the same period of 1998 and the second consecutive quarter of positive growth. The increase in activity was reflected both in domestic demand (especially in consumption) and in exports. According to latest indicators, among which confidence surveys should be highlighted, the signs of recovery in the Japanese economy were sustained in the third quarter. Likewise, price data indicate that the disinflationary process has been halted, as a consequence of somewhat more expansionary spending decisions. In August the 12-month growth rate of the CPI (0.3 %) was positive for the first time in many months (see Chart 5). One of the factors which has undoubtedly contributed most to the improvement in the outlook for the Japanese economy in recent months has been the increase in demand from Asian countries, which account for 35 % of all its exports. Also, the decision by the Bank of Japan to provide more liquidity directly and the announcement of the implementation of a new expansionary fiscal package in the coming months have been conducive to the strengthening of expectations of economic recovery. Nonetheless, the structural weaknesses of the economy (particularly in its financial system) and the appreciation of the yen may limit the possibilities of sustained growth in the short term.

As from the first quarter, the UK economy has recovered with some vigour. This new upturn has been driven primarily by domestic demand, although the improvement in world activity has enabled exports to rise significantly. In the third quarter, GDP growth reached a quarter-on-quarter rate of 0.9 % (1.8 % year-on-year), the highest rate since the third quarter of 1997. This has taken place against a backdrop of some tightening in the labour market. In August, the unemployment rate fell and wages rose by 4.9 % year-on-year. These pressures have still not been passed through to final

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.

prices. The CPI (net of mortgage interest) rose by 2.1 % in September, significantly below the government target of 2.5 %. However, the rise in other prices, such as those in the property sector, shows the existence of latent inflationary pressure.

As regards the Asian countries affected by the summer-1997 crisis, their economic recovery in recent months has generally been stronger than expected. However, significant differences persist between the various countries. GDP growth rates of between 4 % and 6.5 % are forecast for South Korea, Thailand and Singapore this year. The gains in competitiveness arising from the depreciation of their currencies and their expansionary fiscal policies have contributed to this turnaround. Growth is still low in the other countries, although Indonesia is the only one for which a negative rate is forecast for 1999.

In Latin America, although developments are currently positive for the area as a whole, the improvement seen in recent months has not been across-the-board. On the one hand, the Brazilian economy (representing around 45 % of the GDP of the area) is showing relatively clear signs of recovery, and growth is expected to return to positive rates in the third and fourth quarters of the year. Likewise, developments in the Mexican economy have been very favourable in 1999, underpinned largely by the strength of the US demand for its exports. On the other hand, Argentina is suffering the contractionary effects of cumulative losses of competitiveness caused by the devaluations of the currencies of other Latin American countries and by the increase in domestic interest rates prompted by foreign-exchange pressures. This situation has been accompanied by negative inflation rates. According to the latest indicators of activity, the recession seems to have continued in the third quarter. However, insofar as the Brazilian recovery firms, this may boost the activity of the area as a whole, and (given their close trade links) of Argentina in particular. In this respect, the ending of the disputes that arose between the Mercosur countries in the middle of the year, which led to the suspension of certain trade agreements, is significant.

Fresh bouts of financial instability have affected certain small countries in Latin America in recent months, without extending to the area as a whole. In particular, Ecuador announced the suspension of debt service payments on part of its debt issued through collateralised Brady bonds, and Colombia decided to abandon its currency regime (crawling bands against the US dollar) for a free float. A similar decision was taken by the Chilean authorities, whose

currency has fluctuated freely since the beginning of September. This leaves only Venezuela, Uruguay and Argentina, in Latin America, maintaining semi-fixed (the first two) or fixed (the case of the Argentine currency board) exchange rates against the US dollar.

Turning to fiscal policy, economic growth in the US is generating a substantially higher-than-forecast increase in revenues. Thus, the fiscal year, which ended in September, will probably have closed with a higher surplus than in the previous period (1.7 %).

In Japan, the successive fiscal stimulus programmes have generated successive increases in the deficit and public debt. On the latest IMF forecasts, the deficit will reach almost 10 % of GDP in 1999, with a total public debt equivalent to 129 % of GDP. In the UK, a moderately expansionary budget came into effect in March. However, the outturn data to September reveal considerably more favourable results than projected. These may be obtained for the year as a whole if economic activity continues to outpace its forecasts.

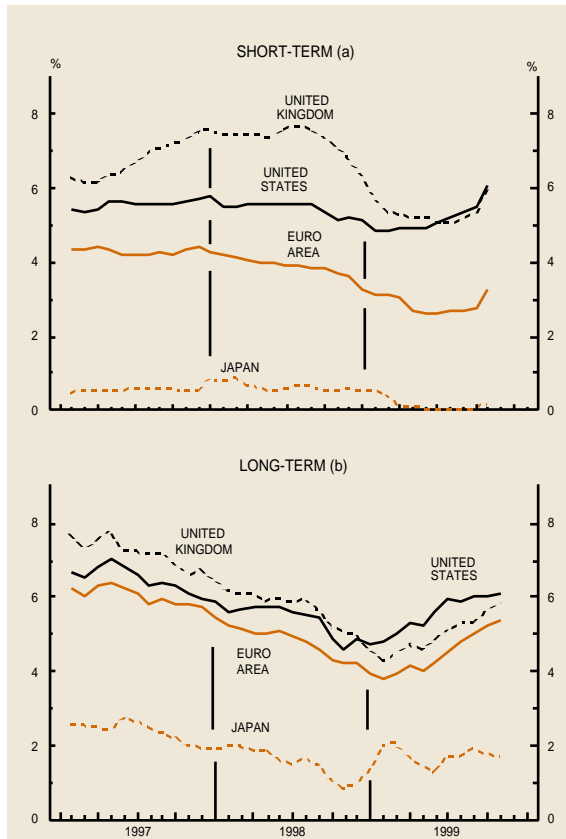
The monetary policies of the United States and the United Kingdom changed course in the third quarter. Continued strong growth in the US economy and the strength of the British recovery, in a context of latent labour-market pressures and, especially, of persistent increases in the price of energy commodities, has given rise to inflationary risks, prompting the central banks of both countries to raise their official interest rates. Since the end of June the Federal Reserve has increased its target for the federal funds rate on two occasions, by a total of 50 basis points to 5.25 %. Subsequently, at its meeting on 5th October it decided to leave interest rates unchanged, but announced its readiness to make further increases in the near future, depending on the information provided by inflation indicators. The Bank of England reversed the downward path followed by its base rate since June 1998, raising it by 25 basis points in the first week of September to 5.25 %. There have been no changes in official interest rates in Japan, although the central bank continues to supply a broad range of liquidity, which has been particularly notable in recent weeks, in order to curb the appreciation of the yen on the foreign exchange markets.

The course of short-term interest rates has been determined by the increases in official interest rates (see Chart 6). Nonetheless, in late September, the three-month interest rates of the main developed economies rose by between 0.2 and 0.7 percentage points. This seems to have been due mainly to the anticipa-



CHART 6

Interest rates



Source: Banco de España.

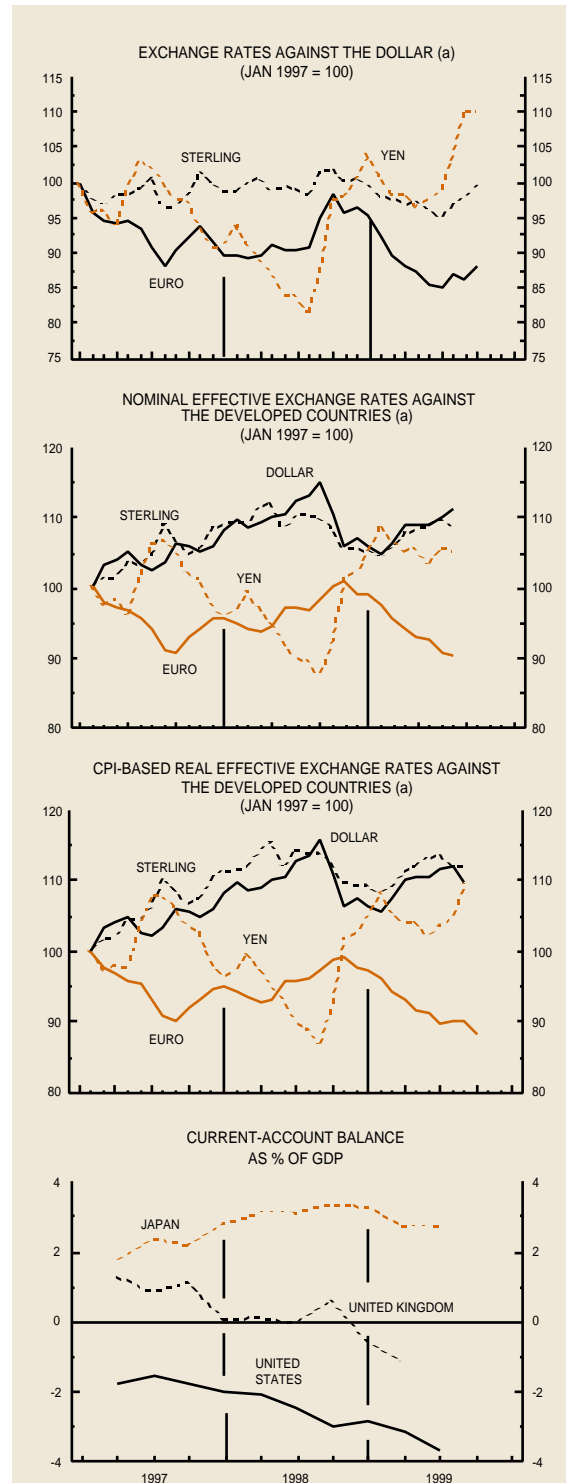
- (a) Three-month interbank market interest rate. Euro area: until December 1998, weighted average of the 11 euro area countries; in 1999, three-month EURIBOR.
- (b) Ten-year government bond yields. Euro area: until December 1998, weighted average of the 11 euro area countries.

tion of a possible excess demand for liquidity as a consequence of the so-called Y2K effect. US long-term rates, having remained relatively stable at around 6 % since June, have increased slightly in October, to stand at 6.2 % in the second half of the month. In the case of the UK, yields on 10-year government bonds have been increasing since April, reaching around 6 % by the end of October. Finally, in Japan long-term rates have hardly changed, remaining at around 1.7 %. As regards equity markets, the New York Stock Exchange has been on a downward trend since late August. By the second half of October it had fallen by 10 % from the high of August 25th, although it was still 15 % up on the beginning of the year and historically very high relative to corporate earnings.

On the foreign exchange markets, the upward path of the US dollar came to an end and since July it has depreciated against the main

CHART 7

Exchange rates and current-account balances



Sources: Banco de España, BIS and national statistics.

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

currencies (see Chart 7). The depreciation of the US currency has been particularly sharp against the yen. After reaching a high of 122 yen to the dollar in May, the rate stood at between 105 and 106 yen to the dollar in October, a depreciation of 13 %. Against the euro,

the US dollar depreciated over the same period by 5.4 %. In nominal effective terms against the developed countries, the dollar depreciated by 5 % between June and October, while the yen appreciated by 12 % and sterling by 0.4 %.

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

#### 3.1. Economic developments

The economic recovery in the euro area that began to become discernible in the first half of the year has tended to firm over the course of the third quarter. Exports are proving to be the driving force of activity at present. And contributing to their significant growth in the euro area has been the increase in external demand (now the crisis of the emerging-market economies is behind) and, to a lesser extent, the gain in competitiveness brought about by the cumulative depreciation of the euro since its birth. At the same time, the increase in the oil price has led to a rise in the euro-area inflation rate since June, although the partially counterbalancing effect derived from the trend of prices of other consumer goods has lessened the impact.

On National Accounts data, GDP for the area as a whole grew by 1.6 % year-on-year during the first two quarters of the year (see Chart 8). There was a progressive acceleration in the related quarter-on-quarter growth rates from 0.1 % in the fourth quarter of 1998 to 0.4 % and 0.5 % in the following two quarters.

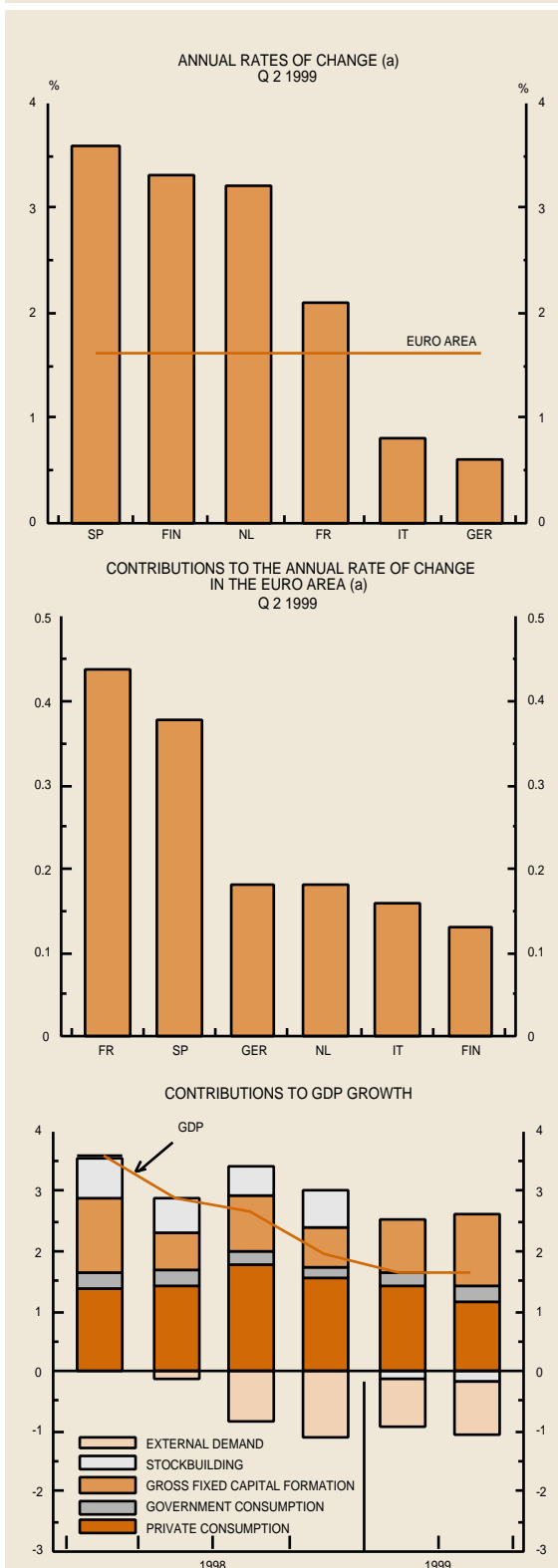
The greater momentum of economic activity in the first half of the year was accompanied by a change in the composition of growth: in the second quarter, domestic demand was on a slowing trend while exports picked up notably. The pattern is clearly perceptible in the case of the contributions of the various components to the quarter-on-quarter increase in GDP. Specifically, in the second quarter the contribution of the external sector was slightly positive (0.1 percentage points), in contrast to its negative contribution (0.2 percentage points) in the first quarter, while the momentum of domestic demand diminished from 0.6 to 0.4 percentage points owing to the greater slackness of private-sector consumption and investment.

These results for the euro area as a whole mask an increase in the dispersion of growth rates across the different EMU members. The lowest increases in GDP have been in Germany and Italy, with year-on-year rates holding at 0.6 % and 0.8 % in the first two quarters of 1999, respectively, while gross rates on the other countries have been above the average for the area. The firming of economic recovery in the euro area in the coming months will thus largely depend on the two aforementioned countries – which account for 51 % of the area's GDP – embarking on a path of sustained growth.

The indicators available on economic developments in the euro area in the third quarter

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.

show the recovery to be stepping up. Most notable is the apparent improvement in Germany's situation, as shown by the increases in orders and in the output and industrial confidence indicators. The latest European Commission surveys have likewise shown a slight rise in industrial confidence across the euro area (see Table 1). In this connection, the rise in expectations regarding future output and orders, especially those from outside the euro area, is particularly significant. Along these lines, the industrial production index has shown signs of picking up, resuming positive growth rates.

With regard to consumer confidence, the latest results show it to have stabilised around the levels attained in the spring, somewhat below the historical highs posted in the first quarter. The indicators available on area-wide private consumption in the third quarter offer mixed evidence; counterbalancing the sustained strong growth of new passenger car registrations is the lesser momentum of retail sales.

In the labour market, the unemployment rate for the euro area as a whole has remained stable at 10.2 % of the labour force since April. Nonetheless, employment in industry has been falling since the final quarter of 1998 as a direct result of the loss of buoyancy in industrial activity. Elsewhere, the data on wages point to a continuing moderate increase, furthering the pattern in the first two quarters of the year.

In the first half of 1999, and despite the pick-up in exports in recent months, the current-account balance for the euro area ran a surplus of EUR 26.4 million, compared with EUR 29.8 billion in the same period a year earlier. The reduction in the overall deficit of the sub-balances of income and current transfers (to EUR 14.2 billion, against EUR 26 billion in the first half of 1998) did not suffice to offset fully the reduction in the merchandise balance surplus (EUR 54.7 billion and EUR 45.5 billion in the first six months of 1998 and 1999, respectively) and the deterioration in the services balance, where payments exceeded receipts by EUR 4.9 billion (compared with the surplus of EUR 1.1 billion in the first half of 1998). The balance on capital account ran a surplus of EUR 5.1 billion, slightly lower than the related figure in the same period a year earlier.

The inflationary situation has deteriorated slightly in recent months, without this jeopardising, in principle, the maintenance of price stability in the near future. The 12-month growth rate of the HICP rebounded from 0.9 % in June to 1.2 % in September (see Chart 9). Against a background of marked stability of the prices of non-energy industrial goods, processed food

TABLE 1

## Euro area. Qualitative indicators

	1989-1998	1998	1998		1999			1999					
			Q 3	Q 4	Q 1	Q 2	Q 3	APR	MAY	JUN	JUL	AUG	SEP
<b>MONTHLY SURVEY (NET REPLIES):</b>													
Industrial confidence	-8	-1	-1	-5	-11	-10	-6	-11	-11	-9	-7	-7	-5
Order books	-18	-5	-4	-11	-20	-21	-17	-20	-22	-22	-18	-17	-15
<i>Foreign orders</i>	-20	-7	-5	-15	-24	-26	-20	-25	-25	-27	-22	-21	-18
Stocks	11	9	8	10	14	13	10	14	13	11	11	10	10
Construction-sector confidence	-22	-19	-13	-15	-9	-7	-7	-7	-8	-6	-5	-9	-8
Order books	-30	-25	-19	-21	-17	-14	-14	-13	-16	-12	-13	-15	-15
Retailer confidence	-7	-3	-1	-3	-3	-4	-7	-1	-3	-9	-6	-7	-7
Consumer confidence	-14	-5	-5	-2	0	-4	-4	-3	-4	-5	-3	-4	-4
<b>Economic sentiment index (1985 = 100)</b>	<b>101.2</b>	<b>103.9</b>	<b>104.4</b>	<b>103.7</b>	<b>104.1</b>	<b>103.6</b>	<b>103.7</b>	<b>103.8</b>	<b>103.5</b>	<b>103.5</b>	<b>104.0</b>	<b>103.5</b>	<b>103.7</b>
<b>QUARTERLY SURVEY:</b>													
Capacity utilisation (%)	81.8	83.2	83.7	82.8	81.9	81.9	81.7						

Source: European Commission.

and services, the HICP has followed a trend determined by the strong increase in the price of energy consumer goods, partly offset by the decline in unprocessed food prices. Since posting their maximum 12-month rate of decline (-4.8 %) in December 1998, the behaviour of energy goods prices has been markedly inflationary, running at 6.4 % in September. This is the outcome of the strong rise in the oil price on international markets, driven by the agreement among the main exporter countries to cap their respective output levels. In any event, the rise in energy prices has not been of the same intensity in all the euro-area countries; on the contrary, significant differences are discernible. In Spain, Luxembourg and Germany, the energy component of the HICP increased by around 9 % in the 12 months to September, while in Portugal it continued to decline (-1.9 %). Although such disparity has numerous causes, the variety of processes through which fuel prices are determined on national markets is the most relevant explanatory factor.

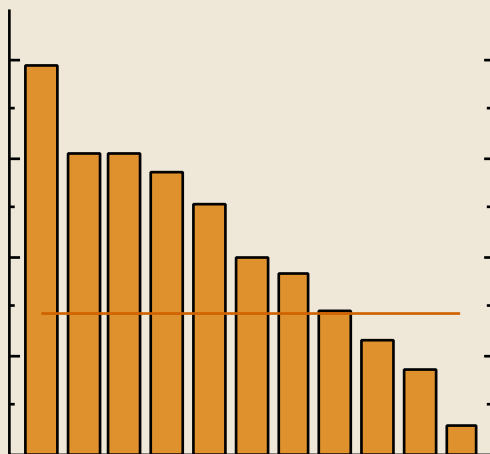
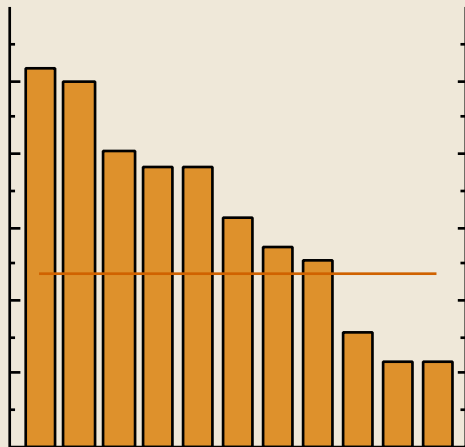
The future course of inflation in the area will be strongly governed by the way in which the rise in energy prices manifests itself in firms' production costs. In this respect, the acceleration in the growth rate of industrial production prices to the point of turning positive in August for the first time since April 1998 is worthy of mention. Against a backdrop of strengthening economic activity in the area, this factor and the muted intensity of the fiscal consolidation process, the high growth of the monetary and credit aggregates and the cumulative depreciation

of the euro over the year (by slightly more than 7 % in effective terms against the developed countries), despite its recent appreciation, pose the chief risks to price stability being sustained. Nonetheless, the structural reforms aimed at heightening market competition and the measures to deregulate certain government-regulated prices could have a restraining influence on inflation.

According to the notifications sent by the Member States in September to the European Commission under the excessive deficit procedure, almost all the countries will close the current year with a more favourable budget balance than that targeted in their respective stability programmes (see Table 2). However, these results do not generally reflect the attainment of healthier structural positions but, rather, the contribution of factors whose favourable impact on public finances is of a temporary nature. These are, namely, the reduction in debt service costs brought about by the delayed effect of the interest rate cuts in recent years and, above all, the higher-than-forecast expansion of tax revenue, despite the fact that economic growth is not exceeding that envisaged in the stability plans. The only two exceptions to this general pattern are Austria, whose forecast result coincides with that it had programmed, and Italy. This latter country will foreseeably post a deficit in excess of the figure of 2 % of GDP initially targeted; however, it seems likely that the resulting slippage will be less than the 0.4 percentage points foreseen some months back.

CHART 9

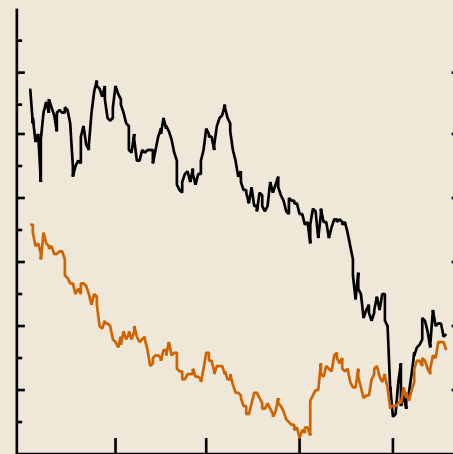
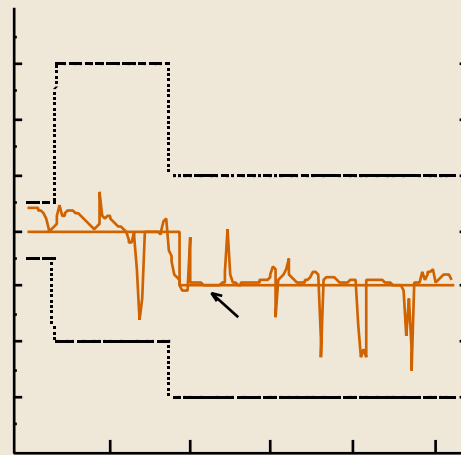
Harmonised indices of consumer prices  
12-month percentage change



Source: Eurostat.

CHART 10

ECB interest rates and euro exchange rates



Sources: Banco de España and ECB.

(a) Dollar/euro and yen/euro exchanges rates.

In the light of the information available on the various budgetary plans for next year, it may be affirmed that, although the envisaged headway in fiscal consolidation is in general somewhat more ambitious than reflected in the stability plans, such progress will in most cases not suffice to ensure a sound structural position in the medium term to meet the challenges posed by public finances. Further, it would probably be advisable that, in some of the countries that are ahead in the business cycle, the fiscal policy stance should be kept tighter so as to counter the demand pressures prevalent in these economies.



TABLE 2

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

	1995	1996	1997	1998	1999 (a)
Belgium	-3.8	-3.1	-1.6	-0.9	-1.0
Germany	-3.3	-3.4	-2.7	-2.1	-1.9
Spain	-7.1	-4.5	-2.5	-1.7	-1.6
France	-4.9	-4.1	-3.0	-2.9	-2.2
Ireland	-2.1	-0.2	1.0	2.4	3.2
Italy	-7.7	-6.6	-2.7	-2.7	-2.4
Luxembourg	1.8	2.8	3.8	2.5	1.7
Netherlands	-4.1	-1.8	-1.0	-0.7	-0.5
Austria	-5.1	-3.7	-1.8	-2.2	-2.0
Portugal	-5.7	-3.3	-2.5	-2.2	-1.8
Finland	-4.6	-3.1	-1.2	1.0	2.5
MEMORANDUM ITEM:					
Euro area					
Primary balance (b)	0.7	1.3	2.5	2.4	
Overall balance (b)	-5.0	-4.1	-2.5	-2.1	
Public debt	84.8	76.1	75.4	73.6	

Sources: European Commission and ECB (to 1998).

(a) Balances notified to the Commission pursuant to the excessive deficit procedure.

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

### 3.2. Monetary and financial developments

The relatively generous monetary and financial conditions in the euro area manifest in the first half of the year were broadly retained in the third quarter of 1999. The monetary and credit aggregates continued to exhibit high growth rates, driven by the low level of nominal interest rates and by the improvement in the economic outlook for the area. Real interest rates remained at historically low levels.

Nonetheless, compared with the previous quarter the situation has changed in some respects. Long-term nominal interest rates climbed significantly during the quarter whereas short-term rates held fairly stable until the end of September. These movements were the result of both domestic factors and a knock-on effect from US financial markets, and they prompted a significant increase in the yield curve (see Chart 11). The firming of a better economic outlook and the upward revision of the expected growth of prices, owing to the performance of energy prices, meant that short-term interest rates also began to rise from late September.

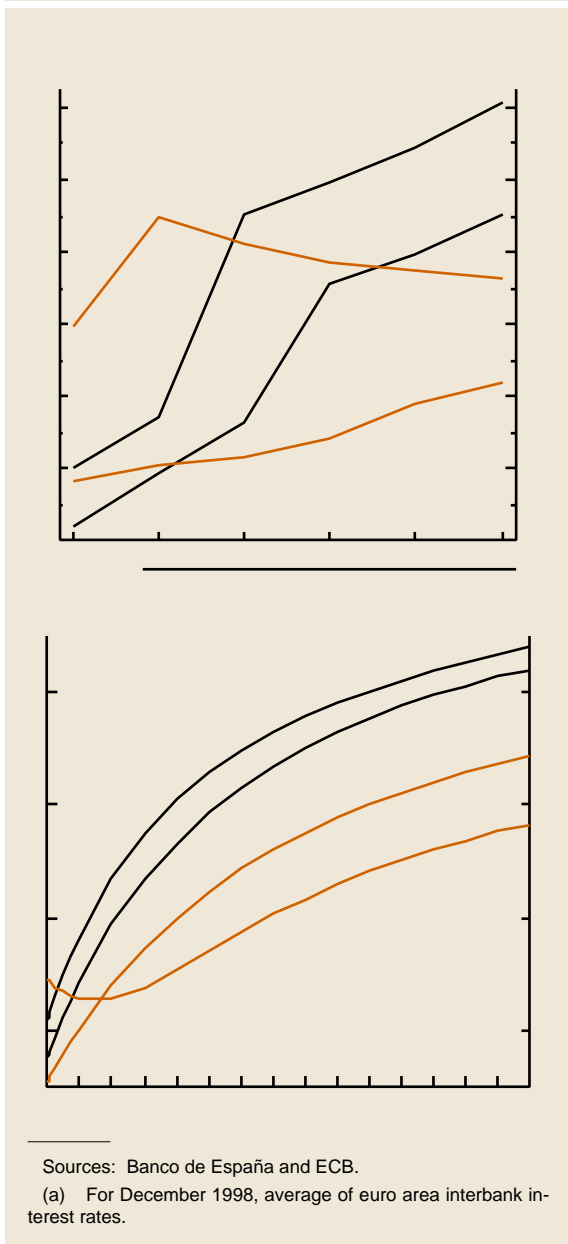
The average level of ten-year interest rates in the euro area increased by somewhat over 70 basis points between June and September, adding to which was a rise of over 25 basis points in the period to 13th October. Given the lower relative increase in US rates, these move-

ments gave rise to a significant narrowing of the 10-year spread over the United States, from levels of over 140 basis points in June to 70 basis points. The change in this spread, along with heightened uncertainty about the sustainability of the US bull market, probably contributed to the appreciation by the euro vis-à-vis the dollar. Against this backdrop, the euro tended to appreciate against the dollar: from August to the date of this Bulletin going to press, it traded at between 1.06 and 1.08 dollars, around 4 % above its levels in June and July.

Until late September, short-term interest rates held fairly stable. Thus, the overnight interbank rate for the euro (EONIA) stood at slightly higher levels than the rate on the main refinancing operations (2.5 %), except in the final days of the reserve maintenance period when there were marked reductions in EONIA. The three-month interbank rate scarcely moved in July and August, standing at around 2.7 % compared with an average level of 2.6 % in June. In parallel, 6- and 12-month maturities began to rebound, with their average level in August standing at around 40 basis points above the related level in June. This came about against a background of an improved growth outlook for the area and expectations of an upward movement in the Eurosystem's intervention rates. The situation was broadly sustained for most of September. However, as from 29th September quite considerable rises began to take place in all interbank market ma-

CHART 11

Euro area yield curves



turities, and these held and intensified up until the close of this report. Hence, from 28 September to 18th October, three-month and one-year interbank rates climbed by 74 and 43 basis points, respectively.

Part of the rise in money market interest rates since late September might be attributed to the existence of certain operational risks associated with the so-called Y2K effect. This is evident from the course of forward rates and of futures contracts on the derivatives markets maturing at the end of 1999 and at the onset of the coming year. This effect is difficult to quanti-

CHART 12

Monetary and credit aggregates and interest rates in the euro area



fy but, in any event, it would only account for some of the increases seen.

The rises in market interest rates feed through, albeit with a certain delay, to the rates applied by Monetary Financial Institutions (MFIs) in their lending operations and to the rates on longer-dated deposits. Thus, the average rates on credit extended by euro-area MFIs to households and non-financial firms moved upwards, especially those on longer-term transactions, where the increase exceeded 40 basis points.

Despite the foregoing trend of long-term interest rates, euro-area equity markets were on a moderately rising trend in July. This was subsequently corrected, partly as a result of the knock-on effect of movements on the US stock market. By 15th October, then, the Dow Jones Euro Stoxx index had undergone a correction of around 3 % in relation to its end-June level.

Monetary and credit aggregates in the euro area continued to display high growth rates, against a background marked by the low level of interest rates and a brighter economic outlook. In August, the year-on-year growth of the benchmark M3 monetary aggregate was 5.7 %. That took its latest three-month moving average to 5.6 %, increasing the deviation from the reference value (4.5 %) in respect of the preceding months. The information for September, released by the ECB on 27th October, showed M3 to be more expansionary, with its year-on-year rate for that month running at 6.1 %.

The growth of M3 was essentially the result of the strong expansion of overnight deposits and, to a lesser extent, of the increase in the demand for money market fund shares. The sharp rate of increase of overnight deposits, which ran at an annual growth rate of 15 % in

August, is the factor behind the strong growth of the narrow monetary aggregates, M1 and M2, which respectively posted rates of 12.8 % and 7 % that month.

Turning to the counterparts of M3, the trends seen in previous months continued. There was strong growth in credit to the private sector which, in year-on-year terms, stood at 10.7 % in August, and relative stability in financing to general government, the annual rate of increase of which was 0.2 %. As in the case of M3, the buoyancy of credit to the private sector is basically due to a more optimistic outlook regarding the pace of activity in the area taking root and to the maintenance of relatively low interest rate levels. In turn, the longer-dated liabilities of MFIs showed an annual change of 5.5 %. Finally, the external position of MFIs continued to worsen as a result of the sustained, heightened expansion of credit to the resident sectors, set against the increase in liabilities vis-à-vis these sectors.

With regard to monetary policy implementation during the third quarter, the pattern described in previous reports was maintained. The Eurosystem kept its intervention rates unchanged and the liquidity provided by it during the sixth, seventh and eighth maintenance periods totalled EUR 187.9 billion, 194.6 billion and 194.9 billion, respectively. Significantly, in the eighth maintenance period (from 24th August to 23rd September) there was something of a reduction in the excess reserves held by MFIs, which fell to their lowest level since the start of Stage Three. It is not yet known whether this movement is of a permanent nature or not. But it may be due to improved treasury management by MFIs as a result of the learning curve and adaptation to the new monetary policy implementation framework. Resort to the marginal lending facility and the deposit facility was relatively scant.

## 4. The Spanish economy

### 4.1. Demand

In the second quarter of 1999, on provisional INE estimates, national demand grew by 5.3 % in real year-on-year terms (2), holding at the same rate as in the final quarter of 1998 and in the first of 1999 (see Chart 13). The stability of national demand growth was a consequence of the behaviour of household consumption expenditure, while construction was more expansionary and capital investment moderated slightly. Net external demand was more contractionary in the second quarter, reducing real output growth by 1.7 percentage points. This was due to the acceleration of imports, in step with final demand, which was not fully offset by the stronger momentum of exports.

The less-than-complete information available for the third quarter of the year indicates that national demand continued to grow at a similar or even higher rate than in previous quarters. It is estimated that household final consumption expenditure recovered slightly, in relation to the preceding quarter, while capital investment continued to grow at high – albeit slightly falling – rates. Noteworthy here is the turning point that may have been reached by construction investment, after its prolonged acceleration. The contribution of net external demand to GDP growth may have been somewhat less contractionary than in the second quarter, with foreign sales showing signs of a recovery that should be confirmed in the next few months, although the scarcity of foreign trade data makes this a somewhat tentative forecast.

On Quarterly National Accounts (QNA) estimates, the final consumption expenditure of households and private non-profit institutions increased, in real year-on-year terms, by 4.2 % in the second quarter of 1999. The latest information on the third quarter indicates that this aggregate behaved in a similar fashion as in the preceding quarters or was slightly more expansionary. Chart 14 shows that the rate of growth of the indicator of apparent consumption of goods and services, calculated on the basis of very incomplete information, increased with respect to the preceding quarter. However, this outcome was largely determined by the path estimated for the services component which, in the absence of data, is essentially based on forecasts. The goods component, for which there is more information, has been less dynamic. A similar profile of sustained spending in the third quarter is seen in the case of the retail sales index.

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

Given that sectoral accounts estimated within the framework of the Spanish National Accounts, 1995 (CNE 95) are still not available, it is particularly difficult to approximate the path of household income in 1999. Nonetheless, the indicators referring to some of the components of this aggregate show that disposable income continued to grow at similar rates to those estimated for 1998. Although the compensation of wage-earners has tended to post large increases – albeit lower than those of 1998 – the expansionary effect caused by the reduction in withholdings on income from employment, following the reform of personal income tax, has helped to sustain the buoyancy of household income. At the same time the cumulative decline in interest rates continues to be a factor conducive to the demand for consumer durables, particularly cars, as financing has become significantly cheaper. However, although the rate of growth of vehicle registrations is still very high, certain signs of weakness are apparent. An additional factor contributing to the high growth of consumption, by favouring the taking of spending decisions, is households' optimism – according to opinion surveys – regarding their financial situation in the near future. All this helps to explain the moderate decline in the savings ratio that, according to the available estimates, is taking place.

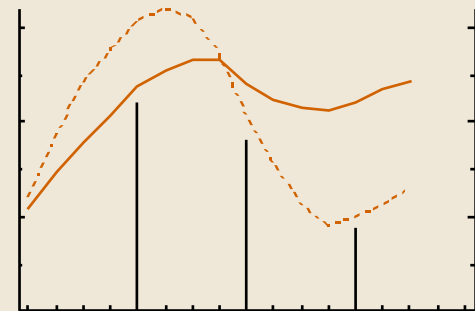
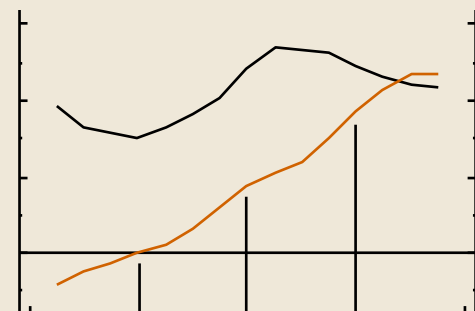
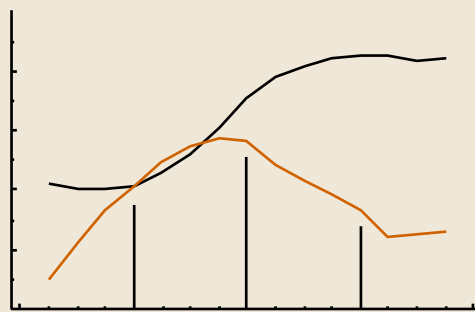
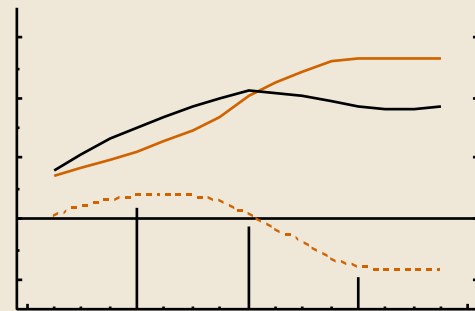
According to the QNA, general government final consumption expenditure grew year-on-year, in real terms, at 1.3 % in the second quarter of 1999, in line with the progressive moderation seen in previous quarters. This rate of growth remained practically unchanged in the third quarter. All the components of government consumption are contributing to the containment of the aggregate, with the moderation in the compensation paid to general government wage-earners being particularly notable.

On QNA data, gross fixed capital formation accelerated again in the second quarter of the year to a real year-on-year rate of 11.5 %. This heightened buoyancy stems both from the marked recovery in construction spending and the sustained vigour of capital investment. The information on the third quarter of the year suggests that this component of demand will post a slightly lower rate of increase than in the second quarter, as the growth rate of investment in construction may well have peaked in the second quarter.

Among the indicators of capital investment, apparent investment in capital goods tended to sustain a significant growth rate during the summer months, underpinned by the progressive recovery in domestic production and by the extraordinary buoyancy of imports (on data to Au-

CHART 13

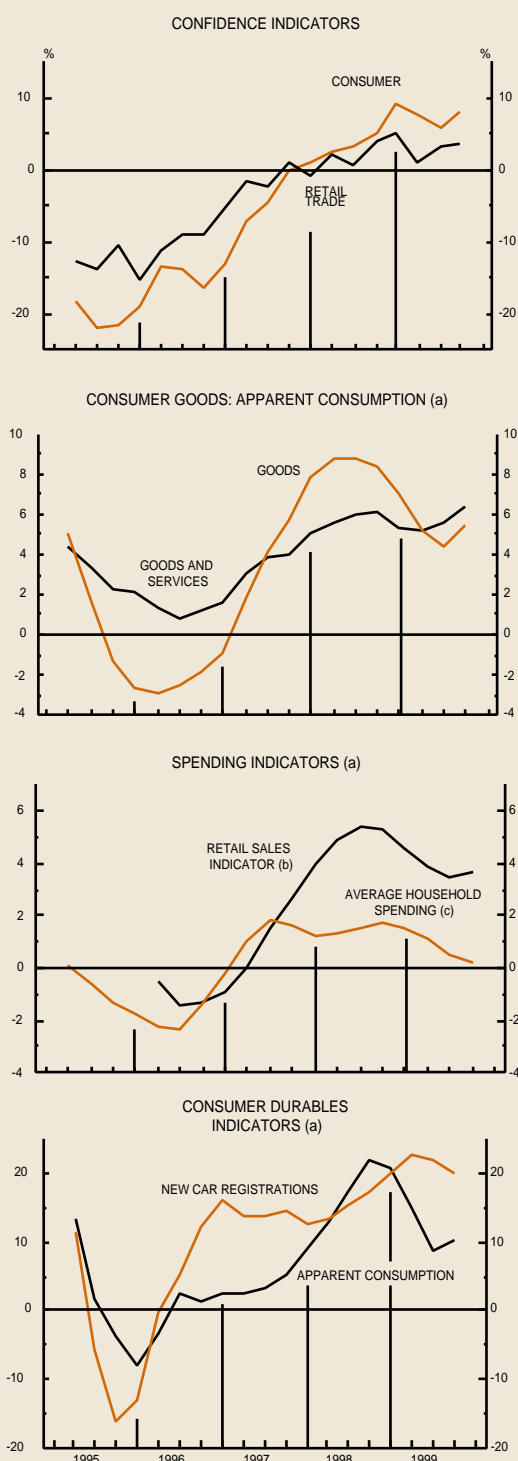
Main macroeconomic aggregates (a)



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

CHART 14

Private consumption indicators



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

- (a) Non-centred annual percentage change, based on the trend of the indicator.
- (b) Deflated by the CPI.
- (c) Household expenditure survey, deflated by the CPI.

gust) (see Chart 15). As regards the type of product, apparent investment in transport equipment has led the expansion of the aggregate, while apparent investment in other capital goods displayed a slightly decelerating profile. The buoyancy of investment and the outlook of continuity are also reflected in the business survey published by the Ministry of Industry and Energy (MINER). The upward trend of previous months in both the expected orders for industry as a whole and the business confidence indicator in the capital goods sector strengthened in July and August. Finally, the latest projection of the half-yearly investment survey revised upward the forecast of investment growth in 1999 that was made last autumn.

The current strength of spending and the favourable demand expectations, which are firming for the coming months, warrant the continuation of high capital-investment growth rates. Such investment is also being stimulated by the favourable borrowing conditions, which firms are capitalising on, not only to expand their installed capacity, but also to rationalise and modernise their productive structure. The Quarterly Balance Sheet Survey data for the first half of 1999 showed that the profit and loss accounts of non-financial firms continued to improve in that period and both the return on net assets and on equity remained at comparatively high levels, which clearly exceeded the cost of debt, indicating that the financial position of these firms continued to be favourable for the execution of investment projects.

Investment in construction continued to gain momentum in the second quarter of the year, reaching a real year-on-year rate of 11.8 %. The information provided by the currently available construction indicators suggests that the growth of this aggregate stabilised in the third quarter, as a consequence of the reduced vigour of spending on civil-engineering works since, by all indications, expenditure on building sustained the vigour it had been displaying previously. Specifically, the second-quarter data of the quarterly construction industry survey – the most relevant indicator for measuring activity in the sector – already seem to be indicating a change in the expansionary trend of activity.

The coincident indicators of construction showed more clearly a change in construction activity to a phase of somewhat less intensive growth (see Chart 15). Thus, the trend growth rate of apparent consumption of cement, with a year-on-year increase of 5.1 % in the third quarter, continued to fall, in line with its behaviour since the first few months of the year. Among the employment indicators, in July and August the acceleration of previous months in social



security registrations in construction came to a halt and the rate of decline of registered unemployment in the same sector was curbed in the third quarter. Finally, indicators of sentiment in the construction industry show a moderation in the activity of the sector since the beginning of the year.

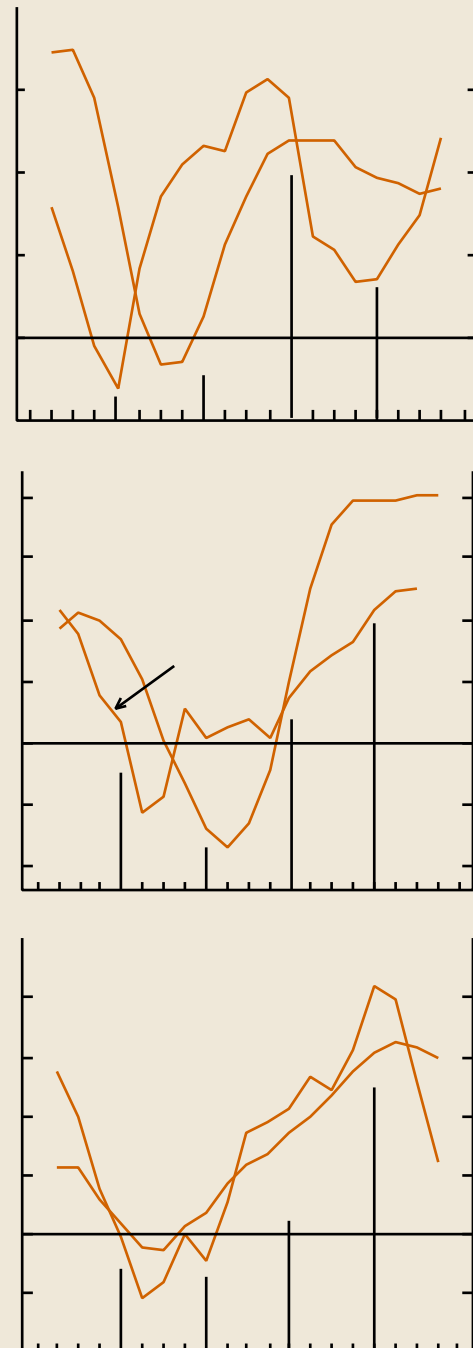
In any event, the buoyancy still retained by the construction industry is generally confirmed by the leading indicators. The information on building starts (the approvals of architects' associations and permits granted by local councils) has been very expansionary during 1999. The strength of residential building is consistent with the favourable performance of its determinants: the low levels reached by interest rates, the longer mortgage repayment periods, the cumulative gains in financial wealth and the favourable path of household disposable income. In addition, the rising trend of house prices in recent months may have led households to bring forward their spending on housing somewhat and to the existence of a demand for housing as an investment. However, if these price pressures persist they will eventually tend to moderate spending on housing. Official civil-engineering tenders grew significantly less in the first five months of 1999 than in the preceding year, so that this component of expenditure should weaken somewhat.

On QNA data, stockbuilding made a negative contribution to GDP growth of minus one-tenth of a percentage point in the second quarter, as against a positive contribution of the same size in the preceding quarter. The latest information available for this aggregate – European Commission survey findings – indicates a slight increase in the level of stocks with respect to the preceding quarter, as the number of firms declaring stocks at higher-than-desired levels increased.

The contribution of net external demand to output growth became more strongly negative in the second quarter of 1999, since the recovery in exports of goods and services was not sufficient to offset the greater vigour of imports. The information available for the third quarter (referring to July and August, for the most important indicators) continues to show a moderate recovery of exports in the face of strengthening imports. However, the behaviour of the determinants of exports augurs a stronger recovery in this aggregate than seen to date. The depreciation of the euro against the dollar and, in particular, the improvement in the international environment should stimulate Spanish sales abroad. In fact, the latest results of the quarterly survey of exporters indicate greater optimism in relation to expected medium-term external

CHART 15

Gross fixed capital formation indicators

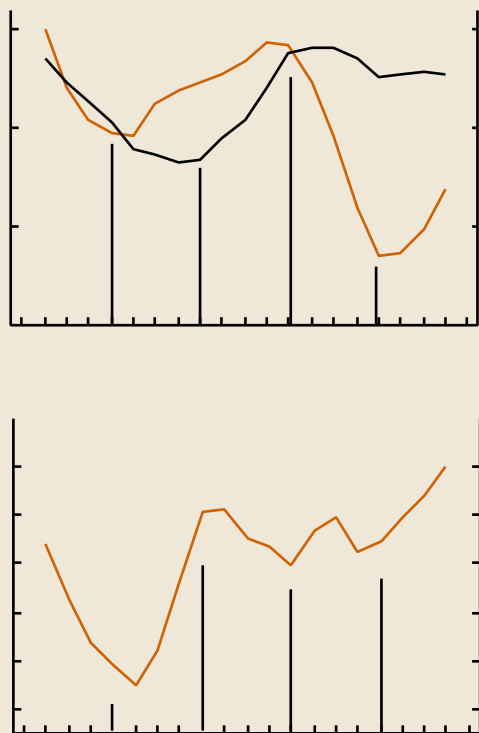


Sources: Instituto Nacional de Estadística, Ministerio de Industria y energía, Ministerio de Fomento, Oficemen, Instituto Nacional de Empleo and Banco de España.

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

CHART 16

Foreign trade (a)



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

- (a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.
- (b) Series deflated by the corresponding unit value indices.

sales. Consequently, it is estimated that the contribution of external demand may have been somewhat less negative in the third quarter, having stood at  $-1.7$  percentage points in the second.

Goods exports have been rising at very low rates since the second half of 1998. According to the QNA they grew in the second quarter of 1999 by 3 % year-on-year, and Customs figures indicate a modest recovery in July and August. This outcome has been largely a consequence of the weakness in sales to Latin America. By product group, all the components have posted moderate growth rates, except for capital goods, which have grown notably in real terms, amid falling prices. In contrast to the behaviour of goods exports, tourism receipts continued to display notable buoyancy to July, although the strong growth rate moderated with respect to previous months. This behaviour is also observed when real indicators of tourism are anal-

ysed; the number of foreign visitors lodged in Spanish hotels, their overnight stays and the number of tourists visiting Spain has decelerated. The depreciation of the euro in 1999 and the high levels of confidence of European consumers must have contributed to the expansionary trend of tourism.

Insofar as can be estimated on the basis of Customs data to August imports, stimulated by the buoyancy of final demand, continued to display notable vigour in the third quarter, having increased by 11.8 %, in QNA terms, in the second. By group of product, the sizeable increase in purchases of capital goods, is noteworthy, while the growth rate of imports of consumer goods moderated with respect to the first half and the upward profile in the previous quarter of purchases of non-energy intermediate goods flattened off somewhat. Finally, the second-quarter slowdown in tourist payments was curbed.

#### 4.2. Output and employment

GDP growth in Spain held steady in the second quarter, at a year-on-year rate of 3.6 % (see Chart 17). Growth is estimated to have been slightly higher in the third quarter, reflecting a slight acceleration in national demand and a somewhat less negative contribution from external demand, as mentioned in the previous section. From the viewpoint of the productive branches this mild recovery in output would have been the result of greater buoyancy of industrial production, a less negative contribution from agriculture and stable growth in services. Construction activity would have posted slightly lower growth than in the previous quarter, although it would still have been the fastest growing branch. As for employment generation, the number of full-time-equivalent jobs grew by 3.4 % in the second quarter, one-tenth of a percentage point up on the previous quarter, while the indicators available for the third quarter point to a slight slowdown in this variable. This would have permitted a recovery in apparent labour productivity in this period, from the very low rates of growth posted in the preceding quarters.

The unfavourable weather conditions continued to govern primary activity during the second quarter of 1999, when the decline in the value added of this branch steepened to a year-on-year rate of  $-6$  %, on QNA estimates. The reduction in agricultural output has extended, with a greater or lesser impact, to most crops, although there were also increases in the production of tubers and citrus and other fruit. Live-stock farming output was weakened by the

scant rainfall. This prompted the partial substitution of industrial compounds for pasture, with the consequent reduction in the value added of the sector. The most recent economic information holds out no hope for a prompt recovery in agricultural output; the employment indicators – social security registrations and registered unemployment – have deteriorated further, as have the manufacture of products for agriculture and the construction of agricultural machinery.

It appears that the ongoing recovery in the world economy and, in particular, in the EU and south-east Asian countries will be a key factor driving Spanish exports in the coming months. The recovery discerned in industrial activity can be attributed to the buoyancy of external demand and the firmness of domestic demand. In fact, the ongoing loss of vigour in the sector since the beginning of 1998 seems to have come to an end in the second quarter of 1999 when, on QNA estimates the value-added of this branch continued to slow, to reach a year-on-year rate of 1.2 %. However, it can be seen from the monthly profile of the industrial production index that a timid recovery in activity commenced in May and June, which was confirmed by the stronger momentum recorded in July and August, with year-on-year growth, corrected for calendar effects, of 3.8 %. The greater buoyancy of the industrial sector is also seen in the latest data for social security registrations. Nonetheless, the business confidence indicator published by the European Commission still shows some uncertainty in the views of businessmen with regard to their future prospects.

An analysis at the level of the various productive branches reveals some differences. Besides the features specific to each branch, it also shows the incipient state of the current industrial expansion. Specifically, the expansions in the extraction, chemical and other manufacturing branches were notable, while in the metal working branches the recovery is weaker and more recent. As for the energy branches, they are posting moderate growth focused on electricity and gas production.

As mentioned in relation to construction expenditure, the phase of heightened construction activity extended into the second quarter of 1999 when, on QNA estimates, the value added of this branch increased at a year-on-year rate of 11.4 %. This fresh boost to construction has stemmed from the building component, since according to the quarterly construction industry survey, civil engineering work – albeit still highly buoyant – decelerated slightly. Third-quarter information suggests that the growth of this activity was more moderate. Specifically, employment and input indicators show a clear slow-

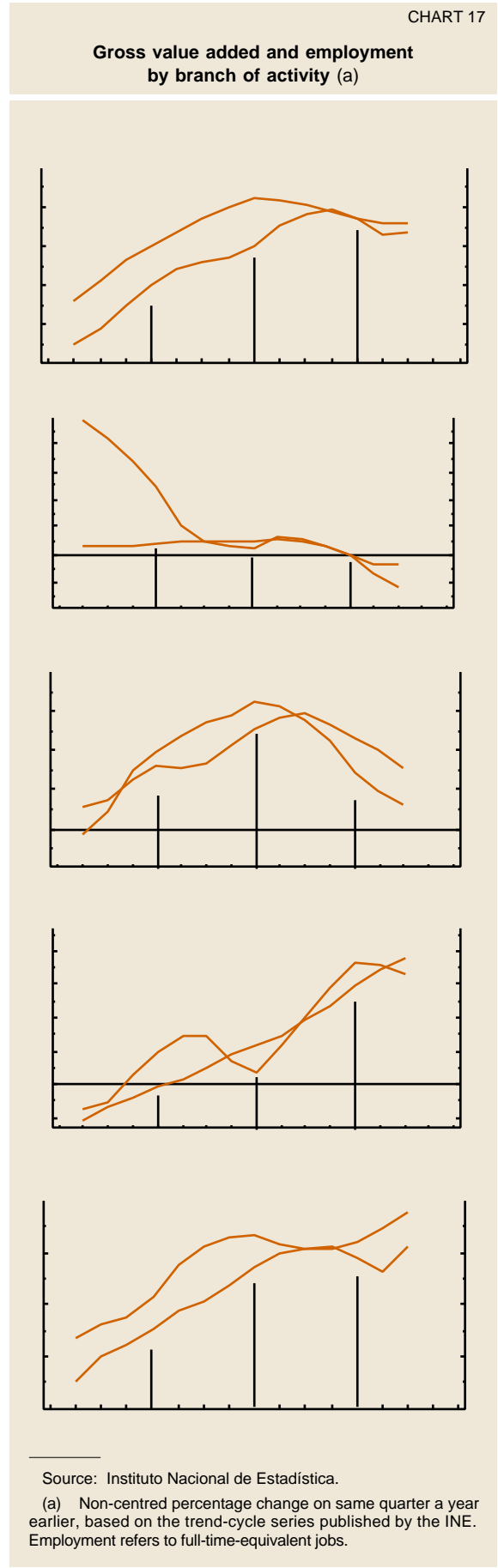
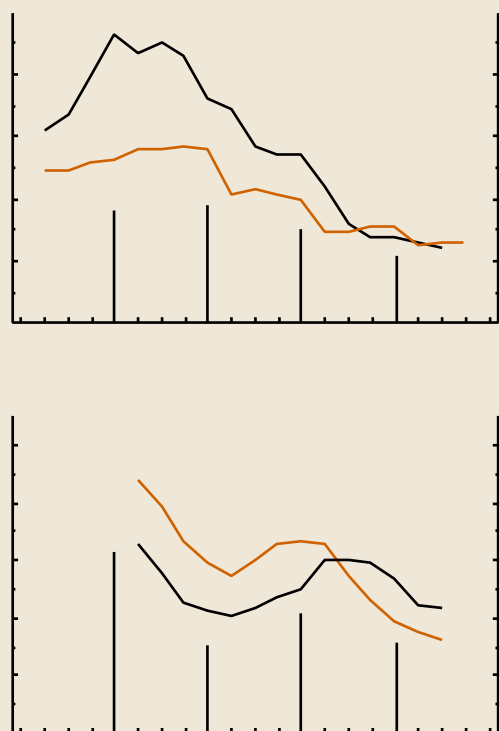


CHART 18

Wages and labour costs (a)



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

- (a) Percentage change on same quarter a year earlier.
- (b) Basic pay.
- (c) Rates based on QNA trend-cycle series.

down, although their growth rates remained high. The identification of a cyclical peak in construction is consistent with the recent behaviour of the confidence indicator.

Gross value added in the services branches grew at a year-on-year rate of 3.7 % in the second quarter of 1999, two-tenths of a percentage point above the rate recorded in the previous quarter. Higher growth was seen in both the market and non-market services branches, although in the latter case the growth of activity was less marked, as shown by the fact that the year-on-year increase in the second quarter of the year was 1.6 %. The growth rate of market services rose by two-tenths of a percentage point to 4.4 %, extending the expansion that began in the second quarter of 1998. The information on the third quarter of 1999 tends to indicate that growth continued at high rates. This strength is based on the credit and insurance,

communications, health and transport branches, sectors in which the employment indicators display accelerating profiles. The behaviour of the distributive trade was somewhat less certain until the second quarter, but it firmed in the summer months, when the buoyancy of the employment indicators was joined by the improvement in the sales indicators. Finally, in the case of the restaurant and hotel industry, the relevant statistics show a slight loss of momentum during the summer.

The latest QNA data confirm the buoyancy of employment creation, which continued to accompany the notable output growth in the first half of 1999. Specifically, jobs, measured in homogeneous terms as regards working hours (3), having grown at rates close to 4 % in the second and third quarters of 1998, increased by 3.4 % between April and June this year, which was very close to the figure for the first quarter (3.3 %). Practically all the employment created in the second quarter was dependent, with the number of wage-earners increasing by 4.4 % in relation to the same period of 1998. In fact, although this group slowed down slightly in the first two quarters of 1999, the latest information shows that a high level of buoyancy has been sustained, assisted by the moderation of compensation this year. The number of self-employed workers fell again in the spring of 1999, in relation to the same period a year earlier, although to a lesser extent than in the first quarter. Employment, measured in terms of employed persons (information provided for the first time within the ESA 95 framework), has behaved similarly to full-time-equivalent jobs.

According to the Labour Force Survey (EPA), employment creation in the second quarter of 1999 accelerated sharply (by close to one percentage point). Employed persons grew by 4.7 % and dependent employment by 6.5 %. However, as seen on previous occasions (4), these figures should be interpreted with caution, because certain changes to the survey, introduced at the beginning of 1999, have affected the comparability of some of the main aggregates over time. In fact, up to a certain point, such expansionary behaviour contrasts with the aforementioned QNA employment data and with the other labour market indicators, all of which coincide in signalling a large, but not accelerated, increase in employment. In any

(3) Called full-time-equivalent jobs by the INE. The QNA employment data will refer to the latter, unless otherwise indicated.

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

event, despite all the caveats, the predominance in employment generation of dependent employment as opposed to self-employment, as reflected in the EPA, is a feature of the last two quarters that is also reflected by the QNA. As for third-quarter information, social security registrations increased considerably in July, but by much less in August and September, so that the quarter ended with an average growth rate similar to that of the previous quarter. This behaviour by registrations would be compatible with continuation of the mild slowdown in employment, already displayed by the QNA data in the first half, with an increase in apparent labour productivity. As for unemployment, according to the EPA it continued to fall, and at an increasing rate (-16.9 % between April and June). This contrasts with the loss of intensity, as the year has elapsed, in the decline in the numbers of unemployed registered with the National Employment Institute (INEM). Yet a significant reduction in the volume of unemployment can be expected in the third quarter of 1999. Against a background of moderate growth in the labour force, this would be accompanied by a further cut in the rate of unemployment.

As regards employment by type of contract, in the second quarter wage-earners with permanent contracts grew at the same rate as in the previous quarter, while there was a small recovery in wage-earners with temporary contracts, which took their growth rate close to that of stable employment. Despite the caution with which these EPA figures should be treated, it is worth pointing out that they are generally consistent with the greater momentum sustained by temporary contracts registered with INEM, and with the strength displayed by permanent contracts in this period, partly as a consequence of the bringing forward of hiring decisions prompted by the announcement of the reduction in rebates from May. In the third quarter, when this effect had disappeared, permanent contracts slowed, while there was a pick-up in temporary contracts.

### 4.3. Costs and prices

The information on price and cost developments in the third quarter has clearly shown the effects of the rise in energy prices. There has been a surge in the twelve-month growth rates of the main price indicators (from import prices to consumer prices), which will probably be passed through to the final demand deflator. Domestic costs, and labour costs in particular, have followed patterns closer to those observed in the first half of the year, although two qualifications may be made. First, the estimated re-

CHART 19

### Price indicators (a) Spain

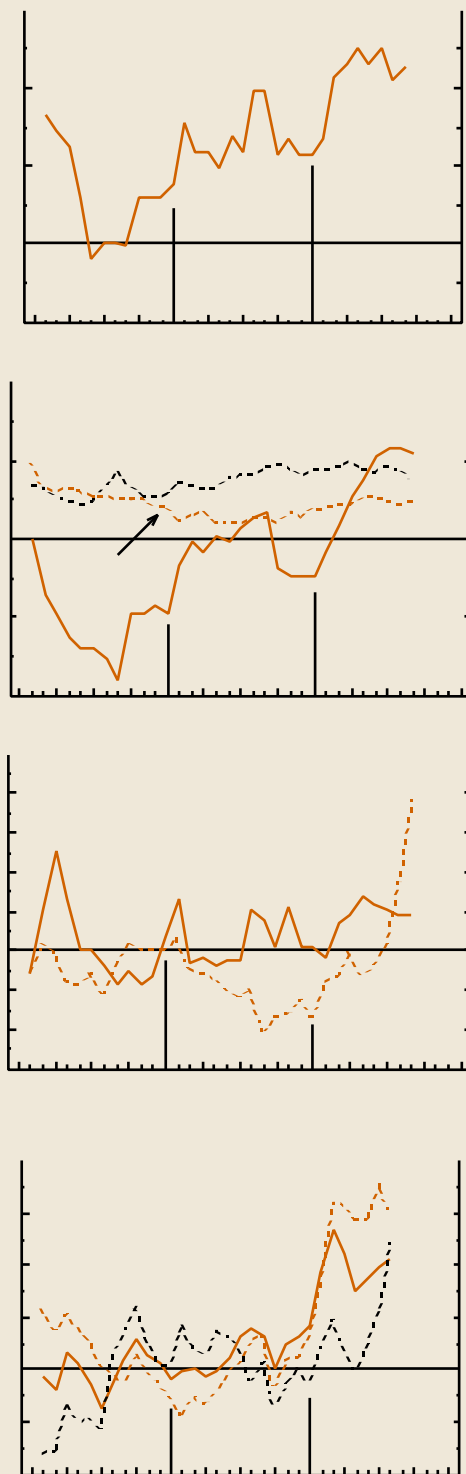


Source: Instituto Nacional de Estadística.  
(a) Percentage change on same period a year earlier, based on the original series.



CHART 20

Price indicators (a)  
Monetary Union



Sources: Eurostat and Banco de España.

(a) Annual percentage changes in the original series.

covery in labour productivity during the third quarter may have caused unit labour costs to slow moderately in the same period. Second, although the latest collective bargaining results continue to display containment of wage growth, they have incorporated a certain incremental effect, arising from the upward revision to expected year-end inflation.

On wage survey data, average hourly earnings, in terms of basic pay, slowed during the second quarter of 1999 to 2.2 % in relation to the same period of the previous year. As is becoming customary, the increase in average monthly earnings was somewhat less (1.9 %), basically as a consequence of the impact of the expansion of part-time employment (in particular, in services) on average compensation per worker. Wage growth in the second quarter was not uniform across branches of activity. The largest increase in average hourly earnings was in construction (3.6 %). Although this figure is high, it marks a departure from the accelerating profile displayed until the first quarter of the year. Wage growth was more moderate in the other branches, running at 2.3 % in industry and at 1.9 % in services. In the former case, this entailed a stabilisation of the rate of growth, while in services there was a cut with respect to the first few months of the year. Comparing these data with those for collective bargaining does not reveal any significant wage drift. This is basically a consequence of the elimination in some branches of compensation for years of service and of slower growth in the amount of overtime worked.

The wage data available for the third quarter relate to the collective agreements signed in that period. The average settlement negotiated to September 31st was 2.3 %, three-tenths of a percentage point below the increase in 1998. Given the time of year, most agreements registered in the third quarter were newly signed. Until September the average settlement under newly signed agreements was 2.4 %. However, in recent months there has been an acceleration, as a consequence of the upward revision to expected year-end inflation. Settlements under existing agreements were very similar (2.3 %) and wage rises have been fairly uniform across branches of activity, at around 2.3 %.

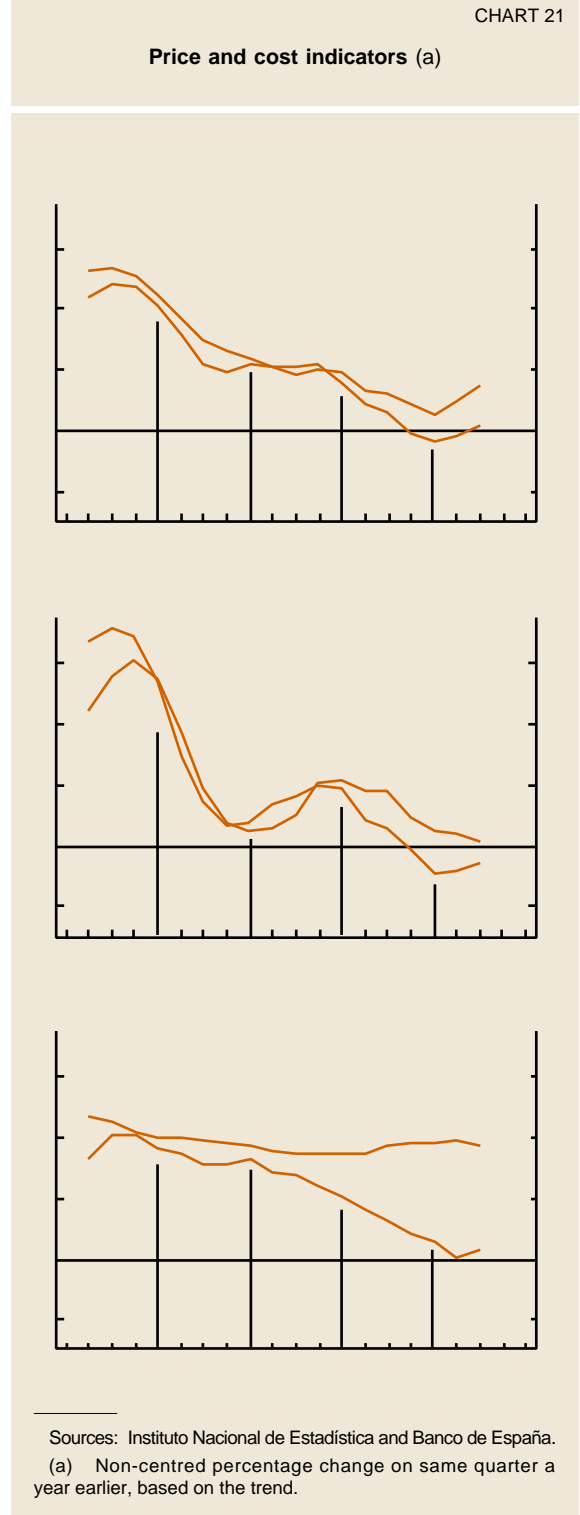
According to most of the indicators of price developments in the Spanish economy there was a deterioration in the third quarter of the year, largely caused by the upward trend in the price of oil on international markets, combined with the depreciation of the euro against the dollar. The twelve-month rate of change in the CPI (the main indicator of final prices) stood at 2.5 % in September, three-tenths of a percent-



age point higher than in June. This rate was only 2 % if energy goods are excluded. The HICP also grew by 2.5 % in September with respect to the same month a year earlier. Given that the rate for the euro area as a whole remained at 1.2 %, the inflation differential continued to widen. The gap in the energy goods component is particularly important, although it closed somewhat last month (see Chart 20).

The most erratic components of the CPI moved in opposite directions in the third quarter (see Chart 19). The growth rate of the energy component rose significantly to reach 9.4 % in September, 7.8 percentage points above the rate at the end of the second quarter. This is the result of the rise in oil prices on international markets, reinforced by the euro/US dollar exchange rate. The prices of calor gas, heating oil and the various types of petrol were affected particularly strongly. Royal Legislative Decree 15/1999 has been approved in order to offset, at least partially, the impact of these increases on the general index. It reduces the price of calor gas, by lowering the rate at which VAT charged on this product, exempting it from excise duty and reducing the pre-tax price. Also, the price of calor gas will be kept frozen for one year. Although it is difficult to predict oil prices, it should be pointed out that, according to the prices on futures markets, a gradual moderation in the oil price can be expected over the coming months. Unprocessed food prices, meanwhile, fell in the third quarter, reaching a rate of -0.2 % in September. This slowdown, despite the smaller decreases being sustained by the prices of certain types of meat, such as chicken, is largely due to the lower rate of increase of fruit prices, as a consequence of supply increases.

Among the other CPI components, the rate of growth of processed food prices was fairly stable, standing at 2.3 % year-on-year in September. Nonetheless, it should be pointed out that this rate incorporates a number of largely temporary factors associated with the prices of a number of specific products (such as olive oil, tobacco and wine), whose effects may tail off in the first few months of the year 2000. The twelve-month growth rate of the prices of non-energy industrial goods stabilised in the third quarter at 1.4 %. As yet, the cut approved in the prices of medicines does not seem to have been reflected in this index. Finally, the twelve-month growth rate of the prices of services – traditionally the most downwardly sticky component – fell by two-tenths of a percentage point between June and September, to 3.3 %. However, this cut can be almost entirely attributed to telephone prices; the effects of the increases in charges in August last year have dropped out of the twelve-month rate and telephone charges were reduced by Royal



Legislative Decree 4/1999. Furthermore, a new reduction in the charges of the main telephone operator has recently been approved. As regards other services, their prices have been notably stable, against a background of decelerating wage costs.

As mentioned above, the Spanish HICP also grew at a twelve-month rate of 2.5 % in

September, four-tenths of a point higher than in June. In the euro area as a whole the increase was only one-tenth of a percentage point, so that the inflation differential between Spain and the euro area widened to 1.3 percentage points. Component by component, the significant increase in the energy differential was particularly notable, for which there are two reasons. First, the weight of fuel in the Spanish index is higher than in that of the euro area as a whole, so that with the same price changes, the impact of an oil disturbance in Spain is greater. Second, the price of calor gas has risen considerably more in Spain than in other euro area countries.

As for the other price indicators that provide information on the various stages of the price formation process, the ongoing acceleration since the beginning of the year in the producer price index (available to August) has stepped up in recent months, taking the twelve-month increase to 1.4 %. This behaviour of the general index is basically attributable to the intermediate energy goods component, whose growth rate reached 7.1 % in August, nine percentage points higher than three months previously. Meanwhile, the prices of the agricultural products for human consumption – July is the latest published figure for the index of prices received by farmers – have displayed negative rates of change. The most up-to-date partial information, relating to the prices set in wholesale markets to October, would seem to indicate a moderation in this period. Finally, the prices of imports rose by 3.8 % in August. The upward path of the prices of energy imports should be noted.

The information on prices and costs discussed above enables conclusions to be drawn as to how the price formation process is developing, both at the aggregate level and in the main branches of activity. The indicators included in Chart 21 illustrate this process, with data to the second quarter of 1999. In non-financial firms as a whole the behaviour of final prices is very similar to that of total average costs, although a certain tendency for margins to widen is apparent in recent quarters. It should be pointed out that the path of total costs is the result of a combination of very different profiles for labour costs, which despite their recent moderation (see Chart 18) continue to grow faster than final prices (excluding taxes), and for input costs, which were still growing at negative rates in the first half of the year.

At a less aggregated level, the markedly different behaviour still observed in manufacturing and services should be noted. In manufacturing, final prices tended to recover in the first half of the year, although they were still posting negative growth rates. Total costs grew faster than

prices, as a consequence of the acceleration of unit labour costs, thus prolonging the contraction of the unit operating margin, which had already occurred in 1998. The acceleration of unit labour costs in manufacturing reflects, in turn, a strong downward trend in labour productivity.

In services, the significant slowdown in average total costs – the consequence of both cuts in intermediate costs and of much less expansionary unit labour costs than in manufacturing – has not been passed through to final prices. The latter have continued to grow at a notably stable rate of somewhat over 3 %, so that the unit operating margin has tended to widen significantly.

#### 4.4. State budget

The draft State budget for the year 2000 includes an initial projection of revenue and expenditure in the current year, which enables the available data on the State budget outturn to be analysed more precisely. This information, which is presented in Table 3 (columns 2 and 3), replaces the initial budget figures used in previous reports. According to this projection, State revenue will grow by 5.7 % (ESP 1,005 billion) more and expenditure by 3.1 % (ESP 578 billion) more than initially budgeted. This will enable the State cash deficit to be reduced by 10.7 % in 1999, instead of the increase projected in the initial budget. This improvement in State finances, in cash terms, is basically attributable to the buoyancy of indirect tax revenue and, to a lesser extent, to the higher receipts from corporate income tax. It will enable the deviations in expenditure, mainly resulting from the payment of obligations arising in previous years, to be offset.

The cumulative State cash deficit to September was around 40 % higher than in the same period of the previous year, standing at ESP 1,180 billion. As pointed out in previous reports, it should be noted that the year-on-year comparison of the budget outturn generally tends to be distorted by the different timing of receipts, rebates and payments. In particular, the heavy concentration of interest payments in the first few months of 1999 continues to distort – albeit to a declining extent – the growth rate of expenditure. Likewise, the early payment in 1999 of personal income tax rebates corresponding to the previous year has had a significant impact on revenue. Other factors with an uneven impact on the various revenue and expenditure items, which will be analysed below, must be added to the foregoing. If the impact of these factors is removed by evening out the personal income tax receipts and financial expenses in

**Drug prices and the latest measures to restrain them**

The retail price of drugs is made up of four elements: the laboratory selling price, the distributor's margin, the chemist's margin and indirect taxes. All of these elements are regulated. As regards margins, those that may be applied by both distributors and chemists are subject to maximum levels imposed by legislation. Currently, the maximum distributor's margin is 9.6% of the wholesale price(1), excluding taxes, in the case of normal packaging and 5 % in the case of hospital packaging, and the maximum chemist's margins for the same types of packaging are 27.9 % and 10 %, respectively, of the retail price, excluding taxes. The adjoining table shows what proportions of retail drug prices in EU countries correspond to margins. The Spanish distributor's margin is seen to be in line with EU margins, while the chemist's margin is slightly higher, although it should be pointed out that the margins for the EU as a whole are high.

Laboratory prices are determined using two different systems (see adjoining diagram). On one hand, the prices of publicly funded prescription-only drugs are subject to ceilings imposed by regulations. A method exists to set the laboratory price of new drugs according to their costs, which limits the incentive to try to reduce them. By contrast, in the case of drugs already on the market, only the revisions to the laboratory selling prices are regulated; since July 1996 they are calculated on the basis of the growth in the CPI less a percentage, based on costs and productivity gains. On the other hand, the laboratory prices of over-the-counter drugs are deregulated, and the same is the case for prescription-only pharmaceutical products excluded from public funding. In the case of the latter however, if their sale has been authorised before January 1st 1998, there is a three-year transitional regime, ending on January 1st 2001, during which their price revisions are subject to maximum increases imposed by regulations. In addition, the government may exempt from price regulation those products that it considers face sufficient competition on the market.

As can be seen in the adjoining chart, which depicts the CPI and its medicines sub-index, over the past year retail medicine prices have been growing at markedly higher rates than the CPI. Over the same period, public spending on pharmaceutical products has grown at very high rates (10.57 % to September 1999). In this context, the government has introduced a number of measures aimed at reducing drug prices. The introduction of generic drugs should be mentioned here. These are pharmaceutical products with the name of the active ingredient, whose commercial patent has expired, so that their prices are from 20 % to 25 % cheaper than bio-equivalent brand drugs. Initially, in 1997, only six generic drugs were introduced. In 1998 the list was extended to 47 and it is predicted that another 400 will be authorised this year. Although the effect of their introduction was very small at first, in recent months their consumption has grown appreciably. Even so, their presence is still well below the average EU market share for generic drugs (around 20 %).

Likewise, margins have been reduced on several occasions in recent years. The most recent reduction was in May 1999, when the distributor's margin for normal packaging was reduced from the 11% applied since 1997 to 9.6%. This cut produced a fall of 2 % in June in the medicines sub-index of the CPI. Subsequently, its year-on-year rate, which had stood at around 4 % since the beginning of the year, has turned negative, owing to the strong increase in the index a year ago. Moreover, this sub-index is expected to moderate further in the coming months, when the cut approved in the maximum prices of medicines sold on prescription which cost more than ESP 558 is incorporated. For some products, the cuts, which came into force on September 15th 1999, were by as much as 10 %.

Restraint of the drugs sub-index of the CPI is also foreseeable when Royal Legislative Decree 12/1999 of July 31st 1999 comes into effect. It establishes that where the prices of medicines for which no generic substitute is available have been used to calculate the reference prices (2) of homogenous sets (3) of medicines and they exceed such reference prices, then they shall be reduced to the level of the latter.

(1) The wholesale price is obtained by adding the distributor's margin to the laboratory price.

(2) The reference price shall be the maximum payable by the public health service for a specific active ingredient.

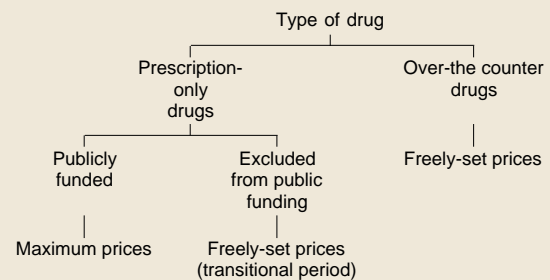
(3) The same products, not only the same active ingredient, but also in the same dose and form.

**Composition of drug prices in the EU**

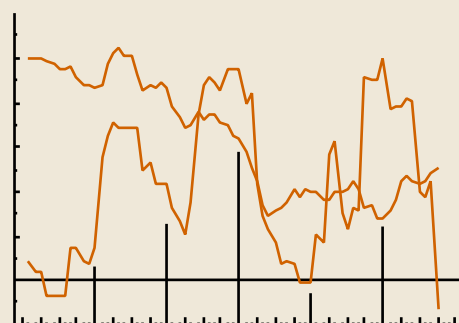
Country	% of the retail price (excluding VAT)		
	Laboratory	Distributor	Chemist
Germany	62	10	28
Austria	63	7	30
Belgium	65	8	27
Denmark	70	5	25
<b>Spain</b>	<b>65</b>	<b>7</b>	<b>28</b>
Finland	64	5	31
France	68	7	25
Greece	69	6	25
Netherlands	63	12	25
Ireland	65	10	25
Italy	66	7	27
Luxembourg	62	8	30
Portugal	72	8	20
United Kingdom	64	10	26
Sweden	75	3	22
<b>EU mean</b>	<b>66.5</b>	<b>7.5</b>	<b>26</b>
<b>EU mode</b>	<b>68</b>	<b>7</b>	<b>25</b>

Sources: GIRP European Pharmaceutical Data 1997 (except Ireland and Spain); author's calculations for Spain.

**Drug prices**



**General CPI and medicines CPI  
Twelve-month growth rates**



Source: Instituto Nacional de Estadística.

TABLE 3

State Budget outturn

PTA bn and %

	Outturn		Percentage change 3=2/1	Outturn		Outturn	
	1998	Initial projection 1999		Percentage change 1999/1998	1998 JAN-SEP	1999 JAN-SEP	Percentage change
	1	2		4	5	6=5/4	7=6/5
<b>1. Revenue</b>	<b>17,534</b>	<b>18,450</b>	<b>5.2</b>	<b>9.4</b>	<b>12,753</b>	<b>13,255</b>	<b>3.9</b>
Direct taxes	7,457	7,696	3.2	13.6	5,359	5,593	4.4
<i>Personal income tax</i>	4,992	5,103	2.2	7.9	3,889	3,740	-3.8
<i>Corporate income tax (a)</i>	2,324	2,430	4.5	47.7	1,362	1,729	27.0
<i>Other</i>	140	164	16.6	17.9	108	123	14.0
Indirect taxes	7,015	7,916	12.8	13.0	5,241	5,868	12.0
VAT	4,373	5,090	16.4	16.1	3,281	3,757	14.5
<i>Excise duties</i>	2,391	2,557	7.0	7.3	1,776	1,912	7.6
<i>Tariffs</i>	132	142	7.3	10.4	95	106	11.9
<i>Other</i>	120	127	5.9	8.8	89	93	4.1
Other net revenue	3,063	2,837	-7.4	-8.6	2,153	1,793	-16.7
<b>2. Expenditure</b>	<b>18,649</b>	<b>19,445</b>	<b>4.3</b>	<b>9.5</b>	<b>13,598</b>	<b>14,435</b>	<b>6.2</b>
Wages and salaries	3,053	3,108	1.8	0.4	2,187	2,170	-0.8
Goods and services	388	468	20.4	16.5	275	305	10.7
Interest payments	3,334	3,277	-1.7	22.5	2,442	2,678	9.7
Current transfers	9,906	10,330	4.3	8.2	7,308	7,883	7.9
Investment	898	1,184	31.9	22.2	638	710	11.4
Capital transfers	1,071	1,079	0.7	-10.9	749	688	-8.1
<b>3. Cash-basis deficit (3 = 1 - 2) (b)</b>	<b>-1,114</b>	<b>-995</b>	<b>-10.7</b>	<b>10.8</b>	<b>-845</b>	<b>-1,180</b>	<b>39.7</b>
MEMORANDUM ITEM: NATIONAL ACCOUNTS:							
Revenue	17,313	—	—	11.0	12,306	13,073	6.2
Expenditure	18,529	—	—	10.4	13,079	14,232	8.8
<b>Net borrowing (+) or lending (-) (c)</b>	<b>-1,216</b>	<b>-1,194</b>	<b>-1.8</b>	<b>6.4</b>	<b>-773</b>	<b>-1,158</b>	<b>49.9</b>

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

(a) The January-September 1999 outturn includes all revenue from the tax on the income of non-residents.

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

(c) The annual figures (columns 1 and 2) are drawn from the Spanish Finance Ministry's response to the Excessive Deficit Procedure questionnaire (ESA 79 methodology).

each of the years concerned, the State cash deficit to September would be in line with the initial projection discussed above.

The data available in National Accounts terms also provide somewhat equivocal information on developments in public finances. They reveal an increase in the State deficit to the third quarter of close to 50 %, to reach ESP 1,158 billion (around 1.3 % of GDP), when the target for the year as a whole was a 1.8 % reduction. In this case too, the strong growth in expenditure is still governed by the different timing of public debt maturities in 1998 and 1999, which has entailed 28 % growth in interest payments to September. At the same time, revenue has been affected by the early payment of rebates in 1999. When adjusted for these temporary effects, the State finances, in National Accounts terms, would be compatible with the annual targets for the general government deficit contained in the Stability and Growth Pro-

gramme (1.6 % of GDP for 1999) and with the projections in the State budget for the year 2000, which put it at 1.4 % (5). Notable on the revenue side is the strength of indirect taxes and, within the latter, VAT, with growth rates higher than those which, according to the estimated historical relationships, would be explained by the behaviour of consumption and imports. Meanwhile, on the expenditure side, strong restraint of government consumption continued to be seen. The course of revenue

(5) It is necessary to make this distinction as the use of the National Accounts series is temporarily subject to methodological problems due to the adoption of the new ESA 95 accounting framework. In fact, the deficit figures provided by the draft State budget for the years of 1999 (1.4%) and 2000 (0.8 %) have been estimated on the basis of ESA 95 accounting principles. By contrast, the targets set for 1999 (1.6 %) were fixed in terms of the ESA 79 methodology, and the monthly data available on State revenue and expenditure in National Accounts terms continue to be compiled within the ESA 79 framework.

**Social security budget outturn**

On budget outturn data to July, the social security system ran a surplus of ESP 489 billion, ESP 281 billion higher than in the same period of 1998. This result is a significant improvement on the budget forecast for the year as a whole, which was for an increase in the deficit of ESP 57 billion with respect to the 1998 outturn. It is also an improvement on the data to April 1999, discussed in the previous quarterly report on the Spanish economy.

This performance was due to revenue growth of 8.5 % to July, well above the budget forecast, and to the increase in expenditure (both 4.9 %), as well as to the fact that in recent months the latter have slowed down to a greater extent than the former. Receipts from social security contributions rose by 8.2 % (6.3 % in the whole of 1998), exceeding the budget forecast by almost five percentage points. This was attributable, above all, to the notable buoyancy of registrations. On data to September, the number of registered workers grew by 5.6 %, against 5.1 % in 1998. The other major source of revenue, current transfers from the State, despite having slowed down recently, also increased by more than budgeted.

The growth of expenditure during the first seven months of 1999 was somewhat below the budget forecast for the year as a whole. The greater-than-budgeted increases in consumption-related expenditure (especially purchases of goods and services, the growth rate of which – despite having fallen by two percentage points since April – is still well above the budgeted rate) were offset by the lower growth of benefit-related expenditure, basically contributory pensions and prescriptions (included under the “Other” heading in the table below). Moreover, sick pay slowed significantly with respect to April, although its rate of change is still greater than budgeted.

As regards INEM (the National Employment Office), information is available on the social security contributions received to June, which grew by 12.1 % with respect to the same period a year earlier, and on unemployment benefits to September, which fell by 4.2 %. The sound performance of employment explains these developments. Finally, employment-promoting rebates increased by around 60 % to May.

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

PTA bn and %

	Outturn		Budgeted		Outturn JAN-APR		Outturn JAN-JUL	
	1998 1	1999 2	% change 3=2/1	% change 4	1998 5	1999 6	% change 7=6/5	
<b>Revenue</b>	<b>12,891</b>	<b>13,519</b>	<b>4.9</b>	<b>9.1</b>	<b>7,676</b>	<b>8,326</b>	<b>8.5</b>	
Social security contributions (c)	8,715	9,032	3.6	8.1	4,955	5,361	8.2	
Current transfers	4,023	4,326	7.5	10.6	2,637	2,872	8.9	
Other (d)	153	160	4.3	20.9	84	92	9.4	
<b>Expenditure</b>	<b>12,909</b>	<b>13,593</b>	<b>5.3</b>	<b>5.8</b>	<b>7,468</b>	<b>7,837</b>	<b>4.9</b>	
Wages and salaries	2,049	2,144	4.7	5.8	1,237	1,309	5.8	
Goods and services	1,249	1,285	2.9	8.3	719	765	6.3	
Current transfers	9,438	9,959	5.5	5.4	5,445	5,689	4.5	
Benefits	9,377	9,896	5.5	5.4	5,405	5,647	4.5	
<i>Contributory pensions</i>	<i>7,453</i>	<i>7,892</i>	<i>5.9</i>	<i>4.8</i>	<i>4,245</i>	<i>4,437</i>	<i>4.5</i>	
<i>Sick pay</i>	<i>526</i>	<i>505</i>	<i>-4.1</i>	<i>14.7</i>	<i>273</i>	<i>278</i>	<i>2.1</i>	
<i>Other (e)</i>	<i>1,397</i>	<i>1,499</i>	<i>7.3</i>	<i>5.3</i>	<i>887</i>	<i>932</i>	<i>5.1</i>	
Other current transfers	61	64	4.3	5.9	40	42	6.0	
Other (f)	174	205	18.2	9.2	66	74	10.9	
<b>Balance</b>	<b>-18</b>	<b>-75</b>	<b>—</b>	<b>37.5</b>	<b>208</b>	<b>489</b>	<b>134.8</b>	

Sources: Ministries of Economy and Finance and of Employment and Social Affairs, and Banco de España.

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

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

(c) Including surcharges and fines.

(d) Excluding surcharges and fines, and the contribution from the pharmaceutical industry.

(e) Reduced by the contribution from the pharmaceutical industry.

(f) Reduced by the disposal of investments.



TABLE 4  
**Balance of payments: summary table (a)**

EUR m

	JAN-JUL 1998	JAN-JUL 1999
	Receipts	Receipts
<b>Current account</b>	<b>99,257</b>	<b>103,592</b>
Merchandise	59,546	59,934
Services	24,944	28,207
<i>Tourism</i>	14,997	17,028
<i>Other services</i>	9,947	11,179
Income	7,155	7,379
Current transfers	7,612	8,072
<b>Capital account</b>	<b>3,781</b>	<b>3,863</b>
	Payments	Payments
<b>Current account</b>	<b>97,723</b>	<b>106,976</b>
Merchandise	66,876	73,468
Services	14,333	16,234
<i>Tourism</i>	2,462	2,799
<i>Other services</i>	11,870	13,435
Income	11,770	11,962
Current transfers	4,744	5,312
<b>Capital account</b>	<b>489</b>	<b>577</b>
	Balance	Balance
<b>Current account</b>	<b>1,534</b>	<b>-3,384</b>
Merchandise	-7,330	-13,533
Services	10,611	11,973
<i>Tourism</i>	12,535	14,228
<i>Other services</i>	-1,923	-2,255
Income	-4,615	-4,584
Current transfers	2,867	2,760
<b>Capital account</b>	<b>3,291</b>	<b>3,285</b>

Source: Banco de España.

(a) First provisional results.

and expenditure in the third quarter is discussed below, using cash-basis information, being that which was available with the greatest detail at the time this report was prepared.

During the third quarter, both revenue and expenditure slowed somewhat. However, tax revenues remained highly buoyant, with a growth rate to September of 8 %, in line with the initial projection. As in previous quarters, this aggregate rate masks very different behaviour by receipts from direct taxes, which grew weakly, and from indirect taxes, which displayed considerable strength. Also the two main components of direct taxes (personal and corporate income tax) produced notably different results.

The reduction in personal income tax receipts in the third quarter (down 3.8 % to

September, compared with an increase of 7.9 % to June) was primarily due to the early payment of rebates corresponding to the 1998 tax year, which had a particularly marked effect in this period, and also, to a lesser extent, to the fall in withholdings on capital. By contrast, corporate income tax receipts, despite their slowdown, continued to grow at a high rate. This was basically due to the lower rebates paid in the first few months of 1999 and, to a lesser extent, to the withholdings on the capital gains of mutual funds (only applied since February 1999). Furthermore, in July and August, the revenue from the payment of the balance of tax due in respect of the 1998 tax year was incorporated, with an increase of 14.6 %. If the figures for receipts from this tax to the third quarter are put on an equal footing with those corresponding to the same period of 1998, there would appear to have been a larger increase in receipts in 1999 than in the initial projection.

As already mentioned, indirect taxes remained notably buoyant, with a growth rate to September of 12 %, although they did also tend to slow slightly. The strength of indirect taxes was across-the-board. Especially notable were VAT, the taxes charged on energy (due to the increase in oil prices) and the tax on certain means of transport, reflecting the strong growth in vehicle registrations. Other revenue fell more sharply during the third quarter, with a cumulative rate of change of -16.7 %. Notable here were the reductions in dividends from privatisations and in fees and charges and other revenue, as well as the smaller capital transfers, due to the different timing of the receipt of European funds.

As regards expenditure, the slowdown in its rate of growth in the third quarter was mainly due to interest payments. The latter are, nonetheless, still higher than in 1999, due to the differences in the timing of debt in these two years. During the rest of the year, interest payments are expected to continue declining rapidly, even taking into account the costs of early repayment of debt to be exchanged. This makes it foreseeable that the rate of change of expenditure on interest payments will be in line with the figure given in the initial projection for the whole year (-1.7 %).

Wages and salaries fell somewhat, partly as a result of the decline in compensation paid to current staff following the shift of responsibility for non-university education to certain Regional (Autonomous) Governments. This decline was offset by the increase in the current transfers from the State to the same Regional (Autonomous) Governments to finance these services. Investment ran at rates well below those



given in the initial projection for the whole of the year (11.4 % compared with 31.9 %), the same being the case with goods and services (up by 10.7 % to September, the estimated increase in the projection being 20.4 %). This could mean that such expenditures will be concentrated towards the end of the year. That said, the deviation of these items of expenditure from the figures budgeted is attributable to payments made under obligations contracted in previous years. Finally, the cut in capital transfers primarily reflects the delay in the approval of the "Contrato-programa" which regulates transfers to RENFE.

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

According to balance of payments data, the current and capital accounts ran an overall deficit of EUR 99 million in the first seven months of 1999, in contrast to the surplus of EUR 4,825 million in the same period of the previous year. This outcome largely reflects the strong growth in the trade deficit during this period, stemming from the sluggishness of exports and the strength of imports, which the notable improvement in the tourism surplus was unable

to offset. As for the other items of the current account, the income deficit contracted slightly thanks to the high buoyancy of private-sector income, which has benefited from the expansion of the assets held by this sector. The current-transfers surplus, however, deteriorated, due to the increase in payments to the EU, especially under the GNP Resource, while receipts from the EU held steady at the same level as in the previous year. Meanwhile, the surplus on capital account remained at a similar level as in the same period of 1998, since the slight increase in transfers from the EU under EAGGF – Guidance was offset by the small decline in income from the Cohesion Fund and the European Regional Development Fund.

As mentioned in previous reports, the lack of sectoral accounts based on ESA 95 prevents a proper assessment of the flows of saving and investment of resident sectors. Nonetheless, the nation's borrowing requirement as reflected by these data would seem to indicate a deterioration in the sectoral balances of households and firms, as a result of the buoyancy of residential investment and the strength of private productive investment, as analysed in other sections of this Report.

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

As in the other euro-area countries, the domestic financial environment in Spain has seen a progressive increase in interest rates at all maturities. This is linked mainly to the firmer prospects of economic recovery across the euro area. Notwithstanding, Spanish financial conditions remain fairly generous, especially bearing in mind that Spain is posting higher economic growth and inflation rates than those of the euro area as a whole.

The low level of Spanish interest rates has continued to drive private-sector spending and indebtedness, to the detriment of saving. Nonetheless, retail bank lending rates have begun to rise slightly since the second quarter of 1999, in line with the increase in interest rates on financial markets. Likewise, the rising return on certain assets, mainly medium- and long-term instruments, has made them more attractive to investors, and that may have prompted greater demand for them. However, the rate of expansion of debt remains far higher than that of financial asset purchases. Indeed, the year-on-year growth of liquid financial assets held by households and firms could be running at around 5 %, while the rate of expansion of funds borrowed via bank lending and the issuance of fixed-income securities could be close to 20 %. The domestic stock markets have remained bearish, more so than most of the European equity markets. As a result, the appreciation of financial wealth held by the private sector has moderated considerably.

### 5.1. Interest rates and the financial markets

As previously mentioned, the brighter economic outlook in the euro area has, in recent months, reinforced expectations of higher interest rates. Against this background, there has been a generalised rise in interest rates on the domestic markets, as reflected by the upward shift in the yield curve over the course of the third quarter, accentuating its positive slope.

Specifically, as Table 5 shows, the yield on secondary-market 10-year bonds increased between June and September by around 70 basis points. This climb has intensified in the period to date in October, in which 10-year bond yields have risen a further 20 basis points to 5.5 %. As a result, yield levels not seen since the summer of 1997 have been regained. So far, the short-term tranche has not been so drastically affected by this sharp rise, although the yield on 6/12-month Treasury bills has risen by over 50 basis points between June and the period to date in October.

TABLE 5

## Domestic interest rates and financial markets (a)

	1998			1999			Memo- randum item: OCT 1999
	Q 2	Q 3	Q 4	Q 1	Q 2	Q 3	
<b>RETAIL BANK RATES:</b>							
Deposit synthetic rate	2.79	2.67	2.06	1.90	1.66	1.67	...
Lending synthetic rate	5.93	5.80	5.15	5.02	4.54	4.71	...
<b>TREASURY RATES:</b>							
12-month Treasury bills (b)	4.05	3.67	2.95	2.94	2.75	3.17	3.35
3-year government bonds	4.35	3.96	3.54	3.51	3.29	4.28	4.59
10-year government bonds	5.05	4.75	4.32	4.40	4.59	5.27	5.50
<b>SECONDARY MARKETS:</b>							
6/12-month Treasury bills	4.06	3.64	2.88	2.91	2.68	2.99	3.22
10-year government bonds	5.02	4.47	4.08	4.25	4.60	5.31	5.53
Yield spread over German <i>bund</i>	0.22	0.43	0.20	0.22	0.25	0.26	0.25
Commercial paper	4.30	3.82	3.21	3.09	2.89	3.19	...
Private-sector bonds	4.96	4.35	4.29	3.93	4.18	5.11	...
Madrid Stock Exchange General Index (c)	39.66	8.72	37.19	-0.12	4.22	-1.21	-2.80

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: October 19th 1999.

Yields on the primary market for debt have remained in line with those on the secondary markets. Accordingly, the Treasury began back in June to revise the rates offered at its various tenders upwards. In the case of one-year bills, the marginal rate at issue over the past four months had risen by 75 basis points to 3.5 % as of the tender on 15th October. And as to 10-year bonds, the marginal rate corresponding to the October tender stood at 5.5 %, 1.5 points above end-1998 levels.

The market for private fixed income has continued this quarter to show signs of growing buoyancy. The associated traded volume exceeded EUR 60 billion during the first nine months of the year, threefold the related figure for the same period a year earlier. Although the bulk of trading is in securitisation bonds (which account for almost 50 % of the traded volume on the AIAF market), commercial paper and bond trades have also increased most significantly. The foregoing may be due to the fact that private securities have been placed on the same footing as government debt (in the case of securities held by individuals) with regard to tax treatment; to the slowdown in the volume of government issues; and, finally, to the enhanced attractiveness of private fixed-income paper, owing to its eligibility as collateral in monetary policy operations.

Turning to the equity markets, the main development in the third quarter has once again been the high volatility of prices on the domestic stock exchanges. Specifically, the Madrid Stock Exchange, after a fleeting recovery in the second quarter of the year (a cumulative rise of 4 % was recorded), fell back during the third quarter losing all the ground it had gained over the course of the first six months. Thus, the annual cumulative return as of the end of September stood at -1.2 %, in contrast to the earnings on other European exchanges. Indeed, the Dow Jones Euro Stoxx index (broad), encompassing the main European securities, rose by 6 % over the same period. The worse performance of the Spanish stock market may be due to various factors, such as the greater sensitivity of the major Spanish firms to changes in long-term interest rates and the uncertainty surrounding developments in the Latin-American economies, where Spanish companies have very significant interests. And compounding this are the knock-on effects from international stock markets, especially the US market, given its great sensitivity to Federal Reserve decisions and to the uncertainty over the degree to which shares on the New York Stock Exchange may be overvalued.

With regard to retail bank interest rates, and as discussed at the beginning of this section, the feed-through of the latest official interest

rate cut in April was complete by the end of the second quarter, placing lending and deposit rates at historical lows. Conversely, over the past three months the progressive rise in financial market returns has begun to pass through to retail bank rates, albeit more moderately than in other European countries. Thus, for example, the synthetic retail bank lending rate was 20 basis points lower as of the close of the third quarter than the minimum level recorded in July, while for the euro area as a whole, lending rates to firms and to households for house purchases climbed by around half a point during the summer months. This lesser pass-through of the turnaround in interest rates on financial markets to Spanish retail bank rates is probably due to the fact that banking operations in Spain are more closely tied to the course of short-term than long-term rates. In any event, the coming months will likely see banks continuing to pass through the new interest-rate conditions to their lending and borrowing operations.

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

Information from the financial accounts for the second quarter of 1999 shows the trends observed in the first quarter to be firming, as is the case too for the projections made on this basis for the latest quarter. Table 6 confirms the reduction in the net financial saving of the nation, which stood at 0.7 % of GDP at the end of the second quarter (calculated in cumulative terms over the past four quarters). Essentially, lower household saving has been responsible for this reduction, while non-financial firms, like the general government sector, continue to show a decline in their borrowing needs.

In terms of the private-sector net financial position, measured as the difference between total financial assets and liabilities, the data for the second quarter are slightly down in relation to those for the first quarter (see Table 6). This is due first, to the higher growth of private-sector financial liabilities, as opposed to financial assets; and further, to the sector's flat financial wealth, in contrast to the favourable trend in the price of financial assets (especially stock market instruments) in recent years.

The information on the balance of payments for the January-July 1999 period highlights a turnaround in the financial account vis-à-vis the rest of the world, in line with the widening of the deficit on current and capital account. Table 7 reveals that while Spanish investment abroad in recent years had exceeded non-resident investment in Spain, the opposite has been the case

so far in 1999. Thus, the January-July period has seen net capital inflows totalling EUR 3,258 million, compared with net capital outflows of EUR 2,733 million in the same period a year earlier. In any event, instead of focusing on the net result of capital inflows and outflows, emphasis should be placed rather on the significant increase in financial claims on and liabilities to the external sector in recent years, which continues to be evident in 1999.

The salient development in the balance of payments financial account recently has been the expansion of foreign direct investment. In the first half of the year alone, the amount of direct investment has been threefold that of the same period in 1998. The data on direct investment in Spain in Table 7 show a moderate increase on 1998. Portfolio investment by Spanish residents abroad has increased notably in this period, mainly targeting fixed-income securities. As to portfolio investment by non-residents in Spain, the volume of capital inflows has been similar to that of 1998, although their composition has changed: whereas 60 % of such investment in 1998 was for equity purchases, in 1999 this proportion has fallen to 14 % as a result of the uncertainty surrounding domestic stock markets. On the contrary, government debt purchases by non-residents have surged in the first half of the year.

Looking at capital flows by sectors, the liability positions of general government and, especially, the credit system (with increasing resort to foreign financing) have meant there has been a net flow of inward capital over the course of the year. This highlights the fact that domestic financial saving remains insufficient to cover the private sector's sizeable purchases of foreign financial assets. In aggregate terms, the global scope of some of the biggest Spanish firms, which have purchased significant holdings in foreign companies, and the internationalisation of mutual fund portfolios are being financed by the Spanish economy to a significant degree by means of the resort by resident credit institutions to foreign interbank financing.

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

As discussed in the previous section, private-sector net financial saving has continued to fall moderately but progressively during the second quarter of the year to 1.2 % of GDP (in cumulative terms over the past four quarters). This is in response to financial liabilities growing sustainedly at a brisker pace than financial assets, and might continue during the third quarter of the year as no turnaround in this trend is per-

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	
				Q 1	Q 2	Q 3	Q 4	Q 1	Q 2
Financial saving of the nation	-2.6	0.5	1.5	1.3	1.0	1.1	0.9	0.9	0.7
Non-financial firms and households	-0.2	4.9	3.2	2.6	1.7	1.5	1.8	1.6	1.2
<i>Non-financial firms</i>	-3.9	-0.7	-0.7	-0.2	-1.1	-1.0	-1.0	-0.9	-0.5
<i>Households</i>	3.7	5.6	3.9	2.8	2.8	2.5	2.9	2.5	1.7
Credit institutions (a)	1.4	0.7	0.6	0.7	0.8	0.6	0.6	0.6	0.6
Institutional investors (b)	-0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1
General government	-3.8	-5.4	-2.5	-2.2	-1.8	-1.2	-1.7	-1.4	-1.2
	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	-19.2	-18.0	-17.7	-18.1	-19.2	-19.9	
Non-financial firms and households	39.5	47.7	52.7	59.2	68.4	77.1	86.4	85.7	
<i>Non-financial firms (c)</i>	-17.1	-16.3	-13.5	-10.9	-6.8	-4.8	-0.3	0.1	
<i>Households</i>	56.6	64.0	66.2	70.1	75.3	81.9	86.7	85.6	
Credit institutions (a) (c)	12.4	14.0	12.9	12.1	12.8	14.2	14.2	14.7	
Institutional investors (b)	-1.1	-1.2	-1.0	-0.9	-0.6	-0.6	-0.6	-0.6	
General government	-34.9	-41.9	-46.1	-50.3	-52.6	-52.0	-49.9	-48.5	

Source: Banco de España.

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

(b) Insurance companies, portfolio investment institutions and securities-dealer companies and securities agencies.

(c) Shares excluded from liabilities.

(d) Second-quarter data.

ceptible. Indeed, monthly monitoring of the subset of financial magnitudes analysed in this "Quarterly Report" (i.e. liquid financial assets and credit financing) appears to confirm the prolongation of this trend over the past three months.

The liquid component under the financial assets heading has shown a much more moderate growth rate than total financial assets as a whole have been exhibiting. In fact, as can be seen in Table 8 and Chart 22, whereas the latter expanded during the second quarter at a year-on-year rate of around 12 %, the growth of liquid assets (comprising cash, bank deposits, repos, banks securities and shares in fixed-income mutual funds) has held relatively stable at around 5 %. Cash and cash equivalents, the most liquid component of financial assets, were highly buoyant, growing by 17.5 % in the second quarter compared with a year earlier. And this rate will foreseeably have been sustained as of the end of the third quarter. Other assets with a lesser degree of liquidity, such as variable-yield and international mutual funds, equities and insurance products, continue to run at a very strong rate.

Lastly, drawing on Table 8 and Chart 22, the liabilities incurred by households and non-financial firms posted high growth rates (of close to 16 %) throughout the second quarter. The focal point of these high growth rates is mainly bank credit and financing from the issuance of fixed-income securities, which accelerated somewhat during the second quarter running at around 19 %, a rate likely be sustained in the third quarter.

### 5.3.1. Financial flows of households

During the second quarter of 1999 there was a reduction in household net financial saving. It fell to below 2 % of GDP compared, for example, with the average of 5.6 % in the 1993-1997 period. The underlying factors here are essentially related to the scant return on liquid financial assets and to the heightened volatility and risk implicit in other financial instruments, such as equities. These circumstances have encouraged households to seek out alternative investment instruments to financial assets, as is the case with real assets which are apparently more profitable and less risky. Further, the

TABLE 7

Balance of payments on financial account

EUR m

	1997	1998	JAN-JUL	
			1998	1999
<b>BALANCE ON FINANCIAL ACCOUNT</b>	<b>-2,775</b>	<b>-1,188</b>	<b>-2,733</b>	<b>3,258</b>
<b>CHANGE IN LIABILITIES VIS-À-VIS EXTERNAL SECTOR</b>	<b>34,479</b>	<b>65,681</b>	<b>53,599</b>	<b>58,586</b>
<b>Direct investment (a)</b>	<b>5,621</b>	<b>10,152</b>	<b>5,205</b>	<b>6,028</b>
<b>Portfolio investment (b)</b>	11,068	15,354	18,829	19,137
General government	9,952	4,125	7,584	10,636
Other resident sectors	1,183	8,469	6,878	5,182
Credit system	-67	2,760	4,367	3,319
<b>Other investment</b>	<b>17,790</b>	<b>40,176</b>	<b>29,565</b>	<b>33,421</b>
General government	21	866	-344	-299
Other resident sectors	544	4,319	3,472	9,385
Credit system	17,226	34,991	26,437	24,335
<b>CHANGE IN ASSETS VIS-À-VIS EXTERNAL SECTOR</b>	<b>37,255</b>	<b>66,870</b>	<b>56,332</b>	<b>55,328</b>
<b>Direct investment (a)</b>	<b>10,970</b>	<b>16,507</b>	<b>9,272</b>	<b>26,350</b>
Other resident sectors	9,844	14,756	8,100	27,291
Credit system	1,126	1,751	1,172	-941
<b>Portfolio investment (b)</b>	<b>14,377</b>	<b>40,985</b>	<b>17,254</b>	<b>36,077</b>
Other resident sectors	10,049	29,873	13,516	22,392
Credit system	4,328	11,112	3,738	13,685
<b>Other investment</b>	<b>1,555</b>	<b>21,625</b>	<b>30,504</b>	<b>11,762</b>
General government	331	388	266	54
Other resident sectors	12,392	17,668	18,359	-5,148
Credit system	-11,168	3,569	11,879	16,856
<b>Reserves</b>	<b>10,352</b>	<b>-12,248</b>	<b>-698</b>	<b>-18,861</b>

Source: Balanza de Pagos. Banco de España.

(a) Includes portfolio investment in unlisted shares.

(b) Includes direct investment in listed shares.

favourable financing conditions prevailing have led households notably to step up and sustain their indebtedness. Lastly, given low interest rates, the general incentive has been towards current spending, to the detriment of saving.

The course of household net financial saving, along with the scant contribution of the appreciation of financial assets, has led to the flattening of the growth rate of net financial worth in the first half of the year. In any event, the preliminary projections for the third quarter show a slight increase in financial assets against the background of the pick-up in returns on certain instruments.

Regarding the recent course of total financial assets (see Chart 23), year-on-year increases of around 8.7 % were seen in the first two quarters of the year. With respect to the composition of the growth of financial assets, liquid financial assets have sustained a moderate contribution, running at a steady growth rate of around 2 %. Nonetheless, the growth rate of cash and cash equivalents has quickened in the second and

third quarter of the year to 14 % compared with a year earlier, while the other liquid assets have continued to run at a negative growth rate of 6 %. Thus, the bigger increase in assets has been brought about by the high growth of those that are not considered liquid. These are mainly comprised of shares in variable-yield and international mutual funds, equities and insurance products. Overall, the course of these components might account for almost eight percentage points of the increase in total financial assets in the third quarter.

Throughout the year, households' financial liabilities have been displaying very high growth rates, in excess of 15 % (see Table 8 and Chart 23). The financing obtained through resident credit institutions, which is the main funding channel for the sector, has held at a growth rate of over 19 % since late 1998. However, drawing on the information furnished by credit institutions about the end-use of credit in the second quarter of the year, there has been a slight slowdown in the rate of advance of credit extended for house purchases and for the con-



TABLE 8

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

	Latest quarter balance (a) (b)	Four-quarter % CHANGE					
		1998			1999 (b)		
		Q 2	Q 3	Q 4	Q 1	Q 2	Q 3
<b>HOUSEHOLDS AND NON-FINANCIAL FIRMS:</b>							
<b>Total financial assets</b>	<b>1,311.7</b>	<b>15.2</b>	<b>11.8</b>	<b>14.3</b>	<b>10.8</b>	<b>11.7</b>	<b>13.9</b>
Liquid financial assets	548.6	5.4	5.1	5.4	4.3	4.6	4.7
<i>Cash and cash equivalents</i>	258.3	7.7	10.2	14.6	14.8	17.5	17.3
<i>Other liquid financial assets</i>	290.3	3.8	1.8	-1.1	-2.9	-4.7	-4.4
Other financial assets	763.1	24.8	18.0	22.6	16.2	17.5	21.6
<b>Total financial liabilities</b>	<b>879.0</b>	<b>12.7</b>	<b>12.3</b>	<b>13.1</b>	<b>14.2</b>	<b>15.9</b>	<b>16.5</b>
Bank financing plus fixed-income securities	572.2	15.4	14.8	16.2	15.6	18.7	19.7
<i>Credit from resident credit institutions</i>	453.8	16.7	15.9	15.8	14.5	16.4	16.5
Other financial liabilities	306.8	8.1	8.1	7.8	11.9	11.1	11.0
<b>HOUSEHOLDS:</b>							
<b>Total financial assets</b>	<b>832.2</b>	<b>13.6</b>	<b>9.0</b>	<b>12.9</b>	<b>8.6</b>	<b>8.8</b>	<b>11.4</b>
Liquid financial assets	449.3	4.3	4.5	3.6	2.0	1.7	1.7
<i>Cash and cash equivalents</i>	193.9	4.9	6.5	8.9	10.5	14.1	14.2
<i>Other liquid financial assets</i>	255.4	4.0	3.4	0.4	-3.1	-6.1	-6.0
Other financial assets	382.8	29.1	16.2	27.7	17.8	18.4	25.4
<b>Total financial liabilities</b>	<b>358.1</b>	<b>12.1</b>	<b>11.9</b>	<b>13.1</b>	<b>15.5</b>	<b>15.0</b>	<b>15.4</b>
Bank financing plus fixed-income securities	252.7	17.4	16.5	18.3	18.5	18.3	18.6
<i>Credit from resident credit institutions</i>	228.4	18.2	17.2	19.1	19.3	19.0	19.3
Other financial liabilities	105.5	2.2	3.1	2.7	9.1	8.0	8.4
<b>NON-FINANCIAL FIRMS:</b>							
<b>Total financial assets</b>	<b>479.5</b>	<b>18.5</b>	<b>17.4</b>	<b>17.1</b>	<b>15.1</b>	<b>17.2</b>	<b>18.5</b>
Liquid financial assets	99.2	11.2	8.6	14.8	17.0	19.7	20.7
<i>Cash and cash equivalents</i>	64.3	18.1	24.7	35.4	30.1	28.8	27.8
<i>Other liquid financial assets</i>	34.9	2.4	-9.8	-13.5	-1.6	6.5	9.6
Other financial assets	380.3	20.7	19.9	17.8	14.6	16.6	17.9
<b>Total financial liabilities</b>	<b>520.8</b>	<b>13.0</b>	<b>12.5</b>	<b>13.1</b>	<b>13.3</b>	<b>16.5</b>	<b>17.3</b>
Bank financing plus fixed-income securities	319.5	13.9	13.5	14.7	13.3	19.0	20.6
<i>Credit from resident credit institutions</i>	225.4	15.4	14.7	12.7	9.8	13.8	13.8
Other financial liabilities	201.3	11.7	11.0	10.7	13.4	12.9	12.4

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

sumption of durables (these two components are growing at annual rates of 16 % and 20 %, respectively). Logically, the lower growth of these consumer-credit components should be assessed in relative terms, since over the past four quarters they have sustained particularly high rates, with average annual increases of 23 % in the case of housing finance and 53 % in the case of consumer durables purchases.

### 5.3.2. Financial flows of non-financial firms

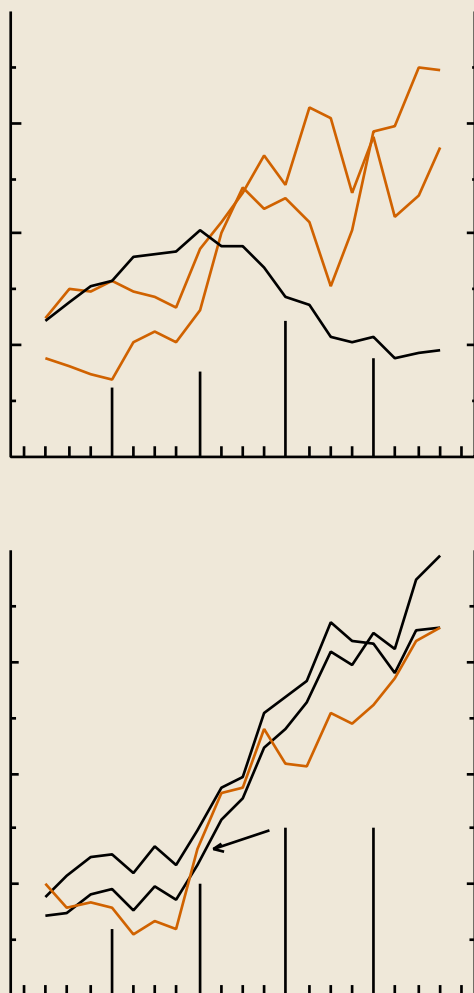
The financial position of firms during the second quarter of the year continued to show greater balance between the growth of financial

assets and liabilities. Specifically, there was during this quarter an acceleration in both retail lending operations, derived from heavy purchases of foreign assets, and in borrowing operations, probably associated with the financing of a portion of such purchases (see Chart 24). Preliminary estimates for the third quarter point to the strong, steady growth of firms' financial assets and liabilities being sustained.

The recent course of non-financial firms' financial assets has shown similar buoyancy to the preceding quarters, with year-on-year growth of total financial assets having run at 17 % in the second quarter and potentially accelerated during the July-September period.

CHART 22

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



Source: Banco de España.

- (a) The data for the third quarter of 1999 are provisional estimates.
- (b) Excluding shares.
- (c) Excluding trade credit.

The explanation for this high increase is a considerable expansion of this sector's cash and cash equivalents, which have been increasing at a rate close to 30 %, and, to a lesser extent, the advance by other liquid assets. Regarding the latter, it is claims on the rest of the world and, more specifically, portfolio investment that have been the main target of corporate financial investment over the past two quarters. In fact, the purchase of foreign shares by non-financial firms amounted to over EUR 20 billion during the second quarter. Hence, the purchase of foreign assets alone accounts for more than seven

percentage points of the year-on-year growth of this sector's total financial assets in each of the last two quarters.

In parallel with the increase in financial assets, there was also a notable rise in firms' financial liabilities during the second quarter, with a growth rate at slightly below 17 %. The related rate for the third quarter might be somewhat higher. The reason for this acceleration lies both in the resort by firms to the resident banking system and in the increase in credit obtained from non-resident credit institutions. Overall, bank financing plus fixed-income securities climbed from a rate of expansion of 13 % in the first quarter to 19 % in the second, and, extrapolating, growth in the third quarter will have followed suit.

With regard to the end-use of bank financing, the information for the second quarter highlights the notable increase in credit extended to productive activities, which has quickened significantly in all branches. Thus, financing to industry grew 19 % year-on-year in the April-June period, compared with 11 % in the first quarter. In turn, financing to the services sector (which accounts for 52 % of the total credit extended for productive activities) accelerated in the second quarter with growth in the second quarter running close to 20 %. Finally, credit to the construction sector was also more buoyant in the second quarter, with growth of 14 % year-on-year.

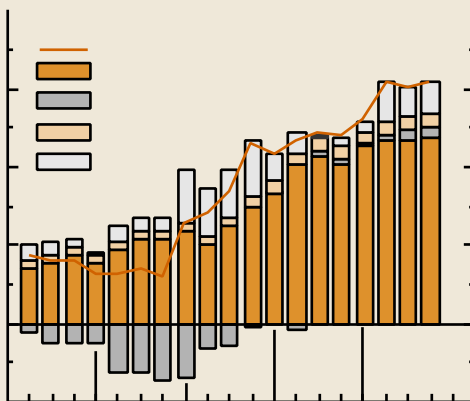
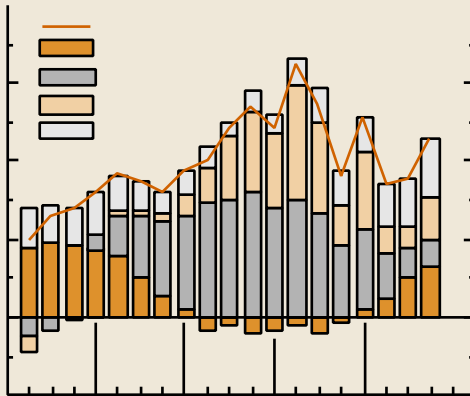
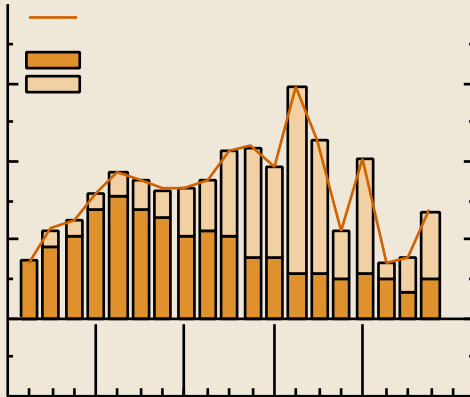
**5.4. General government financial flows**

Data on general government net borrowing for the second quarter of 1999 (for which, following the methodology used for this analysis, the cumulative figures over the last four quarters are taken) reveal a further reduction to 1.2 % of GDP, compared with 1.4 % the previous quarter and 1.7 % as of end-1998. As discussed in previous sections, this result reflects the favourable course of the general government budget during the year and the high likelihood of meeting the budget targets set at the start of the year by the end of 1999.

In line with financing requirements, financial liabilities have been on a continuous slowing course throughout 1999, with their associated growth rate running at virtually zero compared with a year earlier (see Chart 25). Nonetheless, during the period under study, the composition of the stock of financial liabilities has altered since there have been positive net issues of long-term liabilities throughout the year, while the stock of short-term instruments has diminished, thereby extending the average life of fi-

CHART 23

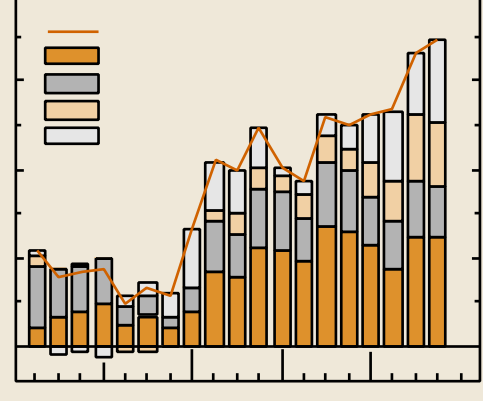
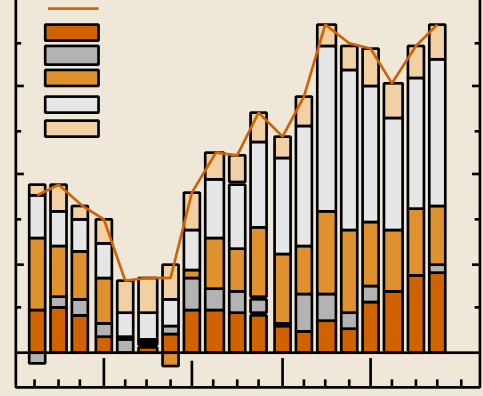
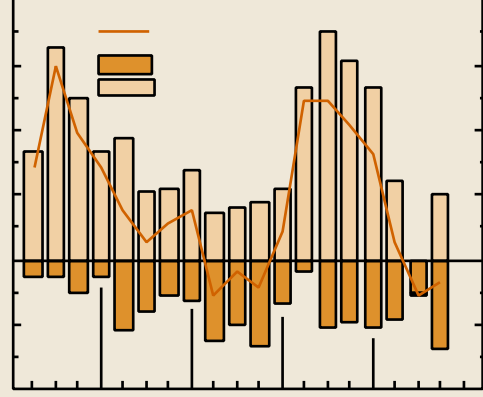
Households (a)



Source: Banco de España.  
 (a) The data for the third 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

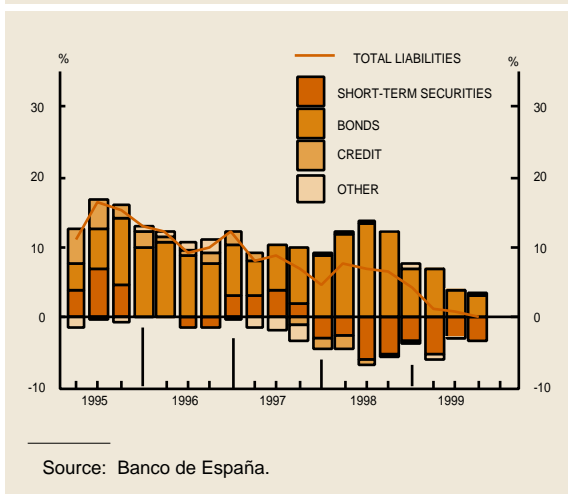
Non-financial firms (a)



Source: Banco de España.  
 (a) The data for the third 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**



financial liabilities. Currently, the average life of peseta-denominated government debt stands at 5.5 years, when at the end of 1998 it was 4.9 years.

Public securities issues to date in 1999 have amounted to EUR 7 billion. This is the result of a net issue of medium- and long-term instruments totalling EUR 18 billion and redemptions of short-term financing amounting to EUR 11 billion. The covering of financing requirements to September was ensured, especially during the third quarter, by the resort to general government deposits (especially in the Banco de España) for an amount totalling EUR 0.5 billion.

Turning to the primary markets for public securities, it is worth mentioning in connection with the July-September period that the Treasury has re-launched its early debt redemption and exchange initiatives, the aim of which is to lower the financial cost of public debt in the coming years. Nonetheless, these initiatives are expected to involve an increase in the financial charges borne during the present year, since the redemption of the liabilities with the highest interest rates and their replacement by instruments remunerated at a lower rate will be recorded as an addition to financial costs in the current year.

28.10.1999.