

BANCO DE ESPAÑA

annual report

2001

# annual report

## 2001

BANCO DE ESPAÑA

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## Abbreviations

AIAF	Association of Securities Dealers	HICP	Harmonised index of consumer prices
BE	Banco de España	ICT	Information and communications technology
BIS	Bank for International Settlements	IMF	International Monetary Fund
CNE	Spanish National Accounts	INE	National Institute of Statistics
CNMV	National Securities Market Commission	INEM	National Employment Office
CPI	Consumer price index	INVERCO	Association of Collective Investment Institutions and Pension Funds
EAGGF	European Agricultural Guidance and Guarantee Fund	LFA	Liquid financial assets
ECB	European Central Bank	LIFFE	London International Financial Futures Exchange
ECOFIN	Council of the European Communities (Economic and Financial Affairs)	MEFF	Financial Futures and Options Market
EDP	Excessive Deficit Procedure	MEFF RF	Fixed-income derivatives market
EMU	Economic and Monetary Union	MEFF RV	Equity derivatives market
EONIA	Euro overnight index average	MFIs	Monetary financial institutions
EPA	Official Spanish Labour Force Survey	MMFs	Money market funds
ESA 79	European System of Integrated Economic Accounts	MROs	Main refinancing operations
ESA 95	European System of National and Regional Accounts	NCBs	National Central Banks
ESCB	European System of Central Banks	NPISHs	Non-profit institutions serving households
EU	European Union	OECD	Organisation for Economic Co-operation and Development
EU15	The fifteen current European Union Member States	PPP	Purchasing power parity
EURIBOR	Euro Interbank Offered Rate	QNA	Quarterly National Accounts
EUROSTAT	Statistical Office of the European Communities	SCLV	Securities Clearing and Settlement Service
FIAMM	Money market funds	SDRs	Special Drawing Rights
FIM	Securities funds	TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer system
GDP	Gross domestic product	TFP	Total factor productivity
GDPmp	Gross domestic product at market prices	ULCs	Unit labour costs
GVA	Gross value added	VAT	Value added tax

Abbreviations of countries and currencies in ECB publications:			
Countries		Currencies	
BE	Belgium	} EUR	Euro
DE	Germany		
GR	Greece		
ES	Spain		
FR	France		
IE	Ireland		
IT	Italy		
LU	Luxembourg		
NL	Netherlands		
AT	Austria		
PT	Portugal		
FI	Finland		
DK	Denmark	DKK	Danish krone
SE	Sweden	SEK	Swedish krona
UK	United Kingdom	GBP	Pound sterling
JP	Japan	JPY	Japanese yen
US	United States	USD	United States dollar

In accordance with Community practice, the EU countries are listed using the alphabetical order of the country names in the national languages.

## Conventions used

M1	Notes and coins held by the public + sight deposits.
M2	M1 + deposits redeemable at notice of up to three months + deposits with an agreed maturity of up to two years.
M3	M2 + repos + shares in money market funds and money market instruments + debt securities issued with an agreed maturity of up to two years.
bn	Billions ( $10^9$ ).
m	Millions.
pp	Percentage points.
...	Not available.
—	Nil, non-existence of the event considered or insignificance of changes when expressed as rates of growth.
0.0	Less than half the final digit shown in the series.

The cut-off date for the information included in this report was 31 May 2002

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## CHAPTER I

# OVERVIEW



## **I.1. THE CULMINATION OF ECONOMIC AND MONETARY UNION**

During the year to which this Annual Report relates, developments in the Spanish economy were influenced by two unrelated events of singular importance: the culmination of Economic and Monetary Union (EMU) with the changeover to the euro, and the change in the international scenario brought about by the US slowdown and the effects of the terrorist attacks of 11th September.

During the opening months of the present year the most visible phase of the process of Monetary Union in Europe has been concluded. Euro banknotes and coins have been introduced and the cash denominated in the former national currencies of the 12 current euro-area countries has been withdrawn. The changeover, an operation of enormous logistical complexity, has been seen through at a swifter pace than envisaged by the European authorities and has been notably successful, as highlighted by the high degree of acceptance of the new money. Three years after the start of Stage Three of EMU, then, the euro is being used in all types of transactions by 300 million citizens, and it has satisfied a significant part of the expectations created with its introduction in 1999. A highly integrated economic area comparable in size to the United States and bigger than Japan has been formed in Europe, and its common currency has begun to play an increasingly important role in the international monetary system.

Above all, however, the euro area has become a region of high macroeconomic stability, underpinned by the monetary policy of the Eurosystem, and unequivocally geared to the maintenance of price stability. The benefits of EMU will continue to be seen over

time as the advantages of growing integration are harnessed, as the region's economies overcome the structural shortcomings still restraining them and as their growth possibilities firm. Nonetheless, among the immediately perceptible effects is the ability the area as a whole has shown to withstand, with fewer macroeconomic or financial disturbances than in the past, the bouts of international instability that have occurred since January 1999.

Naturally, this did not prevent the euro area, against an increasingly globalised economic background, being affected last year by the considerable deterioration in economic activity in the main industrialised countries. Despite some remaining uncertainty, this cyclical slowdown should have touched bottom in the closing months of 2001.

For the Spanish economy, participation in Monetary Union has meant the culmination of a long process aimed at establishing a regime of macroeconomic stability and it has spurred the adoption of reforms to improve the workings of its markets and institutions. The advantages of the new macroeconomic regime, accompanied by progress in economic liberalisation, have allowed Spain to grow sustainably and to create employment at a faster rate than the other countries in the area. The outcome has been steady headway in real convergence in terms of per capita income. The change in the international scenario in 2001 impacted the Spanish economy when it was still enjoying high growth, underpinned by the sound position of households and firms and by a notable improvement in public finances. Yet signs of the expansion being in its late stages had already emerged in the form of inflation differentials with the euro area, an increase in the trade deficit and greater private-sector indebtedness.

TABLE I.1

## Main indicators of the Spanish economy

	1997	1998	1999	2000	2001
REAL CONVERGENCE INDICATORS (Spain/EU) (a):					
GDP per capita (b)	79.9	81.0	82.3	83.1	83.5
<i>Apparent labour productivity</i>	93.4	92.8	92.5	91.9	91.7
<i>Employed as proportion of total population</i>	83.9	85.6	87.3	88.7	89.2
<i>Population aged 16-64 / total population</i>	101.9	102.0	101.9	101.9	102.0
DEMAND AND OUTPUT AT CONSTANT PRICES (c):					
Private consumption	3.2	4.5	4.7	4.0	2.7
Government consumption	2.9	3.7	4.2	4.0	3.1
Gross capital formation	4.8	10.3	9.0	5.0	2.9
<i>Fixed capital in equipment</i>	10.8	13.3	7.7	4.8	-2.2
<i>Fixed capital in construction</i>	2.3	8.1	9.0	6.2	5.7
Exports of goods and services	15.3	8.2	7.6	9.6	3.4
Imports of goods and services	13.2	13.3	12.8	9.8	3.7
Gross domestic product	4.0	4.3	4.1	4.1	2.8
EMPLOYMENT, WAGES, COSTS AND PRICES (c):					
Total employment	3.1	3.8	3.7	3.1	2.4
Compensation per employee	2.3	2.7	2.7	3.4	4.3
Unit labour costs	3.1	4.2	4.0	3.8	1.9
GDP deflator	2.3	2.4	2.9	3.4	3.9
Consumer price index (12-month % change)	2.0	1.4	2.9	4.0	2.7
Consumer price index (annual average)	2.0	1.8	2.3	3.4	3.6
Consumer price differential with the euro area (HICP) (d)	0.2	0.6	1.1	1.2	1.0
SAVING, INVESTMENT AND FINANCIAL BALANCE (e):					
Resident sectors: saving (f)	23.7	23.7	23.4	23.1	23.6
<i>General government (f)</i>	0.0	0.8	2.4	2.9	3.4
Resident sectors: investment	22.1	23.2	24.5	25.6	25.5
<i>General government</i>	3.2	3.3	3.5	3.3	3.5
Resident sectors: domestic					
net lending (+) or net borrowing (-)	1.6	0.5	-1.1	-2.5	-1.9
<i>General government</i>	-3.2	-2.6	-1.1	-0.3	0.0
General government gross debt	66.5	64.5	63.1	60.4	57.8
MONETARY AND FINANCIAL INDICATORS (g):					
ECB weekly intervention rate	—	—	2.7	4.0	4.3
Ten-year government bond yield	6.4	4.8	4.7	5.5	5.1
Synthetic bank lending rate	7.2	5.9	4.9	5.9	5.8
Madrid Stock Exchange General Index (DEC 1985 = 100)	556.1	817.7	894.4	994.8	853.4
Dollar/euro exchange rate (h)	1.1	1.1	1.1	0.9	0.9
Nominal effective exchange rate vis-à-vis developed countries (i)	100.7	100.4	98.7	95.8	96.3
Real effective exchange rate vis-à-vis developed countries (j)	98.7	99.9	99.2	97.3	99.3
Nominal effective exchange rate vis-à-vis euro area (i)	100.5	100.1	100.0	100.0	100.0
Real effective exchange rate vis-à-vis euro area (j)	97.9	99.6	100.5	101.9	103.7
Cash and cash equivalents	9.9	10.3	14.4	8.5	3.9
Liquid assets (k)	3.3	1.7	2.4	8.8	8.5
Households: total financing	11.7	16.5	19.1	17.5	14.2
Non-financial corporations: total financing	8.9	11.6	18.3	21.3	18.2

Sources: Instituto Nacional de Estadística, Intervención General del Estado and Banco de España.

(a) EU = 100.

(b) Calculated using series at constant 1995 prices and in EU PPPs.

(c) Rates of change.

(d) Differentials calculated using the Eurostat series with information to December 2001, before methodological changes were introduced.

(e) Levels as percentages of GDP. The saving and investment figures for 2001 are Banco de España estimates.

(f) Includes net capital transfers received.

(g) Annual average levels for interest rates and exchange rates and rates of change for financial assets and liabilities.

(h) Prior to 1999, dollar/ecu exchange rate.

(i) 1999 H1 = 100.

(j) 1999 H1 = 100. Measured with unit labour costs.

(k) Includes cash and cash equivalents, other bank liabilities and money-market funds.

The sharp turnaround in the international economic situation had an appreciable bearing on the course of the Spanish economy, with a deceleration of economic activity that tended to abate in the first few months of 2002. GDP growth in real year-on-year terms stood at 2% in 2002 Q1 (according to INE seasonally adjusted estimates), as against 3.2% at the beginning of last year. The loss of buoyancy was particularly intense in manufacturing and entailed a heavy contraction in investment in capital goods. Nonetheless, the cyclical correction has not derailed the ongoing advance in real convergence, thereby breaking with the pattern of past episodes of deceleration. This new pattern reflects the change induced in the functioning of the economy as a result of its satisfactory integration into the new economic and monetary area. It has helped disengage the mechanisms which in the past, in the absence of sufficient macroeconomic stability, tended to magnify cyclical swings, whereby periods of rapid unbalanced growth would result in sharp corrections via harsher recessions than in neighbouring countries.

Let it not be thought, however, that the changes wrought by EMU membership guarantee that recent patterns will be maintained in the medium and long term. Indeed, along with the significant structural changes accompanying monetary integration, there have been expansionary impulses of a temporary nature. Hence convergence towards the interest rate levels characteristic of an area of price stability boosted the vigour of domestic demand. The adaptation by agents to this permanent but unrepeatable change in the cost of financing was conducive to an increase in indebtedness, consistent with the new conditions. Nonetheless, once the adjustment is over and the composition of households and firms' balance sheets is as desired, spending decisions will tend to move onto a normal footing, with the disappearance of some of the factors that have been sustaining the greater relative robustness of the Spanish economy.

Following the transition, the levels of macroeconomic stability in the euro area are conducive to the sustainability of growth in the Spanish economy and eliminate many of the sources of imbalance that handicapped the continuity of buoyancy in the past. But they do not ensure on their own headway in real convergence. In the new circumstances this depends on the final determinants of the economy's competitiveness. These are tied to the rise in and

efficient use of available resources by means of increased productive capacity, the harnessing of technological innovations, the tailoring of employee skills to productive processes and the flexible functioning of the markets for goods, services and factors. Medium- and long-term challenges may arise in this field and should be addressed sufficiently in advance, since they require reforms and economic policy decisions whose implementation is not immediate and whose effects occur with considerable lags.

On the culmination of EMU, therefore, the key features of developments in the Spanish economy are being shaped by its reaction to the slowdown in the world economy and to the challenges involved in maintaining real convergence in the medium and long term, now that the transition period has been successfully concluded.

## **1.2. CYCLICAL TURNAROUND IN THE WORLD ECONOMY**

During 2001 the world economy underwent an appreciable slowdown. To differing degrees, all geographical areas were affected. The US economy dipped from growth of 4.1% in 2000 to 1.1% in 2001. Likewise, in the euro area, the increase in GDP was barely 1.5% last year compared with 3.4% in 2000. Japan was once again beset by a technical recession, concluding a cycle of 10 years in which the annual average growth of GDP did not exceed 1%.

Generally, the emerging economies posted lower growth rates than a year earlier, but higher than those of the developed economies, with China, India and Russia being notably robust. In particular, the Latin American countries were most affected by the economic slowdown in the United States and the low level of the international price of the commodities that some of the countries in the region export. The heightening of the recession in Argentina highlighted the unsustainability of the exchange rate regime in place and prompted the suspension of payments on public debt. After floating the Argentine peso early this year, the country is undergoing a phase of great uncertainty characterised by the sluggishness of economic activity, the vulnerability of the financial system, the fragility of the financial situation of households and firms, and substantial social, political and legal instability (see Box II.3). That said, and contrary to the outcome of other re-

cent bouts of instability on emerging markets, there have been scarcely any significant contagion effects in other countries, despite the seriousness of the crisis. That generally denotes the application of better economic policies and of more transparent information-disclosure practices, which has given international investors better means with which to assess the position of each individual economy, in accordance with their specific conditions.

The coincidence of the recent cyclical downturn in a large number of industrialised economies has in part been related to the strengthening in recent years of the international channels through which economic fluctuations are transmitted, thereby providing for a greater synchrony of economic cycles. Thus, although no significant increase in the degree of openness of the major countries has been detected recently, corporate interests along with household and bank portfolios are evidently more diversified across the globe. Such conditions are conducive to a greater correlation of developments in consumption and investment across the different economies.

Nonetheless, the generalised slowdown in the main economies last year was largely linked to the contractionary effects of disturbances bearing simultaneously – albeit to differing degrees of intensity – on all geographical areas. Hence, as was the case at the onset of the eighties, the buoyancy of activity has been dented by the strong growth of oil prices, which increased threefold between early 1999 and late 2000, and the subsequent adverse effect on the production costs and disposable income of agents in the oil-importing countries. Likewise, the crisis in the ICT goods and services-producing sectors has been felt throughout the world. Its effect, however, has naturally been greater in the United States and in certain northern European and south-east Asian countries, whose economies are comparatively more exposed to developments in the market for technological products. Finally, the terrorist attacks of 11th September 2001 in the United States and the subsequent military conflict sharply impacted certain industries (such as transport and insurance) which account for a significant portion of value added in the advanced economies. These events led to a generalised though transitory deterioration in investor and consumer confidence.

These successive widespread disturbances, against the background of the globalisation of finan-

cial activity, have been instrumental not only in the international synchronisation of the economic downturn but also in the similar way in which the slowdown has unfolded in different countries. Particularly telling is the fact that, in the United States and the euro area alike, the marked reduction in the growth rate of GDP from 2000 to 2001 should have been the result of the loss of momentum of investment, whereas the growth rate of consumption posted only moderate declines. The forceful slowdown in exports was offset by the loss of vigour of imports, meaning that in both areas the external sector did not contribute significantly to the decline in the growth rate of economic activity (see Chart I.1).

In step with this lesser economic buoyancy and the fall in energy commodity prices as from mid-2001, inflation tended to decline during the year in the United States and the euro area. In Europe, however, inflation fluctuated significantly as a result of the successive livestock farming crises that beleaguered the region. In any event, the moderate rise in labour costs, thanks to continuing high productivity growth in the United States and the relative containment of wage demands in Europe, contributed to the firming of favourable expectations regarding inflation over the medium term in both economies. Consumer prices have admittedly risen in the euro area in the opening months of the current year, essentially due to weather-related factors and to the increase in indirect taxes. But the inflation rate, measured by the HICP, will foreseeably stand in the near future below the reference rate of 2% adopted by the ECB for its definition of price stability as long as there is no further surge in oil prices.

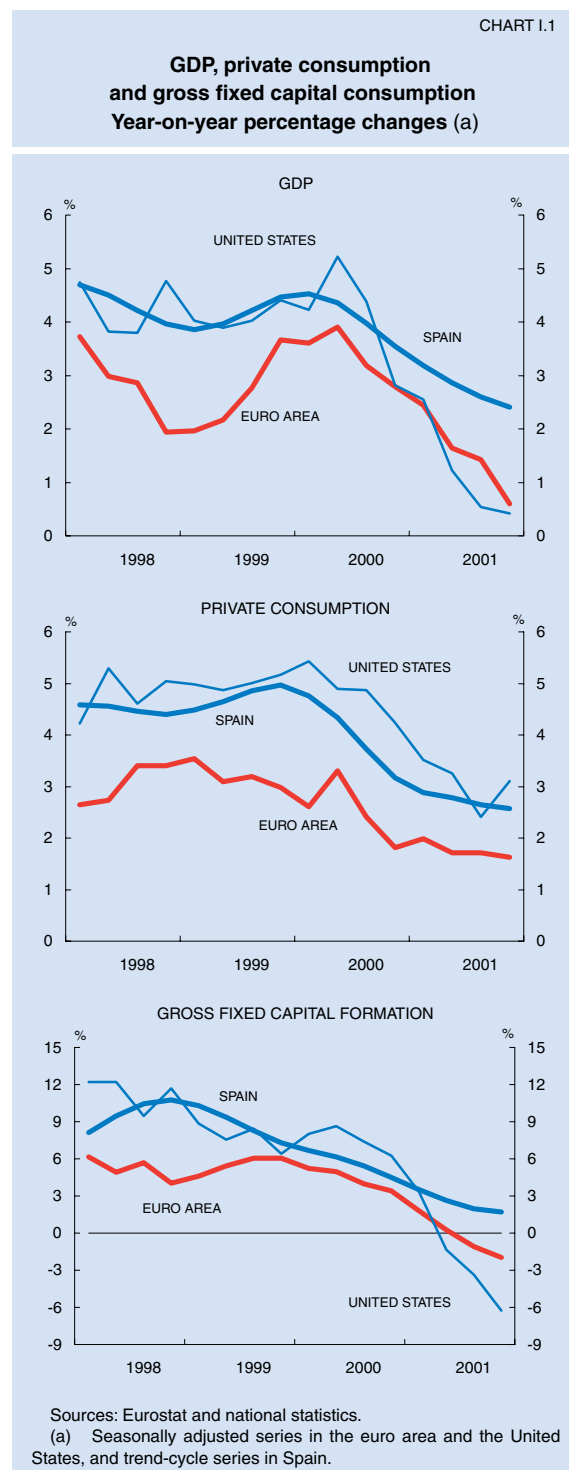
Against this backdrop of slowing economic activity and the favourable outlook for prices, monetary policies in the main industrialised economies adopted an appreciably looser stance during 2001 than the previous year. The US Federal Reserve cut its target rate by more than four percentage points. The ECB reduced the rate on its main refinancing operations by 1.5 percentage points, whereby real rates in the economies making up the euro area stood at levels close to their historical lows over recent decades. Following these adjustments, monetary conditions on both sides of the Atlantic are in place to encourage the growth of economic activity. In the euro area this is, moreover, corroborated by the high growth rate of the monetary and, to a lesser extent, credit aggregates.

Fiscal policies, too, adopted an expansionary stance in most countries. This change was particularly prominent in the United States as a result of the tax-cut packages agreed by the new administration, the aid programmes to the industries most susceptible to the crisis ensuing from the terrorist attacks of 11th September, and the subsequent increase in military spending. In the euro area, general government financial balances were adversely affected by the operation of automatic stabilisers and, in certain cases, by the adoption of expansionary discretionary measures that brought to a halt the ongoing reduction in the structural deficit of the area as a whole which had been initiated early in the nineties. In certain countries, the deterioration in public finances has jeopardised compliance with the public deficit ceilings established in the Stability and Growth Pact.

Since the close of 2001 and the onset of the current year, signs of a potential pick-up in global economic activity in 2002 Q1 have begun to firm. And the recovery may strengthen further in the coming quarters. While these favourable signs are apparent both in the US economy and in the euro area, the conditions under which both areas face the potential onset of a fresh expansionary cycle are, however different. This might affect the intensity and duration in each area of the incipient phase of more robust activity.

In this respect, the strong slowdown in the US economy in 2001 calls into question the more optimistic estimates of the effects of the new economy on the magnitude of economic fluctuations. That said, the new technologies do appear to have contributed to improving inventory management and, in this connection, to moderating the traditional amplifying impact of stockbuilding on business cycles. In any event, the maintenance of productivity growth rates far higher than those in previous cyclical downturns is consistent with the continuity of the pattern of growth, linked to innovation and technological diffusion, that prevailed in the late nineties. This pattern enabled the US economy to post notable simultaneous increases in output, employment and productivity in the closing years of the past decade in a context of moderate inflation (see Box I.1).

During 2001 some of the imbalances that had built up in the US economy during the expansion years were partially corrected. In addition to the



progressive reduction in the surplus of accumulated capital, technology-stock prices fell: in February this year the Nasdaq index was more than 60% below its end-1999 level.

Hence both the continuing buoyancy of productivity in the United States and the foreseeable peetering out of the disinvestment phase (once the installed capital stock is adjusted) might be conducive to the resumption in the near future of high growth

rates. The resumption of the expansionary cycle would initially be underpinned by a fresh period of expansion of gross capital formation. This is because it is unlikely that consumption, which grew at a year-on-year rate of 3.1% in 2001 Q4, will surge significantly, and a marked increase in US export markets in the coming months is not foreseeable.

Nonetheless, considerable uncertainty surrounds this scenario of a progressive recovery in US activity. In particular, the ongoing growth of private-sector debt in the United States, despite the slowdown in activity, might contribute to tempering agents' spending decisions. Rising indebtedness also points to the greater vulnerability of households' and firms' financial position in the face of possible unfavourable events affecting the value of their asset holdings or their income expectations (see Box I.2).

The fact the household saving ratio is at an historically low level and household debt is at levels close to 100% of gross disposable income have admittedly contributed to restricting the scale of the deceleration. But, in particular, they add a factor of uncertainty to the prospects of the US economy picking up, especially if the likely increase in the financial burden of household debt in the near future is taken into account. In fact, the downward trajectory of nominal interest rates – which are already at very low levels – may have run its course, while no significant inflationary pressures are perceptible. Consequently, the downward course of real interest rates may have already come to an end. It should further be borne in mind that, despite the correction of equity prices, stock market indices remain at high levels in relation to corporate earnings. Nor can a possible correction in real estate prices, which have recently risen sharply, be ruled out. Under these conditions, any disturbance that significantly affects household income expectations, or the value of wealth, might prompt sharp changes in consumption and investment decisions, leading in turn to a premature interruption of the upturn in activity.

As in the US economy, the outlook for recovery in the euro area depends essentially on its capacity to expand gross capital formation, following the stagnation of this variable in 2001. In principle, the generosity of monetary and financial conditions, the tailing off of the run-down in inventories, the improved outlook for the property sector in Germany (after the crisis of recent years) and the foreseeable

expansion of exports, if the pick-up in the US economy is confirmed, should all be propitious to heightening the vigour of investment in the euro area in the coming months. Indeed, the indicators relating to the opening months of the current year point in this direction.

The European economy faces this incipient recovery with somewhat sounder macro-financial fundamentals than those of the US economy. Thus, European households have a higher saving ratio (despite its decline in recent years) and lower debt (in relation to their disposable income) than their US counterparts; the current account in Europe is virtually in balance, compared with the high US deficit; and private-sector exposure to a potential equity price correction is more moderate, as a result of the lesser weight of stock market financing in corporations' liabilities and of equity instruments in household portfolios, although this weight has increased recently. That said, the marked growth of corporate debt in recent years (see Box I.2), due in part to the acquisition of third-generation telephony licences (UMTS) and the financing of mergers and acquisitions, might exert an adverse effect on companies' readiness to undertake new investment projects.

In any event, the limited duration and scope of the previous expansionary phase and the relative intensity of the subsequent slowdown might be indicative not only of the nature of the disturbances that have affected the European economy but also of some of its structural shortcomings. In 2001, then, labour productivity remained flat after growing very modestly the previous year. This was partly the result of the decline in activity and, possibly, of greater employment-generating capacity, following the reforms in certain countries in recent years. However, the scant growth of labour productivity in Europe, both in historical terms and compared with the United States, reflects – in addition to the effects of cyclical factors and changes in the intensity of use of this factor in productive processes – the European economy's difficulty in broadening and modernising its productive apparatus at a satisfactory pace (see Box I.1).

The lower productivity of the European economy has direct effects on citizens' welfare. It hampers the growth of per capita income, exacerbating the effects of the modest level and growth of the labour force on this variable. Further, it impairs the

## Economic growth and productivity in the United States, the euro area and Spain

In the nineties, the economic expansion in the United States was notable for its intensity and, above all, for its prolonged duration. The euro area embarked on this upturn in the second half of the decade, but with lower growth rates. That prompted a debate on the reasons behind the lesser dynamism of the European economy.

In the first five years of the nineties, expanding GDP in the United States was accompanied by increases in employment and productivity, in line with the usual pattern. In Europe, by contrast, comparatively lower growth was consistent with a notable rise in labour productivity, brought on largely by the abrupt employment destruction in this period, giving rise to a well-known increase in the capital/labour ratio (1).

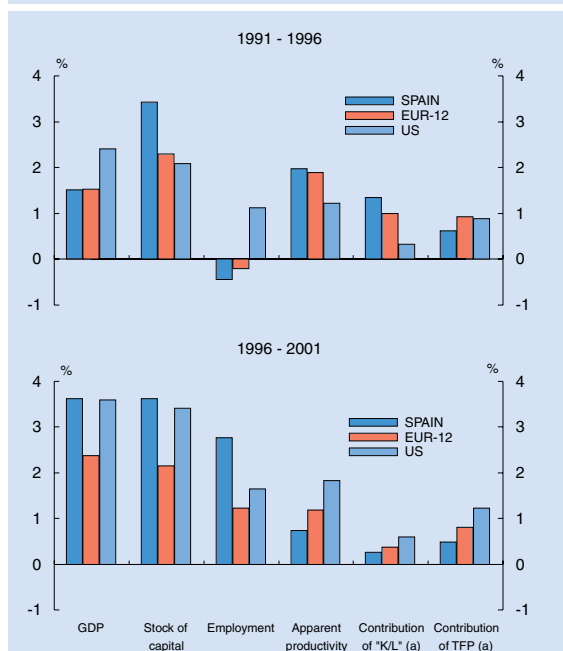
In the second half of the decade, the US economy remained resilient and also saw higher increases in productivity and employment than in the previous period. Economic activity in the euro area quickened somewhat, albeit with modest productivity growth due, in part, to the pronounced increase in employment. Above all, this expansion in employment reflects the effects of the policies pursued in recent years – with differing degrees of resolve by the Member States – to promote participation in and the flexibility of the labour market. Nonetheless, this factor is insufficient to explain why productivity is less robust in Europe than in the United States.

Under certain assumptions, apparent labour productivity (AP) may be split into the contribution of the capital/labour ratio (K/L) and that of total factor productivity (TFP) (2). The first component captures relative factor use and, therefore, directly incorporates the effects of the labour market reforms. The changes in TFP, meanwhile, are an estimation of the true productivity gains associated with technical change and with other factors bearing on the efficiency of productive processes (3). In the case of the United States, although the capital/labour ratio increased somewhat in the second half of the decade, it is the rise in TFP, due foreseeably to the introduction and spread of technological advances in IT and telecommunications, that has made for the sustained expansion of productivity and employment and, therefore, of GDP potential. In Europe, the modest contribution of the capital/labour ratio to productivity growth compared with the United States is the logical consequence of the increase in employment generation, while the absence of improvements in TFP suggest that structural difficulties hampering the efficient use of productive factors remain in place.

In recent years the Spanish economy has seen higher growth in activity than the euro area. Moreover, the employment rate has risen substantially as a result of the depth of the market reform measures undertaken in our country. However, the contribution of TFP to productivity growth has held stable over the past decade at significantly lower levels than those of the euro area, denoting the presence of structural shortcomings.

Thus, if Europe intends to raise its growth capacity, the obstacles to the innovation and dissemination of new technologies must be removed. In this respect, along with the specific measures to promote research and innovation and improve training, the conditions must be set in place for the more flexible and competitive working of product and factor markets. In Spain, this task is particularly important if a high growth rate is to be maintained and further headway in real convergence made.

**Annual average GDP growth and its main determinants**



Source: European Commission.

(a) Contribution of the capital/labour ratio and of total factor productivity to the growth of apparent productivity.

(1) The comparison of productivity between the two areas is influenced by the way in which employment is accounted for: in terms of numbers employed or of hours worked. As neither of these options is free of limitations, this box has taken the first, which poses fewer statistical problems.

(2) In accordance with the expression:

$$\Delta AP = (1 - s) \cdot \Delta(K/L) + \Delta TFP$$

where  $s$  is the labour share and  $\Delta$  denotes growth.

(3) In any case, this variable must be interpreted with caution since, being estimated residually, it reflects the combined effect of many factors, such as the effective efficiency gains associated with the diffusion and assimilation of technical progress, the characteristics of the institutional and regulatory framework, and the quality of public and private infrastructure and of human capital, as well as possible measurement errors.



economy's competitiveness and, therefore, hinders sustained job creation. In this respect, the fact the European economy has not in recent years posted significant gains in export market shares, despite the pronounced nominal and real depreciation of the euro since 1999, is a cause for concern. It thus seems logical that one of the European authorities' first priorities should be to adopt new reforms aimed at creating a framework conducive to the robust investment that fuels higher productivity in the economy. This requires changing those aspects of market workings that reduce the expected return on investment and hamper the financing of innovative projects. In this sense, the initiatives agreed at the Barcelona European Council in March are particularly timely and promising.

In particular, with the aim of promoting business activity, it has been decided to adopt by the end of 2002 a new legal framework allowing Community competition rules to be modernised. Further, the Council has reaffirmed its commitment to achieving fully integrated securities and risk capital markets by 2003 and financial services markets by 2005. The necessary action will also be taken to liberalise electricity and gas supply to companies in 2004 and, by 2005, the Member States are to have a level of electricity interconnections equivalent to at least 10% of their installed production capacity. As regards boosting technological innovation and education, the Barcelona Summit entered into specific commitments, including most notably increasing overall spending on R&D to 3% of EU GDP in the year 2010, in such a way that two-thirds of this new investment comes from the private sector.

### **1.3. THE SLOWDOWN IN THE SPANISH ECONOMY**

The annual growth rate of the Spanish economy, which was already at an advanced stage of the cycle, gradually declined last year, in step with the deterioration of the world economy. The collapse of international markets passed through to exports and the gloom overshadowing expectations bore on corporate and, to a lesser extent, consumer spending plans.

On balance, the position of the Spanish economy in 2001, following an expansion lasting over four years, remained relatively favourable, against a background in which the monetary conditions prevailing

in the euro area continued to be relatively generous for domestic requirements. Real GDP rose by 2.8% and the rate of increase of employment was 2.4% (in National Accounts equivalent jobs terms), providing for a further decline in the unemployment rate. This performance was better than that in the European Union (EU) as a whole, whereby the Spanish economy has, as earlier stated, continued to make headway in terms of real convergence with the EU Member States. Growth was basically underpinned by household spending (consumption and house purchases) and by public-sector investment in infrastructure. These variables held up throughout the year, whereas the persistent weakness of investment in capital goods and the growing loss of momentum of exports (which were nevertheless far more buoyant than imports) set the pace of the economy's deceleration. The decline in investment and exports dragged industrial activity in its wake, while construction and those services branches more related to consumption posted high growth rates.

The available data for the first few months of 2002 show, to some extent, an extension of these trends. The rate of deceleration, as already mentioned, is tending to decline, and although there are still no signs of recovery in capital investment and exports (the two key variables that will set the tone of the economy during the year), their notable loss of momentum seems to be coming to an end. This more subdued behaviour of activity has also affected the employment data and both the EPA and the homogeneous Quarterly National Accounts figures have shown a rate of job creation which, albeit positive, has moderated considerably, while unemployment has risen.

The slowdown in the Spanish economy has therefore been marked by the maintenance of positive rates of growth, job creation and real convergence. Headway has continued to be made in fiscal consolidation, to the point that budget balance has now been attained. And although the levels of indebtedness of the non-financial private sector have risen rapidly (against a background of very low interest rates), its ability to save is tending to recover. This, together with the greater saving by general government, has curbed the increase in the nation's net borrowing. As for the inflation rate, it rose above 4% in mid-2001 and fell thereafter, partly tracking the movement of oil prices on world markets as well as the prices of certain food products.



## Features and implications of private-sector indebtedness: an international comparison

In the second half of the 1990s, the debt of the non-financial private sector grew at a consistently higher rate than GDP in the United States, in the euro area and in Spain (Chart A). This higher indebtedness, which is partly the result of structural factors, may have important macroeconomic consequences as well as implications for financial stability.

All three have been simultaneously affected by the economic slowdown, yet their private-sector indebtedness has not behaved in exactly the same way. In the United States, the growth of private-sector debt seems higher than would be expected at this stage of the cycle from the experience of previous slowdowns. In the euro area, meanwhile, indebtedness has, with a certain lag, stabilised somewhat in line with its historical pattern. In Spain, however, the deceleration of indebtedness has been very muted following the high rates of growth during the upswing.

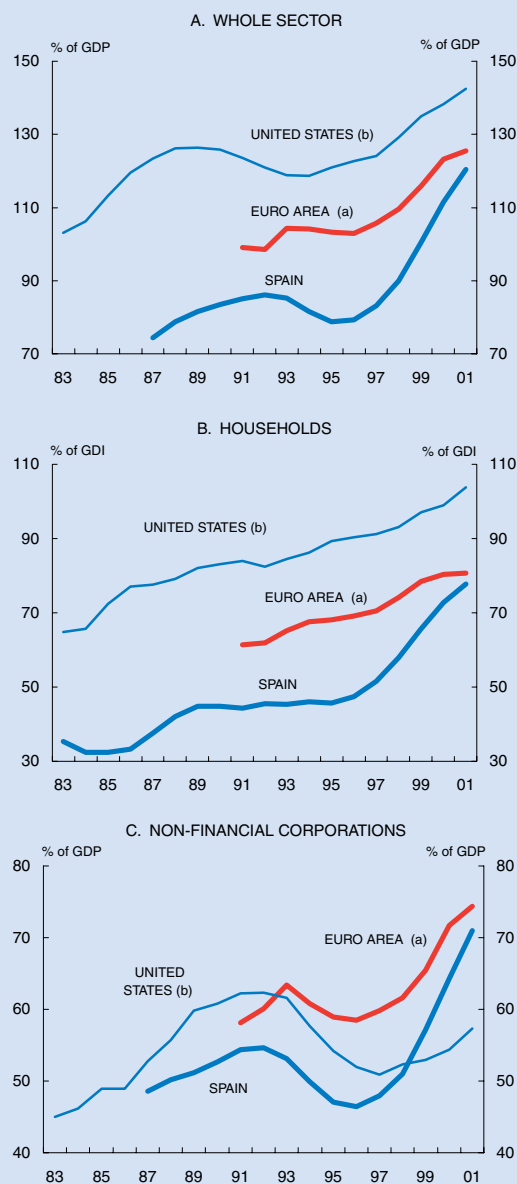
Household debt has been expanding in all three economies since the beginning of the 1980s (Chart B). In the United States, the indebtedness of this sector is significantly higher, and its growth rate in recent years has been higher than in the euro area, underpinned principally by the revaluation of real and financial wealth and expectations of high income growth. In the euro area, however, wealth plays a less important role and the growth of household debt has been lower, with a clear deceleration in 2001. Finally, in Spain, households have traditionally had a lower propensity to borrow. In recent years, however, their debt ratios have converged rapidly towards the average levels in the euro area, as a result of greater macroeconomic stability arising from participation in monetary union, which has reduced the cost of borrowing significantly, and of vigorous job-creation and the revaluation of property assets.

In the case of non-financial corporations, indebtedness (loans and fixed-income securities) has a more pronounced cyclical profile, which is similar in all three areas (Chart C). In the United States, corporations have a different financial structure and their level of debt is lower. However, although in historical terms the level of debt is not high, recent growth has been considerable and is partly explained by the phenomenon of debt-financed share buy-backs, which have been used as a way of remunerating shareholders. In the euro area, where the debt ratio of corporations is higher, recent growth in debt has been largely determined by mergers and acquisitions and by the financing of UMTS licences. In the case of Spain, the indebtedness of corporations has also displayed convergence with average euro-area levels, primarily as a consequence of their international expansion.

Accordingly, although private-sector indebtedness cannot be considered excessive in any of the three areas analysed, insofar as they are the result of changes of a structural nature, the current levels of debt have increased the financial vulnerability of the sector to any unexpected rise in the cost of refinancing, as well as to unfavourable developments that might affect income expectations or the value of investments. In this respect, the European economy seems to be in a somewhat sounder financial position than the United States economy, being less exposed to changes in financial asset prices. The viability of the strategic alliances and of the technological projects that have given rise to the increase in corporate debt is perhaps the most important element of vulnerability in the European case. In Spain, where debt ratios are still relatively low, the increasing exposure of Spanish households to changes in house prices is an element of risk.

In any case, it cannot be ruled out that the current levels of indebtedness may have some restraining effect on agents' consumption and investment decisions, which would inevitably tend to moderate the extent of the recovery that seems to have commenced in the both the US and the European economies.

### Indebtedness of the non-financial private sector



Sources: ECB and other national central banks, Eurostat, Federal Reserve and Banco de España.

(a) Information from annual Financial Accounts for 8 countries: extended with information from the ECB.

(b) Includes the sector nonfarm nonfinancial corporate business in the US financial accounts.

As will be analysed below, in the first few months of 2002 there was a fresh surge in consumer prices, which widened the inflation differential with the euro area to more than one percentage point.

By assuming the stability standards of EMU membership (in terms of lower inflation rates, low interest rates and fiscal discipline) and adding to this improvements in the workings of markets and in the flexibility of the economy, a change has been brought about to the Spanish economy's pattern of behaviour over the course of the cycle. It therefore seems the need to correct the macroeconomic and financial imbalances that usually arose during the years of expansion with adjustments entailing slippage in real convergence has been left behind (see Box I.3).

Employment growth has proven a pivotal factor for sustaining household income and enabling households to continue increasing – under favourable financial conditions – their spending on consumption and housing investment. These two basic pillars underpinned the growth of the economy last year and, in a more qualified fashion, in the opening months of 2002. Nonetheless, it is estimated that the growth of real disposable income was, on average in 2001, less than in the previous year. In addition, the losses in the value of financial wealth and the worsening of consumer expectations exerted a contractionary effect on household consumption decisions. This restricted the annual rate of growth of this variable (2.7% against 4% the preceding year, according to the INE estimate) and saw the saving ratio begin to pick up from its low levels in 2000.

The resilience of investment in housing, which has only in recent months begun to show signs of contracting, has been underpinned by the advantageous financing conditions in place. But it is also associated with the increase in the number of households and with the surge in second-home purchases, partly by non-residents. Moreover, the demand for property has grown, fuelled by the high relative return on this form of investment, in a context of low interest rates, by the ongoing rise in house prices and, more recently, by capital losses on alternative financial investments.

The forceful expansion of household spending (on consumption and on housing) has been notably favoured by the accessibility of sizeable financial resources under advantageous conditions. The strong

fall in interest rates as a result of the Spanish economy's integration into the euro area, the wealth gains built up in recent years and competition among banks have all proven conducive to the expansion of credit. Nonetheless, although household debt ratios have risen significantly, they are in line with the European average and below those in the United States. In any event, this process has substantially increased the exposure of the household sector to changes in financial and real asset prices.

The other demand components that (more modestly) helped sustain the real growth rate of the economy were government consumption and investment. The slowdown in revenue from certain taxes owing to the cyclical turnaround and the higher-than-scheduled increase in some expenditure items meant that the State and Territorial Government deficits both stood at 0.4%. In the latter case, this figure far exceeded the initial forecast. As a result, the balanced public finances attained in 2001 were possible thanks to the substantial contribution of the Social Security surplus, due to the buoyancy of hiring and employment. The growing vigour of public investment as the year unfolded played a positive role; without jeopardising the continuity of the fiscal consolidation process (see Box I.4), it contributed to sustaining activity and gross capital formation, partly countering the notable slackness of private investment in capital goods.

The slowdown in capital investment steepened during 2001. Its real rate of change for the year on average was -2.2%, with its rate of decline approaching 4% in the final quarter of the year. The prevailing climate of uncertainty across the world last year, the decline in capacity utilisation and the diminished vigour of final demand in the economy contributed to the negative behaviour of this variable.

Business investment showed signs of only moderate dynamism throughout the recent cyclical upturn compared with its habitual behaviour in previous expansions. This fact, despite the significant reduction in the growth rate of the user cost of capital (essentially as a result of lower interest rates), is a rather unsatisfactory feature of the Spanish economy in recent years, but one which the other European economies have shared in differing measures. Such behaviour, at a time of far-reaching technological changes that are transforming key areas of economic activity, tends to weaken productivity

### Employment over the latest cycle: a comparison with the previous cycle

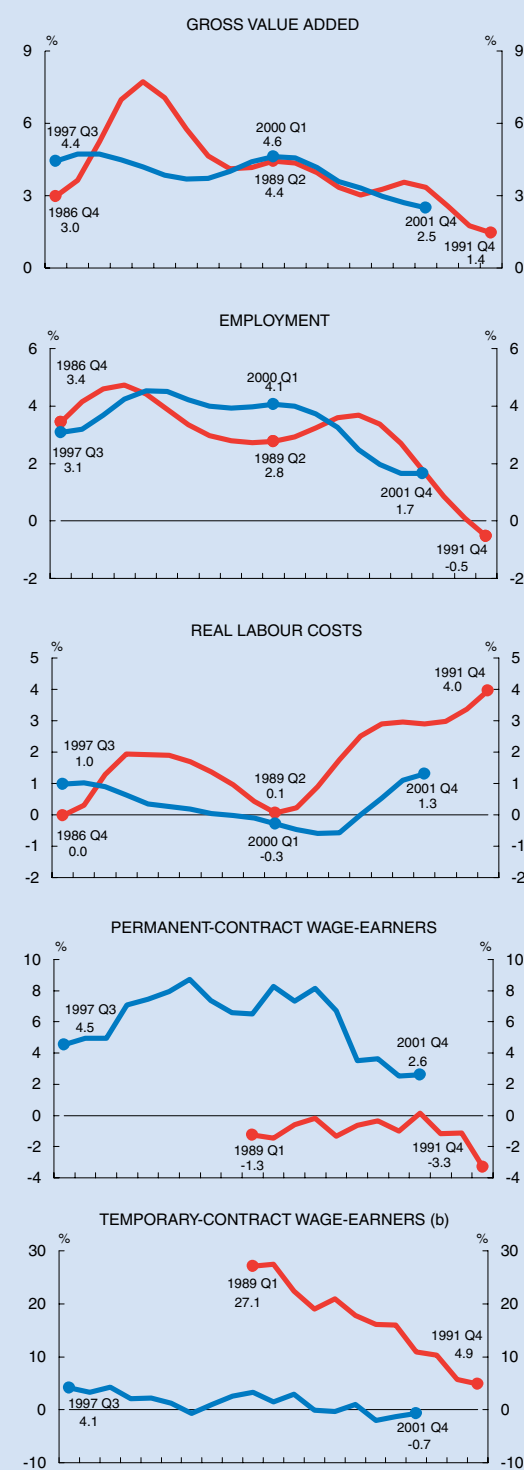
There are significant differences between the behaviour of employment in the current cycle and in that which commenced in the mid-1980s and finished well into 1993 with a drastic reduction in output and employment. It is therefore a worthwhile exercise to identify the relevant aspects of the macroeconomic environment and of the workings of the labour market that have contributed to the more favourable performance of employment in the latest cycle. The adjoining chart compares employment and activity in the market economy during the two cycles in question. The first two panels show that the expansion in the 1990s, characterised by more moderate and stable growth rates, saw relatively more vigorous job-creation than the previous one. Following the peak of the cycle, employment slowed in both cases, but in the current cycle its rate of increase has tended to stabilise, as compared with the ongoing loss of momentum in the previous downswing.

Different factors have been involved in these two performances, with the behaviour of real labour costs standing out among them. In the previous cycle, real labour costs increased at high rates (especially from 1989, against a background of rising inflation), which prevented greater job-creation and made a larger adjustment necessary when activity began to fall. In the most recent cycle, costs displayed moderate decreasing year-on-year rates of change until end-2000, against a backdrop of low inflation expectations. Although there was an upturn in real labour costs in 2001, the agreement signed by the social agents to promote wage moderation in 2002 (Acuerdo Interconfederal para la Negociación Colectiva) has tended to offset its possible adverse consequences for employment.

Certain factors relating to the labour market explain other important changes in employment. In 1984, measures were taken to stimulate temporary employment contracts, which led to an intense process of adjustment towards a much higher proportion of temporary employment. It can be seen in the chart that permanent employment was already falling at the beginning of the slowdown, while temporary employment continued to rise at very high rates, but that rates did not turn negative until the slowdown in activity intensified. By contrast, between 1997 and 2001 various measures were taken to promote permanent employment. These have led the two categories of employment to move in opposite directions. Temporary employment began to fall at the end of 2001, while permanent employment continued to rise.

This aggregate performance was the result of very different patterns in industry and market services. The case of industry is similar to that of the market economy: employment growth in the latest cycle has been more vigorous than in the previous cycle. Real labour costs have played a pivotal role in the favourable performance of industrial employment, having trended moderately in recent years. In market services, on the other hand, the pace of job creation is proving to be relatively less favourable in this cycle. The downward trend in employment began when the rate of growth of real labour costs was still negative, perhaps indicating the substitution of capital for labour in technological activities. Moreover, in 2001 there was a notable acceleration in real labour costs, which could make the slowdown even more pronounced.

#### Market economy (a)



Sources: QNA and EPA.

(a) Year-on-year rate of change.

(b) Data on temporary workers not available until 1988 Q1.

growth. And it is this variable that is posting far lower rates of increase in Europe than in the United States (see Box I.1).

The contraction of business investment may have been partly due to sizeable investment flows being diverted abroad in search of greater diversification and higher returns, given the significance and ongoing liberalisation of numerous markets offering new business opportunities. The strong increase in investment abroad since the mid-nineties has seen funds equivalent to approximately 50% of the value of capital investment channelled towards such markets in the past five years.

Broadly speaking, Spanish firms are in a relatively healthy position which, foreseeably, will allow them to increase their investment plans sustainably as the turnaround in expectations augured by the latest data takes root. The high debt levels of recent years are partly in response to the financing of investment projects abroad under most favourable conditions; indeed, the financial burden of companies is still at historically low – albeit rising – levels.

The strong decline in world trade in 2001 has had a marked influence on goods exports, the rate of increase of which slowed appreciably as the year unfolded. The deceleration was particularly acute in the second half of year when European markets were affected by the collapse of world trade, which appears to have bottomed out in the opening months of 2002. Tourism receipts held up better, despite the concerns related to the events last September, and the fall in some incoming-visitor flows was not across the board. Further, tourism prices have continued to undergo considerable rises. Although the growth rate of imports also fell notably over the year as a whole, in line with capital investment and exports, they were generally more sustained, in step with the behaviour of other demand items. In these circumstances, the contribution of net external demand to GDP growth during 2001 progressively worsened, standing at –0.3 percentage points in the final quarter.

The partial data available at present show that goods exports generally maintained their presence in the different areas last year, with no significant changes in market share in the major regions. What is in principle a favourable fact should perhaps be qualified; given the low share still characterising

Spanish export activity, continuous progress will be necessary if full growth potential is to be developed. The Spanish share in intra-Community trade scarcely exceeds 6%, approximately half the figure for Italy, while the share of real Spanish exports in overall EU imports has stabilised over the past three years at a figure slightly below 4%. This followed gains of around one percentage point in the mid-nineties, in the wake of successive depreciations of the peseta. Now that the exchange rate adjustment mechanism has been lost, such a performance requires attention be focused on the problems that may arise if current competitiveness levels are not strengthened.

On the usual indicators, the Spanish economy broadly maintains favourable levels of competitiveness against most of the industrialised countries, but persistent differences in the relative growth rate of prices and costs may ultimately erode them (see Chart I.2). In this respect, the information available shows that, in recent years, Spanish unit labour cost indices have been increasing, drawing closer to those of the main EU economies (with which we compete on markets abroad and at home). This has essentially been due to the greater increase in compensation per employee and, to a lesser extent, to less robust productivity. But regard should also be had to the growing presence on the international stage of the newly industrialised economies (some of which will become part of the EU in the coming years), many of whose products compete under very favourable cost conditions with Spanish goods.

An overall analysis of developments in costs, prices and margins reveals that the notable increase in unit costs has been generalised. Against this backdrop, the branches least exposed to competition (construction and services) were able to pass through these increases to their prices, thereby continuing to increase their unit margins. Margins in the industrial branches, meanwhile, were squeezed. Such patterns are not sustainable in the medium term, as they impair the competitiveness of Spanish goods and services and lead ultimately – in the industries most exposed to competition, as indicated above – to employment adjustments.

The duality between exposed and sheltered sectors can be seen on analysing final prices. Generally, the growth rate of industrial and export prices tends to adapt to that of competitor countries,

## Achieving budgetary stability

Achieving sound public finances has been central to the economic policy strategy pursued in recent years, in order to secure Spain's participation in Stage Three of EMU and, having achieved that goal, to ensure compliance with the Stability and Growth Pact (SGP). Fiscal adjustment has been based mainly on cuts in current spending, although (against a background of cyclical expansion) public revenue has also increased and been restructured. The interest burden, meanwhile, has fallen by more than two percentage points of GDP since 1995, as a consequence of the decline in interest rates since the end of that year and the reduction in public debt. Finally, public investment has been sustained at relatively high levels. This fiscal consolidation strategy has enabled the government to meet its commitments, so that in 2001 general government finances were in balance and public debt stood below 60% of GDP. Also, the structural budget deficit has been cut during the period to reach, last year, a level consistent with medium-term budgetary stability.

The benefits of fiscal discipline are numerous. Sound public finances, along with a monetary policy geared towards achieving appropriate inflation targets, are necessary requirements for the achievement of macroeconomic stability, and thus for establishing the conditions for sustainable economic growth. In this respect, the fiscal consolidation carried out in Spain in recent years has had a direct impact on inflation expectations and, by permitting a more balanced policy mix, has helped reduce long-term interest rates. The achievement of budgetary stability has also enabled fiscal policy to re-assume its role as a macroeconomic stabilisation mechanism. Recent experience, both in Spain and in the rest of the OECD, shows that the fiscal imbalances recorded in the past made it more difficult for fiscal policy to exert a stabilising influence and, at times, even made it necessary for pro-cyclical policies to be implemented. Fiscal consolidation, with a medium-term perspective, is in short an inescapable requirement for planning effective public investment policies to increase the economy's stock of capital and factor productivity, as well as to meet social protection commitments.

In Spain, the entry into force on 1 January 2002 of the budgetary stability laws has provided a further instrument for fiscal discipline. These laws have introduced the principle of budgetary stability, which is understood to mean that the various agents making up the Spanish public sector are obliged to keep their annual accounts in balance or surplus. The application of this principle is particularly important in the case of the regional (autonomous) governments, given the significant spending and revenue responsibilities they have assumed and their delay in undertaking lasting correction of fiscal imbalances.

Maintaining budgetary stability will, however, require further reform of the Spanish public sector. In this respect, the new budget law announced for the first half of 2002 should help reform budgetary procedures so as to improve the control, transparency and efficiency of public expenditure. In addition, the sustainability of public finances needs to be secured in the medium term when population ageing, which will basically affect spending on pensions and health, becomes more acute. Finally, it is necessary to press ahead with the development of strategies for public spending and revenue that improve the Spanish economy's growth fundamentals.

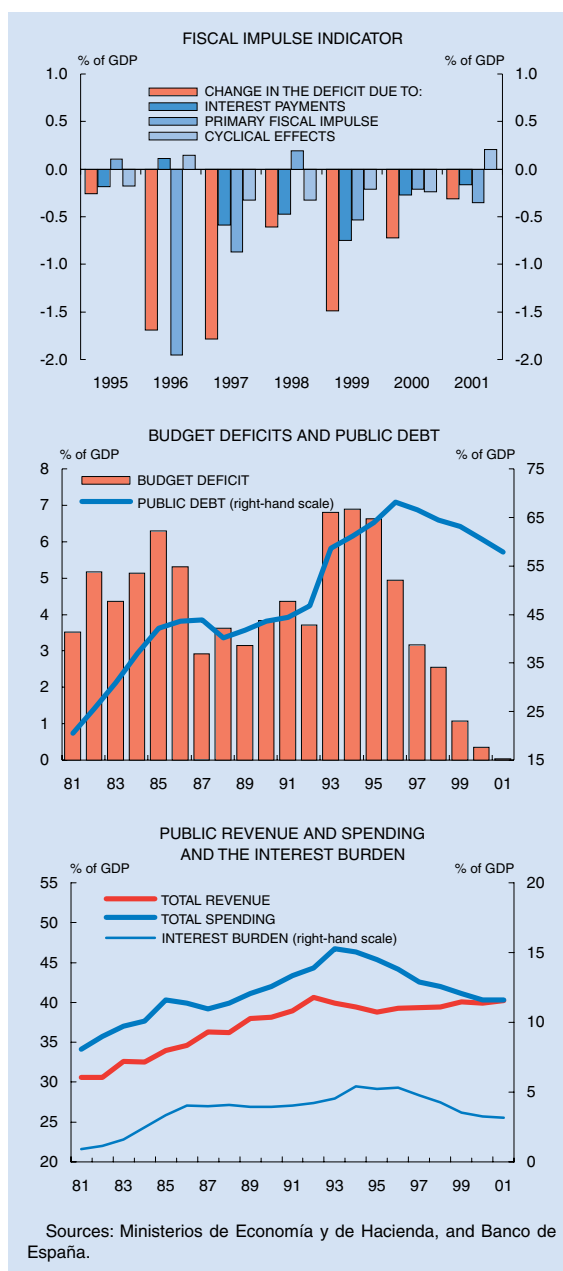
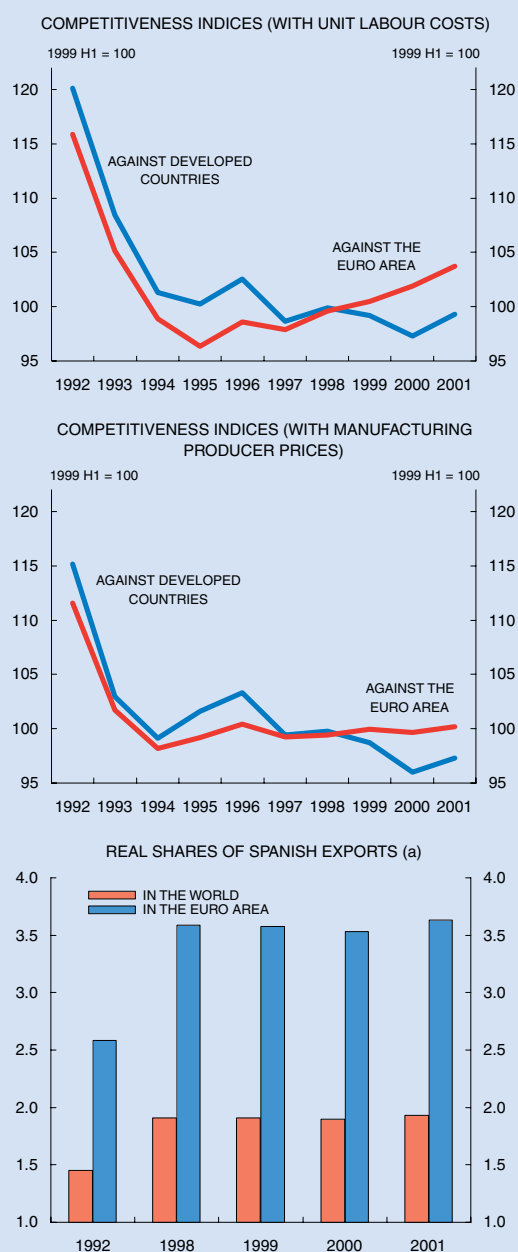


CHART I.2

**Competitiveness indices and export shares**

Sources: INE, ECB, OECD, IMF and Banco de España.

(a) Spanish export shares in world and EU imports, in constant 1995 dollars.

while consumer prices retain a positive differential, which is particularly persistent in services.

It has already been mentioned that the rate of increase of the consumer price index (CPI) moderated appreciably in the second half of 2001, although the prices of non-energy industrial goods and services held at relatively high rates of increase. At the beginning of 2002 a new method of compiling the CPI was introduced, which will enable the

Spanish economy's inflation rate to be measured more accurately, correcting numerous biases which, in most cases, had led to overestimation. The inclusion in the new system of calculation of the sales prices of numerous products involves an important change in the seasonal pattern of the index, which initially hampers the interpretation of the changes observed in some of its components. In any event, in the year to date there has been an acceleration in the rate of change of consumer prices, which has widened the differential with that of the euro area. Part of this upward movement seems to be related to the launch of euro banknotes and coins, since the lack of familiarity with the new unit of account has been conducive to rounding in certain sectors of the economy. Although this effect is, by its very nature, temporary and should not be incorporated into agents' inflation expectations, the widening of the inflation differential with the euro area amounts to a warning of the persistence of certain inflationary biases in the economy, which should be eradicated through improvements in market efficiency and competition.

#### I.4. THE MEDIUM- AND LONG-TERM CHALLENGES FOR THE SPANISH ECONOMY

The Spanish economy's growth prospects in the short and medium term are favourable. They are largely rooted in the benefits stemming from the macroeconomic stability offered by membership of the euro area. Forecasts point to a resumption of dynamism during 2002, with the economy gradually picking up to growth rates close to those of potential output. That said, the influence of other factors which temporarily exerted a positive influence on national demand during the initial stages of EMU will progressively dwindle. However, to ensure in the long run that the Spanish economy continues to grow at higher rates than those posted by the core EU countries and that it obtains all the potential benefits that participation in a monetary union may offer, prices and costs must be prevented from systematically outgrowing those of their European partners. The persistence of any such gap would worsen Spain's competitive position internationally and jeopardise the possibilities of growth fulfilling its potential. Economic policies should thus strengthen their long-term perspective and act chiefly on the supply side of the economy in order to boost productivity growth.

Throughout the latest cyclical upturn, competitiveness has been influenced by the low growth of productivity. However, productivity is a difficult variable to measure and furnishes insufficient information on technical progress and gains in efficiency. Accordingly, it is worth distinguishing between the influence of primary productive resources (and, in particular, the capital/labour mix) and that of other factors (technological and non-technological alike) which have a bearing on how innovations and technical progress are incorporated and, ultimately, on the economy's degree of efficiency. The contribution of these latter factors to growth can usually be approximated through total factor productivity, although the interpretation thereof is not free from difficulty.

The moderate productivity growth observed in the Spanish economy in recent years is the outcome of a job-creation-intensive pattern of growth which should be maintained so as to continue reducing the gap in terms of economic welfare with the more advanced EU countries. However, the similarly weak growth of total factor productivity points to potential shortcomings in the technology incorporated which may restrict long-term growth capacity.

This behaviour has come about, moreover, in a setting in which significant technological advances have been made in the information and communications sectors, requiring a considerable modernisation drive by the most advanced economies. In Spain, the use of capital goods related to the new technologies has also increased recently but still accounts for only a small portion of the total capital stock. However, their contribution to the growth of productivity in the economy as a whole has been significant, although it has not been able to offset the low contribution of other productive capital.

The differing performance of prices and costs in Spain and the EU countries and the inertia of underlying inflation indicate that, despite the reforms undertaken, certain markets for goods, services and productive factors exhibit inefficiencies as a result of an insufficient degree of competition. The persistence of these inflationary biases might undermine growth potential not only through the distortions to income and price formation processes but also because the lack of a competitive environment has a discouraging effect on innovation.

The assimilation of innovation is a fundamental determinant of long-term productivity growth. Its effects depend not only on the influence exerted on the new-technology-intensive productive branches but also, largely, on the capacity of business to incorporate advances in knowledge, to absorb technical progress and to adapt productive processes, human resource management and corporate strategies.

Technological dynamism in the Spanish economy resides mainly on the incorporation of innovations generated mostly abroad and on the dissemination of their effects to the whole of a productive structure specialising relatively in low-technology activities. Under these conditions, a flexible and competitive environment is of particular importance to promote the incorporation of technological advances through investment in fixed capital, the imparting of skills to and ongoing training of employees and the reorganisation of business activities.

Bolstering domestic innovation is also important for increasing the capacity to assimilate new technologies. This requires an institutional framework properly combining business incentives for investment in research and development with an efficient channeling of the public funds earmarked for this area (the level of which still clearly lags that in the EU) to projects in which Spanish researchers have proven their potential worth on the international stage.

To obtain the long-term benefits of the new regime of macroeconomic stability and prevent losses in competitiveness arising, the liberalising reforms undertaken in several areas and industries in the economy must be furthered. Of particular importance are the reforms relating to the labour market, the market for land, services and, in particular, the network industries. The labour market has already seen numerous reforms which, ultimately, have contributed to increasing its capacity to generate employment and – modestly – to reducing the degree of duality. The reforms have, at the same time, provided for wage moderation. Significantly, however, the ratio of temporary to permanent employees remains high, higher in any event than the thresholds deemed compatible with the efficient working of the economy, since an excessive turnover in temporary workers is an obstacle to them gaining skills and to business productivity. The reforms should remain geared to improving the mix of flexi-

bility and stable working conditions, with the aim of extending access to new forms of stable hiring and narrowing the gap between the average severance costs for permanent and temporary employment contracts.

Significant headway has also been made in reducing unemployment, long-term unemployment in particular. However, the unemployment rate in certain groups (the lesser-skilled, mainly, and workers aged over 45 whose skills have become obsolete) remains high. Consequently, work must continue to incorporate these groups into the labour market. To resolve the mismatch between the skills offered by these workers and those required by potential employers, investment in training should be increased. At the same time, it should be identified to what extent the set of incentives resulting from the interaction of unemployment benefits and redundancy payments may discourage the unemployed from accepting new jobs. Further, priority should be given to training the unemployed and firming their readiness to re-join the labour market. Lastly, there is clearly room to further increase female participation rates, which are still very low compared with the core EU countries, and the same holds for older people. Accordingly, the institutional and economic determinants underlying the decision to participate in the labour market, particularly current early retirement arrangements and the means of partial access to the job market, should be revised.

The reform in recent years of the collective bargaining system has been on a lesser scale and its achievements, therefore, are more modest. Indeed, the signing of the Inter-confederal Pact for Collective Bargaining by employers and trade unions last December may be conducive to wage moderation in the agreements negotiated this year. But it does not eliminate the need to reform collective bargaining, which remains notably centralised. The system in place gives rise to high uniformity of wage settlements, which are barely related to the specific positions of companies and particularly penalise small and medium-sized firms. The reform should thus be aimed at a greater decentralisation of collective bargaining, allowing aspects such as wage conditions or the length of the working day to take firms' positions and employee characteristics into account.

The market for land is also an essential determinant of the overall workings of the economy. This is

because the prices of property assets and rental payments play a part in price and cost formation processes (with a greater impact on certain tertiary activities) and have a bearing on a crucial aspect for the labour market, namely the degree of regional mobility. Despite the fact the market for land use has undergone some reform in recent years, the present regulations remain insufficient since they limit available supply and, ultimately, exert upward pressure on prices and rentals. The need to reduce this inflationary bias and eliminate the distortions bearing directly on regional mobility advise pushing through a reform of the regulations in the sector, although to do this it will be necessary to revise in parallel the financing mechanisms of the local tax authorities.

The importance of speeding liberalising policies in the network industries lies in the fact that these activities supply basic inputs to the other productive sectors and provide a channel for a large portion of technological advances, which gives them great strategic importance. Consequently, changes in the competitive environment in which they operate give rise to far-reaching synergies allowing for the spread of gains in efficiency and cost cuts to the rest of the economy. The liberalisation of these industries in Spain has already (to differing degrees, depending on the stage at which liberalisation is in each industry) increased the number of competitors, improved the services on offer, widened consumer choice and, ultimately, reduced prices. There is still room, however, for further headway here.

The opening up of the telephony market has resulted in a larger number of operators (although the former incumbent retains its dominant position in all market segments) and an across-the-board decline in the prices of various services. Notwithstanding, the average cost of fixed telephony is still higher in Spain than on average in the EU and competition in the final network segment is advancing slowly, owing to the difficulties the new operators still face in gaining access to the subscriber loop. Mobile telephony has also seen positive developments. These are manifest in a notable increase in the degree of penetration and in a fall in prices. As in other European countries, the launch of UMTS technology has, however, been delayed, and the granting of new licences is not envisaged for the moment, a factor that may stifle competition in the industry.



In the electricity industry, rates have fallen continuously since 1997 (a sharper fall than in the EU on average) and last year there was a relatively significant increase in the number of consumers freely negotiating prices. Nonetheless, the industry remains highly concentrated, in both the production and distribution and marketing segments, and the vertical integration of the various activities is still significant. Lastly, in the gas industry, the actual degree of competition has continued increasing, albeit more slowly, since the measures approved in June 2000 have been progressively adopted with some delay, with some still to be applied.

In sum, reform in the network industries is already bearing fruit. In the future, the liberalising policy in these industries should be steered by how the actual degree of competition evolves. That will not depend solely on the increase in the number of operators; sufficiently competitive conditions of entry for new operators must also be ensured. In the energy sector, an assessment must be made of the levels of concentration in production and in distribution in response to the regulatory changes made in recent years. In telecommunications, efforts should be directed chiefly at improving competition in the final segment of the network and at speeding through the liberalisation of all factors that provide for the swift spread of the new information and communications technologies. Liberalisation in the network industries will unfold more fluidly the more transparent and stable the related regulatory framework is.

The ongoing liberalising drive required by the Spanish economy to enhance its competitive position is all the more important in the light of the fall in and ageing of the population that will more than likely take place in the medium term if the demographic patterns of recent years – marked by a sustained decline in the birth rate over the past 25 years and a continuous rise in life expectancy – do not change drastically. These developments have made for a slowdown in the growth rate of the Spanish population and a far-reaching change in the population structure, as shown by the current shape of the population pyramid (see Chart I.3). That said, the birth rate has picked up somewhat recently and there has been a sharp increase in the number of immigrants which has eased the slowdown in the growth rate of the population. The foregoing trends, which most of the EU countries share, point to a decline in the proportion of the



population of working age and to a continuous increase in that accounted for by the over-65s. That will ultimately see an increase in the dependency ratio which will be lagging to some extent what may happen in Europe but, from a given time, will be on a greater scale. These population trends might have considerable effects on numerous areas of economic life, in particular on the potential growth of labour supply and productivity and on public-sector saving patterns (which will be highly influenced by

changes in spending on pensions, health and care for the aged). If measures to tackle the problems that may build up over time are not addressed sufficiently in advance, there is a risk that the Spanish economy's growth potential may decline in the long run.

Naturally, maintaining a labour market that offers incentives for inactivity or that makes for low use of available resources will amplify the effects of

ageing on labour supply. The longer the required changes to the current arrangements governing social insurance systems and the drive to rationalise healthcare and lower social spending are left, the greater the pressures on public finances will be. In this context, the economic policy measures needed to limit the impact of ageing are fully consistent with those required to improve the workings of the labour market and to boost productivity growth.

## CHAPTER II

# THE EXTERNAL ENVIRONMENT OF THE EURO AREA

## II.1. OVERVIEW

In 2001, world GDP grew by 2.5%, compared with 4.7% the previous year. The fall in the rate of growth, which had begun in 2000, took the form of a progressive economic slowdown in the three main areas, namely the United States, the European Union and Japan. This coincidence of downturns in all three areas had not occurred since the 1970s (see Table II.1) and would seem to be evidence, on one hand, of the commercial and financial interdependence of the different economies and, on the other, of the existence of a number of common shocks, such as the crisis in the technology- and IT-related sectors, the rise in oil prices in 1999 and 2000 and, subsequently, the terrorist attacks of 11 September 2001, which appreciably raised uncertainty at the world level. Meanwhile, the emerging economies as a whole were adversely affected by the decline in the rate of activity in the main developed economies (see Chart II.1 and Table II.2). In the latter months of 2001 and the opening months of 2002 the signs of imminent recovery in the US economy were becoming stronger and it is expected that during the year this recovery will extend, to a greater or lesser extent, to other areas.

A particularly notable phenomenon last year was the small reduction in world trade (1.5%), in marked contrast to its 12.4% growth the previous year. It is normal for world trade to have a very pronounced cyclical pattern, especially when the cycles of the main economies are highly synchronised, or when a large number of countries are undergoing slowdowns or recessions, as can be seen in Chart II.2. That said, one has to go back to 1974 to find such a sharp change in trade growth rates as that seen in 2001.

The fact that world output growth was skewed last year towards large and relatively closed emerg-

ing economies (such as China, India and Russia) may also help to explain how a given increase in output has been achieved with a smaller expansion of trade. Additional factors that help to explain the singular sluggishness of world trade include: the difficulties besetting certain trade integration processes, such as Mercosur; the World Trade Organisation's lack of headway in opening up certain markets with a very high growth potential (such as agriculture and textiles); the increase in trade-related insurance costs in the wake of the attacks of 11 September, and the decline in flows of financing to the most export oriented emerging markets. On top of all this there was the crisis in the technological sector and, in particular, in semiconductors. This industry had sustained a high level of buoyancy in previous years, but in 2001 its output, highly concentrated among a few countries, fell by 33% in terms of export volume, after growing at annual average rates of 12% during the 1990s.

The global economic slowdown was accompanied by a general reduction in inflationary pressures, while the deflationary situation in Japan persisted. However, underlying inflation tended to be higher than headline rates, which is explained by the downward trend in commodity prices and by the sharp fall in oil prices in 2001, which meant that by the end of the year they stood almost 60% below their peak in 2000. Nonetheless, approximately half of this fall was cancelled out during the first few months of the current year (see Chart II.3), so that oil prices represent a risk factor for the incipient world recovery

Consistent with the absence of inflationary pressures and with the cyclical downturn, the economic policies of the industrialised countries and of many emerging countries tended to become, to a greater or lesser extent, more expansionary, especially in the United States. The monetary authorities re-

TABLE II.1

## Main macroeconomic indicators of the United States, Japan and the United Kingdom

	1997	1998	1999	2000	2001	2001			
						Q1	Q2	Q3	Q4
UNITED STATES:									
GDP (a)	4.4	4.3	4.1	4.1	1.2	2.5	1.2	0.5	0.5
Private consumption (a)	3.6	4.8	5.0	4.8	3.1	3.5	3.2	2.4	3.1
Private investment (a)	9.6	11.4	7.8	7.6	-2.0	3.4	-1.3	-3.4	-6.4
External demand (b)	-0.3	-1.3	-1.1	-0.9	-0.1	-0.4	-0.2	0.0	0.0
General government financial balance (c)	-1.3	-0.1	0.6	1.5	0.1				
CPI (a)	2.3	1.6	2.2	3.4	2.8	3.4	3.4	2.7	1.9
Current-account balance (c)	-1.7	-2.5	-3.5	-4.5	-4.1	-4.4	-4.2	-3.9	-3.9
Unemployment rate (d)	4.9	4.5	4.2	4.0	4.8	4.2	4.5	4.8	5.6
JAPAN:									
GDP (a)	0.2	-1.0	0.7	2.2	-0.4	1.4	-0.6	-0.5	-1.9
Consumption (a)	-0.2	0.6	1.9	1.3	1.1	2.1	0.7	0.3	1.4
Gross fixed capital formation (a)	-1.1	-4.2	-0.7	3.2	-1.7	1.4	-0.9	0.9	-8.3
External demand (b)	1.0	0.3	-0.1	0.5	-0.7	-0.5	-0.9	-0.8	-0.5
General government financial balance (c)	-3.7	-5.6	-7.6	-8.5	-8.5				
CPI (a)	1.7	0.6	-0.3	-0.7	-0.7	-0.4	-0.7	-0.8	-1.0
Current-account balance (c)	2.2	3.0	2.5	2.5	2.1	2.7	2.3	2.7	3.1
Unemployment rate (d)	3.4	4.1	4.7	4.7	5.0	4.7	4.9	5.1	5.4
UNITED KINGDOM:									
GDP (a)	3.4	3.0	2.1	3.0	2.2	2.9	2.4	2.0	1.6
Consumption (a)	3.0	3.2	3.9	3.9	3.7	3.7	3.6	3.5	3.9
Gross fixed capital formation (a)	7.1	13.2	0.9	3.9	0.1	4.0	1.9	-1.0	-4.0
External demand (b)	-0.5	-2.2	-1.4	-0.7	-0.8	-1.2	-0.8	-0.4	-0.6
General government financial balance (c) (e)	-1.5	0.3	1.5	2.0	0.4				
CPI (a)	3.1	3.4	1.6	4.4	1.8	2.5	1.9	1.8	1.0
Current-account balance (c)	-0.2	-0.6	-2.1	-1.8	-1.8	-0.9	-2.1	-1.0	-3.0
Unemployment rate (d)	7.3	6.4	6.0	5.5	5.1	5.1	5.0	5.1	5.2

Sources: IMF and national statistics.

(a) Annual rate. For the CPI, average annual percentage change.

(b) Contribution to the increase in GDP.

(c) Percentage of GDP.

(d) Percentage of labour force. Average for each period.

(e) Excluding proceeds from sale of mobile telephone licences.

duced interest rates substantially and the stance of fiscal policies became more accommodating. In Japan, however, the authorities were severely constrained by the lack of any additional leeway to pursue expansionary fiscal or monetary policies.

In this global setting there was some correction last year of the external imbalances of the three major blocks, although whether it will continue is uncertain. In the United States the current account deficit narrowed from 4.5% of GDP in 2000 to 4.1%, basically due to the sharp slowdown in do-

mestic demand, although its effects were limited by the strength of the dollar. In Japan the surplus was reduced from 2.5% to 2.1% of GDP, while in the EU the balance swung from -0.4% to 0.5%. Finally, the decline in the imports of the developed countries was reflected in a worsening external position for the rest of the world, especially in those countries most dependent on external demand (such as south-east Asia) or on commodities exports.

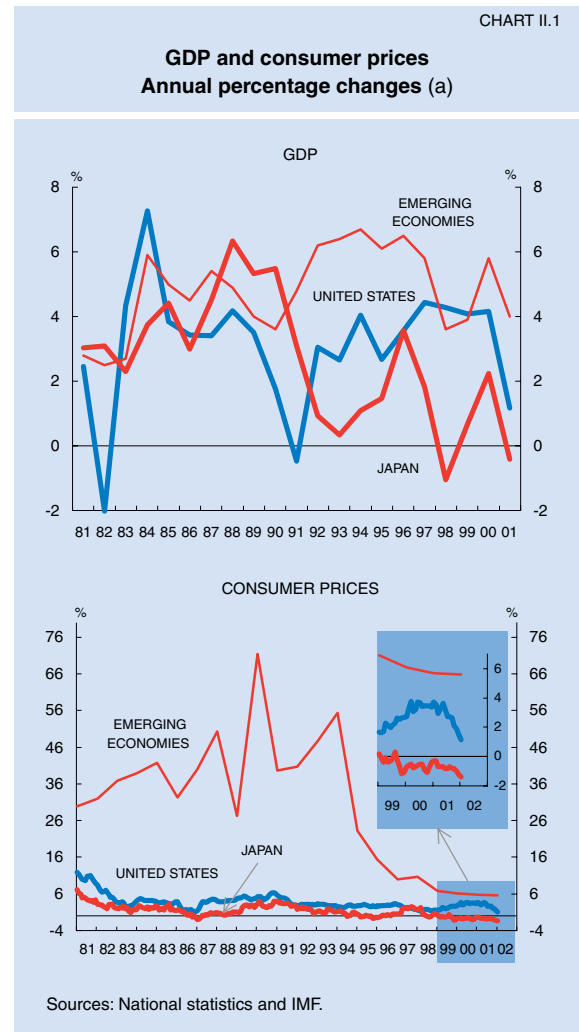
As regards exchange rate developments, the sustained strength of the dollar and, in the final part

of the year, the depreciation of the yen (see Chart II.4) were notable. The movement of the yen is consistent with the weak fundamentals of its economy, although its course may also have been somewhat influenced by the strategies of the Japanese authorities. As regards the strength of the dollar against the euro, its persistence over diverse cyclical conditions, including a shock as severe as the attacks of 11 September, is notable. Meanwhile, the exchange rates of the emerging economies held relatively steady, the most notable exceptions being Turkey, South Africa and certain Latin-American countries. South-east Asian currencies appreciated in effective terms, basically as a result of the weakness of the yen in the latter part of the year.

International financial developments were dominated by a continuation of the tendency for share prices to fall during most of the year and by the relative stability of long-term interest rates. The fall in stock markets, in step with the weak general economic situation and the negative performance of earnings, was exacerbated by the September attacks. This situation was subsequently reversed, the upward trend continuing into the first few months of the present year, given the prospects for economic recovery. As in 2000, technology share prices fell furthest, although their divergence from the general indices was less pronounced than in the previous year. Emerging equity markets followed a similar course to those of the developed economies, with a clear downward trend during the first three quarters of the year (except in Russia and China) followed by a recovery in Q4, which was generally stronger than that seen on the markets of the more developed countries.

Yield curves in the developed countries tended to steepen significantly as a result of the large reduction in short-term interest rates. Long-term rates held relatively steady, with a slight downward trend over the year as a whole which was, however, practically cancelled out during the latter months of 2001 and the early months of 2002. The latest trends generally seem to incorporate the prospects for economic recovery and, in the case of the United States, a certain deterioration in the fiscal position. In Japan, the low long-term interest rates remained notably steady in 2001, albeit displaying a slight upward trend.

Risk premiums on private fixed-income markets in the more developed countries, which had been



rising in previous years, showed signs of a certain downturn in the first half of 2001. The attacks of 11 September led to a significant increase in these risk premiums, the worse credit ratings showing the largest increases. However, this increase was cancelled out during the latter months of 2001 and first few months of 2002 (see Chart II.5).

Most noteworthy on the emerging financial markets was the scant contagion caused by the Turkish and Argentine crisis, in marked contrast to previous crises, such as the south-east Asian one in 1997 and the Russian one in 1998. This can largely be explained by improvements in diverse areas introduced as a result of recent crises, such as the increase in transparency, improved access to information and more successful risk management by financial-market participants (who seem increasingly capable of discriminating better between some emerging markets and others). The lower weight of hedge funds in global financial markets and the anticipation of the effects of the Argentine crisis

TABLE II.2

## Emerging markets: main macroeconomic indicators

	1995	1996	1997	1998	1999	2000	2001
GDP (a):							
Asia							
South Korea	8.9	6.7	5.0	-6.7	10.9	9.3	3.0
China	10.5	9.6	8.8	7.8	7.1	8.0	7.3
India	7.6	7.5	5.0	5.8	6.7	5.4	4.3
Thailand	8.8	5.5	-0.4	-10.2	3.3	4.6	1.8
Indonesia	8.2	7.8	4.7	-13.1	0.8	4.8	3.3
Malaysia	9.8	10.0	7.3	-7.4	5.8	8.3	0.4
EU accession candidates							
Hungary	1.5	1.3	4.6	4.9	4.5	5.2	3.8
Poland	7.0	6.0	6.8	4.8	4.1	4.1	1.1
Czech Republic	5.9	4.3	-0.8	-1.2	-0.4	2.9	3.6
Romania	7.1	3.9	-6.1	-4.8	-2.3	1.8	5.3
Russia	-4.2	-3.4	0.9	-4.9	3.2	9.0	5.0
Latin America							
Argentina	-2.8	5.5	8.1	3.9	-3.4	-0.8	-3.7
Brazil	4.2	2.7	3.3	0.2	0.8	4.4	1.5
Mexico	-6.2	5.2	6.8	4.9	3.8	6.6	-0.3
INFLATION (b):							
Asia							
South Korea	4.5	4.9	4.4	7.5	0.8	2.3	4.1
China	16.9	8.3	2.8	-0.8	-1.4	0.4	0.7
India	10.2	9.0	7.2	13.2	4.7	4.0	3.8
Thailand	5.8	5.8	5.6	8.1	0.3	1.6	1.7
Indonesia	9.4	8.0	6.7	57.6	20.5	3.8	11.5
Malaysia	3.5	3.5	2.7	5.3	2.7	1.6	1.4
EU accession candidates							
Hungary	28.3	23.5	18.3	14.1	10.0	9.8	9.2
Poland	28.1	19.8	15.1	11.7	7.3	10.1	5.4
Czech Republic	9.2	8.8	8.5	10.6	2.1	3.9	4.7
Romania	32.2	38.8	154.8	59.1	45.8	45.7	34.5
Russia	197.5	47.7	14.7	27.7	85.7	20.8	20.7
Latin America							
Argentina	3.4	0.2	0.5	0.9	-1.2	-0.9	-1.1
Brazil	66.0	15.8	6.9	3.2	4.9	7.0	6.8
Mexico	35.0	34.4	20.6	15.9	16.6	9.5	6.4
GENERAL GOVERNMENT FINANCIAL BALANCE (c):							
Asia							
South Korea	1.3	1.0	-0.9	-3.8	-2.7	2.5	3.2
China	-1.0	-0.8	-0.8	-1.2	-2.1	-2.8	...
India	-8.5	-8.1	-8.7	-8.5	-9.6	-11.2	-10.8
Thailand	3.0	2.4	-2.1	-7.6	-10.5	-3.2	...
Indonesia	2.2	1.2	-0.7	-2.7	-1.1	...	...
Malaysia	2.2	1.1	2.5	-1.5	-4.1	-4.2	...
EU accession candidates							
Hungary	-6.3	-3.1	-4.5	-6.3	-3.7	-3.4	-4.5
Poland	-2.6	-2.5	-1.3	-2.4	-2.0	-3.5	-3.9
Czech Republic	0.5	0.9	-1.9	6.6	-1.6	-4.2	-7.0
Romania	-4.1	-4.9	-3.6	-2.8	-2.6	-3.8	-3.3
Russia	-5.2	-7.9	-7.0	-5.0	-1.7	4.3	2.0
Latin America							
Argentina	-0.9	-2.5	-1.5	-1.4	-2.6	-2.4	-3.0
Brazil	-7.1	-5.9	-6.3	-7.9	-10.0	-4.6	-5.2
Mexico	-0.9	-0.3	-1.4	-1.2	-1.3	-1.1	-0.7
CURRENT-ACCOUNT BALANCE (c):							
Asia							
South Korea	-1.7	-4.4	-1.7	12.7	6.1	2.7	2.1
China	0.2	0.9	4.1	3.3	1.6	1.9	1.7
India	-1.0	-1.7	-1.2	-1.4	-1.0	-0.9	0.0
Thailand	-8.1	-8.1	-0.9	12.7	10.2	7.6	5.4
Indonesia	-3.2	-3.4	-2.3	4.2	4.1	5.3	4.5
Malaysia	-9.5	-4.6	-4.8	12.9	15.9	9.4	8.2
EU accession candidates							
Hungary	-5.6	-3.7	-2.1	-4.8	-4.4	-2.9	-2.4
Poland	4.5	-1.0	-3.0	-4.3	-7.5	-6.3	-4.0
Czech Republic	-2.6	-8.1	-6.3	-2.3	-2.0	-5.6	-4.7
Romania	-5.0	-7.3	-6.3	-7.3	-3.8	-3.7	-5.9
Russia	2.2	2.9	0.8	0.8	12.4	17.4	11.3
Latin America							
Argentina	-1.9	-2.4	-4.1	-4.9	-4.3	-3.1	-2.1
Brazil	-2.6	-3.0	-4.2	-4.3	-4.7	-4.1	-4.6
Mexico	-0.6	-0.7	-1.9	-3.8	-3.0	-3.1	-2.8

Sources: IMF and national statistics.

(a) Annual percentage changes.

(b) Annual average percentage change in consumer prices.

(c) Percentage of GDP.

also played a role. Fixed-income markets in the emerging countries benefited for a large part of the year from the shift of investment from shares to bonds, in line with the global trend. However, this trend appears to have been reversed recently as a result of the prospects for economic recovery. Indices of average yield on emerging fixed-income markets, corrected for the Argentine effect, ended the year up by around 20%.

Total external private-sector financing to the emerging countries increased in 2001 with respect to the previous year. This increase was concentrated in the direct investment component, where flows rose by 10%, which more than offset the sharp falls in portfolio investment and, especially, in bank loans (see Chart II.6). The growth of direct investment was highly concentrated among a few countries, including notably China, where capital inflows had as their counterpart heavy acquisition of reserves. Official multilateral financing also grew with respect to the previous year, from USD 14,000 to 46,000 million.

## II.2. THE MAIN INDUSTRIALISED ECONOMIES

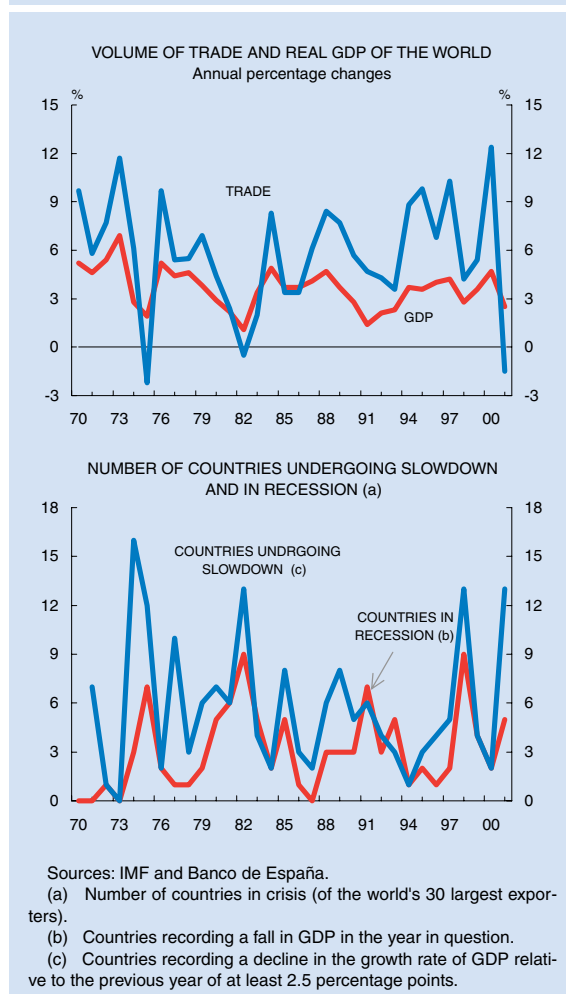
### II.2.1. United States

After nine years of uninterrupted expansion the US economy entered a phase of rapid slowdown. According to the National Bureau of Economic Research, on the basis of the wide range of economic indicators it uses to determine the cyclical position, this slowdown officially became a recession in March 2001. However, recent revisions indicate that the technical requirement usually used to define a recession, i.e. two consecutive quarters of negative output growth, was not met. In any case, even if it is eventually accepted that there was a recession, it will have been one of the mildest and shortest of recent US economic history, which highlights the economy's flexibility and capacity to adjust to very severe shocks (see Box II.1).

GDP growth fell from 4.1% in 2000 to 1.2% in 2001, while inflation, as measured by the CPI, declined from 3.4% to 2.8%, in annual average terms, as a consequence of the weakness of domestic demand, excess capacity and the fall in energy prices.

CHART II.2

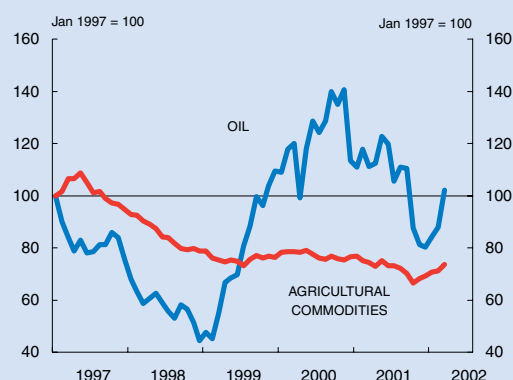
### World trade and output



Unlike in some recent cycles, the notable reduction in the rate of activity, which was particularly intense in manufacturing, was mainly caused by the sharp contraction in private investment, which fell by 2% in 2001, along with the large downward adjustment in stocks, while private consumption continued to grow at unusually high rates of around 3% (see Chart II.7). The sharp increase in private investment until mid-2000, especially in the telecommunications- and IT-related sectors, led to excess capacity and notable growth of corporate debt, which came on top of the high levels of household debt. The subsequent fall in corporate earnings, and the decline in share prices, in a climate of depressed demand, showed up even more clearly the excess capacity, especially in the telecommunications- and IT-related sectors, while aggravating the problems arising from high levels of debt. Another special feature of this cycle was the unfavourable impact of the attacks of 11 September in the latter part of the

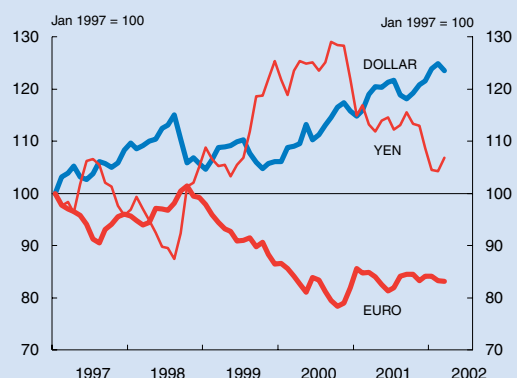


CHART II.3

**Commodity price index**

Source: Banco de España.

CHART II.4

**Nominal effective exchange rates against the developed countries (a)**

Source: Banco de España.

(a) An increase (decrease) denotes an appreciation (depreciation) of the currency.

year, which drastically increased uncertainty and prompted an even more resolute economic-policy response to the fall in activity.

As mentioned above, despite the fall in share prices and the consequent wealth effect on households, private consumption proved highly resilient. This exceptional behaviour is primarily explained by the low levels of unemployment in the US economy at the beginning of the year, by the buoyancy of the property sector and the increase in house prices (fuelled by lower interest rates) and by the favourable financing conditions for purchases of durable goods, such as cars, especially in the latter part of the year.

In the labour market, the rate of unemployment, which started at levels of around 4% at the beginning of the year, gradually increased to reach 5.8% in December, as a consequence of lay-offs, which intensified following the September attacks. The large wage settlements that had accompanied the cyclical upturn moderated as the economy weakened. Productivity growth was particularly notable in such a weak economic setting (1.9% during the year and 5.5% in Q4, in terms of the annualised quarterly rate), in contrast to the much lower and even negative levels seen in the same phase of previous cycles.

Amid high uncertainty as to the scope and duration of the economic slowdown, the attacks of 11th September gave rise to additional doubts and a sharp fall in confidence. As a consequence of the

economy's underlying weakness, exacerbated by the events of September, negative GDP growth of -1.3% was recorded in Q3, in annualised quarterly terms. However, the impact of the attacks was not as strong or lasting as feared, as shown by the pick-up in Q4 to 1.7%.

The response of monetary policy to the slowdown was rapid and resolute from early in the year, in the form of a reduction in the Federal Reserve's target rates from 6.5% in January to 3% in August. The expansionary stance of monetary policy was strengthened after 11 September when the Federal Reserve initially injected a generous amount of liquidity and subsequently lowered official interest rates to a forty-year low of 1.75%.

The Federal Reserve's actions in this downward part of the cycle contrast with its more gradualist approach at similar times in the past, especially as regards the speed with which interest rates were reduced. Possible explanations for this more aggressive behaviour by the monetary authorities could include, initially, the fear of an excessive stock market correction and its adverse impact on the delicate financial position of corporations and households and thus, on economic activity and, subsequently, the risk of a collapse in confidence following the attacks. All this occurred against a background of favourable trends in producer prices, wages and unit labour costs which, by reflecting a relatively reassuring situation on the inflation front, was conducive to the expansionary stance of US monetary policy last year.

## Recent cyclical trends and the monetary policy response in the United States

The US National Bureau of Economic Research (NBER), the institute responsible for dating US business cycles, announced that the US economy had entered recession in March 2001. However, subsequent developments have shown that the usual requirement of two consecutive quarters of negative quarter-on-quarter growth was not met. It seems clear that the duration of the recession, if it is eventually confirmed that there has been one, will be brief, and less than the 11-month average calculated by the NBER for US economic recessions since 1960. It will probably be more similar to that of the 1990-1991 recession which lasted only eight months, than to the 16-month recessions of 1973-1975 and 1981-1982. Moreover, in all US recessions to date there has been at least one quarter in which GDP fell by more than 3% in annualised quarter-on-quarter terms, while on this occasion the fall was only 1.3% in Q3.

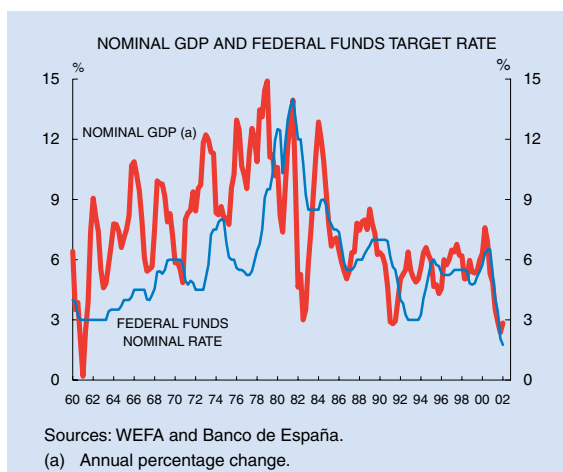
Although the decline in the rate of activity in 2001 cannot be considered atypical (1), there are certain particular features that distinguish it from similar episodes in the past. Private consumption has been much more resilient, with average growth of 3.1% in 2001 compared with -1.2% in the 1990-1991 recession and -0.1% on average in the recessions between 1960 and 1991. Business investment fell less, by 3.2%, as opposed to 4.8% in the 1990-1991 recession and by 6.1% on average in the recessions between 1960 and 1991, while the contribution of changes in inventories was more negative in 2001 than in 1990-1991 (-1.2, compared with -0.8 percentage points of GDP), although it did not reach the average of -1.6 points in the recessions of the period 1960-1991. The fall in industrial output was milder, 3.7% in 2001, as against 7.5% on average in the previous recessions and 4.4% in 1990-1991. Finally, other distinctive signs in 2001 were the positive residential investment and productivity developments. The former grew by 1.5% in 2001, compared with falls of 1.9% on average in previous recessions and, in particular, the fall of 23.5% in 1990-1991. Productivity grew by 1.9% year-on-year, as against an average decline of 0.6% in previous recessions and a similar fall in 1990-1991.

The reaction of monetary policy to the economic slowdown has been rapid and resolute, especially as regards the rate at which interest rates have been reduced, from 6.5% in January 2000 to 1.75% at the end of 2001. The same can be said of fiscal policy, which, at first, introduced a stimulus through tax cuts and, following the attacks of 11 September, through higher spending on defence and emergency assistance to the sectors most affected. This economic policy action is possibly one of the reasons for the relative mildness and brevity of the US economic slowdown.

The resolution and speed with which monetary policy has reacted on this occasion is highlighted by comparison with the events of the 1990-1991 recession (see adjoining table). Although the reduction in official interest rates was larger in 1990-1991, on that occasion rates started from higher levels and the period of cuts was much longer. In addition, the monthly rate of reduction of official interest rates has been more than double that in the period 1990-1991; the largest one-month reduction has been 100 basis points, as against 50 basis points in 1990-1991; and the number of times rates have been reduced by 50 basis points has been eight out of eleven, as opposed to three out of twenty-four in 1990-1991. The adjoining chart also shows that the policy of the Federal Reserve has reacted extremely quickly in this cycle, since on previous occasions the reduction in rates was not so closely synchronised with the slowdown in nominal GDP, but tended to follow it with a certain lag.

The factors that might explain the rapid action by the Federal Reserve in this cycle include initially, the threat represented by the delicate financial position of corporations and households, which had been accumulating large amounts of debt for a number of years, while share prices rose to very high levels. The risk was, thus, of a sharp fall in share prices exacerbating the imbalances of corporations and households, with potentially severe repercussions for economic activity and banks. Subsequently, the events of 11 September were a heavy blow to the confidence of agents, which led the Federal Reserve to increase the supply of liquidity substantially and to lower interest rates by more than would have been necessary in normal circumstances.

The negative side of the mildness of the cyclical downturn in the United States is that the significant and persistent imbalances in the US economy have not been corrected. Thus, the current account deficit has only decreased from 4.5% to 4.1% of GDP, which is relevant insofar as a recovery has never before commenced with such a large current-account deficit. At the same time, the debt of households and corporations remains at historically very high levels, while the private saving ratio is still very low. These are significant risk factors for the strengthening of economic recovery.



## Reduction in official rates (a) (b)

	Jun 1989- Sep 1993	Jan-Dec 2002
Total reduction (bp)	675	475
Path (%)	9.75 - 3	6.5 - 1.75
Number of cuts	24	11
Of which 50 bp	3	8
Monthly rate (bp)	15.69	39.58
Max. one-month cut (bp)	50	100

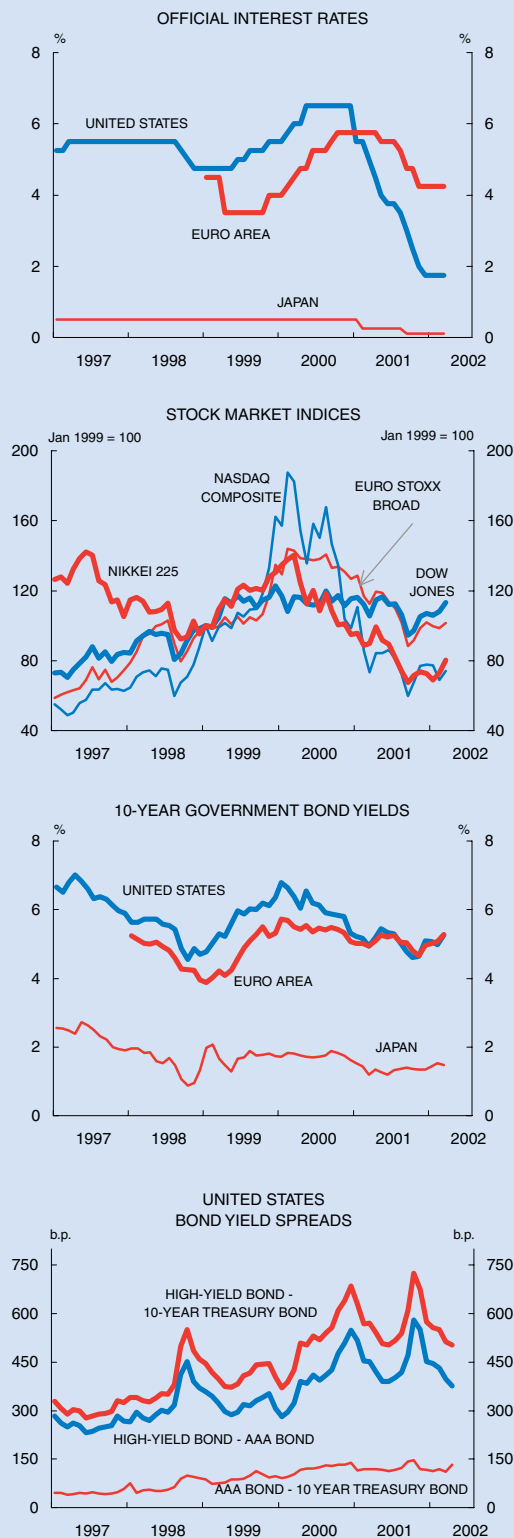
(a) Federal funds target rate.

(b) The whole period of rate cuts is taken in each case.

(1) See Chapter III "Recessions and Recoveries" of the IMF's World Economic Outlook (April 2002).

CHART II.5

### International economy Interest rates and share prices

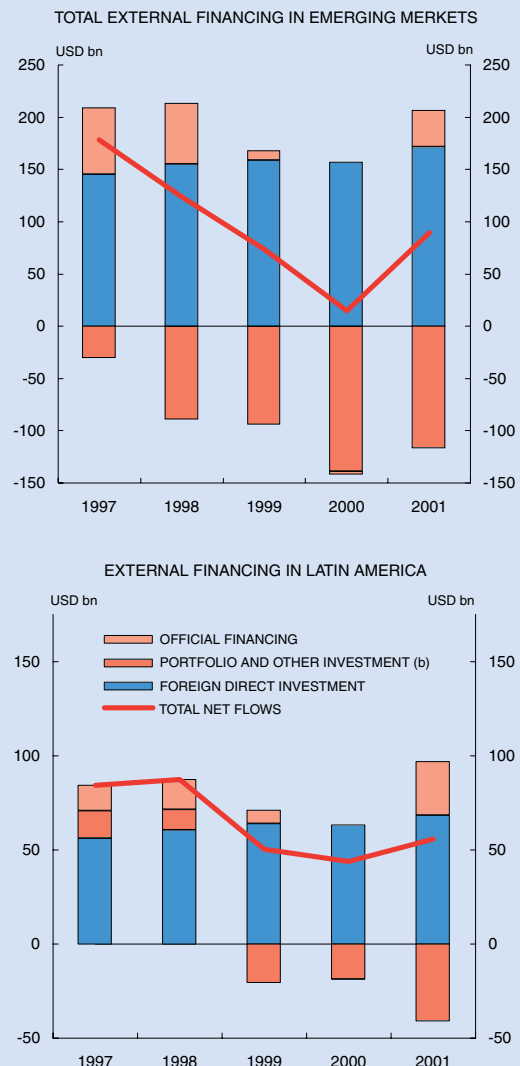


Sources: Banco de España and Bloomberg.

(a) The data on private bonds are for bonds issued by industrial corporations rated AAA by Standard & Poor's and an aggregate of 10-year high-yield bonds rated B2.

CHART II.6

### Emerging markets. External financing (a)



Source: International Monetary Fund.

(a) Total net capital flows in billions of US dollars.

(b) Includes bank loans.

Some fiscal stimulation had already been implemented before 11 September, based on the new plans of the Bush administration, which were oriented towards tax cuts, although certain increases in expenditure were also envisaged. As a result of the attacks this stance was strengthened, with emergency assistance to the sectors most affected. The cyclical effects of the recession on revenues and expenditure, the emergency plan to overcome the most immediate consequence of the attacks and the increase in military spending in Afghanistan led to a substantial fall in the budget surplus in 2001 to USD 127 billion, down from the initially projected level of USD 275 billion and from USD 236 billion the previous year.

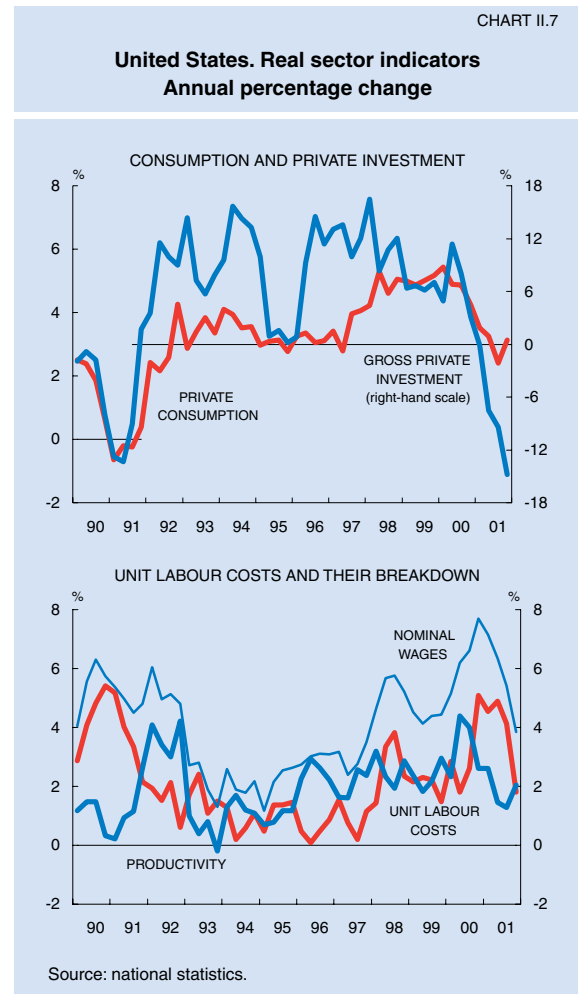
As mentioned above, the preliminary data for 2001 Q4 and the indicators available in the first few months of this year suggest that the fall in the rate of activity has been milder than was at first predicted and that economic recovery appears to be under way, although its intensity and duration has yet to be assessed. In particular, some caution seems necessary when judging the strength of the recovery since, beyond the initial stimulus linked to completion of stock adjustment, it will be necessary for the main components of demand to contribute to its momentum.

In this respect, it is doubtful whether consumption will be able to drive significant output growth, precisely because it has remained relatively high during the downturn and because the likely increase in the cost of borrowing for households this year may limit the room for expansion. Thus, private investment, which was the key component in reducing the rate of activity, must also play a key role in the recovery from the crisis. However, excess capacity and the uncertainty regarding the future course of corporate earnings (worsened by the recent problems of certain major corporations such as Enron) may limit its strength. This means that the behaviour of corporate earnings will be decisive for the future growth of investment and, in consequence, for the sustainability of the recovery.

### II.2.2. Japan

In Japan, following the brief recovery of activity in 2000, when GDP growth reached 2.2%, GDP fell at a rate of 0.4% in 2001. In fact, the Japanese economy slipped back into a technical recession in 2001 Q3, for the second time in three years and the third time in the last decade. This reflected deep stagnation, with serious still unresolved structural problems, particularly in the banking sector, and with economic policies having proved to be incapable of stimulating recovery. The depressed activity was accompanied by deflation, with average annual consumer price falls of 0.7% in the last two years.

The relapse of the Japanese economy was basically a consequence of the weakness of external demand, which particularly affected the products of telecommunications- and IT-related sectors. This led to the largest decline in industrial output since the 1970s and, through the rise in unemployment, had a very adverse impact on domestic demand. Ex-



ports of goods and services tumbled at a rate of -6.6%, having grown by 12.4% in 2000, although at the end of last year the rate of decline moderated owing to the depreciation of the yen. Imports of goods and services also declined progressively, although less sharply than exports, with a reduction of 0.6% as against an increase of 9.6% in 2000. As a result, the trade surplus suffered its largest fall since the 1970s.

Domestic demand, in the year as a whole, was practically unchanged. Private consumption remained stagnant, held down by the rise in unemployment and the fall in disposable income, while private investment was somewhat more dynamic, although firmly constrained by the unfavourable economic outlook and by the banking system's difficulties extending credit. The recession and the progress in corporate restructuring led to a sustained reduction of employment from the middle of the year and an ongoing rise in the rate of unemployment, which had reached 5.6% by the end of the year, the highest figure recorded by the Japa-

nese economy in the last four decades. As a result of the economic deterioration and the fall in commodity prices, deflationary pressures intensified from Q2, the growth rate of consumer prices reaching -1.2% in December.

In this environment of deflation and recession, the efficacy of monetary and fiscal policies was very low, owing to the slim margin available for any loosening, with short-term interest rates very close to zero and public debt exceeding 140% of GDP, as a result of the strongly expansionary fiscal policies implemented over the last decade. The most stimulating factor was the depreciation of the yen against the dollar, which reached a cumulative total of 10% in the latter months of the year.

Despite the small leeway available, the Bank of Japan tried to increase the expansionary stance of its monetary policy from March last year by means of a strategy based on the establishment of expansionary targets for bank reserves. However, this did not succeed in boosting private credit or economic activity, because the monetary policy transmission mechanism was blocked as a result of the banking system problems. At the same time, the high level of public debt led the government to present a more restrictive budget for the fiscal year 2002-2003 than in previous years, with a public spending cut of 1.7%. Nonetheless, the deficit is expected to remain at levels of 8.7% of GDP, basically due to declining revenues.

Finally, few details of the new administration's reform plans were known, except for the intention to control medium-term public finances. The delay in carrying out the necessary reform of the financial system and, in particular, of the banks, has worsened its delicate situation. The latter has been exacerbated by the fall in bank share prices, which have not reacted to the recent improvement in the rest of the Japanese stock market (see Chart II.8), and by the increase in the default rate as a consequence of the recession. All this has given rise to justified concern over the potential systemic consequences for the global financial sector that might arise from any worsening of this situation.

### **II.2.3. Other developed economies**

Among the EU countries outside the euro area, the UK saw a gradual slowing of economic

activity during 2001. Growth fell from 3% in 2000 to 2.2% in 2001, but remained higher than in most industrialised countries. The resilience displayed by the British economy was basically a consequence of private consumption, which grew by 3.9% in 2001, a similar rate to that of the previous year, driven by the high wage gains of previous years, cuts in interest rates, sharp rises in property prices and the low level of unemployment. The strength of private consumption partly offset the sharp slowdown in investment, which grew by 0.1% during the year, as against 3.9% in 2000, and the negative contribution from external demand, stemming from the global slowdown and the strength of sterling with respect to the euro. The conjunction of a recession in manufacturing and a boom in the services sector led to a widening of the trade deficit. Inflation held at moderate levels during the year, although there were slight rises around the middle of the year. Subsequently, the further fall in energy prices and a certain moderation of wage settlements caused the inflation rate to edge down to 1.9% in December, although underlying inflation, excluding food and energy, stood from the middle of the year at above 2.5%.

The Bank of England cut the official interest rate by 200 basis points to 4%. Over the period January-August the rate was reduced by a cumulative total of 100 points, owing to the increasingly visible signs of economic slowdown, and subsequently by another 100 points following the attacks of 11 September, amid widespread rate reductions by other central banks. The public sector surplus fell to 0.4% of GDP, from 4.4% in 2000, owing to the increases in public spending and investment, to improve infrastructure and public services, and to the decline in revenues as a consequence of the economic slowdown.

The other EU countries outside the euro area, Sweden and Denmark, also suffered the consequences of the global slowdown and their growth rates fell in 2001 to 1.2% and 0.9%, from 3.6% and 3% in 2000, respectively. In both countries, not only was external demand, dragged down largely by the crisis in the new technology sector, the main factor behind the slowdown, but also domestic demand proved very weak. Despite the slight reduction in the budget surpluses with respect to those in 2000, their public finances remained sound (surpluses of 4.7% and 1.7% respectively). The inflation rate in

Sweden stood at the end of the year above the Riksbank's target, boosted by the depreciation of the krona.

## II.3 THE EMERGING ECONOMIES

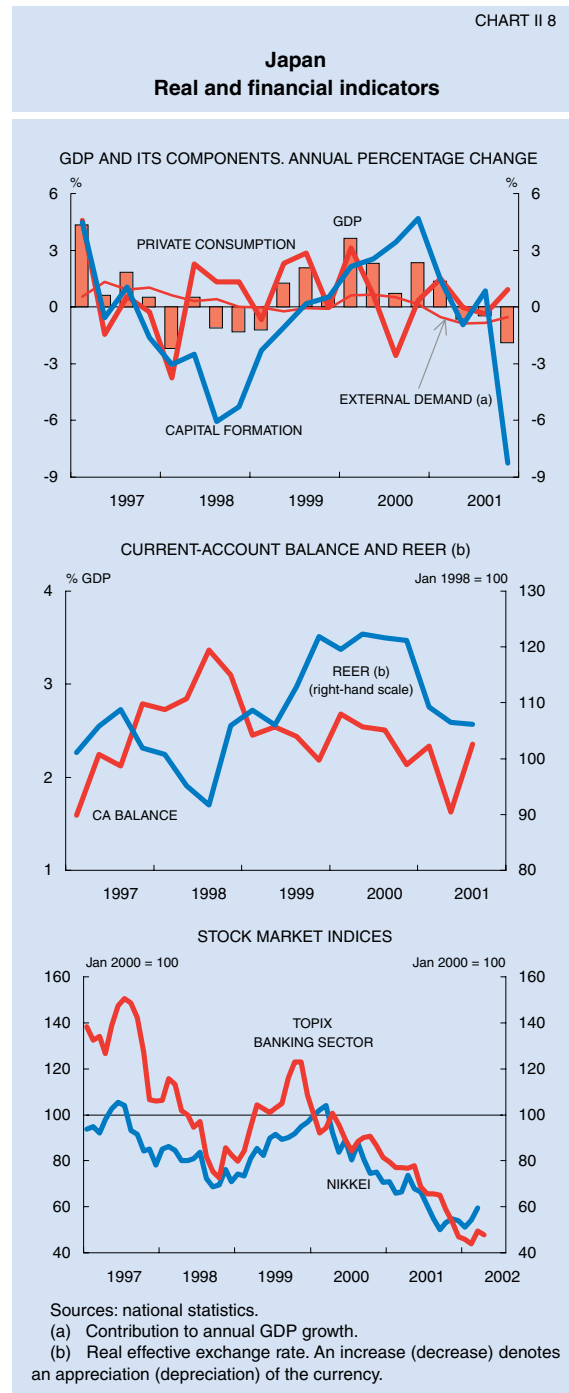
### II.3.1. The EU candidate countries

The process of accession to the European Union of Central and Eastern European countries received a notable boost in 2001. The ECOFIN held in Gothenburg in June 2001 set an intended time frame under which a group of 10 countries (made up of Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Malta and Cyprus) could complete accession negotiations by the end of 2002, and could therefore participate in elections to the European Parliament in 2004. Later dates are envisaged for Bulgaria, Romania and Turkey.

The economies of these countries were affected by the global slowdown last year, although their deceleration was milder than in other emerging regions. Excluding Turkey, they grew by an average of 3.1%, as against 1.5% in the euro area. Almost all these countries stepped up their structural reform processes, while making headway in reducing their inflation differentials with respect to the euro area, assisted by the fall in commodity prices. As a result, the inflation rate had fallen on average to 6% (excluding Turkey) by the end of 2001, while long-term interest rates had also declined.

In many of the countries fiscal policy was expansionary in response to the slowdown in external demand, leading to larger and, in some cases, worrying budget deficits. Most of the currencies of these countries appreciated against the euro during the year or held steady in the case of countries with fixed exchange rates. As regards changes to exchange-rate regimes, Hungary's abandonment in October 2001 of the relatively narrow crawling peg that it had maintained, and its replacement by a central parity against the euro with fluctuation bands of  $\pm 15\%$ , with similarities to ERM II, was notable. Also, in early 2002, Lithuania replaced its dollar currency board with a euro one.

The profile of declining rates of economic activity was more or less common to the more ad-



vanced countries of the region, with the notable exception of Poland, the largest of all. Hungary, the Czech Republic, Slovakia and Slovenia suffered the impact of lower growth in the EU countries, which adversely affected industrial production, although domestic demand proved resilient, buoyed by expansionary fiscal and monetary policies. Output growth moderated with respect to the previous year in most of the countries, but still recorded rates of 3-4%. On the negative side, budget and current account deficits generally remained very large. In Poland,



### The Argentine crisis in perspective

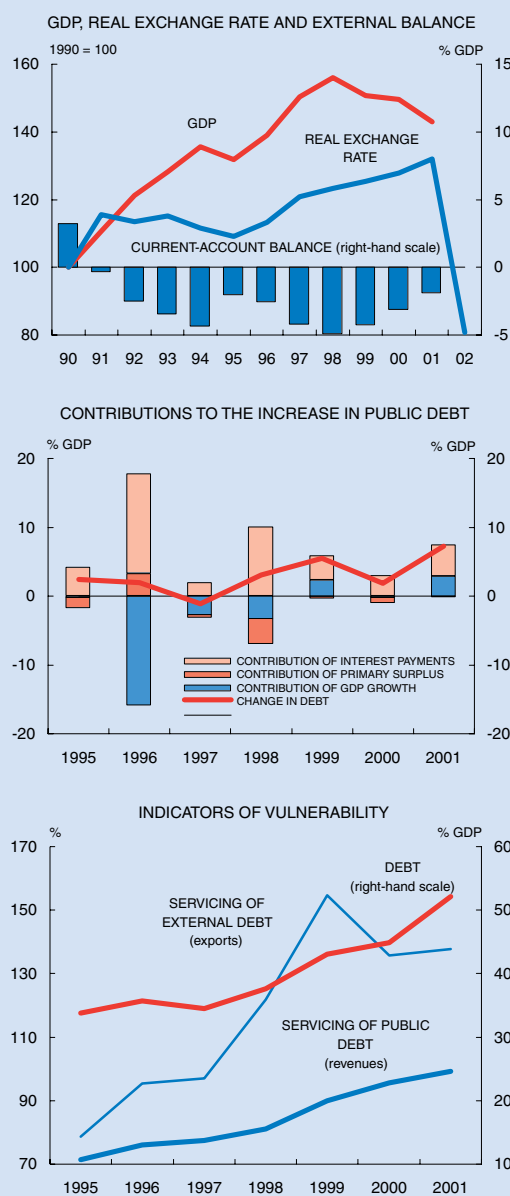
In late 2001, after more than ten years in place, Argentina suddenly abandoned its currency board and suspended payments on its foreign debt. During a large part of the decade the Argentine model, based on the liberalisation of the economy, trade integration and monetary and currency stability, had secured high economic growth along with price stability. However, from 1999 the economy entered a deep recession. This led to increasingly acute problems of fiscal unsustainability and lack of credibility of the fixed exchange rate, which successive government plans were unable to overcome. In any case, the Argentine experience has shown that in the long term maintenance of such a rigid monetary regime requires a high degree of discipline in public finances and flexibility of the economy, which the Argentine economy failed to achieve.

In 1989, the effects of hyperinflation, stemming from the monetary financing of burgeoning budget deficits, prepared the ground for a radical change of direction in economic policy by the new administration. In 1991, parity between the peso and the dollar was established by law and backed by a currency board, which required all money issued to be backed by foreign reserves. The surrender of autonomy in monetary policy and the desire to finance fiscal imbalances in an orthodox fashion were intended to give the new economic strategy a credible anchor and to eliminate inflationary expectations, goals that were initially achieved. Moreover, the period 1991-94 was characterised by the start of the privatisation programme, partial deregulation of the economy and a boost to the opening up of trade with the creation of MERCOSUR in 1991, although progress was not made at the same rate in the fiscal sphere and in certain structural reforms.

After several years of expansion, growth was temporarily interrupted in 1995, owing to financial contagion from the Mexican crisis. However, the banking liquidity crisis that occurred was successfully resolved despite the absence (inherent to the currency board) of a traditional lender of last resort. Eventually, the currency board and the banking system emerged strengthened from this episode. The recovery of inflows of foreign capital (especially direct investment), together with the boost to foreign trade entailed by the Brazilian "Plan Real" formed the pillars of the subsequent cyclical expansion.

The second half of the decade (1995-1999) commenced with a high rate of economic growth, accompanied by abundant capital inflows and an improvement in foreign financing conditions. However, the relaxation of the foreign constraint and large privatisation receipts were conducive to an excessive increase in government spending, at both the central and the provincial levels. Moreover, this favourable period was not taken advantage of to introduce pending reforms (mainly fiscal and labour) to increase the flexibility of the economy and reduce its vulnerability to adverse shocks, like those that arose in subsequent years. Along with fiscal laxity, the increase in spreads arising from the crises in other emerging countries (south-east Asia and Russia) and the growing short-term costs relating to the transition to a funded pension system contributed to a sharp rise in public debt be-

#### Argentina. Real indicators and determinants of public debt



Sources: IMF, national statistics and Banco de España.

### The Argentine crisis in perspective (continuation)

tween 1997 and 1999. As a result public debt was set on a dangerous course that only the robust output growth in these years could offset.

In these circumstances, the large devaluation of the Brazilian real in January 1999 marked a decisive turning point for Argentina. Until then the latent uncompetitiveness of the Argentine economy, resulting from the conjunction of the currency board, excessive labour market rigidity and insufficient corporate restructuring, had been concealed in a way by the buoyancy of activity. However, the depreciation of the real, along with the worsening of the terms of trade arising from the fall in commodity prices and the strength of the dollar, brought these competitiveness problems to the surface and tipped the economy into a deep recession, accompanied by price deflation. With devaluation ruled out at the time, owing to the high costs which the authorities considered it would inflict on a highly dollarised economy, the adjustment required a significant reduction in real wages. However the deflation accompanying the recession, in a context of nominal wage rigidity, hampered this mechanism enormously, while financial costs rose and the expected return on investment deteriorated.

In the midst of recession, Argentina's underlying vulnerabilities began to surface and the problems of external financing became apparent. Debt servicing costs represented a very high and growing part of fiscal revenues (given the weak tax base) and of exports (given the low degree of openness). With the drying up of external financing, increasing recourse was had to domestic agents to finance the state. At the end of 1999 the new coalition government, with the backing of the IMF, attempted to implement significant fiscal adjustment.

Meanwhile, the provinces taking advantage of their strong political position continued their uncontrolled spending. The fiscal restrictions, which focused more on increasing revenues than cutting expenditure, served to aggravate the recession, although the strong expansion of external demand enabled its effects to be temporarily mitigated. In the second half of 2000 the world upturn showed signs of faltering, there was a global flight to quality on financial markets, which significantly harmed the emerging markets. As a result, economic activity in Argentina contracted further, jeopardising its fiscal targets against a background in which external financial restriction was increasingly apparent.

In this situation, a political crisis in the government, caused by the resignation of the vice-president in October 2000 opened the long process of economic backsliding which continued throughout 2001. After many financial difficulties, the approval of a substantial package of aid by the IMF in January seemed to dispel the danger, but only two months later problems resurfaced with the resignation of two economy ministers in the space of three weeks which led to the closing off of access to foreign capital markets. Various changes of direction in economic policy were attempted, with the emphasis either on reactivating the economy, or on fiscal discipline, in order at least to preserve the currency board and to restore domestic and external confidence. However credibility continued to decline, sovereign spreads carried on widening and the recession became ever more acute. Economic policy errors and excessive meddling aggravated the situation and it became more and more apparent that the situation was unsustainable.

At the same time, the solid foundations on which the Argentine financial system was built were being eroded. First, economic uncertainty generated an ongoing shift towards cash and dollar deposits which, under the convertibility regime, led to a notable fall in reserves and, consequently, a strong contraction of liquidity. Second, the attempts to provide liquidity to the system through the central bank undermined convertibility. Lastly, increasingly frequent recourse to the domestic financial system to finance public net borrowing (through voluntary debt swaps and other mechanisms) weakened its balance sheet. Following a fresh IMF package in September a number of very restrictive, and to a certain extent desperate, measures were adopted, such as the zero deficit law and a final swap of domestic debt in November. In the face of repeated failure to meet fiscal targets, the IMF decision to suspend payments scheduled for December and the restriction on the withdrawal of deposits (the "corralito") to avoid financial panic precipitated events, which concluded with the resignation of two presidents, abandonment of the currency regime and the suspension of external payments over Christmas 2001.

Convertibility put an end to the traditional hyperinflation in Argentina and, along with the process of liberalisation and reforms, laid the foundations for the high growth the country enjoyed in the first half of the 1990s. However, the insufficiency, lack of depth and discontinuity of the reforms, the absence of fiscal discipline, together with a number of external shocks led to a deep recession. The loss of international confidence and the attempt to maintain convertibility over all other considerations ended up entailing the sacrifice of the financial system and the violation of property rights. The latter are two of the basic elements of a market economy and will require a long and complex process of reconstruction.



the mix of an expansionary fiscal policy with a restrictive monetary policy was reflected in high real interest rates, which affected private investment and employment and reduced GDP growth to 1.1% in 2001, from 4.1% in 2000. Recently, with greater fiscal discipline and a gradual decline in interest rates, this situation is beginning to be corrected. The three Baltic countries, along with Bulgaria and Romania, recorded higher growth rates than the others (over 4%), and in some cases higher than in the previous year. Romania recorded growth of 5.3%, as against 1.8% in 2000, thanks to the strength of its exports and its industrial output.

Turkey, following the financial crisis it suffered in February last year, which forced it to let its currency float, did not at first achieve the results expected, despite the financial assistance granted by the IMF, the ambitious programme drawn-up by the latter, which was adopted in May, and the effort to adhere scrupulously to the programme in terms of fiscal cuts and monetary control. Turkey suffered its worst recession for more than 50 years, its GDP falling by 7.4% in 2001, while inflation and interest rates rose to over 65% and 75% respectively. In the latter months of the year, with expectations of a further package of aid from the IMF, the financial variables improved considerably. Thus, the Turkish lire, having lost 60% of its value during the year to October, appreciated by more than 20% between October and December. During the same period the stock market recovered by 60% and sovereign debt differentials narrowed by 200 basis points. At the beginning of February this year the IMF approved a new loan for Turkey.

### **II.3.2. Latin America**

Following the high economic growth in the region in 2000 initial prospects for 2001 were for a slight moderation in the rate of activity. However, this relative optimism was soon overshadowed by the force of the global slowdown, the greater prudence shown by international financial markets towards emerging countries (see Chart II.9), negative commodity price developments and the growing problems in Argentina. Consequently growth in the region fell drastically in 2001, to 0.6%, from 4% in the preceding year. Although this result was heavily skewed by the

deep recession in Argentina (already in its fourth year with an estimated decline in GDP of 3.7% in 2001), other countries also recorded negative growth rates. The case of Mexico is striking. Its growth fell from 7% in 2000 to 0.3% in 2001, dragged down by the US deceleration. However, despite this, its perception on international financial markets improved considerably.

The weakness of external demand and the correction of commodity prices had negative effects on trade flows in the region, which fell by 1% in value terms. However, trade balances did not generally deteriorate owing to the simultaneous slowdown in imports. Accordingly, current account balances held steady at around -3% of GDP.

The difficulties of the Argentine economy, described in greater detail in Box II.2, became more and more severe as the year elapsed. After numerous failed attempts to restore confidence, with economic plans of various types and successive debt swaps to try to reduce the pressure on public finances, a severe social, political and economic crisis broke out towards the end of the year which finally forced the suspension of payments on external debt and the abandonment of the fixed exchange rate regime (convertibility) that had been in place since 1991.

The effects of the Argentine crisis on the rest of Latin America differed from country to country and, in all cases, decreased as the year elapsed. During the lengthy gestation of the crisis, in the latter months of 2000 and during 2001, it was clear that the financial markets were discriminating between the main countries of the area. Thus, Mexico was hardly affected, while Brazil's, and to a lesser extent Chile's currencies, came under pressure as the situation in Argentina worsened. In Brazil, debt spreads were affected as well. In other smaller countries of the region the impact varied and declined as the year elapsed.

In Brazil, high external net borrowing, the sensitivity of public finances to exchange rate developments (through the increase in debt interest payments) and a serious energy crisis gave rise to a perception of vulnerability that put the economy in a delicate position in the first half of the year. However, the resolute response by the authorities, who adopted prudent monetary and fiscal policies geared towards safeguarding macroeconomic stability,

were conducive to the return of confidence in the second half of the year. All this was reflected in an appreciation of the exchange rate and a reduction in debt spreads in the final months of the year.

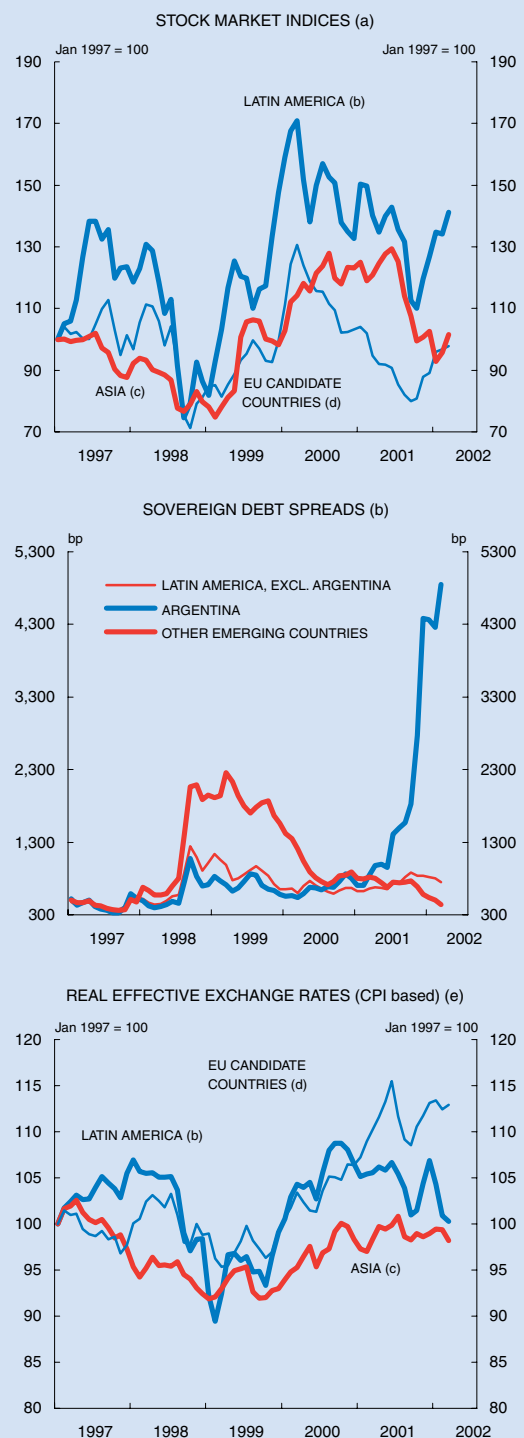
The distinction increasingly drawn between the situation in Latin America as a whole and that in Argentina is a sign that the international financial markets recognise the efforts made by most countries of the region in recent years to set in place a framework of stability favourable to sustainable growth. It also reveals the greater ability of the participants on these markets to discriminate. In any event, given the long duration of the crisis, such participants had time to cover their positions. Moreover, the backing given by multilateral organisations to some of these countries with sounder policies, such as Brazil, also helped to restore confidence. This meant that when the Argentine crisis entered its decisive phase, in late 2001, the impact on the rest of the region was fairly limited, with the exception of Uruguay, given its close trade and financial links with Argentina. The recent social, political and economic turmoil in Venezuela is attributable largely to domestic problems. In the last quarter of 2001 and in the first few months of 2002 external financing conditions have been considerably relaxed for the rest of the countries of the region.

The case of Mexico is striking. Despite having been the country most seriously affected by the recession in the US, it has received the backing of the international financial markets. This backing enabled the exchange rate of the Mexican peso to remain strong and public debt spreads vis-à-vis the US to narrow. In addition, this country has recently been granted investment-grade status by the main credit rating agencies, which has clearly improved its financial outlook.

Nonetheless, the reduced attractiveness of the region as a whole to foreign investors for a large part of the year resulted in modest net inflows of private capital, 40% lower than those of the previous year. However, the gap was filled by large inflows of official capital, so that total net flows actually rose slightly. Flows of direct investment remained at acceptable levels (although a significant part was attributable to a single operation by a North American bank in Mexico), but other private net flows, especially those related to international bank loans, posted a negative balance (see Chart II.6).

CHART II 9

### Emerging economies: financial indicators



Sources: Banco de España, JP Morgan and Bloomberg.  
(a) January 1997 = 100. Weighted by GDP in PPP of the countries indicated.  
(b) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.  
(c) China, Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.  
(d) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.  
(e) An increase in the index denotes a loss of competitiveness.

In spite of the difficulties in Argentina, headway continued to be made in terms of macroeconomic stability in the region as a whole. Thus, inflation in the area fell by more than one percentage point with respect to 2000, to stand at 5.8%, and inflation targets were generally met. The economic slowdown and the fall in commodity prices helped to contain inflationary pressures and, despite the significant depreciation of exchange rates in countries such as Chile and Colombia, there was a very limited pass-through of exchange rates to prices, so that interest rates could be reduced. Only in Brazil, where the appreciation of the real was especially acute in the first half of the year, were the monetary authorities forced to raise interest rates temporarily, although the inflation target was still not met. In any event, overall these results strengthened the credibility of the monetary regimes adopted in recent years by many countries in the region based on direct inflation targets, while the number of countries with fixed or semi-fixed exchange rate regimes decreased, with the abandonment of convertibility in Argentina and the flotation of the Venezuelan bolivar in early 2002. Such regimes now only remain in place in certain relatively small economies that have generally opted for dollarisation.

Budget deficits generally remained at reasonably moderate levels, considering the cyclical deterioration, the increase in financing costs in many countries and the fall in the price of oil, which is a basic source of budget revenues for countries such as Venezuela, Mexico and Ecuador. The overall budget deficit of the region stood at 3.2% of GDP, only half a percentage point higher than in the previous year. Improvements in revenue collection in countries such as Brazil, Mexico and Colombia contributed to these results. In spite of this, the maintenance of fiscal discipline in the cyclical downturn hindered the stabilising role of fiscal policy, its procyclicality being a characteristic feature of the region (see Box II.3).

In sum, 2001 was negative in terms of economic growth, although there are certain encouraging factors that should help put the process of economic recovery on a more solid footing. On one hand, the cyclical pattern in countries such as Mexico and Chile increasingly resembles the usual pattern in the developed coun-

tries, which is uncommon in Latin American economies. Traditionally, the latter are prone to suffering deep crises in circumstances such as those seen in 2001. On the other hand, the lack of contagion effects from the Argentine crisis on financial markets should at least partly be interpreted as being the result of recognition by the international markets of the prudent and sound policies adopted in most countries of the region in recent years. Finally, it is worth pointing out that the prospects for recovery in 2002 have been firming in step with the foreseeable improvement in the economic situation in the advanced countries. Nonetheless, elements of uncertainty persist. Notable among these are the extremely delicate situation in Argentina and the doubts over the strength of the global recovery, on which the incipient pick-up in commodity prices (crucial to most of the countries of the region) depends.

### **II.3.3. South-east Asia and other emerging areas**

Most of the south-east Asian economies from the beginning of the year showed great sensitivity to the world economic slowdown and the consequent fall in the demand for exports (especially of technological products), which subsequently spread through falls in confidence and employment to their domestic demand. The low levels of inflation and the improvement in the economic fundamentals of these countries following the Asian crisis of 1997 enabled them to implement counter-cyclical fiscal and monetary policies which, along with a relatively comfortable exchange-rate position, following the adjustment in previous years, helped to sustain domestic demand in several countries. Some recent indicators, such as the increases in prices and in semiconductor orders and the favourable outlook for the US economy, point to recovery.

Economic activity in 2001 was much stronger in countries such as India and China, which grew by 4.3% and 7.3% respectively. The prolonged buoyancy of the Chinese economy is particularly striking. The strength of domestic demand, and of public investment in particular, and the vigour of foreign direct investment, stimulated by the favourable trade and growth expectations created by China's membership of the World Trade Organisation are

### The procyclicality of fiscal policy in Latin America

In the Latin American economies, the stabilising role of fiscal policy has traditionally been obstructed by the lack of public sector budgetary discipline, as reflected in the relaxation of spending control during the expansionary phases of the cycle. In turn, recessions have usually resulted in a widening of both the budget deficit, owing to a shortage of revenues and the downward rigidity of public spending, and a worsening of the external imbalance, which has led to the adoption of severe fiscal adjustment programmes which have tended to depress the level of activity even further. As a result, fiscal policy in Latin America has traditionally been procyclical and has not played an effective stabilising role (1). During the 1990s, the reform and macroeconomic stabilisation plans included fiscal reforms whose goals were to consolidate public finances by strengthening tax systems and rationalising expenditure, to ease access to international capital markets, thanks to the reduction in sovereign risk and, in short, to make the adoption of stabilising fiscal policies possible.

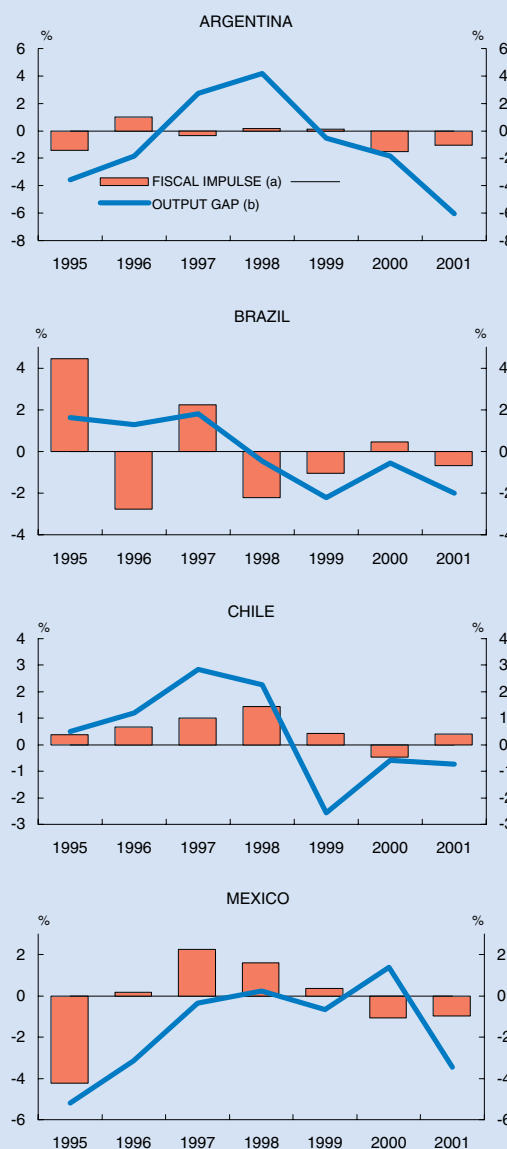
In order to analyse whether the efforts made in the budgetary sphere by the main Latin American economies during the 1990s have resulted in stabilising fiscal policies, the measure of Fiscal Impulse (FI), proposed by the IMF, and in this case calculated on the basis of the primary balance, can be used as a qualitative indicator of the stance of fiscal policy.

If the FI is negatively correlated with the cyclical position of the economy, as represented by the output gap, the stance of fiscal policy can be considered counter-cyclical. As can be seen in the adjoining chart, the tone of fiscal policy in the countries analysed during the period 1995-2001 has generally been in step with the business cycle, and therefore does not appear to have helped stabilise the economy. In Argentina fiscal policy was expansionary until the crisis of recent years led to a series of fiscal adjustments. In Brazil too, fiscal policy has generally been procyclical, with the exception of 1996, when it was contractionary owing to the application of the stabilisation plan. Also in Mexico the physical impulse has tended to move in step with the cycle, except in 2000, when there was a large increase in oil revenues. In Chile, by contrast, fiscal policy appears to have been more countercyclical in recent years, helped by the sound economic situation, including in the public sector.

The procyclicality of fiscal policy in most of the countries analysed shows the persistence of significant structural deficiencies in the public accounts, aggravated by an insufficient degree of economic stability. The inefficiency of tax systems hampers the role of taxes as automatic stabilisers and hinders consolidation of the financial position of the public sector, burdened by the high level of debt. Also, the debt burden is generally particularly sensitive to changes in interest rates and the exchange rate. As a result, recessions may relatively suddenly degenerate into dynamics of unsustainable debt requiring severe budgetary adjustment, which is particularly damaging to growth in a recession, as in Mexico in 1995 and in Argentina recently. Moreover, they run the risk of aggravating the problems of sustainability of public finances.

In consequence, an appropriate programme of structural reforms (such as greater revenue-raising efficiency, more fiscal co-responsibility with the regions and the introduction of fiscal systems with greater automatic stabilisers) plays an essential role, by helping secure a gradual and sustained reduction of the perception of risk by agents. This process eventually enables the economic authorities to implement stabilising macroeconomic policies.

#### Fiscal policy stance in the main Latin American economies



Sources: IMF, national statistics and Banco de España. 2001 data are preliminary estimates.

(a) A positive sign denotes an expansionary discretionary fiscal-policy stance.

(b) Output gap:  $(GDP - GDP \text{ trend}) / GDP$  (%). A Hodrick-Prescott filter with lambda equal to 10 has been used to calculate the GDP trend.

(2) See Gavin, M. and R. Perotti, *Fiscal Policy in Latin America*, NBER Macroeconomic Annual, 11-71, 1999.

some of the factors responsible for this positive performance.

The region's financial and currency markets were relatively stable. Following the September attacks equity prices recovered and debt spreads narrowed, while hardly any contagion from the Turkish and Argentine crisis has been observed. On the currency markets, exchange rates held steady, although the appreciation of the yen in late 2001 has

made the competitiveness situation of many of these countries somewhat more complicated.

In Russia, GDP growth remained vigorous in 2001, driven by recent progress in structural reforms, although it moderated to 5%, from 9% the previous year, as a consequence of the decline in oil prices and the impact of the global slowdown. The budget and current account surpluses were reduced to 2% and 11.3% of GDP, respectively.

### CHAPTER III

## THE EURO AREA AND THE COMMON MONETARY POLICY

### **III.1. ECONOMIC CONDITIONS IN THE EURO AREA**

The economic slowdown that commenced in mid-2000 in the euro area intensified last year, in step with the deterioration of activity in the rest of the world. Real GDP increased by 1.5%, two percentage points down from the rate recorded a year earlier, primarily as a result of the stagnation of gross fixed capital formation, the fall in inventories and the pronounced deceleration of exports, while both private and government consumption were more subdued. The rate of creation of employment fell only moderately, so that the decline in the rate of unemployment was able to continue. Despite remaining above the 2% reference rate, inflation displayed a downward trend in the second half of the year in step with the reduced economic buoyancy and with the decrease in commodity prices. Against this background, monetary and fiscal policies were relatively accommodating, helping to curb the deterioration in the confidence of agents and in the outlook for economic growth. This was conducive to a recovery in activity, which already began to be discernible in the first half of 2002.

#### **III.1.1. Activity and employment**

The slowdown in output in the euro area during 2001 was a consequence of various shocks that were largely common to the rest of the world. Thus, the buoyancy of activity was affected by the strong growth in oil prices in the two previous years, by the capacity adjustments in the information and communication technologies sectors, by the falling stock markets and by the sharp slowdown in world trade. Finally, the terrorist attacks of 11 September 2001 caused a general, albeit tempo-

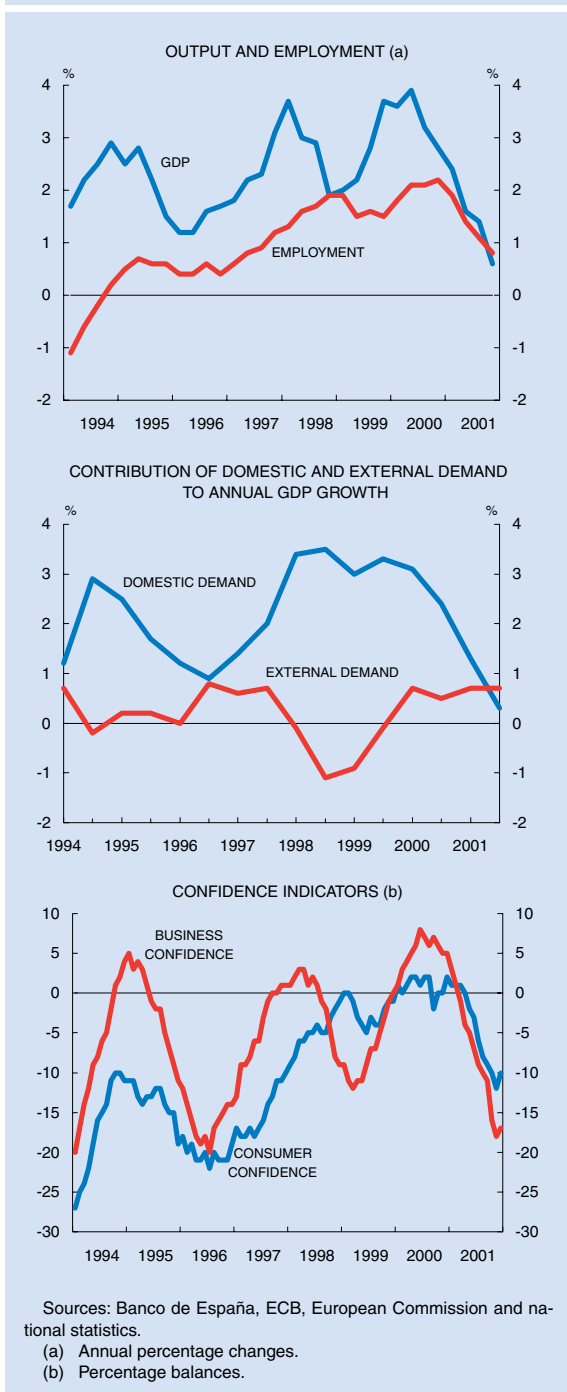
rary, deterioration in the confidence of consumers and employers (see Chart III.1). However, besides the evident consequences that these factors have had on the rate of growth of the economy, the persistence of certain problems of a structural nature may also have had unfavourable effects on economic developments in the euro area. These problems relate to the rigidities still present in European markets, which damage the economy's adjustment mechanisms and discourage expansion and modernisation of the capital stock.

Half of the two-percentage-point slowdown in the rate of economic growth in 2001 was attributable to the sharp fall in fixed investment. On top of the slackness already displayed by construction investment came the decline in investment in capital goods, which having increased by 8% in year-on-year terms at the end of 2000, fell by 5% in the final quarter of 2001. The slowdown in final demand, the climate of uncertainty that dominated world events last year and the moderation of corporate earnings contributed to the adverse behaviour of this variable. In addition, there is some evidence (see Box III.1) that, despite lower bank lending rates, the cost of the finance raised by certain large corporations may have risen, due to an increase in risk premiums prompted by their higher level of indebtedness. The latter was partly linked to the financing of large-scale projects, such as the acquisition of mobile telephone licences and mergers and acquisitions that have yet to generate the results projected.

The weak growth of world trade had a pronounced effect on exports, which decelerated throughout the year, despite the relatively low euro exchange rate. However, as the rate of growth of imports fell to a greater extent than that of exports, in line with the trend in final demand, the

CHART III.1

### Euro area. Composition of growth, confidence indicators and employment



contribution of external demand to output was positive, and similar in size to the contribution in 2000. According to trade data that are still incomplete, the share of goods exports in the volume of world trade held steady, which meant that the process of gradual loss of export shares by the euro area in previous years had come to a halt. The increase in net exports, together with the improvement in the terms of trade, enabled the current ac-

count to move into balance, having recorded a deficit of 0.9% of GDP in 2000.

The increase in employment and the reduction in the tax burden enabled household income to hold steady, and this helped private consumption sustain only a moderate fall last year (see Table III.1). However, the fall in the value of financial wealth, the deterioration of consumer expectations and, possibly, the debt accumulated over previous years, had a dampening effect on household consumption decisions, so that the annual rate of change in private consumption was 1.7%, as against 2.5% the previous year. As a result the household saving ratio picked up, to reach more than 14% in terms of gross disposable income.

In 2001 all the euro-area countries suffered a significant economic slowdown. However, there were still substantial differences between them in terms of GDP growth rates and the composition of such growth. The central countries of the area were less dynamic than others (such as Ireland, Greece and Spain), but the gap was slightly less acute than in previous years (see Chart III.3). These differences are largely attributable to the prolonging of the expansionary effects that joining the euro area entailed for some of the less advanced countries of the area. They are conducive to, but do not guarantee, real convergence (see Box III.2).

However the divergences in 2001 were also a consequence of idiosyncratic factors and of the different responses of some economies to common shocks. Thus, Germany recorded the lowest growth rate in the area, partly as a result of the adverse situation in its property sector, which was closely linked to processes arising from reunification. Meanwhile, Finland was particularly affected by the international crisis in the IT and telecommunications industry, on account of the great relative importance of this sector.

The rate of job creation moderated, although it remained high, standing at 1.3 % in 2001, 0.8 percentage points down on the previous year. The rate of unemployment fell from 8.8% in 2000 to 8.3% in 2001, although a slight upward trend was discernible in the latter months of last year. As explained in Box III.3, the greater job-creation capacity per unit of output in the euro area is linked, among other factors, to the moderation of real wage costs and to the measures introduced in the countries of the area to make their labour-market structures more



## The role of financial conditions in the slowdown of productive investment in the euro area

During 2001 gross fixed capital formation declined substantially, primarily as a result of the loss of vigour in the capital-goods component (1). As can be seen in the upper panel of the chart, investment in capital goods in the euro area during 2001 was in line with the global slowdown in activity and with the downward revision in business expectations. The sluggishness of investment has coincided with an increase in corporate debt and with a deterioration in financial conditions for some corporations.

The weight of corporate debt in the euro area (approximated by bank lending to firms plus outstanding debt securities issued by firms) stood at 49% of GDP in 2001, around eight percentage points higher than in 1997. Although the rate of growth of corporate debt moderated over the course of 2001, it is still expanding at high rates of around 8%. This phenomenon should be seen in the context of declining corporate earnings (see the profile of the indicator of stock-exchange earnings in the central panel of the adjoining chart), which has meant that many firms, despite having reduced their investment, have still had to resort to significant levels of external finance.

The increase in indebtedness in a less dynamic economic setting has meant that some firms have had to face a certain hardening of financing conditions. Despite the decline in bank lending rates (favoured by the progressive easing of the monetary policy stance in the euro area), firms, especially those with a less sound financial position, have had to face higher risk premiums.

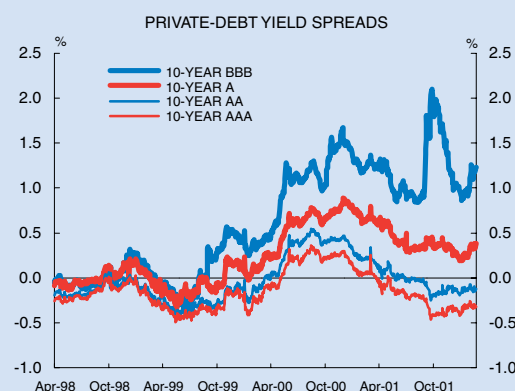
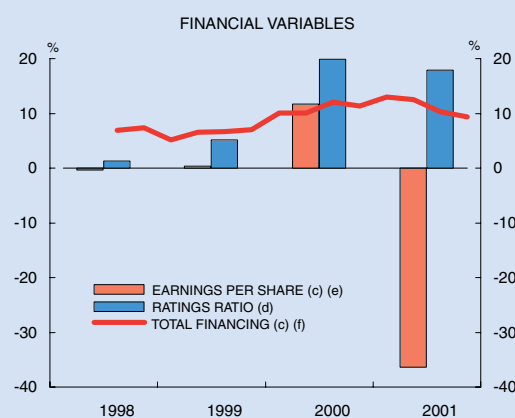
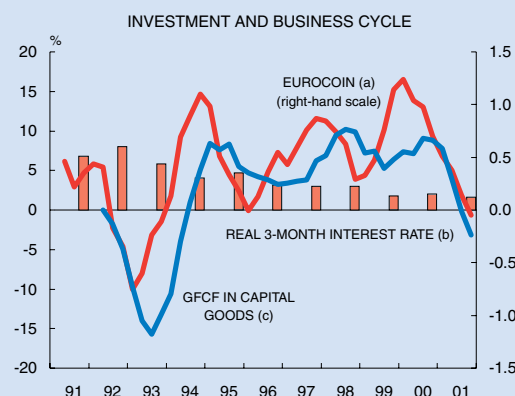
In this respect, the credit ratings of European firms issuing private debt have had to be revised downwards, so that the volume of debt issued by firms whose rating has worsened has been much higher than the volume issued by corporations whose rating has been revised upwards (see the central panel of the adjoining chart). At the same time, there has been a very significant increase in the spreads between private and public debt, especially for those corporations with a lower credit rating (see the lower panel of the chart) (2). Although the relative importance of debt-security issuance for European firms is less than in other areas (particularly the United States), it should be noted that the funds obtained through the issuance of such securities by European firms in the period 1999-2001 were relatively large and, in fact, represented almost one quarter of the flow of corporate debt in that period. Moreover, although disaggregated data are not available on the cost of financing in the case of bank lending, it can be expected that the asymmetric behaviour observed among corporations that can raise finance on the capital markets will also be found among firms that only have access to intermediated finance.

In short, the above evidence suggests that, amid high levels of debt, the sharp slowdown in the rate of growth of corporate earnings has entailed a deterioration in the terms of access to external financing for the corporate sector, which may have had a bearing on the slowdown in investment. This process may also limit the financing of future projects, especially for higher risk firms and those whose financial position is less sound, which may also be the most dynamic ones in terms of investment behaviour.

(1) Given the lack of statistics on private productive investment for the euro area, its growth is approximated in this box by means of gross fixed capital formation in capital goods, calculated in turn by aggregating this component for the eight countries of the euro area that have quarterly national accounting. The basic difference between these two concepts lies in the fact that the former includes, in addition, business investment in non-residential construction.

(2) This information is only available from April 1998, basically because of the significance of volumes of private debt is a relatively recent phenomenon in the euro area.

### Investment and financial variables



Sources: Banco de España, CEPR, ECB, Eurostat, Datastream, Moody's and Merrill Lynch.

- (a) CEPR indicator of the euro area business cycle.
- (b) Level of 3-month interbank interest rates less actual inflation.
- (c) Annual percentage changes.
- (d) Ratio of volumes of debt security issues of non-financial firms revised downwards to those revised upwards.
- (e) Calculated as the Morgan Stanley Composite Index divided by the relevant PER.
- (f) Includes credit and debt securities issued.

TABLE III.1

## Euro area: main macroeconomic indicators (a)

	1999	2000	2001	2001			
				Q1	Q2	Q3	Q4
DEMAND AND OPUTPUT:							
Gross domestic product	2.7	3.5	1.5	2.5	1.6	1.3	0.3
Domestic demand	3.4	3.0	0.8	1.8	1.1	0.7	-0.4
Private consumption	3.3	2.5	1.7	1.9	1.7	1.8	1.5
Government consumption	2.1	1.9	2.2	2.3	2.4	2.3	1.9
Gross fixed capital formation	5.9	4.7	-0.5	1.6	0.2	-1.7	-2.2
Exports	5.3	12.2	2.5	7.7	4.5	0.9	-2.8
Final demand	3.9	5.4	1.3	3.4	2.1	0.7	-1.1
Imports	7.4	10.9	0.8	6.1	3.2	-1.0	-4.8
Contributions to GDP growth (b):							
Domestic demand	3.3	2.9	0.8	1.8	1.1	0.6	-0.4
Change in stocks	-0.2	0.1	-0.5	-0.1	-0.4	-0.4	-1.1
External demand	-0.6	0.6	0.7	0.7	0.5	0.7	0.7
PRICES AND COSTS:							
Consumer prices (annual average)	1.1	2.3	2.5	2.3	3.1	2.5	2.2
Consumer prices (Dec. annual rate)	1.7	2.6	2.0	...	...	...	...
GDP deflator	1.8	1.2	2.3	2.0	2.3	2.2	2.7
Unit labour costs	1.3	0.9	2.7	2.1	2.6	2.6	3.5
Compensation per employee	2.2	2.4	2.7	2.5	2.7	2.7	2.9
Labour productivity	0.9	1.4	0.1	0.5	0.2	0.1	-0.6
GENERAL GOVERNMENT (c):							
Total expenditure	49.0	48.2	48.0				
Current expenditure	46.5	45.7	45.5				
Interest payments	4.3	4.1	3.9				
Public investment	2.5	2.5	2.5				
Total receipts	47.7	47.3	46.7				
Primary deficit (-)/surplus (+)	3.0	3.2	2.6				
Deficit (-)/surplus (+)	-1.3	-0.8	-1.3				
LABOUR MARKET:							
Total employment	1.7	2.1	1.3	1.9	1.4	1.1	0.8
Unemployment (d)	9.8	8.8	8.3	8.4	8.3	8.3	8.4
BALANCE OF PAYMENTS (c):							
Current account	-0.3	-0.9	0.0	-0.6	-0.6	0.4	0.9
Capital account	0.2	0.2	0.1	0.2	0.2	0.1	0.1

Sources: ECB and European Commission.

(a) Annual percentage change, unless otherwise indicated.

(b) Percentage points of the percentage change in GDP.

(c) As a percentage of GDP. The receipts from the sale of third generation mobile telephone (UMTS) licences are excluded from 2000 and 2001.

(d) As a percentage of the labour force.

flexible. However, the scant growth of labour productivity in recent years may also reflect other factors that are obstructing the efficient use of productive factors and, therefore, damaging medium-term growth possibilities (see Box I. 1).

The economic outlook for the euro area has improved in the first few months of this year. The

available activity indicators show a positive quarter-on-quarter rate of change of GDP in 2000 Q1, following the decline in output in the previous quarter. This recovery is consistent with the bottoming out of the inventory run-down and with the acceleration of exports, in line with the likely upturn in world trade. The improved economic climate should be conducive in the months ahead to a rise

## Lending to the private sector by country and the relationship with its determinants

Since the start of Stage Three of EMU the financing extended to the private sector by euro area credit institutions has been growing sharply. Over the three-year period 1999-2001 the average rate of increase in bank lending to the private sector was 9%, although it had decelerated by the end of the period to an annual growth rate of around 6% in 2001. In terms of GDP, outstanding bank credit has grown by nine percentage points between 1998 and 2001, so that by the end of the period it represented around 89% of GDP. The empirical evidence available on the demand for bank credit in the euro area as a whole confirms that this variable has generally moved in step with the cyclical expansion of the economy and with movements in interest rates, which reached historical lows at the beginning of 2000.

There are, however, significant differences in the growth of bank lending across the euro area countries. In order to identify those countries in which the growth of lending has diverged furthest from the norm, the upper panel of the adjoining chart plots credit growth against nominal GDP for each economy. This chart also includes a straight line whose slope represents the elasticity of lending with respect to long-term GDP, as recently estimated at the ECB. The countries situated above this line are those in which lending has expanded by more than would be explained by the nominal growth of their GDP. Thus, the group of countries in which lending has clearly been more expansionary are Ireland, Finland, Greece, Italy, Portugal, Spain and the Netherlands.

For the first six countries mentioned, participation in the Monetary Union has entailed a substantial change in the economic environment in which domestic agents take their borrowing decisions, since historically they had a lower degree of macroeconomic stability. In this respect, as seen in the middle panel of the chart, these countries generally had below-average levels of outstanding bank credit prior to the creation of the Monetary Union, so that the growth of lending to the private sector in recent years has brought their levels of debt closer to those of the area as a whole.

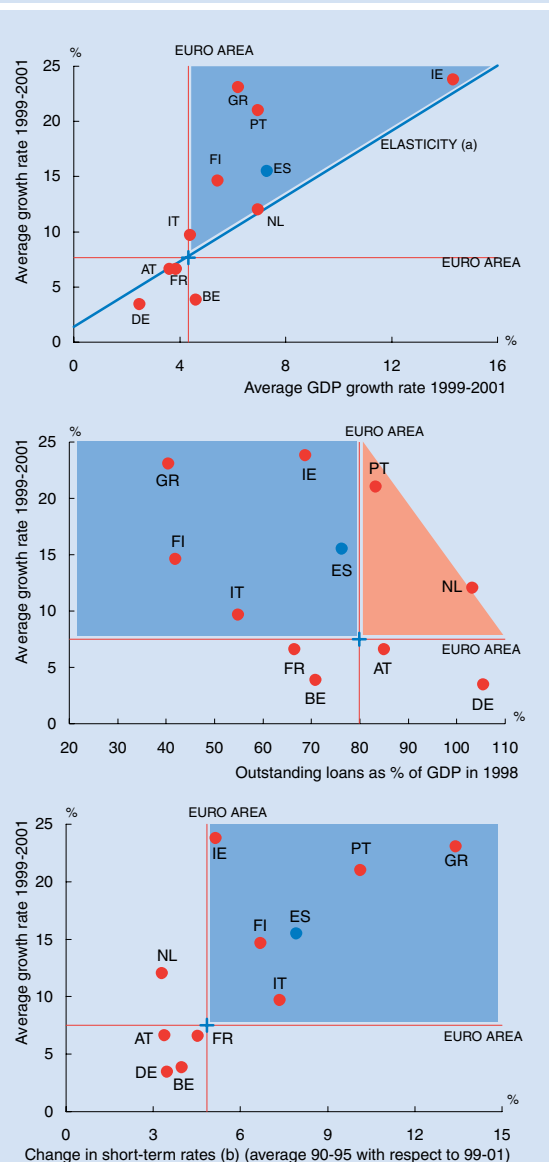
Another of the features characterising the above-mentioned group is the sharp reduction in interest rates that accompanied their nominal convergence, where applicable, prior to the start of Stage Three of EMU. The lower panel of the chart shows that it is in this group of countries that the level of interest rates fell most, compared to the previous situation, e.g. in the first half of the 1990s. This fall (which, in the case of short-term rates, ranged from 6 to 10 percentage points in this group of countries) also helps to explain the recent buoyancy of lending, insofar as it has meant that the higher level of debt has not necessarily led to an increase in financial costs.

By contrast, in the more mature and traditionally more stable economies (such as Germany and France), which started from a relatively low level of interest rates, the creation of the Monetary Union has not involved a substantial change in the behaviour of agents and bank lending has in fact moved broadly in line with its basic determinants. In these economies business lending has determined the growth profile of the private sector as a whole.

Some countries do not follow the general patterns mentioned above. For example, in the Netherlands and Portugal lending has continued to grow rapidly although levels of debt were relatively high at the start of Monetary Union. In the Netherlands, moreover, Monetary Union has not entailed a significant change in the financial conditions that have traditionally faced the private sector. In these two countries (and in others such as Ireland and Spain), the strong expansion of lending has been especially helped by the buoyancy of house purchases by households. Moreover, the ongoing revaluation of this asset (whose prices have risen by much more than the CPI) has, in turn, refuelled the demand for credit. In fact, mortgage financing in these countries grew at average rates of over 20% during the period 1999-2001.

In sum, in the first few years of Monetary Union, a large part of the disparity in the growth of lending to the private sector across countries is explained by the changes that this Union has entailed for many countries. These differences can be expected to narrow progressively as the expansionary effects of this change fade.

### Lending to the private sector by credit institutions in the euro area

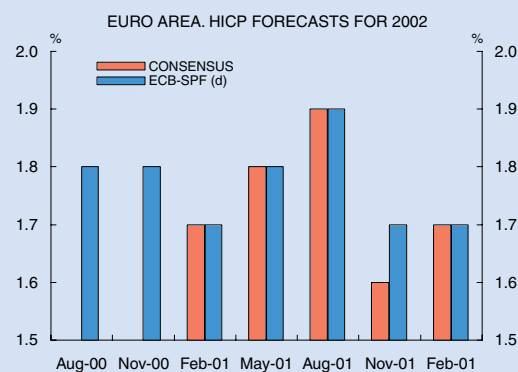
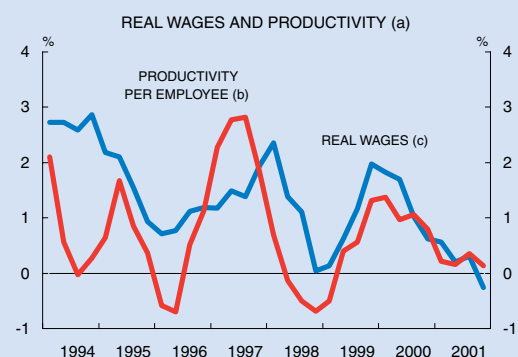
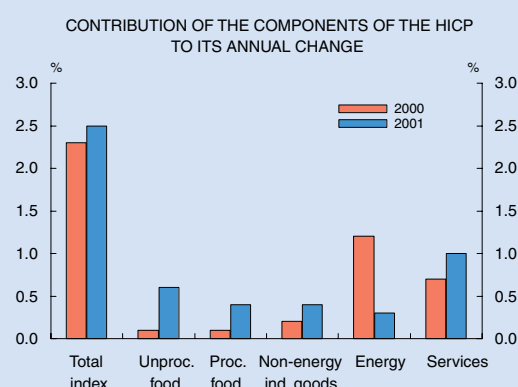
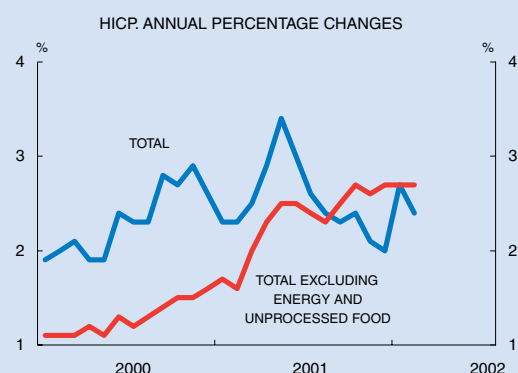


Source: Banco de España.

(a) The slope of the line represents the elasticity of credit with respect to GDP according to the long-term relationship estimated for the area as a whole.

(b) Three-month interbank interest rates on domestic markets.

### Euro area Harmonised indices of consumer prices and wages



Sources: ECB, Eurostat and national statistics.

(a) Annual percentage changes.

(b) Difference between the changes in GDP and in employment.

(c) Difference between the change in compensation per employee and the GDP deflator.

(d) Survey of professional forecasters.

in the buoyancy of consumption and, especially, of investment, which are also supported by favourable monetary and financial conditions and the absence of significant macroeconomic imbalances.

Accordingly, the euro-area economy is likely to secure growth at close to its potential by the end of 2002. Among the main risks to this scenario are the uncertain course of oil prices, against a background of heightened international political tension, and the possibility that financial imbalances in the United States will prevent the economic recovery properly taking off.

### III.1.2. Prices and costs

Price developments in the euro area during 2001 were adversely affected by the delayed effects of higher oil prices and of the depreciation of the euro since its launch in 1999, as well as by the unfavourable course of food prices, arising from health problems in the meat sector. The final demand deflator decelerated in 2001, owing to the sharp reduction in the rate of increase of import prices as the price of oil and the exchange rate stabilised. Domestic prices, in contrast, as approximated by the GDP deflator, increased by more than in 2000 as a result of the acceleration of unit labour costs, which rose in 2001 by one percentage point more than in the previous year. Net indirect taxes hardly increased, while the gross operating surplus per unit of output grew in line with the GDP deflator, so that there were no significant changes in margins.

The unfavourable behaviour of unit labour costs, in nominal terms, was attributable to the loss of momentum of apparent labour productivity, since compensation per employee continued to follow its moderate course of previous years. In fact, although inflation was higher than forecast in the first few months of the year, wage settlements were not excessive, so that in 2001, for the second year running, the purchasing power of employees in the euro area as a whole was unchanged (see Chart III.2). Wage restraint was helped in 2001 by the slowing of the decline in unemployment and by the expectations of higher unemployment reflected in confidence surveys.

The average rate of change in the harmonised index of consumer prices (HICP) was 2.5% in 2001,

## Employment creation and labour-market performance in the euro area

In the latter years of the 1990s the pattern of growth in the euro area was characterised by a high level of employment creation. In addition to boosting domestic demand, this enabled the rate of unemployment to be reduced by more than three percentage points between 1994 and 2001. In fact, the ratio of the rate of growth of employment to that of GDP reached 0.4 during this period, well above the average level of the last 20 years, which was 0.2. However, as seen in the upper panel of the adjoining chart, the rise in the ratio of employment to GDP in recent years has varied significantly across the euro area. Thus, there is a group of countries (the Netherlands, Spain, Ireland, France and Finland) with a ratio of around 0.5, while in the rest of the countries this variable has stood at around 0.2. Although these data are skewed upwards in those countries in which part-time employment has increased most, they may also be indicating the effectiveness of other labour-market reforms.

Generally, the reform programmes implemented by the euro area countries during the 1990s tended to promote labour market flexibility, by boosting labour-force participation, reducing non-wage labour costs and, for the low-paid in particular, increasing the range and flexibility of contracts and working hours and the introduction of efficient collective-bargaining mechanisms. Given the diversity and scope of the basic lines of reform, it is complicated to try to summarise them using a limited number of variables. Moreover, numerous indicators of labour-market performance not only reflect the effects of the measures implemented, but are also influenced by a large number of other factors, which makes it particularly difficult to draw conclusions regarding their sensitivity to the reforms introduced.

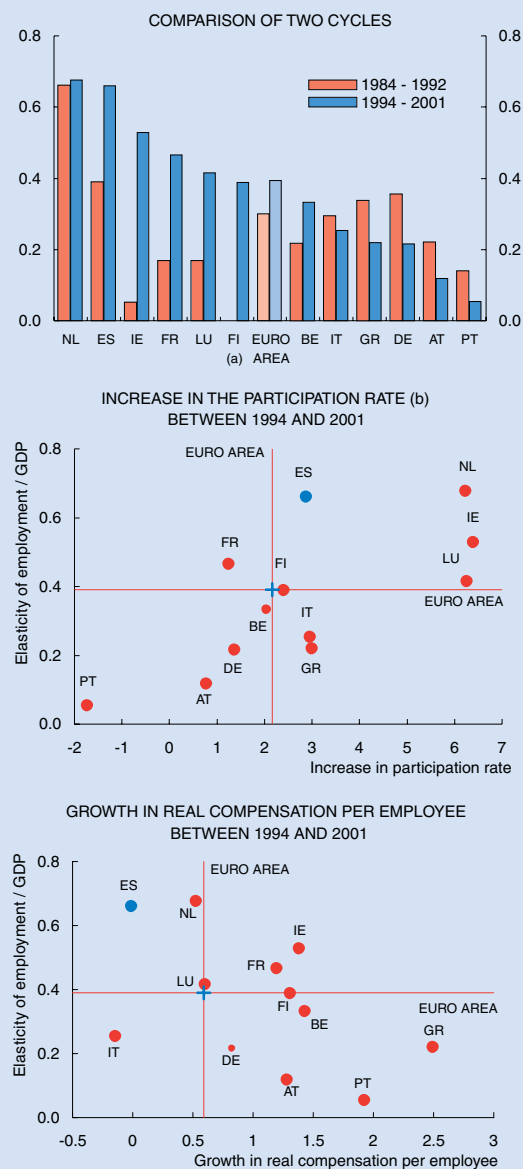
Having made these qualifications, in order to assess the effectiveness of the reforms introduced in the labour market in terms of job creation, the changes in the participation rate and in real compensation per employee (which incorporate information on wages and non-wage costs) have been analysed by country.

Although part of the divergence in employment creation per unit of output is related to the different starting positions, it is generally observed that countries with higher employment/GDP ratios tend, on average, to display favourable trends in the other variables. Thus, on the supply side, countries showing higher job-creation in terms of GDP are, on average, also those with higher levels and more significant improvements in the participation rate during the second half of the 1990s. Notable in this respect are the measures introduced in recent years by the Netherlands, Ireland and Luxembourg, which tend to increase the participation rate of lower-income groups by changing marginal income-tax rates, increasing tax allowances or granting tax credits to these groups. Also, the Netherlands has boosted the female participation rate by making working hours more flexible.

Generally, those countries in which compensation per employee has, in real terms, increased less are also those that have recorded larger increases in employment in relation to GDP. Attempts to reduce the tax wedge (for example, by reducing employers' social-security contributions) have been widespread in the euro area, those made by Italy, France and Spain being particularly notable.

The information discussed shows a gradual improvement in the employment-generation capacity of the euro area economies. At the same time, the data suggest that the measures taken so far have generally been well targeted, although they may have been insufficient, especially in certain countries. Accordingly, achievement of the targets of full employment and an employment rate of 70% in the EU as a whole by 2010, established at the Lisbon Council, require an intensification of the reform process, especially in those countries with the greatest labour market problems.

### Elasticity of employment with respect to GDP in the euro area



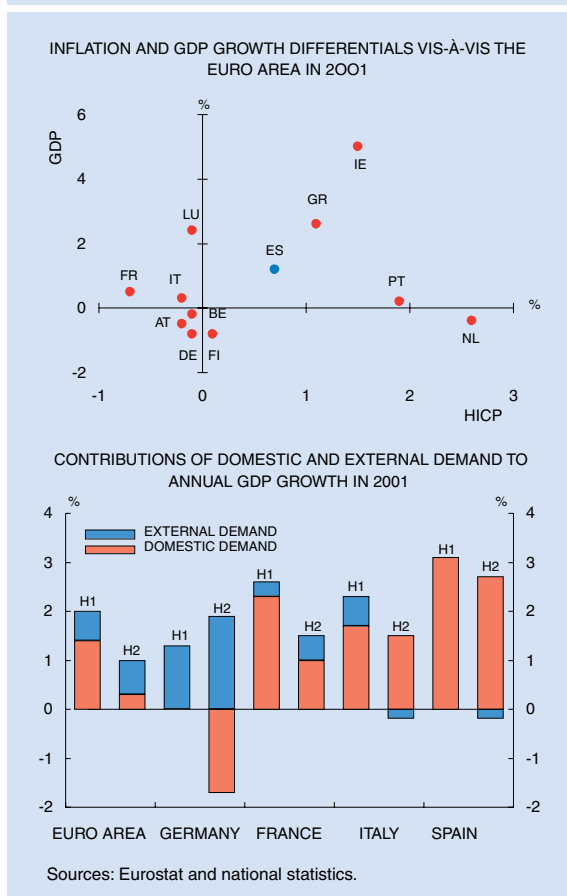
Source: European Commission.

(a) The figure for Finland in the first period was -0.9. It has been omitted so as not to distort the chart.

(b) Average growth of the labour force less average growth of the population of working age (15-64).

CHART III. 3

## Performance by country



0.2 percentage points up from 2000. The behaviour of the HICP during the year was strongly influenced by its more volatile components and showed two contrasting trends: a continuous rise in annual rates, until they reached 3.4% in May, as a consequence of the crises in the food sector, and then a marked decline from June, down to 2% in December, which was mainly attributable to the reduction in energy prices (see Chart III.2). By contrast, there was an ongoing deterioration in the index which excludes unprocessed food and energy, owing to the progressive pass-through of increases in import prices in preceding periods to the prices of consumer goods and services (see Box III.4). However, the gradual incorporation of the higher prices of imported inputs into more stable consumer-price components may have been cushioned by the weakness of demand.

In the opening months of 2002 there was a significant rise in the HICP, which was largely attributable to the performance of the less stable components of the index and to the increase in certain ad-

ministered prices and in indirect taxes. Although the overall effects on consumer prices of the cash changeover from national currencies to the euro are difficult to estimate, according to the available studies this process does not seem to have had a large impact on the course of the HICP in this period. In fact, although there are factors associated with the cash changeover process that might tend to have an upward influence on prices (such as the pass-through to consumers of the costs of transition to the euro), there are other factors whose influence is uncertain (such as the setting of prices attractive to the consumer) or, may even be downward (such as the greater transparency in price-setting and the intensification of competition between firms at the European level). However, in some services components of the HICP unusually high price increases have been observed, which may be attributable to the cash changeover.

In 2001, the dispersion of inflation rates across countries was similar to 2000. Generally, those countries with high growth tend to record higher inflation rates (see Box III.3). This may sometimes reflect relatively high productivity growth in those countries undergoing real convergence. However, they are often the result of the procyclical adjustment of the relative margins of sectors sheltered from competition in economies with higher demand pressure. On the other hand, the inflation differentials seen in recent years seem to correspond also to the different exposure of the economies to products originating from outside the euro area, against a background of pronounced exchange-rate depreciation (see Box III.4). Finally, in 2001, there were adjustments to indirect taxes which largely explain the positive inflation differentials in countries, like the Netherlands and Portugal, which did not enjoy above-average GDP growth.

Although the HICP in 2001 exceeded the 2% level contained in the definition of price stability adopted by the ECB, medium-term inflation expectations were contained, as shown by the main opinion surveys and the course of the prices of indexed bonds. Indeed, expected average inflation in 2002 was always below 2%, which indicates that economic agents perceived the rise in inflation in 2001 and in the first half of 2002 as an eminently temporary phenomenon (see the lower panel of Chart III.2). In fact, it is likely that inflationary pressures will abate during 2002, owing to the improved behaviour of the more volatile components and to the tailing off



### The pass-through of movements in the euro exchange rate to the costs and prices of the euro area

Since the start of Stage Three of EMU the euro has depreciated significantly, both against the dollar (with a cumulative depreciation to the beginning of 2002 of around 25%) and in nominal effective terms (by around 15%). Also, from the time of the introduction of the euro, inflation in the euro area, as measured by the annual percentage change in consumer prices, underwent a sustained rise, from rates of below 1% in January 1999 to a high of 3.4% in May 2001. The exchange rate depreciation was, together with the rise in oil prices, one of the main determinants of the path of inflation, since it raised the cost of goods imported from outside the euro area, which in 2000 accounted for around 14% of GDP. Insofar as the exposure of the various national economies to the exchange rate is not identical within the euro area, the performance of the euro has borne differently on the inflation rate observed in each member country.

In fact, as the red-coloured bars in panel A of the chart below show, the pass-through of a 10% depreciation of the exchange rate against the dollar to input costs ranges from 0.8 percentage points in France, Italy and Spain to around 1.5 percentage points in the Netherlands and Finland. The rate of pass-through to consumer prices (red bars in panel B) is smaller, partly as a consequence of the larger weight of non-tradable goods in consumption than in production. In this case, a 10% depreciation of the exchange rate has an impact on consumer prices ranging from 0.5 percentage points in the Netherlands to 0.2 in Italy.

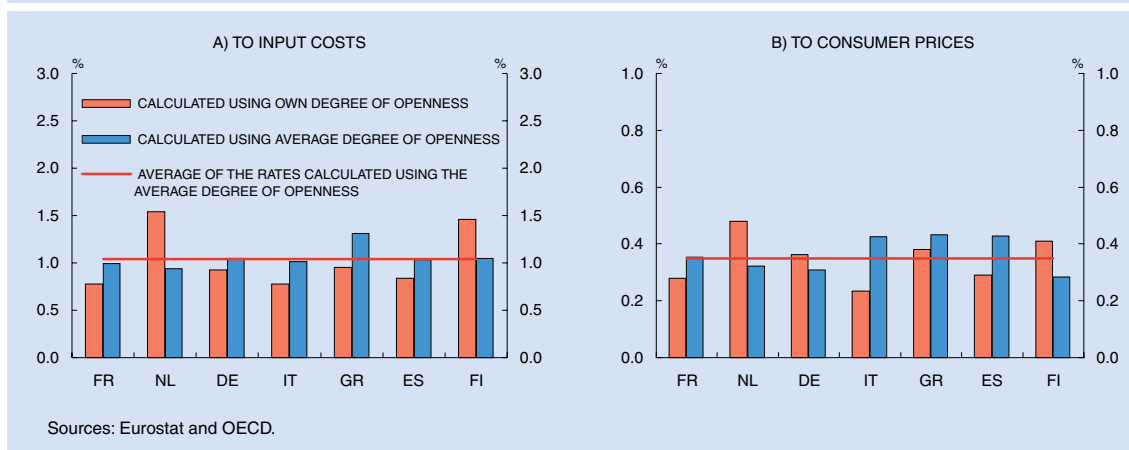
The size of the pass-through of movements in the euro exchange rate to input costs and to the final consumer prices of each country in the area depends on three factors. First, the size of the pass-through is a function of the degree to which movements in the euro exchange rate are transmitted to the prices of each of the goods that each country imports. Second, the effect will depend on the degree of openness, i.e. the weight that goods imported from outside the euro area have in the CPI basket or in total intermediate consumption; and third, on the relative importance of each imported good in the CPI basket or in the basket of inputs.

In order to try to determine the relative importance of the three factors mentioned above, ten groups of goods have been analysed. The results show, first, that for each group of imported goods, the degree of pass-through of exchange-rate movements to prices is similar across all euro area countries. This means that the prices of a single group of imported products are equally affected by the exchange rate depreciation in all countries. Nonetheless, this pass-through varies among the 10 types of goods considered. Accordingly, the differences between countries in the aggregate rates of pass-through to input costs or to consumer prices must be explained either by the different relative weight of imports (degree of openness), or else by the different composition of imports by product group.

The blue bars in the chart depict the rates of pass-through to the input costs (panel A) and to the consumer prices (panel B) of the seven countries studied, when the average degree of openness of all the countries is taken to be the degree of openness of each. The differences between the resulting pass-through rates can then only be due to discrepancies in the baskets of imports of the various countries which, as can be seen, are very small. Accordingly, the degree of openness of each country to imports from outside the euro area seems to be the main source of the differences in the rates of pass-through of exchange-rate movements to prices and costs.

The above calculations assume that exchange-rate movements only affect the prices of those goods that come from outside the euro area. However, given that these goods compete with those produced in the domestic territory and in the other euro area countries, it seems reasonable to think that the prices of these products will also be affected by exchange-rate changes. These effects have not been taken into account in the analysis. Moreover, the very creation of the Monetary Union may have led to a reduction in the magnitude of the pass-through of exchange-rate movements to prices and costs. Two types of argument would justify this change. First, to the extent that the creation of the Monetary Union has involved a reduction in medium- and long-term inflation rates for a sub-group of the member countries, foreign exporters to these countries may prefer to hold their prices unchanged in terms of the currency of the country to which they are exporting if they consider that both the magnitude and the persistence of exchange-rate movements are going to be relatively limited. Second, the creation of the euro area, insofar as it is a large economic area with a single currency, may have strengthened the market power of the European producers who compete with importers, relative to the situation prior to Monetary Union.

#### Exchange rate pass-through rates (for a 10% depreciation)



of the pass-through of previous increases in import prices. However, a further rise in oil prices, a possible increase in labour costs, as a result of high wage demands in certain sectors, and the possibility that the impact on prices of the introduction of the euro has yet to be fully felt are factors that may modify the downward trend of inflation in the euro area.

## **III.2. ECONOMIC POLICIES IN THE EURO AREA**

### **III.2.1. Fiscal policy**

The slowdown of the European economy took place at a time when not all the countries had balanced their budgets in accordance with the Stability and Growth Pact, and when a significant number of the Member States had been attempting to reconcile the achievement or maintenance of a sound fiscal position with a lower tax burden. Against this background, and as has been recognised in recent years, with multilateral vigilance over fiscal policy matters in Europe, it did not seem appropriate to resort to additional expansionary discretionary measures to combat the slowdown in activity. Owing to the lags with which they operate, the impact of such measures may begin to emerge only when the cyclical position has already begun to change, and experience shows that such measures often end up becoming permanent, thereby introducing an expansionary bias into budgetary policy. These risks are particularly significant when the public finances of certain countries still display structural imbalances and when there is an obvious need to build up a sufficient buffer against the future budgetary consequences of population ageing.

In consequence, public finances should normally adapt to a slowdown in activity through the operation of the automatic stabilisers, provided that they do not give rise to an excessive deficit, according to the terms of the Stability and Growth Pact. As stated by the conclusions of the Barcelona European Council, the stabilisers should play symmetrically, so that during upturns they should lead to an improvement in public finances. This would enable them to operate with sufficient strength in periods of economic weakness, without the limits established being breached. In Europe, the cyclical sensitivity of automatic stabilisers (and, therefore, their stabilising potential) is very much higher than in other areas such as the United States, owing to the

higher tax burden and the larger expenditure on unemployment protection.

Last year there was a moderate deterioration in the aggregate budget balance of the euro area. The budget deficit of the euro area as a whole stood at 1.3% of GDP, as against 0.8% a year earlier, the first increase in the deficit since 1993. According to the European Commission's most recent calculations the cyclically adjusted primary surplus (which enables the structural trend in public finances to be assessed) fell by 0.3% of GDP last year, for the euro area as a whole, although this figure is the result of very different behaviour across the Member States. In fact, in four countries the cyclically adjusted primary surplus increased. Among the rest, Germany, Ireland and the Netherlands recorded the most significant deterioration in this balance (see Chart III.4).

The increase in the structural deficit in the euro area as a whole (especially in Germany) was primarily a consequence of the impact of tax reductions that were not offset on the expenditure side, and which were adopted at the beginning of the year before the weakening of activity became apparent. In most cases the tax cuts were part of a broader economic policy strategy pursuing lower taxes on employment in order to boost job creation. However, some countries with public finances in a stronger structural position adopted discretionary measures to combat the decline in growth, although their amount was very limited.

As for the composition of the change in the balance, there was a fall in the weight of public spending in GDP of 0.2 percentage points, which corresponded to a similar fall in interest payments. The share of primary spending in output remained unchanged. Revenues also declined, by 0.6% of GDP.

The unexpected strength of the economic slowdown meant that only four countries of the euro area (Spain, Austria, Finland and Luxembourg) achieved the budgetary targets contained in the stability programmes presented at the end of 2000 (which is indicative of the commitment of these countries to the stability of their public finances). In the other countries there were deviations of varying importance, depending on the degree of weakness of demand, the cyclical sensitivity of budget balances and the expansionary measures, such as tax cuts, decided upon in previous years. Overall,



these deviations are largely explained by the fact that the Member States presumed in their stability programmes that the euro area as a whole would grow by 3.2% in 2001, when the rate actually observed was 1.7 percentage points lower.

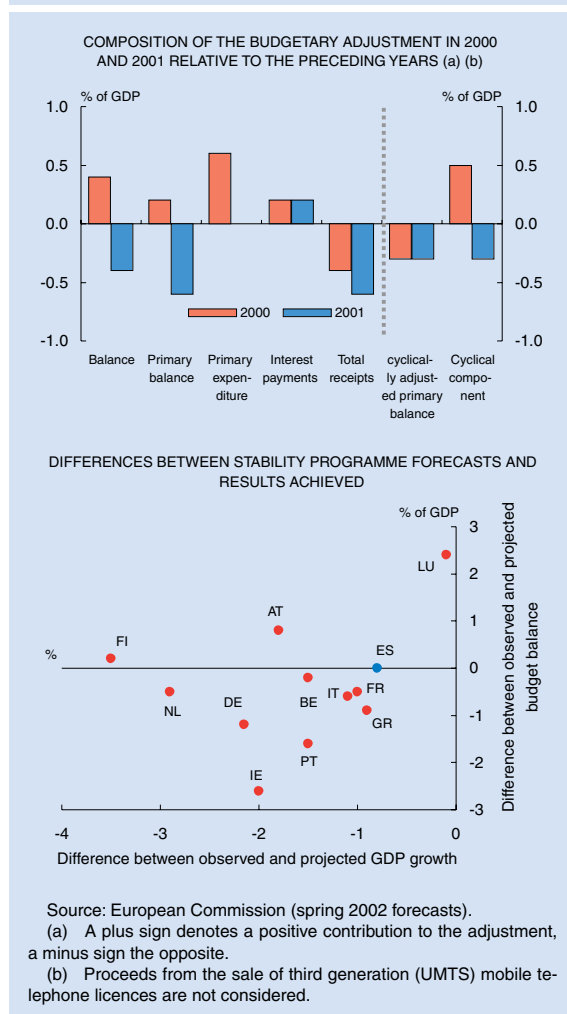
In some countries the impact of the slowdown in activity on public finances has highlighted the insufficiency of the structural adjustment carried out in recent years. The slowness of the consolidation process had been partly concealed by the effect of the cyclical upturn and the reduction in interest payments. However, with the budgetary consequences of low growth becoming apparent in 2001, it became clear that some countries had not achieved sufficiently sound budgetary positions, which meant that the budget deficit in 2001 was close to the limit of 3% of GDP contained in the Stability and Growth Pact. Accordingly, in January 2002, the European Commission decided to propose that the ECOFIN Council should issue a recommendation warning Germany and Portugal of the risk that the 3% deficit limit would be exceeded in 2002 (known as the early warning procedure). The council did not formally adopt this recommendation, since the authorities of both countries publicly undertook to comply with their obligations under the Stability Pact, by ensuring that the budget deficit will in no event exceed 3% of GDP, and in particular to respect the commitment made prior to the current phase of lower growth to balance their budgets in 2004.

### III.2.2. Structural policies

Structural reform programmes received a strong political boost at the March 2000 Lisbon Council when some very ambitious targets were set for the current decade, whose achievement required an overall strategy and the improvement of co-ordination at all levels of the EU. The goal was to raise the growth potential of the European economy to around 3% from its current 2-2.5%, and to achieve full employment by 2010. The Barcelona Council has reviewed the progress made after two years, renewing the momentum in certain areas. This review was made all the more necessary by the fact that during 2001 there was a loss of momentum in the Lisbon reform process, possibly as a result of a sudden change in the priorities of the economic authorities at a time of cyclical weakness in economic activity.

CHART III.4

#### Euro area. Fiscal policy



In the labour market, the targets for 2010 included the achievement of full employment, with a rate of employment of 70% for the economy as a whole, 60% for females and 50% for the 55-64 age group, which are significantly higher than the current levels (see Table III.2). The slowdown in 2001 has increased the level of unemployment in certain segments, such as the long-term unemployed. In order to achieve these objectives, it was proposed at the Barcelona council that the fiscal and unemployment benefit systems should be reviewed in order to increase the supply of labour, and the need for wage determination mechanisms to take into account productivity differences was stressed. In the case of the female rate of employment, targets were set to remove obstacles to women's participation in the labour market. Finally, the EU countries agreed to raise the average retirement age by five years by 2010. Among other things, this would reduce the budgetary impact of population ageing.

TABLE III.2

## Structural indicators

	EU		US	
	2000	2001	2000	2001
<b>LABOUR MARKET:</b>				
Participation rate (15-64)	63.2	64.0	73.9	74.1
Female	54.0	54.9	67.6	67.9
Male	72.5	73.0	80.5	80.6
Participation rate (55-64)	37.8	38.6	57.7	57.7
Female	27.9	28.9	50.1	50.5
Male	48.0	48.7	66.1	65.6
Unemployment rate	9.4	8.4	4.0	4.8
Female	11.0	9.9	4.1	4.7
Male	8.2	7.3	3.9	4.8
Long-term unemployment rate (over 12 months in the euro area and over 27 weeks in the US)	3.6	3.9	0.5	0.6
Direct taxes and social contributions	38.6	37.8	29.0	27.7
<b>INNOVATION AND TECHNOLOGY</b>				
R & D (% GDP)	1.9	1.9	2.7	2.8
General government	0.7	0.7	0.7	0.7
Other	1.3	1.2	2.0	2.1
Percentage of homes with Internet access (euro area)	28.4	37.7	30.0	46.7
Patent applications per million inhabitants (a)	210.1	226.5	455.7	471.2
Spending on IT and communications as % GDP (a)	6.4	6.9	7.9	8.0
IT	3.9	4.2	5.3	5.4
Communications	2.5	2.7	2.6	2.6
High-technology exports as % total exports	19.8	19.9	30.0	
<b>SECTORAL PRICES:</b>				
Telecommunications prices (euro/minute)				
Local calls	0.041	0.041	0.013	0.013
National calls	0.134	0.115	0.063	0.063
Electricity prices (euro/kW)				
Industrial users	0.064	0.063		
Domestic users	0.104	0.103		
Gas prices (euro/gigajoule)				
Industrial users	5.01	6.12		
Domestic users	7.76	8.70		
<b>FOREIGN TRADE AS % GDP (a) (b):</b>				
Intra-Community trade	17.8	17.6		
Total external trade	11.5	11.5	10.3	9.4
<b>FINANCIAL MARKETS:</b>				
Risk capital investment (% GDP)	0.14	0.23	0.50	0.89

Sources: European Commission, OECD, Bureau of Labor Statistics and US Department of Commerce.

(a) The data are for 1999 and 2000.

(b) The data are for 1999 and 2001.

As regards the liberalisation and integration of network industries, significant progress has been made in certain areas. However, there persist a large number of structural rigidities that limit business investment opportunities and the competitive adjustment of prices and which therefore make it difficult for the benefits of the single market to be reaped. In the two basic spheres of action of the network industries (liberalisation and interconnection) the progress has been uneven. In the first case, there has been satisfactory progress in general terms, although not at the same rate in all the countries of the area. The Barcelona council established timetables for liberalisation in the electricity and gas sectors for non-domestic consumers who are estimated to represent around a 60% of the market. As regards the interconnection of infrastructures, progress in the energy and transport sectors is slow, delaying the achievement of a single market for energy in the EU and limiting commercial integration within the Community. In any event, the commitment to achieve by 2005 a level of interconnection between countries of at least 10% of the electricity production capacity is encouraging. The boost given in Barcelona to the Galileo project and, in the area of transport, to the Single Sky programme, to the second railway package and to certain projects designed to reduce bottlenecks in transport through mountain areas, amounted to significant progress. In the telecommunications market, the target of full integration of the sector in 2001 is far from being achieved, although some steps have been taken. Thus, at the end of 2001 a new regulatory framework was introduced, which establishes, *inter alia*, that the treatment of the different media for telecommunications services (fibre-optics, cable, etc) must be uniform.

In the area of competition, sufficient progress has not been made on matters such as state aids, the transposition of directives, the opening up of public procurement processes and the reduction of administrative barriers to business activity, in particular for SMEs. There was also much room for improvement in relation to the information and knowledge economy. Investment in R&D has been significantly below the level in the United States and was, moreover, stagnant in 2001 at well below 3% of GDP, the target established in Barcelona for 2010. Thus, to meet the challenge set in Lisbon of making the EU the world's most dynamic economy requires a redoubled effort to boost technological innovation. The data available on registered patents,

net income from royalties and exports of high-technology goods highlights the inferiority of Europe with respect to the United States in this area.

Finally, the absence of fully integrated markets for securities, risk-capital and financial services in general is hardly compatible with efficient allocation of the savings available at the European level, and thus limits the benefits of the single currency. The lack of a completely uniform legal environment, the insufficient homogenisation and interconnection of clearing and settlement systems, the differences in the tax treatment of savings and the incomplete harmonisation of accounting standards are only examples of the barriers that prevent full advantage being taken of the Monetary Union in the financial sphere. However, following several months of discussions, an agreement has been reached between the European Parliament and the European Commission to apply the simplified and accelerated legislative process proposed in the Lamfalussy report in 2001, which is a promising step. Accordingly, it is expected that a large number of directives and regulations will be approved this year to enable the commitment to achieve integrated securities markets in 2003 to be met and progress to be made towards the goal of integration of all financial services in 2005.

### **III.3. THE COMMON MONETARY POLICY AND MONETARY AND FINANCIAL CONDITIONS IN THE EURO AREA**

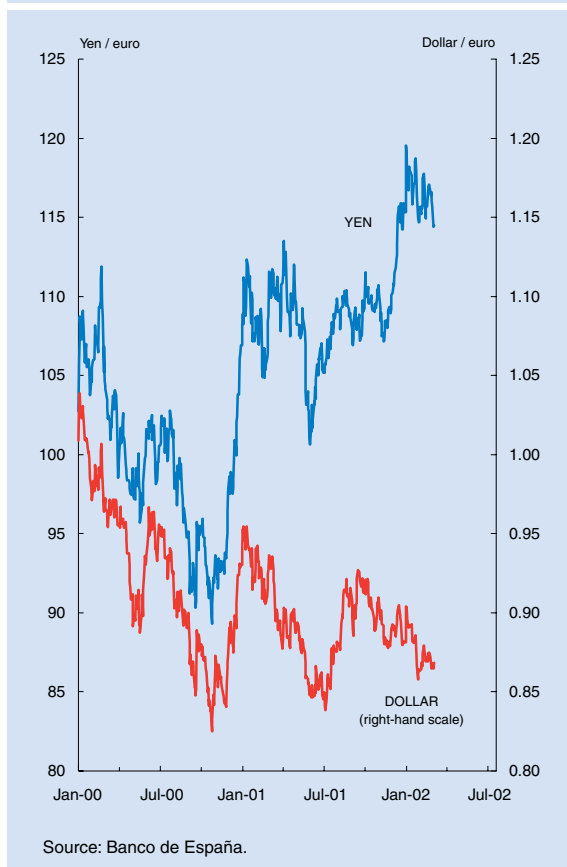
#### **III.3.1. Monetary policy decisions**

During 2001 monetary policy had to be adapted to the progressive slowdown of economic activity in the euro area and to the high degree of uncertainty regarding the future course of the world economy, especially following the events of 11 September in the United States. Although, as mentioned, inflation stood above 2% in 2001 as a consequence of various factors of a temporary nature, the outlook for price behaviour at horizons relevant to monetary policy decision-making remained generally benign. This enabled monetary conditions to be favourable for economic activity and, therefore, helped to moderate the extent of the cyclical slowdown.

During the first four months of the year, monetary policy was governed by the assessment of the

CHART III.5

### Nominal euro exchange rate against the US dollar and the yen



impact of the sudden slowdown in activity in the United States on the euro area. There were signs that the rate of expansion of economic activity was moderating, but the available indicators did not point to an unequivocal deceleration and reflected continuation of the inflationary pressures that dominated the second half of 2000. Meanwhile, the exchange rate of the euro, which had been recovering in the second half of 2000, to reach a relative high of 0.95 US dollars in January 2001, slipped back again. This amounted to a risk factor for inflation (see Chart III.5). Taking into account, also, the relative laxity of the financial conditions in the area, as shown by the trend in the monetary (which it was particularly difficult to interpret during the year) and credit aggregates, the Governing Council of the ECB decided to hold its main interest rate unchanged during the first four months at 4.75%, the level at which it had stood since October 2000, following an upward movement of 225 basis points that began in November 1999.

During Q2 the worsening of the international environment – basically of growth prospects in the

CHART III.6

### Euro-area interest rates

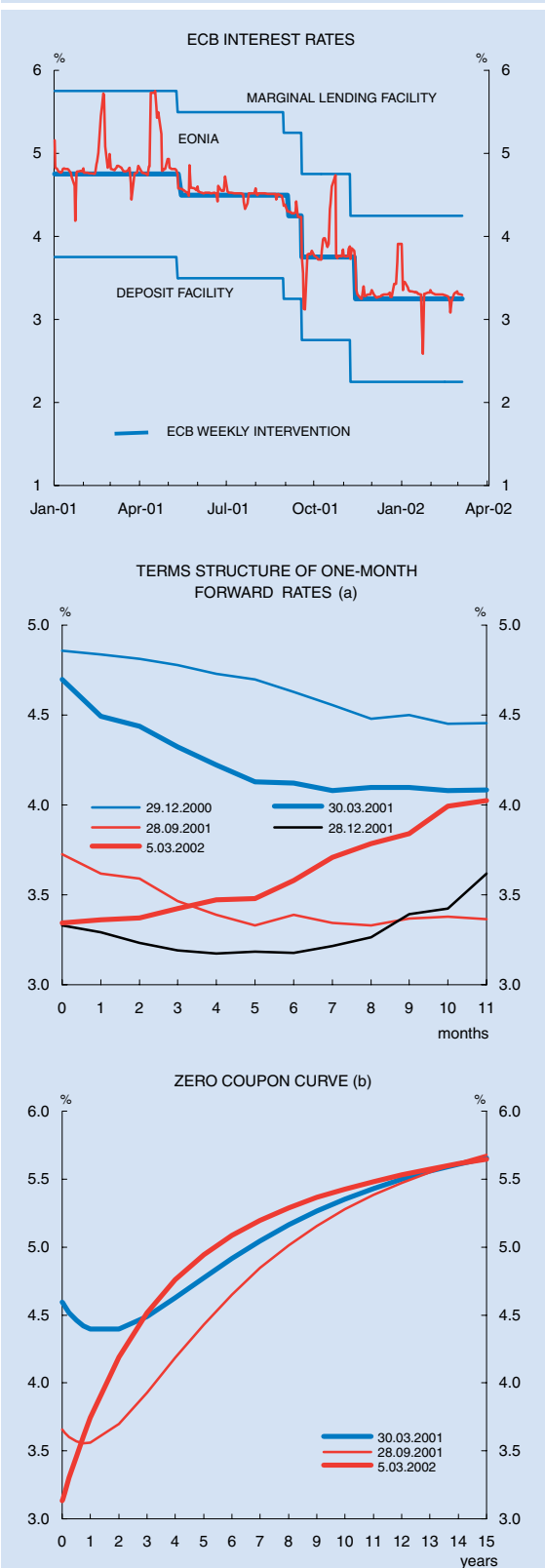
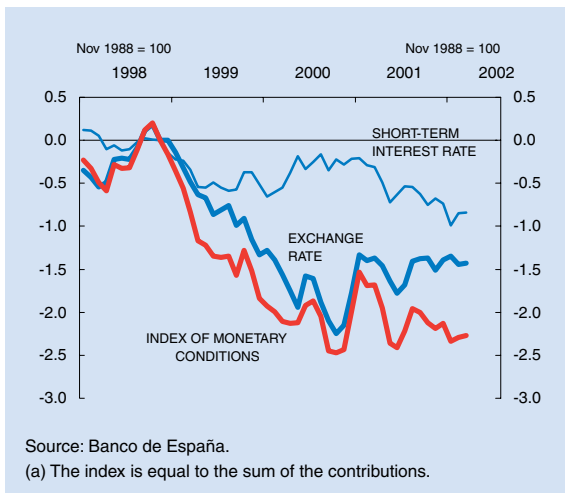


CHART III.7

### Index of monetary conditions in the euro area: contributions (a)



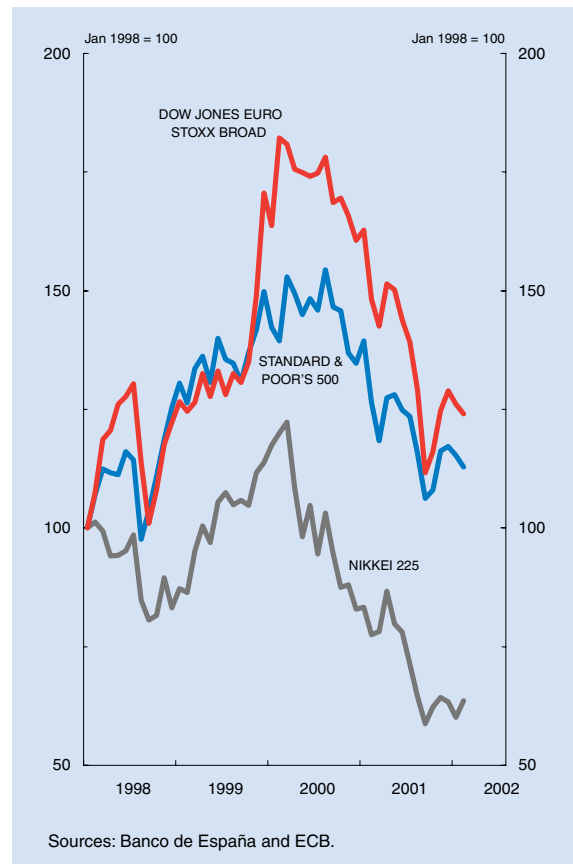
United States (despite the fact that the Federal Reserve had been cutting interest rates sharply since January) – and the intensification of the slowdown in the main economies of the euro area became more apparent. Despite the occasional rise in prices, caused by farming crises, the increasing weakness of activity reduced the risks on the prices front, enabling the Governing Council of the ECB to cut its official reference rate by 25 basis points on 10 May 2001 (see Chart III.6).

During the summer the deterioration in the economic outlook was confirmed while the inflation situation improved, both as a result of the very weakness of demand and of the progressive fading of the effect of the rise in oil prices and of the crisis in the food sector. Against this background, the ECB again reduced interest rates by 25 basis points on 30 August.

The grave events of 11 September entailed a significant increase in uncertainty over the economic outlook and a striking worsening of agents' confidence. The world's main central banks urgently adopted measures to guarantee the operation of payments systems and to minimise the impact on the stability of the financial system. On 17 September the Governing Council of the ECB decided to reduce its official rate by 50 basis points, in line with a similar measure by the US Federal Reserve. The fear of a prolonged phase of economic uncertainty at a world level and a clear downward revision of growth and inflation prospects in the area led the monetary authorities to reduce their reference rate

CHART III.8

### Stock market indices



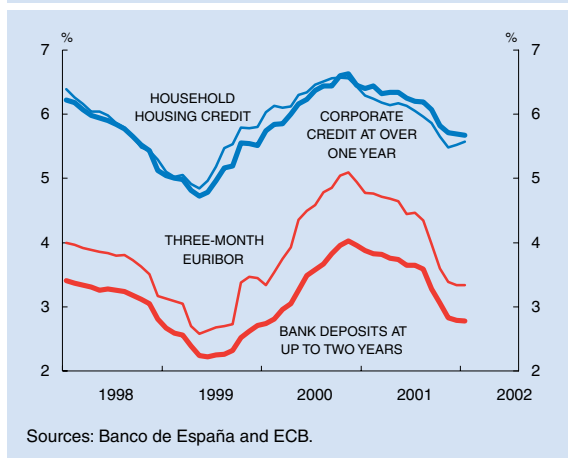
by a further 50 basis points on 8 November to 3.25%. This has been the last cut in interest rates to date and it brought the cumulative reduction in official rates during 2001 to 150 basis points. In recent months, the need for more information on the extent of the incipient recovery and inflation prospects in line with the goal of price stability have led the ECB to hold its monetary policy stance steady.

### III.3.2. Monetary and financial conditions in the euro area

During 2001, the monetary conditions of the euro area were relatively lax, as a consequence of the reductions in official interest rates (which led to very low nominal and real rates, compared to those of recent decades) and of the low level of the euro exchange rate (see Chart III.7). Judging by the yield curves, the markets were discounting a reduction in official rates during 2001, albeit not as large as the one actually made, in step with the progressive deterioration in the economic outlook for the euro area over the course of the year (see Chart III.6).

CHART III.9

## Euro-area interest rates

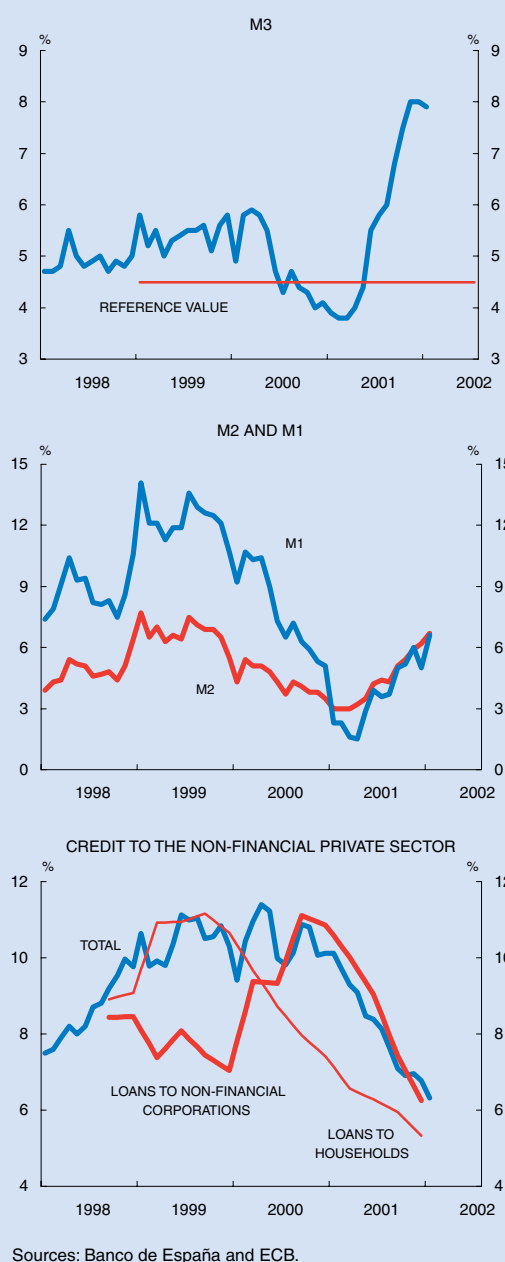


Towards the end of the year, as the signs of the end of the slowdown began to be confirmed and the general uncertainty in the wake of 11 September declined, the interbank markets began to anticipate a turnaround in the monetary policy stance. This trend intensified in the early months of 2002, pointing to a gradual increase in official rates during 2002.

In line with the decline in expected inflation and with the deterioration in growth prospects, long-term interest rates stood approximately 50 basis points below their 2000 levels. Moreover, this decline in long-term interest rates (which, inter alia, involved a reduction in the cost of servicing public debt) was consistent with the financial shifts during the year from equities to bonds, against a background of higher uncertainty. In the same way, the recent increase in long-term rates may reflect market expectations of a higher nominal economic growth rate.

The transmission of monetary policy decisions to the retail bank interest rates set by credit institutions was practically immediate. As seen in Chart III.9, the institutions adapted the yields of their assets and liabilities in line with 3-month EURIBOR. However, as mentioned in the previous section and in Box III.1, this does not necessarily mean that the cost of borrowing has fallen across the board, since the risk premiums applied to those agents who have significantly increased their indebtedness to finance ambitious investment projects have been increased. This factor, along with the fall in European and international stock markets (see Chart III.8), offset to

CHART III.10

Monetary and credit aggregates in the euro area  
Annual percentage rates

some extent the laxity of monetary conditions in the economy.

The monitoring and interpretation of monetary aggregates during 2001 was especially difficult since they were governed by diverse types of factor. First, the ECB changed the composition of the aggregate in order to remove non-residents' holdings of negotiable instruments. Second, the changeover to the euro affected the demand for cash of agents

resident and non-resident in the euro area. The lower demand for cash (anticipating the imminent euro cash changeover) was reflected in the higher acquisition of other liquid instruments, such as sight deposits and deposits redeemable at notice. In fact, despite the sharp fall in the demand for cash (which reached 32.5% in December 2001 year-on-year), all the monetary aggregates accelerated in the second half of the year.

Above all, however, the heightened uncertainty prevailing led to substantial shifts in agents' portfolios, sharply increasing the demand for liquid assets, so that M3 ended the year at an annual growth rate of 8%, well above the reference value of 4.5% established by the ECB (see Chart III.10). This phenomenon (which does not necessarily involve a subsequent inflationary rise in spending) highlights the importance, as stressed by the ECB, of avoiding mechanical interpretations of deviations by M3 from its long-term reference value. In this respect, taking advantage of the flexibility inherent in the ECB's monetary policy strategy, the developments in M3 were interpreted prudently and the behaviour of other monetary and credit aggregates was also evaluated, along with that of the rest of the real and financial variables that are relevant to the assessment of the outlook for future price developments.

Lending to the non-financial private sector by euro area monetary financial institutions (MFIs) grew at high rates in 2001, although there was a progressive slowdown over the year. At year-end the annual growth rate stood slightly below 7%, as against above 10% a year earlier. The slowdown in

lending probably reflects a number of factors, including the delayed effect of the rises in bank lending rates between mid-1999 and end-2000, the lower level of economic activity in the euro area and the reduced importance of other factors, such as mergers and acquisitions and the substantial external investment that European firms had been making, which had temporarily boosted the demand for bank finance in previous years. An analysis of lending by sector shows that lending to households decelerated somewhat more sharply, especially due to lower consumer credit.

As a result of the more moderate growth of lending and of the fact that the domestic funds of the MFIs (obtained through the issuance of instruments included in M3 and more long-term financial assets) increased significantly, the net external indebtedness of the sector was virtually nil in 2001, in contrast to the cumulative increases of the last three years. Meanwhile, in the financial account of the balance of payments, a significant reduction was seen in the net outflows of capital in the form of direct and portfolio investment relative to the previous year. It should be noted that, unlike in 2000, the flow of direct investment was negative, which suggests a lower relative return on investment projects in the euro area than in other more dynamic areas. However, the euro area raised funds in net terms through portfolio investment, as a consequence of the lower acquisitions of equities outside the euro area by residents and higher sales of equities to non-residents, which may be a sign that the shares of European firms are increasingly being included in the portfolios of the major international financial investors.

## CHAPTER IV

# THE SPANISH ECONOMY



## **IV.1. ECONOMIC POLICIES**

### **IV.1.1. Monetary and financial conditions**

Throughout 2001, and against a background of slowing growth, Spanish monetary and financial conditions showed a degree of generosity similar to the previous year. This was because the reduction in the inflation rate and the slight appreciation in the euro exchange rate were offset by the lower interest rates stemming from the easier single monetary policy stance. These conditions remained looser than in the rest of the euro area, although this difference lessened as the buoyancy of demand diminished and the inflation gap between Spain and the euro area narrowed. The more liquid financial assets and, to a greater extent, the credit aggregates grew in Spain for the third year running at high rates, higher indeed than those posted in the euro area. That said, during the year and in 2002 to date, signs of slowing have been observed.

Total financing to non-financial resident sectors grew last year at a rate close to 11%, only one percentage point less than in 2000 and over five points above the increase in this aggregate in the euro area as a whole. Component by component, financing to non-financial corporations and households decelerated, in contrast to the acceleration in financing to general government (see Chart IV.1). However, the growth of financing to non-financial corporations and households stood at 14% year-on-year, with a fresh rise in the debt ratios for the sector (of over four percentage points of GDP in the case of corporations, and of two points in that of households), which is discussed in detail in Chapter V of this Report.

The more liquid financial assets also saw a bigger increase in Spain than in the euro area, although the

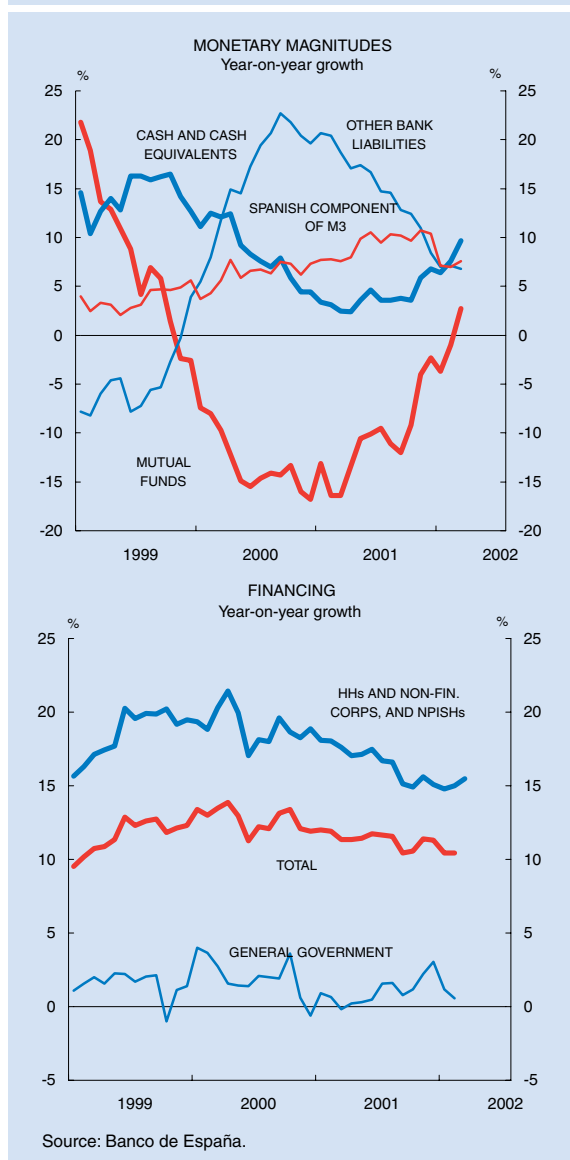
relative differences progressively narrowed. Means of payment, the aggregate comprising cash and sight and saving deposits, posted moderately rising growth during the year, with its year-on-year rate standing at 6.9% at end-2001, despite the substantial contraction in currency in circulation (-21.3% in December 2001). Cash has been influenced by the switch from pesetas to euro at the onset of 2002; the changeover appears to have led a sizable proportion of Spanish households and firms to replace cash by bank deposits. The same quickening trend was seen in shares in collective investment undertakings, which benefited from a new tax change in June 2000, and in the Spanish component of M3, which grew by 10.4% in 2001, compared with 8% in the euro area as a whole. There was a significant reduction only in the pace of deposits with an agreed maturity.

So far in 2002, the credit and, more clearly, monetary aggregates are posting more moderate growth. That shows a degree (albeit insufficient) of convergence towards rates more consistent with the general situation of economic activity in Spain.

### **IV.1.2. Domestic macroeconomic policies**

Fiscal policy in 2001 was geared to attaining a balanced budget, as established under the State Budget for the year. To achieve this goal a fall in general government net borrowing of three-tenths of a point of GDP was required, against a backdrop in which output was expected to grow less and inflation to be lower than the previous year. Drawing on the provisional year-end figures for 2000 available at that time, the Budget estimated an improvement in the fiscal balance for all agents that would be manifest in a fresh cut in State borrowing of

CHART IV.1

**Non-financial resident sectors**

three-tenths of a point of GDP, in a decline of one-tenth of a point in the territorial government deficit (to zero) and, for the third year running, in a social security surplus equivalent to 0.3% of GDP.

The target established for 2001 was part of the fiscal consolidation drive that has been at the heart of economic policy in recent years, in line with the requirements of the Stability and Growth Pact. This target has been updated successively in the Stability Programme. In the update for the period 2000-2004, which the Spanish government presented in January 2001, it was stated that, following achievement of a balanced budget that year, public finances would be in a surplus position that would hold until

the end of the period in question. For its part, the public debt/GDP ratio, after standing at below 60% in 2001, would continue falling to 49.6% in 2004. It was expected this process would be accompanied by a decline in the structural deficit and an increase in the structural primary surplus.

As in prior years, the budget for 2001 had the adjustment of borrowing requirements fall on primary current spending (in particular on employee compensation) and on the decline in actual interest payments. Concurrently, total revenue as a proportion of GDP was maintained, underpinned by the increase in certain extraordinary items of current revenue. Among the measures included in this Budget, mention might be made on the revenue side of the increase in the charge for the use of the radio spectrum (established after the award of the UMTS licences) and the decision to give free play to fiscal drag in connection with personal income tax, which also had an expansionary effect on revenue. On the expenditure side, the budgetary discipline measures took the form of the extension, during 2001, of the restrictions on public-sector hiring, and the exclusion of INSALUD (the Spanish public health service) credits intended for payment of pharmaceutical products from the list of budget appropriations. At the same time, the increase in civil servants' wages and in pensions was set in line with the official inflation target (2%). The application of these measures should enable public investment to be increased (this is a priority of the public spending strategy, in the Stability Programme forecasting horizon) and certain expansionary spending policies to be pursued, without jeopardising the balanced budget. Notable among the latter measures are the extra payment to pensioners for their loss in purchasing power the previous year, the concession of certain tax benefits to specific groups for the rise in fuel prices in 2000, and the payment of rebates on employers' social security contributions for permanent-contract hiring, which remained in force in 2001. Lastly, a provision of €541 million was set aside for the pension reserve fund, without any impact on total expenditure.

The fiscal policy defined on the basis of this set of measures was intended to be of a moderately restrictive stance in keeping with an economic situation where, despite the moderate slowdown foreseen in activity and in inflation, final demand was expected to remain notably buoyant. The fiscal policy stance was also in step with the fiscal recommenda-

tions of the General Economic Policy Guidelines for Spain, approved by the European Council in June 2001. These guidelines further suggested reforming the public pension system and increasing provisions to the reserve fund up to an amount equivalent to 1% of GDP in 2004. Under the conditions set by the lower-than-assumed growth in the budgeted macroeconomic scenario for the year 2001, the fiscal policy stance proved to be as programmed.

The fiscal policy strategy defined for 2002 focused once again on maintaining budgetary equilibrium. The State Budget approved for this year thus aimed to keep public finances in balance. That goal would be subsequently ratified in the Updated Stability Programme for the period 2001-2005. Moreover, in December 2001, important legislative initiatives were approved to consolidate fiscal discipline in the medium and long term, and to further the process of fiscal decentralisation towards the regional (autonomous) governments. Firstly, mention should be made of the budgetary stability laws (1), which came into force on 1 January this year. These lay down the principles of stability and transparency for each of the agents making up the public sector (State, Social Security, Regional Governments, Local Governments and business public sector). The implementation of budgetary policy on the basis of the principle of stability is a necessary requisite for establishing the conditions that ensure sustained economic growth (see Box 1.4). The principle of transparency sets the mechanisms in place to provide for the flow of information relating to the definition of budgetary targets, their distribution among agents and the attendant degree of compliance, facilitating accountability and strengthening the commitment to fiscal discipline. Secondly, the entry into force of the new arrangements for regional government financing (2) should be highlighted. This is considered to be a stable and uniform agreement for all the ordinary-regime regional governments, which integrates health-care financing into the overall regional financing framework and which also raises the degree of fiscal co-responsibility of the regional governments.

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(1) General Budgetary Stability Law 18/2001 of 12 December 2001, and Organic Law 5/2001 of 13 December 2001 complementing the former.

(2) These arrangements are laid down in Organic Law 7/2001 of 27 December 2001, amending Organic Law 8/1980 of 22nd September 1980 on the financing of regional governments, and in law 21/2001 of 27th December 2001 regulating the fiscal and administrative measures of the new financing arrangements for the ordinary-regime regional governments and the city-enclaves with an autonomy statute.

Turning to pension systems, an agreement was signed in April last year to improve and develop the social protection system within the framework of the recommendations of the Toledo Pact. Some of the initiatives agreed would subsequently be reflected in the legislative measures accompanying the Budget for 2002. The agreement stipulated the creation of the Social Security Agency (through which the functions of registration, collection and management of benefits will be integrated), the regulation of the reserve fund and the adoption of certain measures that will allow those aged over 65 to remain active in the labour force, following the regulation of partial retirement and exoneration from the payment of contributions. Nonetheless, the review of the parameters defining the public pension system was deferred until 2003, whereupon the changes needed to improve the financial position of the Social Security System in the medium term were postponed, making the content of the reform less ambitious than was recommended in the General Economic Policy Guidelines.

Employment policies, for their part, influenced the promotion of stable employment and employment for the groups with the highest unemployment rates: youths, women and the over-45s. The attainment of this objective was structured around Royal Legislative Decree 5/2001 on urgent labour market reform measures. Hereunder, the groups that can take up employment-promoting permanent contracts and qualify for rebates on social security contributions were widened, temporary hiring was discouraged through the introduction of firing costs (albeit of a small amount), and measures promoting part-time work were established. This is in line with the employment recommendations included in the General Economic Policy Guidelines. Conversely, the reform of the collective bargaining system, so that agreed wages may take into account productivity and regional differences (also included in these recommendations), was only addressed in a preliminary fashion. Indeed, the Inter-confederal Pact for Collective Bargaining, which was signed at the end of the year to take effect in 2002, is geared solely to ensuring wage moderation during the current year so that the slowdown in the economy should not translate, as in previous downturns, into a sharp employment adjustment. Under this agreement, collective bargaining in 2002 will take as its reference the inflation target set by the government, although wage increases may include partially the productivity gains recorded. This is the only scope for wage

## Implementation of the June 2000 liberalising measures (\*)

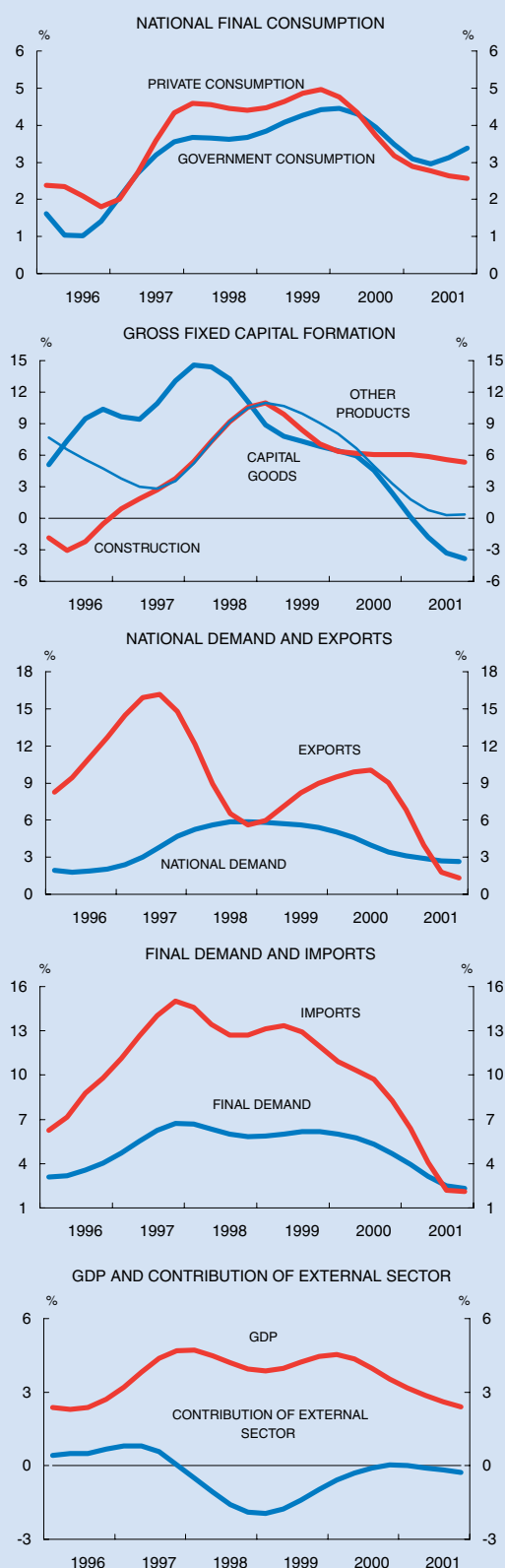
Measures	Implementation and evaluation
<b>NATURAL GAS</b>	
The holding by any group of companies of capital or voting rights of ENAGAS is set at a ceiling of 35%.	The unbundling of ENAGAS has yet to be undertaken, although following approval of Ministerial Order ECO/301/2002 of 15 February 2002, the steps have been taken for the related evaluation, a pre-requisite for the diversification of the shareholder base.
The rights on gas imported from Algeria are divided.	Carried out on 22 October 2001.
The third-party access payments for reception, re-gasification, storage and transport facilities shall be reduced by 8% within one month and until the new distribution arrangements are approved. Likewise, within six months a new cost-based system of natural gas charges and payments applicable to the use of infrastructure by new operators shall be approved. It will come into effect as from 1 January 2001	Royal Legislative Decree 949/2001 of 3 August 2001 approved the new system for calculating charges and payments. Ministerial Order ECO/301/2002 of 15 February 2002 specified remuneration for the regulated activities.
<b>ELECTRICITY</b>	
The steps to acquire big-consumer status are simplified and the threshold for consideration as a big electricity consumer is lowered as from 1 July.	The number of big consumers opting to negotiate prices increased appreciably in the second half of 2000.
Electricity retailing companies are permitted to enter into electricity purchase contracts with foreign suppliers and with domestic special-regime producers.	The regulation enabling purchases from special-regime domestic producers entered into force on 1 July 2001.
Producers with more than a 40% share in generation are not allowed to increase this share in the next five years. The period will be 3 years for producers with more than 20%.	The application of this measure has limited the process of concentration.
Access charges to transport and distribution networks are reduced for big consumers.	Low- and medium-voltage prices have been lowered, and those for high voltage frozen.
Domestic consumer prices are lowered by, at most, 9% during the period 2001-03.	They were lowered by 4% in 2001 and have held unchanged in 2002.
Capacity payments are reduced and network access tariffs are restructured before 1st January 2001.	Capacity payments were reduced on 1 July 2000. The new price framework was introduced pursuant to Royal Decree 1164/2001 of 26 October 2001, and new prices were established in Royal Decree 1483/2001 of 27 December 2001.
<b>LIQUID HYDROCARBONS</b>	
A 25% CLH ownership stake ceiling is set for all individuals and corporations. In addition, overall stakes in companies that refine in Spain may not exceed 45%.	The shareholder base of CLH has begun to be diversified.
Owners of fixed oil storage and transport facilities shall inform the CNE (National Energy Board) of the terms of their network-access contracts. This information will be made public.	The CNE website offers information on network-access contracts provided by network-owners.
Those entities considered as large retail outlets will include at least one service station to be supplied by a minimum of two wholesale oil operators. The administrative requirements for these cases are reduced and made more flexible for large retail outlets that are currently operating and do not have a service station.	There does not appear to have been a significant increase in the number of service stations.
Operators with a retail market share of over 30% are prohibited from increasing the number of service stations over the next five years. The period is limited to 3 years when the share is over 15% and less than 30%.	The effects of the measure are unclear, although in some cases the closing of service stations can be seen to be accompanied by the construction of new stations by the same operators.
Information on prices applied by service stations must be provided, and may be made public	This measure is being applied.

(\*) Excluding those measures which, back in June 2000, it was foreseen would be implemented after the current date.

## Implementation of the June 2000 liberalising measures (cont'd)

Measures	Implementation and evaluation
<b>TELECOMMUNICATIONS</b>	
As from 1 January 2001, fixed-telephony public network incumbents shall provide unbundled access and shared access to the local loop.	The number of subscriber lines managed by companies other than the former incumbent is limited.
Before 15 November 2000, Telefónica shall provide for the pre-selection of local calls.	The regulation on procedures for pre-selection was approved on 30 November 2000, but it was not possible to use this service until mid-February 2001. As at September 2001, a limited number of consumers had this facility.
On 1 November 2000 flat rates shall be introduced for Internet and for voice and data services in local calls.	As from this date, all companies offer flat rates for Internet.
By 15 September 2000, the reference interconnection prices for use of the Telefónica network shall be changed.	Interconnection prices were changed in August 2001.
31 July is set as the deadline for fixed and mobile telephony incumbent operators to submit their cost accounts for the previous year.	This measure is being applied.
Resolve to increase mobile telephony competition in the future.	Authorisations to sell on mobile services have been granted, but the new operators have to negotiate network-use conditions with the network-owning operators.
<b>RETAIL TRADE</b>	
Shop opening hours are amended.	Only the Cantabria region, with 14 public holidays, and Madrid, with 18, have lengthened hours beyond the minimum set by the measure.
<b>OWNERSHIP STAKES</b>	
Ownership stakes of individuals or corporations in more than one company considered to be a main operator in the electricity, hydrocarbon and telephony markets are limited.	On 11 September 2001, the CNE specified the 5 main operators in the electricity, gaseous hydrocarbons and liquid hydrocarbons industries. The incumbent telephony operators were defined at an earlier date. The application of this measure is leading to the revision of financial and non-financial corporations' investment strategies.
<b>BOOKS</b>	
Liberalisation of discounting on text books.	Discounts have been used particularly by large retail outlets. As a result, hypermarkets and department stores had, by June 2001, seen their market share increase by two percentage points on a year earlier.
<b>TOBACCO PRODUCTS</b>	
Wholesale tobacco distributors are not required to cover all of national territory and they have full freedom to engage in the distribution of various products. However, manufacturers and importers are obliged to ensure that their products cover the whole of Spanish territory, provided there is a demand for them.	Logista (entrusted since 1985 with wholesale distribution) is permitted to distribute other goods along with tobacco. At the same time, a significant obstacle to importers and small manufacturers has been introduced.
<b>LAND</b>	
The promotion of developable land is opened to private initiative. Further, administrative procedures are shortened, as the tacit authorisation rule may be applied to approve development planning if, within six months, or the period specified by the regional legislation, no reply has been received.	The effect of this measure on available land supply is not known. In any event, real asset prices have continued rising strongly in 2001.

CHART IV.2

**Main macroeconomic aggregates (a)**

Source: INE.

(a) Year-on-year rates of change based on trend-cycle series in real terms.

differentiation that the agreement allows, with the centralised nature of collective bargaining therefore being maintained.

Lastly, the measures aimed at liberalising and increasing competition in the markets for goods and services, which were adopted during 2001, focused essentially on the implementation of the liberalisation package approved in June 2000 (3). As will be recalled, these measures bore, inter alia, on the conditions under which the network industries operate, with certain delays in the transposition of approved regulations (mainly in the gas and telephony industries — see Box IV.1) being detected. Measures were also taken to encourage research and the new information and communications technologies. In connection with the latter, a plan of action (Iniciativa Info XXI) was adopted for the period 2001-2003. In the field of scientific research, development and technological innovation, the main measures took the form of more extensive tax incentives for R+D+i and financial assistance to be routed through the programmes of the Spanish National Plan for scientific research, development and technological innovation.

## IV.2. DEMAND

Against the background of the relatively generous monetary and financial conditions described in the previous section, and of the slightly restrictive fiscal policy stance adopted, consumer and business spending in the Spanish economy held during 2001 on the mild slowing trend on which it had embarked in 2000. Nonetheless, some demand components, such as exports and productive investment, were affected to a greater extent by the slowdown in the pace of growth in the international economy and by the climate of greater uncertainty brought on by the September attacks in the United States and by the Argentine crisis. As a result, final demand grew by 3% in 2001, against 5.4% the previous year, with a decelerating profile that affected its various

(3) Royal Legislative Decree 7/ 2000 of 23 June 2000 on urgent measures in the telecommunications sector; Royal Legislative Decree 4/ 2000 of 23 June 2000 on urgent liberalising measures in the real estate and transport sector; Royal Legislative Decree 3/2000 of 23 June 2000, which approved urgent fiscal measures to encourage household saving and small and medium-sized enterprises.



components with differing intensity. The growth rates of exports and, especially, investment in capital goods were notably pared, while household spending (on consumer goods and on housing) and general government spending continued to help prop up growth (see Chart IV.2).

The slowdown in household final consumption expenditure that started in 2000 continued throughout 2001, easing off in the closing months of the year. On average in 2001, household spending increased by 2.7% in real terms, below the average growth for 2000 (4%). As Table IV.1 and Chart IV.3 show, the specific expression of the slowdown in private consumption was the strong contractionary behaviour of expenditure on durable goods. The significant exception here was cars, which picked up moderately thanks to the application of the "Plan Prever" (a scheme aimed at renewing the Spanish vehicle stock), the favourable trend of fuel prices (following the strong increase in 2000) and, to some unspecified extent, the bringing forward of purchases before the introduction of the euro in January 2002. Conversely, it is estimated that non-durable consumption increased at similar rates to the previous year.

Chart IV.3 shows that the lower growth of spending in relation to the previous year was set against the slight acceleration in real disposable income, which provided for a moderate recovery in the saving ratio after five years of continuous declines. According to the initial figures released by INE, the higher growth of household real disposable income was essentially due to the greater contribution of the gross surplus and mixed incomes. The contribution of income related to returns on saving was small and similar to that for the year 2000, given that the greater contribution of dividends was offset by a negative effect of net interest received, against a backdrop of high growth in lending to households. The increase in wage income net of social security contributions was similar to that in the year 2000, since the rise in wages offset the lesser pace of job creation. Lastly, mention may be made of the lesser net contribution of general government, arising from the notable growth in direct tax takings. At the same time, the growth rate of social benefits was cut.

Household spending decisions were also influenced by losses in financial wealth during the year, the result of the marked sluggishness of stock mar-

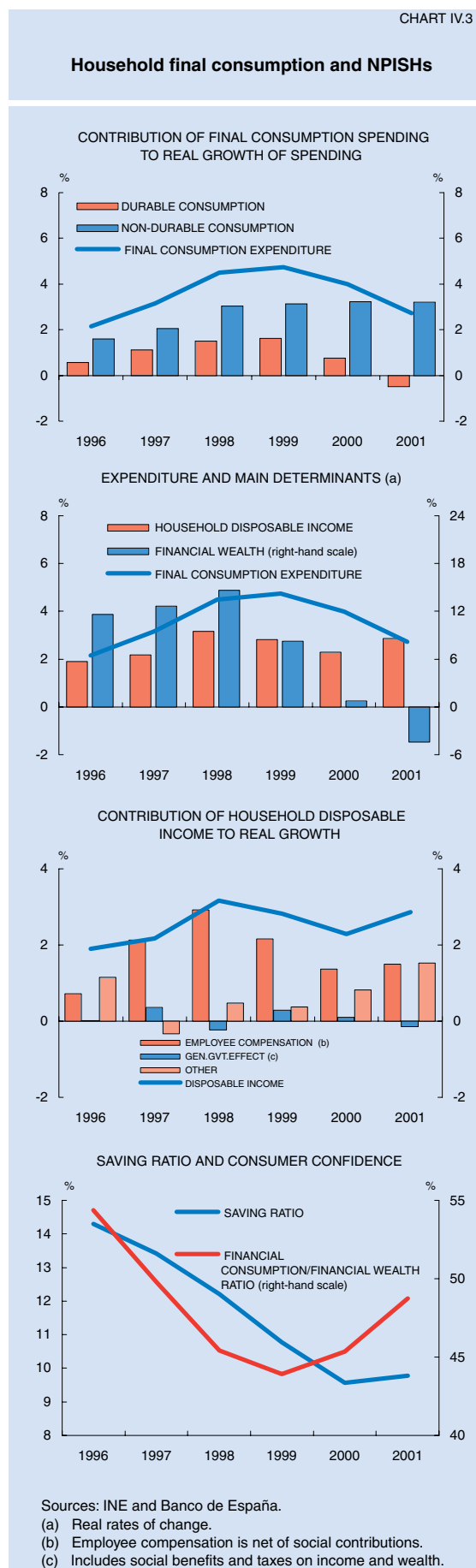


TABLE IV.1

## Consumption and gross fixed capital formation by institutional sector (a)

	% of GDP		Rate of change					
	1995	2001	1996	1997	1998	1999	2000	2001
HOUSEHOLDS AND NPISHs:								
Final consumption expenditure	59.8	59.5	2.2	3.2	4.5	4.7	4.0	2.7
<i>Durable consumption</i>	6.6	7.8	5.0	9.9	12.3	12.4	5.5	-3.9
<i>Non-durable consumption</i>	53.2	51.7	1.8	2.3	3.4	3.6	3.8	3.8
Residential domestic investment (b)	5.7	6.7	9.0	0.3	9.4	8.6	8.2	4.0
CORPORATIONS:								
Private productive investment (c)	12.6	14.6	3.5	7.8	8.8	9.8	6.5	1.0
<i>Construction and other products</i>	6.3	6.9	-3.1	3.9	3.0	11.9	9.4	6.7
<i>Equipment and other products</i>	6.3	7.7	10.1	11.3	13.6	8.3	4.3	-3.6
GENERAL GOVERNMENT:								
Final consumption expenditure	18.1	17.6	1.3	2.9	3.7	4.2	4.0	3.1
Gross fixed capital formation	3.7	3.3	-13.2	2.4	14.0	4.9	-2.5	6.1
<i>Of which:</i>								
<i>Construction and other products</i>	2.9	2.4	-16.9	3.0	18.1	3.4	-6.3	7.0
MEMORANDUM ITEM:								
Gross fixed capital formation	22.0	24.6	2.1	5.0	9.7	8.8	5.7	2.5
<i>Equipment</i>	6.1	7.7	8.1	10.8	13.3	7.7	4.8	-2.2
<i>Construction</i>	12.6	13.1	-1.9	2.3	8.1	9.0	6.2	5.7
<i>Other products</i>	3.3	3.8	6.1	3.3	8.1	10.1	5.7	0.8

Sources: INE and Banco de España.

(a) Data in real terms.

(b) Excludes investment by self-employed entrepreneurs.

(c) Includes investment by self-employed entrepreneurs.

kets. Bourses hit a low in September and, despite rallying in the following months, they closed the year having posted substantial declines. This performance, along with growing uncertainty about the economic outlook, gave rise to an ongoing deterioration in consumer confidence (see Chart IV.4). Countering this, households' non-financial wealth increased significantly in 2001 as a result of the higher number of house purchases and, above all, of house price rises (15.4% for the year on average). Overall, however, the losses in financial wealth, the fact interest rate cuts have run their course and the deterioration in confidence led to a slight recovery in the saving ratio.

Although the growth rate of domestic residential investment eased significantly in real terms last year, after expanding notably between 1998 and 2000 at a rate in excess of 8%, during 2001 it reached a still-high rate of 4%. Among the determinants of this sustained expansion in the past (and,

to a lesser extent, in 2001) were the rise in disposable income and interest rate cuts (see Chart IV.5). Countering this, however, and acting as a deterrent to households, was the rise in relative prices. Moreover, the year 2001 saw the continuation of the trend, initiated in the mid-nineties, involving the strong increase in the formation of new households, against a backdrop of more favourable conditions for mortgage financing and of brighter employment prospects for young people.

The demand for housing as a means of placing wealth also grew appreciably last year. This was due to the favourable financial conditions and to the ongoing increases in house prices, which meant a higher relative return (see Chart IV.5). Residential investment was thus seen as an attractive asset, compared with the losses in value incurred in financial investment. In this context, the prospect of the changeover to the euro at the start of 2002 might also have fuelled additional placements of funds in



residential investment. Finally, the buoyancy of non-resident investment in property in recent years was sustained in 2001, despite the slowdown in the world economy.

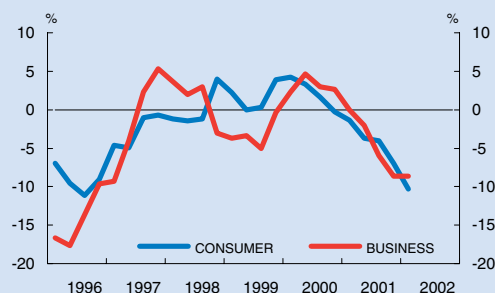
Housing starts slowed last year, reflecting a certain easing of demand in relation to the previous years. That said, new house prices remained on a strongly rising trend that was greater in coastal than in inland areas, owing probably to the rise in second-residence purchases. In any event, it is difficult to evaluate the impact of the relative rise in house prices on the demand for housing. Naturally, price increases have, in principle, a contractionary effect on the demand for housing. Yet insofar as such increases fuel prospects of rising values, they act as a spur to house purchases as an alternative means of maintaining wealth.

On the available estimates, gross fixed capital formation in Spanish companies slowed most significantly in 2001, growing by around 1% in real terms compared with 6.5% the previous year, a rate which, in turn, signified a loss of steam in relation to 1997 and 1999. There was a slowdown in companies' expenditure in 2001 both on construction and capital goods, markedly so on the latter component, the rate of which turned negative as from 2001 Q2 (see Chart IV.2). The buoyancy of construction spending was underpinned by the expansion of investment in infrastructure, routed through management entities and state-owned corporations, which are considered part of the private sector. Meanwhile, spending on non-residential building lost momentum in the second half of the year in virtually all its components except that of warehouses, which grew at a higher rate than the previous year. As to investment in capital goods, the slowdown was also across the board, proving of greater intensity in transport equipment and in office and electronic equipment.

The substantial easing off of private productive investment in 2001 was the result of a combination of unfavourable factors: the lesser resilience of final demand, with the subsequent decline in capacity utilisation; a slight increase in the relative cost of capital; and a deterioration in expectations which, accompanied by heightening uncertainty, prevailed throughout the year (see Chart IV.6). Indeed, according to the half-yearly investment survey conducted by the Ministry of Science and Technology among industrial firms, all factors having a bearing

CHART IV.4

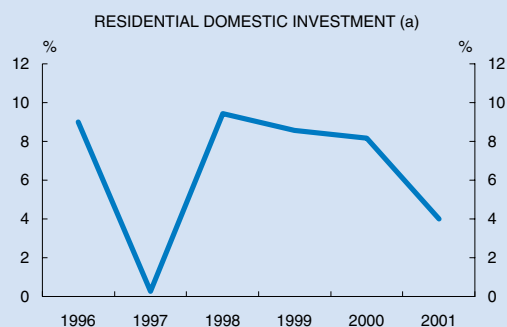
### Confidence indicators



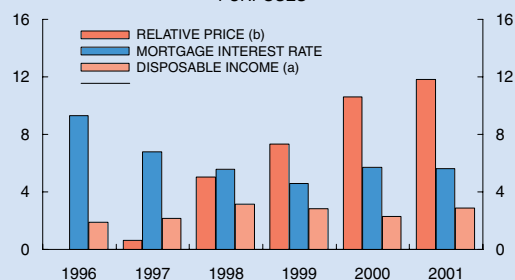
Sources: INE, Ministerio de Fomento and Banco de España.

CHART IV.5

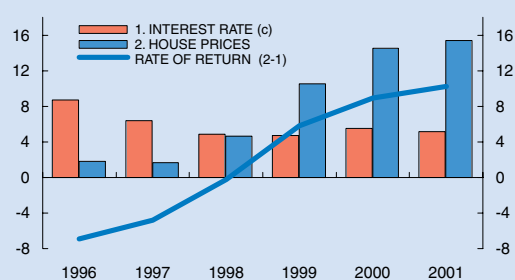
### Residential investment



#### DETERMINANTS OF INVESTMENT IN HOUSING FOR RESIDENCE PURPOSES



#### DETERMINANTS OF INVESTMENT IN HOUSING FOR INVESTMENT PURPOSES

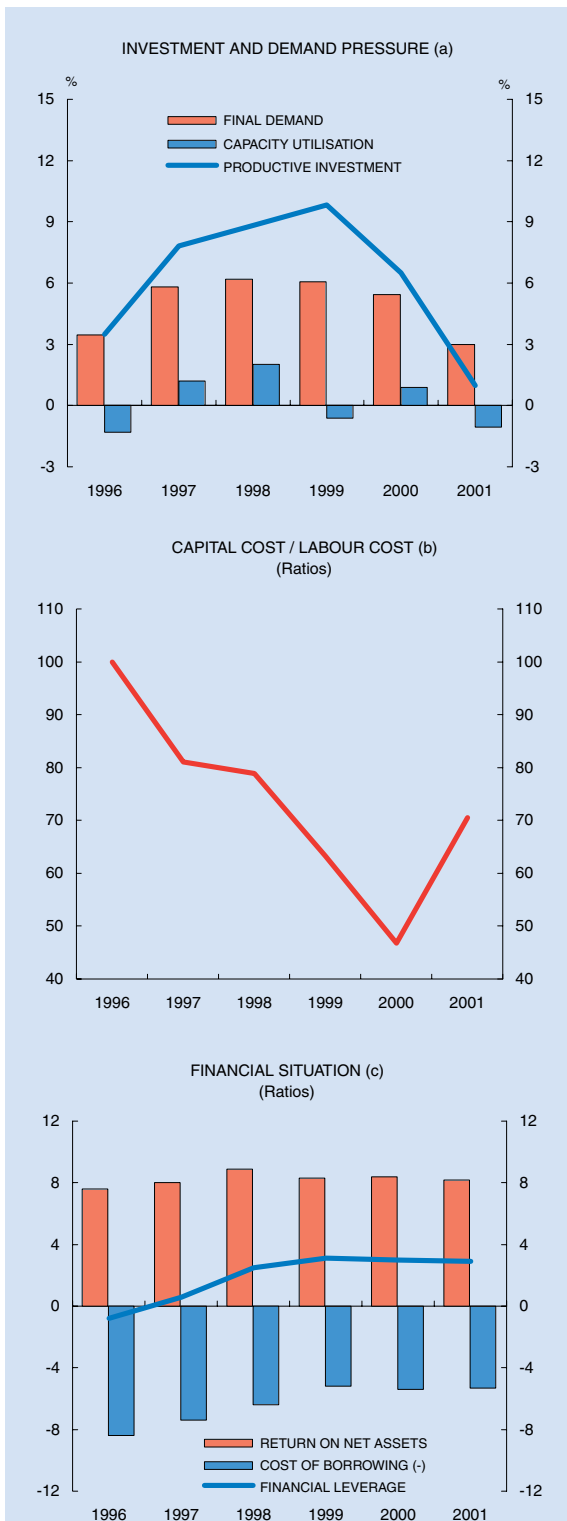


Sources: INE, Ministerio de Fomento and Banco de España.

- (a) Real rates of change.  
 (b) Price of new housing in relation to the private consumption deflator.  
 (c) Ten-year government bond yields.

CHART IV.6

## Private productive investment



Sources: INE, European Commission and Banco de España.

(a) Real rate of change and differences for the degree of plant capacity utilisation.

(b) Relative costs measure the user cost of capital divided by the user cost of labour, proxied by compensation per employee.

(c) Data obtained from the CBA annual survey until 2000 and from the CBQ survey for 2001.

on investment – including the financial situation – deteriorated in 2001.

As earlier commented, final demand slowed significantly during the year, this being sharpest in sales abroad. This diminished demand-side pressure translated into a reduction in capacity utilisation, which stood at the end of the year at a level of 78.3%, a similar figure to that recorded in 1997. Likewise, the proportion of businesses that considered plant capacity to be greater than necessary increased. The lesser buoyancy of demand compounded the growing deterioration in business expectations, as the international economic setting worsened. Further, there was a significant increase in uncertainty, associated with the September events in the United States and the unfolding of the Argentine crisis (see Chart IV.4). This greater uncertainty, against a backdrop of slowing final demand, would have led companies to postpone their investment decisions, almost irrespectively of the return expected thereon. In fact, investment forecasts for the year 2001, which were provided by entrepreneurs themselves in the half-yearly industrial investment survey, were revised substantially downwards during the year.

It is estimated that the relative cost of capital, measured by its user cost in relation to wages, increased slightly in 2001. This was due to the increase in the real interest rate of relevance for its calculation, namely the nominal rate deflated by the rise in capital good prices, which was very small. Nonetheless, the user cost of capital stands at low levels, lower indeed than those in the early nineties, at the end of the previous upturn. Actually, the slowdown in investment in 2001 came about against a background of favourable financing conditions. Interest rates remained low while, according to data from the Banco de España Central Balance Sheet Office Quarterly Survey, company profitability held at high levels. As a result, the leverage ratio (the difference between the return on assets and the cost of financing) remained positive, at a similar value to that of the previous year. However, this result was obtained in a context where activity and the funds generated within businesses were slowing. Consequently, despite the deceleration in investment, borrowing requirements increased: the resort to borrowed funds continued to expand considerably, with a fresh increase in the debt ratio.

Taking a longer view, the small increase in productive investment in 2001 compounds a relatively

modest performance by investment over the latest expansionary cycle which, in part, should be related to the existence of investment opportunities abroad, many of which emerged in the context of privatisation and sectoral restructuring in Latin America. During 2001, investment abroad, though falling, remained high, with flows amounting to 4.5% of GDP and accounting for one-third of total corporate investment and 50% of capital investment.

As indicated in Chapter I, the relative slackness of Spanish investment partly explains the low growth of productivity in the Spanish economy. A pick-up in investment, which is needed to maintain the positive growth differential with the EU countries, resides on the existence of domestic investment opportunities with appropriate returns and requires a sound financial position on the part of companies. In this respect, the current high levels of debt, against the backdrop of the slowdown in funds being generated within businesses, might curtail investment decisions and check the recovery in economic activity.

Stockbuilding contributed positively (one-tenth of a point) to GDP growth in 2001, in line with the usual counter-cyclical behaviour of this variable. According to the monthly business survey, the proportion of businesses reporting a higher than desirable level of stocks continued to rise, meaning the involuntary component of stocks must have increased during the year. Drawing on the same information source, this behaviour was extensive to the whole of industry, although more acute in the case of intermediate goods.

General government final consumption spending grew by 3.1% in real terms in 2001, compared with 4% the previous year. In nominal terms the slowdown was somewhat greater, with growth of 6%, 1.5 percentage points less than in 2000. The pattern was the same across all the consumption components. In particular, general government employee compensation grew by 5.1%, five-tenths of a point down on the previous year, owing to the low increase in compensation per employee, while public-sector employment advanced strongly. Public investment was most buoyant, with real growth of 6.1% compared with the decline posted the previous year. This performance was due to the rise in investment in infrastructure, which continued on the path of recovery initiated at the end of 2000.

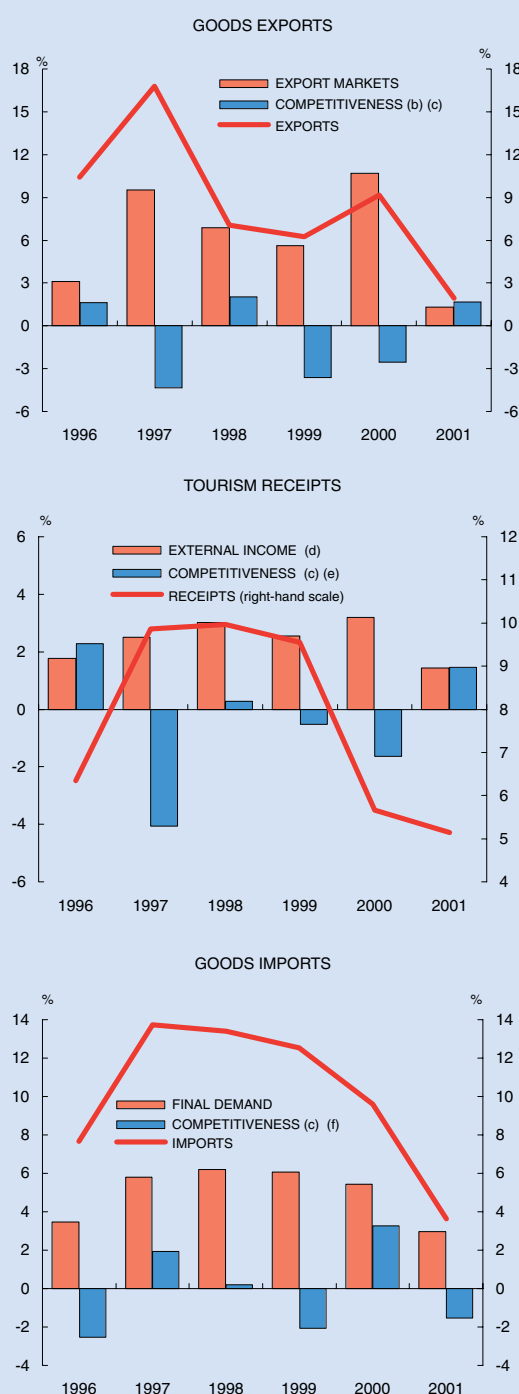
Overall, the moderation of household and corporate spending last year gave rise to growth in national demand of 2.8%, against 4.2% in 2000, moving on a slowing profile. At the same time, the change in the international outlook led trade to slip back. Real exports of goods and services lost momentum with greater intensity than national demand, which is reflected both in the reduction in the average annual growth rate (from 9.6% in 2000 to 3.4% in 2001) and in the fact that they ended the year growing at a rate of 1.3%. The sluggishness of exports was greater in the case of goods, while the slowdown in services was less marked, though they slipped by more than four percentage points to a growth rate of 6.8% in 2001. Under services, tourism held firm following its strong deceleration the previous year.

The deterioration in the international economic situation was reflected in the slackness of foreign markets, the growth of which was abruptly interrupted in 2001 after having surged by more than 12% the previous year. As discussed, goods exports slowed particularly sharply, posting negative real rates of change in the final quarter of the year. The loss of steam was most intense mid-year, when the European economies felt in full the impact of the crisis in the United States and the south-east Asian countries, and both the pace of activity and that of imports weakened appreciably. Although the weakness of foreign demand lay behind the falling off of exports (and, in turn, was conducive to export prices being contained), worsening competitiveness, which was reflected in a generalised way in the various relative price and cost indicators, also exerted a contractionary effect (see Chart IV.7).

Merchandise exports, which according to customs statistics grew by 2% in real terms last year, performed unevenly in the different geographical and economic areas. Sales to the EU increased by 4%, while those to third countries fell by 2.5%. In the EU, exports to certain countries – to Germany and France for instance, which account for more than 50% of trade with the euro area – slowed significantly in nominal terms, reflecting the appreciable loss of momentum in final demand in these countries and the contraction in their imports. Likewise, the growth rates of exports to the United States and Latin America, whose economies are in recession, fell substantially, turning negative in the case of the former. Conversely, the favourable behaviour of exports to central and eastern European

CHART IV.7

## External demand (a)



Sources: IMF, OECD, INE and Banco de España.

(a) Real rates of change.

(b) Measured by relative export prices, proxied by deflators.

(c) Negative values denote a gain in competitiveness, positive values a loss.

(d) Average of GDP of countries of origin of tourists to Spain, weighted according to the relative significance of the number of visitors.

(e) Index of competitiveness vis-à-vis developed countries, measured with consumer prices.

(f) Prices of Spanish non-energy imports in relation to the non-energy producer price index.

countries should be highlighted: following the expansionary boost seen in 2000, they grew at over 20% in nominal terms. The growth of trade with this area, in particular with the ten candidate countries that entered into preferential agreements with the EU, shows the interest of Spanish exporting industries to gain market share in these economies, which have high growth potential and which sustained appreciable import volumes in 2001. The buoyancy of sales means this area is now ranked third in respect of non-Community trade.

In terms of product groups, the weakness of exports was extensive to all its components, more so in sales of capital goods, which contracted with growing intensity throughout the year. Likewise, the growth of consumer goods sales slackened: following their buoyancy in 2000, durable goods, which are very sensitive to transport equipment sales, eased off considerably. Lastly, intermediate goods, like the other components, ended the year running at very low rates.

World tourist activity in 2001 was affected by the growing economic uncertainty and by the consequences of various events that had a marked bearing on tourist flows. Specifically, according to the WTO, the number of international travellers fell by 1.3%, having been below the average for previous periods already prior to the events of 11th September. Against this background, tourist demand for Spain held up, checking the strong slowdown it had undergone in 2000 and consolidating its second place worldwide behind France in terms of tourists received.

Nonetheless, the rate of increase of tourist receipts was cut slightly to 5.1% in real terms, while numbers of visitors entering Spain at borders retained moderate growth rates, in line with the previous year (3.6% against 2.4% in 2000). Price pressures were recorded during the year in tourism-related services which, as the central panel of Chart IV.7 shows, gave rise to a deterioration in the sector's competitiveness, which may influence future developments. In this respect, it should be noted that, in the absence of political instability, the areas competing with Spain offering similar forms of tourism and prices have been absorbing comparatively greater flows from the markets in which Spain specialises.

As a result of the lower growth rate of national demand and the marked slackness of exports, the

average growth of final demand in the Spanish economy fell by 2.4 percentage points last year to 3%. This lesser momentum of final demand fed through to a greater extent to goods and services imports than to domestic output, whereby GDP showed a more contained slowdown than final demand, posting growth of 2.8% for the year as a whole compared with 4.1% in 2000. Real imports of goods and services registered growth of 3.7%, against 9.8% a year earlier. The resulting profile was one of diminished buoyancy in the first two quarters which tended to stabilise at the end of the year, similar to that of final demand. The marked restraint of exports and imports translated into a minor negative contribution of net external demand to GDP growth (−0.1%), slightly less than that of the previous year.

The growth of goods imports in real terms was curbed to 3.6% in 2001, against 9.6% in 2000, when final demand had already shown signs of easing and in which year international prices rose considerably. In early 2001, the slowdown in imports steepened as a result of the marked sluggishness of industrial activity and of exports, although at the end of the year purchases picked up slightly given the growing moderation of import prices (see bottom panel of Chart IV.7). Nonetheless, despite the containment of import prices, the rate of penetration of imported products in the Spanish market (measured in real terms) continued to slacken. And that, together with price developments, contributed to stabilising the weight of nominal imports in the value of final demand.

According to customs data, real goods imports grew by 4.1% last year, with those from the EU increasing by 3.2% and those from the rest of the world by 6%. While nominal purchases from Community countries slowed across the board, those from third countries, such as the United States and Japan, slipped significantly. Conversely, mirroring exports, purchases from central and eastern European countries grew substantially above 14% (30% in the case of purchases from the candidate countries). These increases, along with those recorded in 2000 (exceeding 60%), confirm the growing – although still relatively insignificant – importance of these markets for Spanish trade.

As regards the distribution of imports by type of product, imports of both consumer goods and intermediate products remained quite robust in real

terms, in keeping with the trend of certain demand components. Conversely, capital goods imports fell appreciably, in line with the contractionary behaviour of productive investment expenditure. Energy import volumes increased above average, although in nominal terms they declined owing to the notable correction to oil prices on international markets. Finally, tourism payments, in step with their expansionary course over recent years, grew by 9.2% in real terms, a similar rate to the previous year. The behaviour of tourism expenditure was in line with that of non-durable consumption, although it began to slide when, at the end of 2001, international uncertainty heightened. Nonetheless, the low levels of this expenditure item are worth noting.

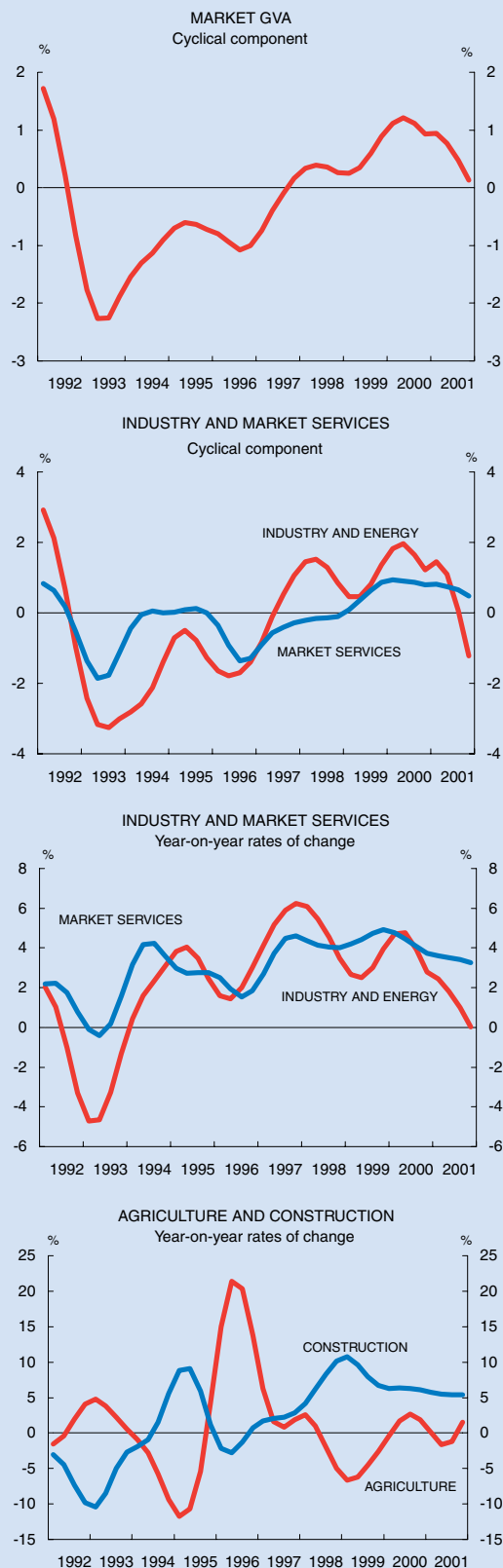
### IV.3. ACTIVITY

Last year domestic output continued on the slowing path initiated in 2000, as the expansionary phase the Spanish economy had enjoyed since the mid-nineties concluded. GDP growth in 2001 thus stood at 2.8%, significantly down on the figure of 4.1% the previous year. The lesser buoyancy of activity was concentrated in the market branches, since activity in non-market services quickened slightly to 2.9%. The growth rate of GVA in the market sector declined by 1.3 percentage points, settling also at a rate of 2.9%. The performance in the market-oriented branches meant that, in 2001 Q4, the GVA output gap disappeared (see top panel of Chart IV.8), following four years in which final demand had been exerting strong pressure on national production capacity. In any event, the trend growth of output (as inferred from an analysis of the associated determinants) also slowed somewhat, albeit less markedly so than final demand. Contributing to this was the more moderate growth of labour supply and the lesser increase in total factor productivity and in the stock of productive capital, due in the latter case to the heavy slowdown in gross investment.

A disaggregated analysis of branches of activity shows that the slowdown in economic activity in 2001 was centred on the sectors most exposed to foreign competition (agriculture and manufacturing industry), whereas construction and market services remained highly buoyant. In the primary branches, output was seen to slip by 0.3%, meaning that the sector was below its trend level for the third year running. This contraction was the result of bad

CHART IV.8

**GVA by branch of activity**  
**Cyclical component (a) and rates of change**



Sources: INE and Banco de España.

(a) Estimated using the Hodrick-Prescott filter.

weather. Indeed, although measures of rainfall were generally very positive, this could not be harnessed by agriculture in view of the inadequate regional and seasonal distribution of rain. Conversely, live-stock production advanced strongly once the health problems affecting certain breeds in the closing months of 2000 were overcome. That said, this could not offset agricultural crop yield losses.

Industry and energy proved particularly vulnerable to the step-up in adverse factors which had begun to become apparent in the second half of 2000 and which prompted a progressive loss of vigour in their activity. GVA increased by 1.3% in 2001, far down on the figure of 4% posted in 2000. The adverse factors in question were essentially the loss of steam in domestic demand and the weakening of the main world economies. This led to a notable deterioration in business expectations and a downward revision of investment plans, amplifying the effects of the lesser robustness of consumption and external demand (see Box IV.2). The increase in uncertainty resulting from the attacks on 11 September exacerbated this unfavourable setting. Thus, activity in these productive branches in the final quarter of the year stood below-trend, closing the expansionary period initiated in 1997 (see Chart IV.8). The industrial branches were more sharply affected than the energy branches by the slowdown in activity, and there were notable cuts in the output of industries with greater technological requirements (reflecting the weakness of the information technologies sector internationally) and in the manufacture of transport equipment intended for private consumption, in contrast to the behaviour of car sales inside Spain.

For the fourth year running, construction was the Spanish economy's most buoyant sector, growing by 5.5%, slightly down from 6.3% in 2000 (see bottom panel of Chart IV.8). This vigour was the result of the continuing high pressure exerted by demand. However, as earlier discussed, construction slowed somewhat in 2001, affecting both strands of building: residential building and, especially, that intended for other uses. Significantly, according to the information available, the loss of momentum in residential construction was sharper in the opening months of the year, with the variable holding up subsequently.

Lastly, market services slowed by seven-tenths of a point in 2001, taking their growth rate to 3.5%.



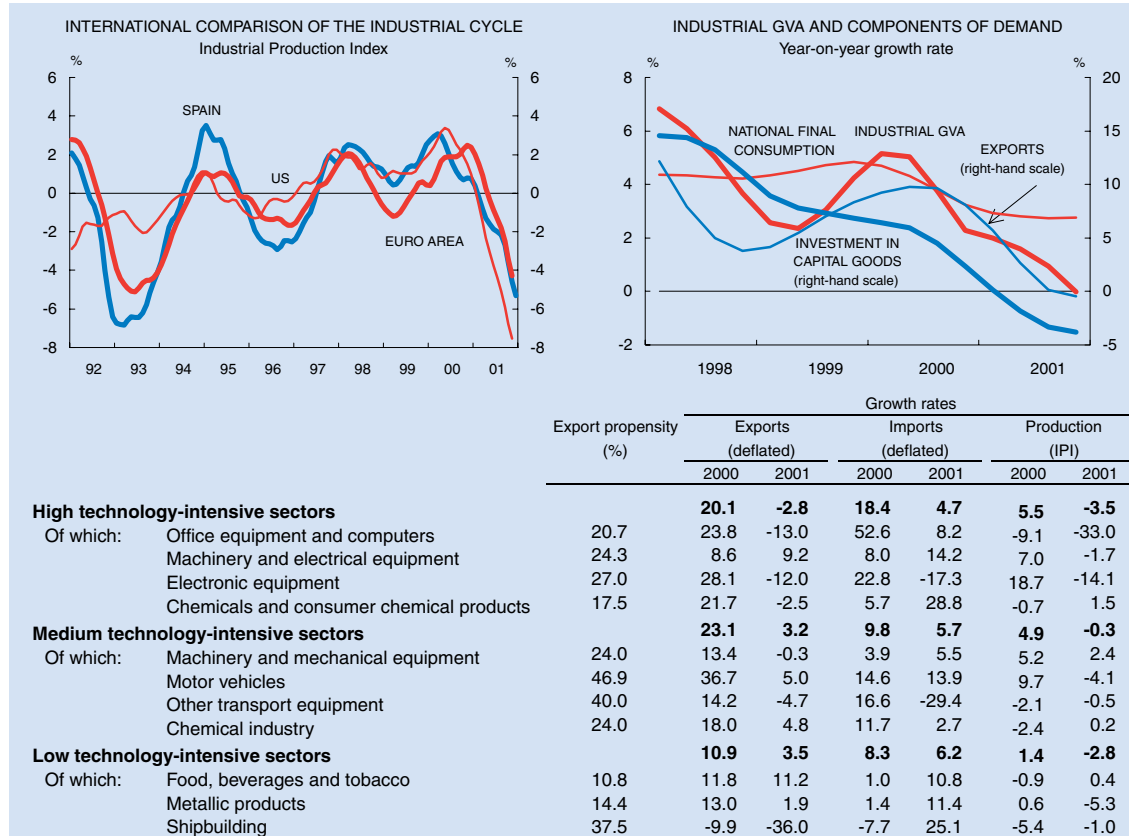
### The contraction in industry

A salient characteristic of the recent slowdown in the Spanish economy has been its relative mildness. Nonetheless, value added in industry fell back in the final months of 2001 on QNA estimates, and the industrial production index fell significantly in most months last year. The coincidence in time of this downturn in Spanish industry with the weakness of the main world economies and, consequently, of international trade, might denote that the fall in exports had triggered the slowdown in industrial activity. Yet the evidence available does not fully back this hypothesis; it assigns a key role also to domestic factors, specifically the lower growth rate of certain national demand components and, more worryingly, the greater penetration of imported industrial products in the national market.

The synchrony between industry in Spain and in the euro area countries has been very high in the past decade, while with regard to the United States there has been simultaneity in the phases of expansion and contraction since the second half of the nineties. However, in the current slowdown the behaviour of Spanish industry has been somewhat idiosyncratic, as the downturn began early in relation to the United States and, especially, to the rest of the euro area (see accompanying left-hand chart). That points to the presence of domestic factors as triggers for the crisis, prior to the decline in exports and coinciding with the turn away from the consumer buoyancy throughout the year 2000 (see right-hand chart). The subsequent conjunction of the loss of steam in consumption with that in investment (which had actually been slowing since 1998) and in exports led to a steeper slowdown in industrial activity.

Analysis of the sectors making up the Spanish industrial structure reaffirms the role of domestic demand as the factor which triggered the recent deceleration in industry, at least in certain key activities. The divergent behaviour of domestic output and exports can thus be seen in sectors such as pharmaceuticals, chemicals, electrical equipment, shipbuilding or food. Where the loss of momentum in output is matched by that in exports is in sectors that do not depend excessively on foreign sales, as is the case with metallic products (see accompanying table). The foregoing would point to domestic demand as the main cause behind the contraction in industry.

The sluggishness besetting the industrial sector in 2001 cannot mask the presence of structural problems in Spanish industry, problems that have resulted in a loss of competitiveness on national markets against imported products. Indeed, the presence of sectors in which imports have quickened (or held stable), while domestic output was losing steam or falling off (electrical equipment, mechanical equipment, cars or metallic products, among others, accounting for up to 33% of output), highlights the losses in domestic market share that industry is undergoing in the face of the greater vigour of foreign products. This development may seriously undermine the future of this sector.



Sources: INE and Banco de España.

As a result, their contribution to the rise in market GVA was 70%. Regarding its cyclical behaviour, GVA continued in 2001 to draw closer to its trend level. This approximation had begun a year earlier, and was a reflection of less demand-side pressure (see Chart IV.8). The diminished robustness of consumption made its most significant impact on wholesale/retail and repair activities (with the exception of car sales), and it was also discernible in real estate activity, albeit to a lesser extent. Tourism, hotels and restaurants, and transport felt the adverse effects of the attacks on 11 September, and activity in these sectors slowed markedly in the final months of 2001. Lastly, the sectors linked to information technologies, as is the case of communications, were impacted by the generalised diminished vigour of the Spanish economy, as well as by the delay in certain expected technological innovations emerging.

#### IV.4. THE LABOUR MARKET

Despite the lesser buoyancy of activity, job creation in 2001 was relatively forceful. This marked a difference from previous slowdowns (see Box IV.3). On QNA data, employment (4) grew by 2.4% against 3.1% the previous year, following a mildly contained profile over the course of the year (see Chart IV.9). As a result, the rate of increase of apparent labour productivity fell to 0.3%, the lowest figure recorded over the past decade. Nonetheless, the slowdown in employment in the market economy was more acute, with growth of 1.9% being posted, half that achieved in 2000. This gave rise to a pick-up in labour productivity to 0.9% (see Box IV.3). The increase in apparent labour productivity in the market economy had a cyclical component, since it was the outcome of lower job-creation and not of the more intense incorporation of technological progress, as total factor productivity (as discussed in the previous section) continued to slow. However, the pick-up in apparent productivity has been somewhat less than in similar cyclical phases.

Across the different branches of activity, the slowdown in employment in the market economy was due both to employment developments in industry and in market services. On QNA data, industrial employment grew by 1.3% year-on-year, two percentage points less than in 2000. This was in

step with the significant loss of momentum in industry, but it induced a cut in apparent labour productivity. In market services, employment grew by 1.7% during 2001, compared with 4.2% a year earlier. Contributing to this was not only the slowdown in activity but also a real process of capital substituting labour. The growth rate of employment in construction also fell, although this remained the most dynamic branch in terms of jobs (5.2%). The other two branches (agriculture and non-market services) trended favourably in terms of occupation, posting rates of 0.2% (after two years of reductions) and 4.4%, respectively.

The labour market reform measures introduced in March 2001 essentially broadened the group of workers who can gain access to the permanent employment-promoting contract (with lower firing costs), they extended permanent-hire incentives by means of rebates on employers' Social Security contributions and they introduced a severance payment of eight days per year worked for temporary contracts. The aim of these measures is to reduce labour market segmentation, reducing the differences in the firing costs for both groups, an area in which further reforms need to be addressed. During 2001, the growth rate of both permanent and temporary workers fell (as can be seen in the second panel of Chart IV.9), posting rates of 2.8% and 1.4%, respectively, according to the EPA (Spanish Labour Force Survey). Since the slowdown was greater in the case of permanent-contract workers, the growth differential between both groups narrowed, so that the reduction in the proportion of temporary to total workers (to 31.7%) was even more modest than in 2000. Nonetheless, the official statistics (INEM) on contracts showed significant growth of 8% in permanent contracts in 2001. This was due to the forceful flow of temporary contracts being converted into permanent ones. The latter grew by 115.2%, benefiting strongly from the March reform, after having been excluded from rebates the previous year. The March reform also made the legal limits for the use of part-time contracts more flexible, and this employment segment experienced a higher year-on-year growth rate than that of full-time employment (3.2% against 2.3%). However, the proportion of part-time to full-time employees increased by only one-tenth of a point during the year (to 8.2%).

The slowdown in economic activity introduced something of a deterrent to participation in the la-

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(4) Measured by the number of full-time equivalent jobs.



bour market. Thus, according to the EPA, the growth of the Labour Force slowed notably from a year-on-year rate of 2% (5) in 2000 to 0.8% in 2001. That said, it should be clarified that the unusually high increase recorded in 2000 might be distorted by the changes made to the EPA since 1999. Owing to the slowdown in the labour force, the increase in the participation rate for the population aged over 16 was limited to three-tenths of a point, rising to 51.6% (65.9% of the population aged between 16 and 64). The less favourable economic setting affected women to a greater extent; their participation rate posted the smallest increase of recent years, standing at 40%. This was also reflected in the moderate reduction (0.9%) during the year in the group of non-participants engaged in household tasks (made up essentially by women), compared with the sharper falls recorded in previous years. Conversely, the group least affected was the under-30s, whose participation rate rose from 59.7% in 2000 to 60.9% in 2001. There was also an increase in the over-45s cohort. This would denote that the permanent employment-promoting measures enacted in March were able, for some of the groups on which they were targeted, to counter the less favourable expectations of finding work in a downturn.

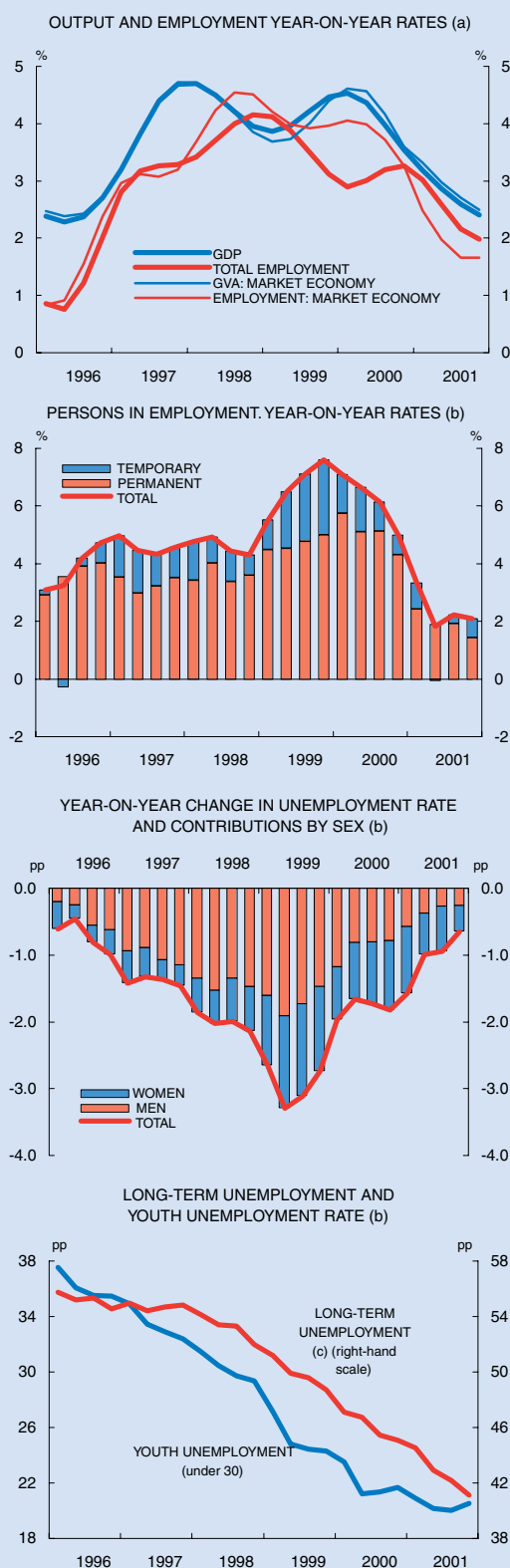
As regards joblessness, despite the fact that there was a fresh reduction in the number of unemployed in 2001, the process of unemployment absorption slowed considerably. The unemployment rate therefore declined from 14.1% in 2000 to 13%, although the rate of decline of unemployment (6.6%) was 2.7 percentage points down on the previous year, exhibiting moreover a markedly diminishing quarterly profile. Indeed, according to EPA, the number of unemployed increased and the unemployment rate rebounded in the final quarter of the year for the first time since 1996. This was confirmed by the INEM registered unemployment figures, which increased by 1% year-on-year that quarter. And the trend has stepped up in the opening months of 2002.

By sex, the easing of the year-on-year rate of decline in unemployment was much more marked among men. The related rate for males declined by 5.4%, half the figure for 2000, meaning that the con-

(5) The growth rates of the EPA variables for 2000 included in this section are those adjusted by INE for the effect of the updating of the censal sections of the survey.

CHART IV.9

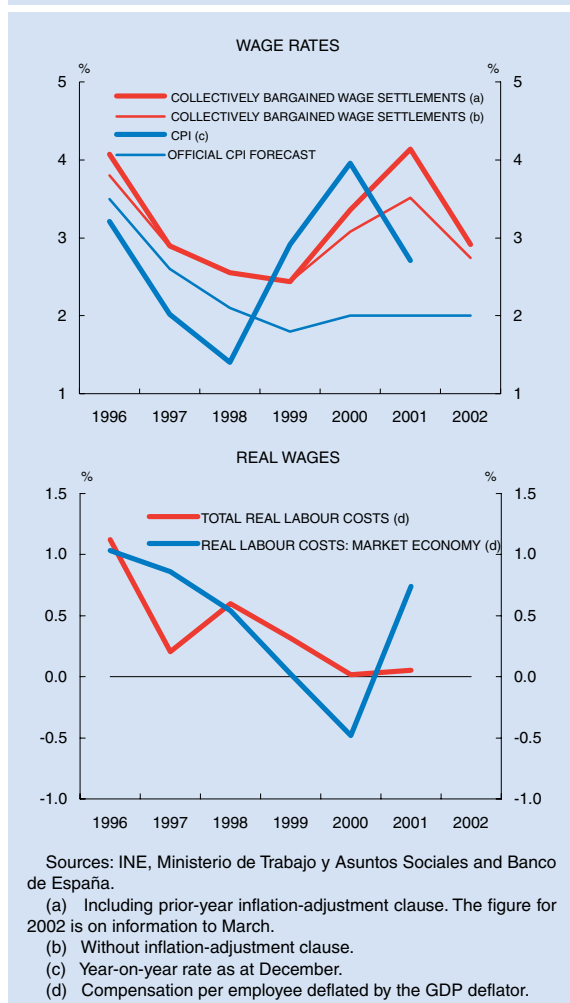
# Labour market: employment and unemployment



Source: INE (QNA and EPA).  
 (a) QNA. Trend-cycle. Full-time equivalent jobs.  
 (b) EPA.  
 (c) Over one year unemployed.

CHART IV.10

## Wage determinants



tribution of women to the fall in the total unemployment rate was greater. Nonetheless, although the gap narrowed, the female unemployment rate (18.8%) remains over twice the male rate (9.1%). Long-term unemployment continued to abate, standing at 42.7% of the total unemployed, below the EU average. As can be seen in the bottom panel of Chart IV.9, this reduction ran in parallel to that in youth unemployment which, though still at a very high level (20.4% in 2001), has fallen continuously and notably in recent years. The successive reforms in the labour market have allowed the upturn in the Spanish economy in recent years to reduce considerably the structural component of unemployment, with the long term unemployed and jobless youths particularly benefiting.

The behaviour of wages in 2001 was influenced by the rising trend of inflation dating back to 1999, which prompted an upward reaction in collectively bar-

gained wage settlements both in 2000 and 2001 (see Chart IV.10). The initial rebound in inflation, which was essentially due to temporary factors external to the Spanish economy, was ultimately incorporated into social agents' inflation expectations, resulting in wage settlements of 3.1% in 2000, and of 3.5% in 2001. Moreover, the presence of inflation-adjustment safeguard clauses in most collective bargaining agreements, which affect over 70% of wage-earners subject to collective bargaining, allowed deviations by inflation from official targets in 1999 and 2000 to be passed through to wage increases in the following years. Specifically, the effect of the clauses for 2000 on the wage increase in 2001 was 0.6 percentage points, giving rise to an average increase in wages of 4.1%. This confirms that the current collective bargaining system causes a delayed adjustment by wages to inflation, the increase in which tends to persist through this channel.

On QNA estimates, compensation per employee (a wider wage-cost item for companies than collectively bargained wage settlements, since it includes all sorts of wage drift and other non-wage costs) grew by 4.3% in 2001, for the economy as a whole, and by 5.3% for the market economy. Consequently, wage drift (i.e. the difference between wage increases negotiated in collective agreements and the average increase in labour costs that firms finally face) increased in 2001, maintaining the counter-cyclical behaviour observed in previous years.

In sum, the rise in social agents' inflation expectations, the operation of the inflation-adjustment safeguard clauses and wage drift all prompted an increase in real labour costs in 2001. This was notably more marked in the market economy and was apparent in a greater slowdown in this sector's job-creation rate (see the bottom panel of Chart IV.10). As from 1999, the effects on wages arising from upward deviations by inflation have seen something of a departure from the wage moderation of recent years, to which cyclical factors may have partly contributed. However, for the Spanish economy, with its still-high level of unemployment, it is vital that the mismatches still present in the labour market should be further corrected so as to continue cutting the unemployment rate without prompting tension in specific market sectors (occupations, regions or industries) that may prevent wage moderation.

In this respect, the signing of the Inter-confederal Pact for Collective Bargaining by trade unions and

## Sectoral productivity, productive structure and convergence

Throughout the nineties, the gap between the Spanish economy's productivity level and that of the EU increased, widening in 2001 to eight percentage points. Since aggregate productivity is calculated as the average of sectoral productivities, weighted by the related weight in employment, the productivity differential in question might be attributable both to sectoral productivity differences and to productive structure differences.

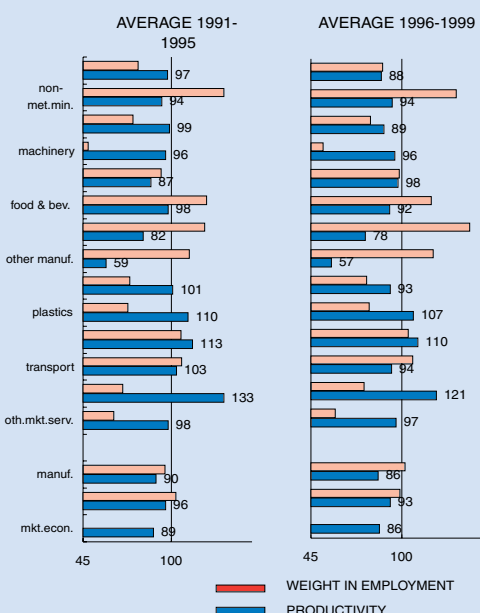
The first figure shows the relative levels of productivity and the sectoral weights of the Spanish economy in relation to the EU (EU=100) for the periods 1991-95 and 1996-99, respectively. For most sectors, it can be seen that productivity in Spain is lower than that in the EU. Nonetheless, notable differences are also discernible in the weight of each sector. There is also something of a negative relationship between these two variables, whereby sectors in which Spain shows a greater relative weight post comparatively lower productivity. This might account, at least in part, for the Spanish economy's lower overall level of productivity in relation to the EU.

To see to what extent different productive structures explain the different level of aggregate productivity, two exercises have been conducted. The first calculates the level of aggregate productivity assuming that the Spanish economy's productive structure, measured by the sectoral weights in employment, is equal to that of the EU as a whole. If the relative level of productivity thus calculated is greater than actual productivity, it is because the different productive composition contributes to explaining the gap in the productivity levels. In the second exercise, the relative level of productivity is calculated assuming that sectoral productivities in Spain are equal to those in the EU. In this case, a level of productivity higher than that observed would indicate that the sectoral productivity differentials help explain the differential of the economy as a whole.

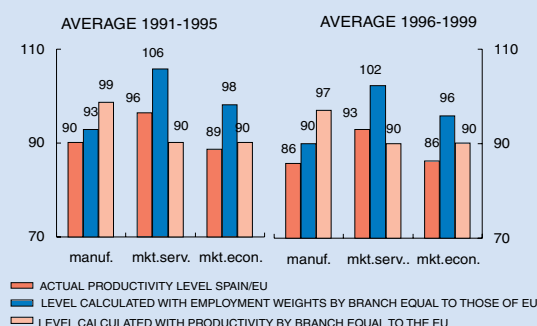
The outcome of these two exercises is shown in the second figure. For the period 1991-95, the relative level of productivity for the market economy as a whole would have been nine points higher than that observed if the productive structure in Spain had been equal to that of the EU. However, if the sectoral levels of productivity had been equal to those observed in EU, this gain in the relative level of productivity would have been only one percentage point. These results suggest that, in this period, the different productive structure has had a greater bearing on the sectoral productivity differentials in the productivity gap of the market economy as a whole. That said, it is important to point out that the results obtained for manufacturing and for market services are divergent. Thus, for manufacturing, the productivity differential for the aggregate is essentially due to the sectoral productivity differentials, while for market services the differential is attributable to a different sectoral composition.

The results for the period 1996-99 are very similar, although greater gains are obtained in the relative level of aggregate productivity when the sectoral productivities of the Spanish economy are made equal to those of the EU. Thus, for the economy as a whole, this gain increases from one point (in the period 1991-95) to four points (in the period 1996-99); for manufacturing, the gain is from 9 to 11. The productivity gains obtained when the sectoral weights are made equal are very similar to those for the first period. Consequently, in the second period, the contribution of the sectoral productivity differentials in the aggregate is greater than in the first period, whereas the contribution of the different productive structures is virtually unchanged, with the gap in the level of aggregate productivity thus widening. This result is due to a less favourable performance of sectoral productivities in the Spanish economy than in the EU for virtually all the sectors considered (as can be seen in the third figure).

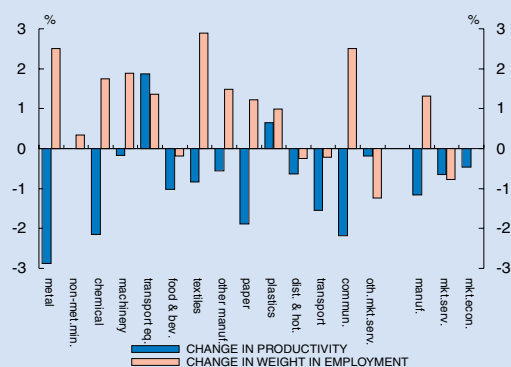
1. PRODUCTIVITY LEVELS AND RELATIVE WEIGHTS IN EMPLOYMENT. SPAIN/EU LEVEL. EU=100 (a)



2. SIMULATED PRODUCTIVITY LEVELS. EU=100



3. DIFFERENCES IN AVERAGE RATES OF CHANGE OF PRODUCTIVITY AND OF EMPLOYMENT WEIGHTS



Sources: OECD STAN database, INE and Banco de España.

(a) The EU aggregate excludes Belgium, Ireland, Greece and Portugal.

employers' associations is a step in the right direction which may provide for moderation in wage settlements in 2002. Nonetheless, this agreement should not sideline the need to reform the current wage bargaining mechanism so as to allow a closer relationship between wage increases and companies' and employees' specific conditions. The greater decentralisation of collective bargaining would widen the possibilities for adjusting wages in the face of different shocks that affect the labour markets, thereby reducing the intensity of employment adjustments. It would also allow the wide differences in unemployment across different groups to be narrowed by offering the necessary incentives for job mobility via greater differentiation in wage increases.

#### IV.5. COSTS AND PRICES

Over the course of 2001, the main price indicators showed, to differing degrees of intensity, a deterioration in the inflationary situation of the Spanish economy. This deterioration was in response to domestic factors since import prices, in line with the declining trend of inflation internationally, posted lower growth. However, in the summer months inflation, which had begun rising in the first half of the year, began to decline, placing the Spanish economy in a more favourable position to tackle the year 2002. This turnaround was the result of a combination of external and domestic factors. On the external front, the declining profile of commodity prices (energy and non-energy goods alike) steepened further as a result of the generalised slowdown in activity and the containment of inflation in the international setting. This process was only partly offset by the depreciation of the euro against the dollar. On the domestic front, the contractionary effect on business margins of diminished demand-side pressure and, in those branches exposed to foreign competition, of the less inflationary external environment ultimately offset the marked rise in unit labour costs.

The inflation rate, measured by the consumer price index (CPI), posted an increase of 0.2 percentage points in 2001, standing at 3.6%. The deterioration was marked in the group of products (services and non-energy processed goods) whose prices exhibit less variability; from growth of 2.5% in 2000, these rose to 3.5% and showed no signs of abating during the year. Such behaviour was the

consequence of processed food price developments, where growth stood at 3.4% for the year as a whole, with a notable rising trend in milk products, cereal derivatives and olive oil. By contrast, service prices slowed slightly in the second half of the year, although they were those which most grew for the year on average (4.3%). The declining profile was marked by the cut in telephony prices and by the stabilising of the rise in transport service prices, which ultimately captured the effect of the fall in energy prices. In the non-energy industrial goods component, inflation held very stable (2.7%), slowing slightly in the fourth quarter of the year

The respective behaviour of the CPI components whose prices show most volatility differed. While the prices of energy products fell by 1% over the year as a whole, declining by up to 9% in the final quarter, fresh food prices climbed by 8.7%. In the case of the former, the cuts responded to the marked decline in the oil price on international markets, which stood at \$24.40 per barrel for the year on average, \$4 less than the previous year. In the case of the latter, the rise in prices was brought on by the veterinary crises beleaguering part of the national livestock, which only began to abate at the end of the year.

At the start of 2002 the inflation rate rebounded due to various factors: the mechanical effect of the energy price cuts at the beginning of 2001 being stripped out; the increase in certain excise duties; and, also, the temporary effect of the adjustment of prices to euro, which has given rise to a certain upward bias in price-setting in the new currency. Nonetheless, price moderation should foreseeably resume, based to a greater extent on domestic factors (expected wage moderation and the progressive closing of the output gap), since on the foreign front commodity prices have risen.

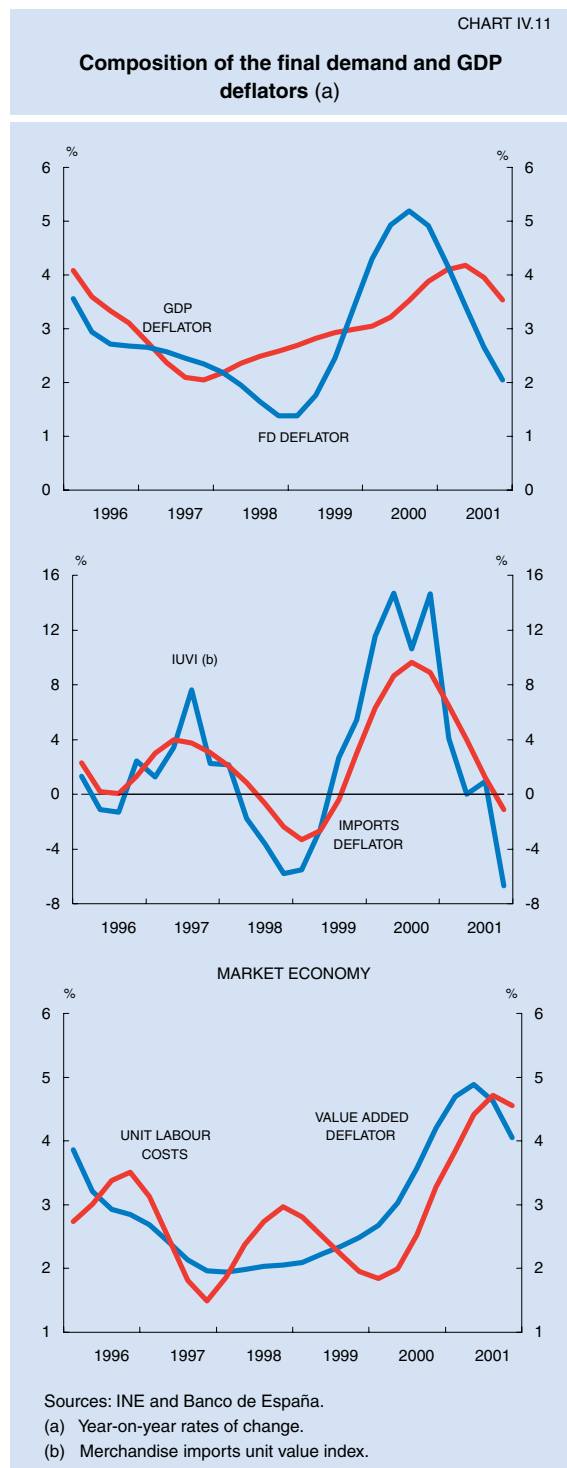
The rate of increase of the final demand deflator was 1.7 percentage points down at 3.1% in 2001. This behaviour was different from that of the private consumption deflator (which, in closer step with the CPI, stabilised at a rate of 3.2%) and was the result both of the reduction in inflation in investment goods and in exports. Export prices are mainly determined by the prices of equivalent products on international markets, given that the weight of Spanish exports in world trade is limited. In the case of investment goods, the growth rate of the deflators of capital goods and of construction un-

derwent a similar cut, although it remained much higher in this latter branch. The moderation of inflation in capital goods was the result of the reductions in the import prices of this type of good; moreover, domestic prices were also less buoyant.

Last year saw the imports deflator slow sharply with a reduction of 9.4 percentage points in its rate of change to 0.4% (see upper panel of Chart IV.11). This slowdown became more acute as the year unfolded, and the year-on-year rates of goods import prices turned negative in the second half of the year. As earlier discussed, the sharpest cut was in energy goods prices, but imported inflation in other goods also fell to a large extent. This performance reflects the moderate increases in the export prices of our main trading partners, in their own currencies, which more than offset the slight depreciation of the euro against the dollar during the year on average (3%), although the euro appreciated marginally in the final quarter.

Unlike the behaviour exhibited by the foreign trade deflators, domestic prices, proxied by the GDP deflator, quickened by 0.5 percentage points to a rate of 3.9% (see central panel of Chart IV.11). This acceleration would, moreover, have been greater had unit indirect taxes net of subsidies not been cut, as a consequence of the freeze on excise duties taxing certain goods and of a slight increase in subsidies. Indeed, the value-added deflator, which excludes the direct impact of net taxes, grew by 4.3% in 2001 compared with 3.4% the previous year. This was not the only favourable contribution of the public sector to the performance of the domestic component of inflation, since the growth rate of the value-added deflator of non-market services declined clearly from 3.5% in 2000 to 2.6% in 2001, the result of the moderate growth of public-sector employee compensation. By stripping out this component and focusing on the domestic determinants of inflation related to the market economy (reflected in the corresponding value-added deflator), the latter could be seen to have accelerated sharply by 1.2 percentage points to 4.6%.

Behind this marked increase in the domestic component of inflation lies the performance of unit labour costs in the market economy. These rose by 4.4% over the year as a whole, two percentage points up on the previous year (see lower panel of Chart IV.11). This substantial rise was in response to the aforementioned acceleration in compensa-



tion per employee (5.3%), which was offset only in part by the muted rise in apparent labour productivity (0.9%). Against this background, and despite the rebound in the value-added deflator, the growth rate of the gross operating surplus per unit of value added eased significantly. While at the aggregate level these developments are consistent with the progressive weakening of demand-side pressure and are qualified by the greater widening of margins in



previous years, at a more disaggregated level the performance of margins was very uneven. In fact, the margins of the branches most exposed to international competition deteriorated to a greater extent, while the opposite occurred in the more sheltered branches. That highlights the fact that there is still scope to increase competition in some of these branches and to use more productive technologies in general, within a framework of moderate wage growth. The shortcomings in these areas have been responsible for the problem of dual inflation in the Spanish economy in recent years (see Box IV.4).

#### **IV.5.1. Costs and prices: the productive branches**

As indicated in the previous section, the growth rate of the market economy's unit margin moderated substantially in 2001, to the point of being virtually stable, as a result of the various branches of activity performing very differently. Specifically, in the branches most exposed to international competition (agriculture and industry), margins continued to be squeezed, while in the more sheltered branches (construction and market services), margins continued to widen, albeit at a slower rate.

As can be seen in the top panel of Chart IV.12, the value-added deflator in primary activities quickened notably in 2001 to a growth rate of 4.2% (–0.3% the previous year). This was more in response to supply-side factors than demand-led pressure. In fact, as previously mentioned, some crops were in short supply, while the prices of livestock products were affected by the health problems arising in certain areas the previous year. This acceleration did not suffice to counter the marked increase in unit labour costs, led by strong wage growth, which only began to turn down towards the end of the year when the diminished momentum of employment allowed for a pick-up in labour productivity. Consequently, the unit margin narrowed once again in 2001 on average, picking up in the second half of the year.

In the industry and energy branch, the value-added deflator grew by 3.8%, 2.5 percentage points up on 2000. There were two clearly differentiated strands to the behaviour of the deflator in 2001. In the first half of the year there was an acceleration, extending the profile of the previous year, while in the second half the lesser pressure of demand (ex-

ternal demand in particular) led the deflator patently to moderate (see Chart IV.8). The trend of the value-added deflator was consistent with a significant slowdown in final sale prices during the year, since the growth of import prices moderated appreciably in relation to the previous year. As a result, the trend of final sale prices was very similar to that of our main trading partners.

The growth of unit labour costs remained high throughout the year, outgrowing the deflator. Accordingly, the unit margin continued to worsen. The course of unit labour costs can be explained by the acceleration in compensation per employee, and by the flatness of apparent productivity, which held at the levels of the previous year. The slackness of productivity is a sign of the limited increase in the stock of capital and of the under-use of technology in these activities. And such slackness is further illustrative of the risk of the pick-up in margins coming about through the diminished robustness of employment, seeing as it is impossible to raise prices against the background of heavy foreign competition in which the sector operates. Significantly, the reduction in the unit margin extended to virtually all the industrial branches, the only exceptions being the processing of food, beverages and tobacco, and the manufacture of rubber and plastics. By contrast, the margin widened in the energy industry as a result of labour productivity gains linked to the employment adjustment undertaken in this branch in recent years.

As can be seen in Chart IV.12, the growth of the value-added deflator in construction remained high (5.6%), although it was significantly lower than a year earlier (8.8%). The main reason behind this price performance was the resilience of demand, which enabled the level of activity to hold significantly above its potential. The unit operating margin widened for the fourth year running, despite the sharp growth of unit labour costs, since the moderate trend of apparent productivity was unable to offset the strong increase in compensation per employee.

In market services, demand-pull pressure diminished as the year unfolded, although activity continued to hold above its trend level. Consequently, as has habitually been the case, the acceleration in unit labour costs passed through without difficulty to prices, raising their growth to 4.5%, nine-tenths of a point up on the previous year. This inflationary bias

## Dual inflation, productivity and sectoral margins

Spanish incorporation into Economic and Monetary Union in 1999 marked a fundamental change in the macroeconomic adjustment mechanisms. In this new setting, the ability to withstand different types of shocks without generating price adjustments that entail losses in competitiveness and fuel the phenomenon of dual inflation (a persistent inflation differential between branches exposed to and sheltered from competition) will depend on the degree of competition in place both for goods and services and for production factors.

The upper panel of the accompanying chart depicts inflation and its respective course for the manufacturing branches (open to international competition) and services, measured by the value-added deflators. The chart shows that services inflation has been systematically higher than manufacturing inflation, although the significance of the dual inflation phenomenon has not been the same over the past 15 years. Two periods can be distinguished in the chart. In the first, commencing in the mid-eighties and ending in the mid-nineties, dual inflation was very high, especially during the first half of the nineties (89-94), when it was 4% on average. The second period coincides with the recent expansionary phase, commencing 1997. During these years the inflation differential between these branches narrowed to levels of around 2%.

The middle panel of the chart offers a breakdown of this differential. In a perfect competition setting, prices are determined by companies' marginal costs, which depend on the relationship between nominal wages and marginal labour productivity. Under imperfect competition, companies will determine their prices setting a margin on these costs. Consequently, the inflation differential between different productive branches will be determined by changes in relative marginal productivity and inter-sectoral margins (i.e. by the degree of relative competition). Given that, under the most commonly used assumptions, productivity may be broken down into so-called total factor productivity (i.e. technological progress) and the capital/labour ratio, the inflation differential between the branches exposed to and sheltered from competition (dual inflation) may be analysed as follows: dual inflation will be higher if total factor productivity grows more in the sectors exposed to competition than in the sheltered sectors (in the manufacturing/services total productivity ratio), if the capital/labour ratio between manufacturing and services increases and if, finally, relative margins in services increase in relation to those in manufacturing.

The second panel of the chart shows that, in the first of the two periods considered, relative productivity in manufacturing as opposed to in services increased moderately. Moreover, and more significantly in quantitative terms, there was a notable reduction in margins in the manufacturing branches (against the background of the greater openness of the Spanish economy and the strong appreciation of the exchange rate), while margins in services showed no adjustment (see third panel). The narrowing of the differential in the second period was rooted in the progressive reduction in relative productivity between manufacturing and services, which essentially masks a falling off of productivity in the branches most exposed to competition. However, the widening of relative margins in the services sector has continued to contribute significantly to the inter-sectoral inflation differential. The contribution of the capital/labour ratio to dual inflation has been of secondary importance.

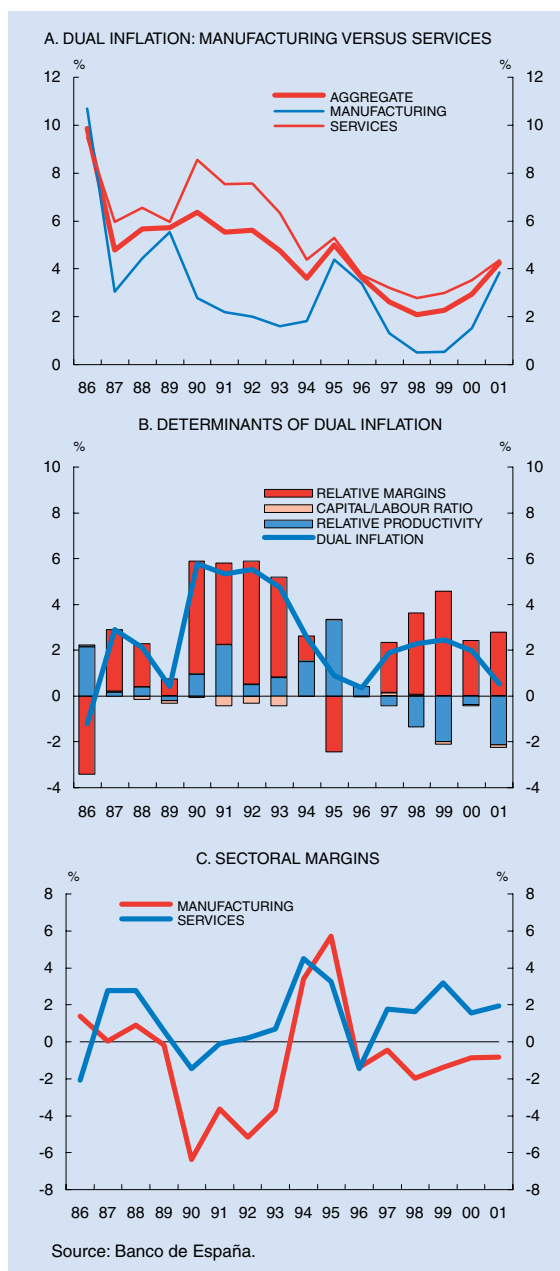
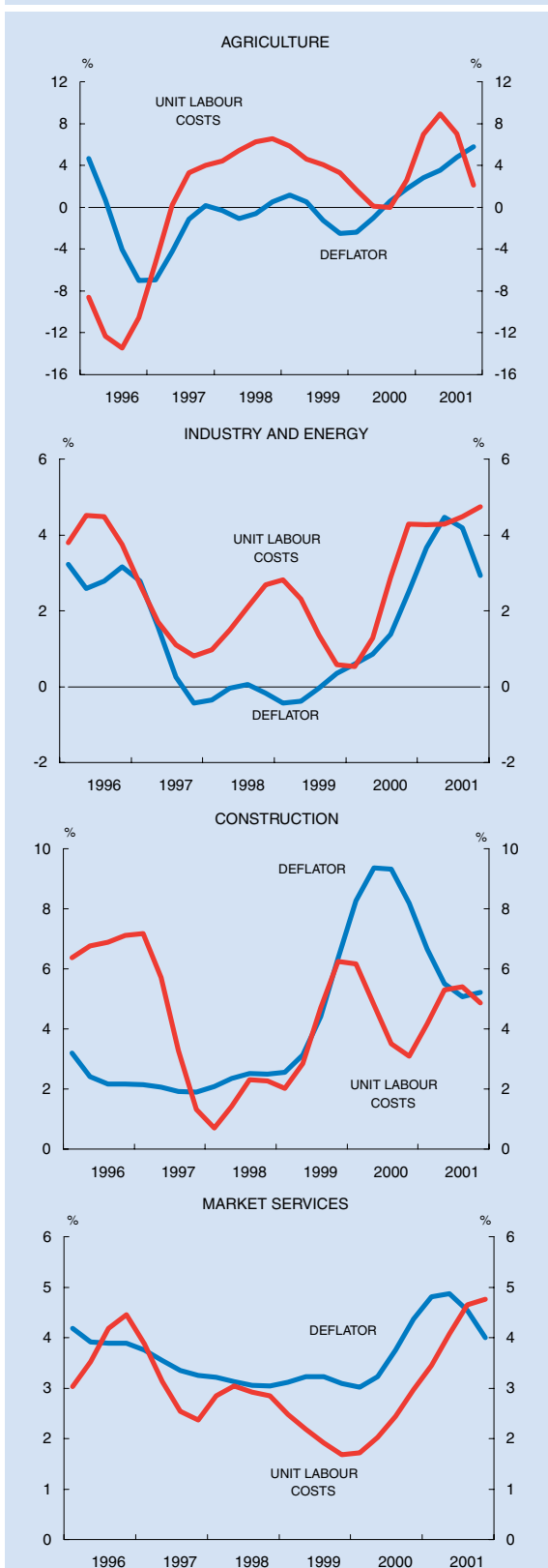


CHART IV.12

**Prices and costs by branch of activity**

Source: INE.

(a) Non-centred year-on-year rates based on QNA trend-cycle series.

prompted a fresh widening of the unit operating margin for the year on average, albeit with a progressively moderating profile over the course of the year. Influencing the dynamics of this situation was the high growth of compensation per employee, which was offset only in part by the vigour of labour productivity, against the backdrop of strongly slowing employment.

The increase in margins was not common to all the services branches. As usual, in both the communications branch (where liberalisation and strong price competition continue apace, making for a sharp adjustment of margins) and in certain corporate services branches (where market power on the demand side is possibly high, making it more difficult to pass on the sharp increases in costs to prices) the unit margin narrowed. Conversely, in the transport branch, margins widened substantially, offsetting the decline the previous year against a background of strong fuel price increases.

**IV.6. COMPETITIVENESS**

As indicated in the foregoing sections, the notable slowdown in Spanish exports in 2001 was due primarily to the weakness of the international economy, although there was also a loss of competitiveness, manifest in a higher growth of Spanish prices and costs compared with our competitors. Indeed, set against an historical experience characterised until very recently by substantial gains in share, over the past years the Spanish share in world trade has remained virtually stable (see Chart I.2), despite the fact that this share is lower than the weight of the economy in world output. However, imports, which grew in prior years at far higher rates than did domestic output, saw their rate of penetration in the Spanish markets largely diminish, despite the moderate increase in their prices. Such a result is, in part, related to the composition of demand last year.

The analysis of export shares shows that sales to the euro area grew over the last three years at a similar rate to this market, while those targeted on third markets initially performed more favourably, in response to the gains in competitiveness recorded. However, a loss of competitiveness in non-Community markets was recorded in 2001, and this translated into a slight reduction in share according to the data available.



Among the factors that help explain the stagnation of the share in the euro area, to which over 60% of exports are directed, the lack of gains in competitiveness in terms of prices and costs is to the fore. Nonetheless, behind these results are also factors of a more structural nature, such as the very characteristics of the Spanish trade pattern. Spanish exports specialise in medium technology products which are relatively vulnerable to the strong increase in sales by emerging countries competing at very favourable prices. In parallel, the Spanish productive structure is not very specialised in those sectors which, in recent years, have stood out for the intensity of demand and the capacity to generate value, as is the case with the ICT sector. In this respect, the information drawn from the export specialisation indices, calculated in relation to France, Germany and Italy, shows that the share in sales of goods produced in high-technology industries is comparatively low, having even declined in the past decade (see Table IV.2). Moreover, the relative structure of imports, measured via the relative dependence indices, reveals that import intensity in high-technology industrial goods (which are essentially investment goods) has slackened since the start of the nineties vis-à-vis the three reference countries.

The overall pattern of the competitiveness indices compiled with various price and cost indicators was affected by the slight appreciation of the nominal component and by the unfavourable behaviour (to varying degrees) of the relative price and cost indicators (see Chart IV.13).

Closer analysis of the behaviour of the price and cost indicators vis-à-vis the euro area shows that the index compiled using consumer prices saw a decline in its rate of increase in relation to the previous year. This was due to the better behaviour of the energy component which offset, in part, the deterioration in the relative prices of non-energy goods and, above all, of services, which reflected the inflationary pressures in the sectors sheltered from foreign competition. Conversely, the indices calculated with relative producer prices saw a halt in the favourable behaviour they had shown in 2000, and evidenced a loss of competitiveness that originated in the positive consumer-good inflation gap. Unit labour costs also outgrew those in the euro area. In particular, in terms of manufacturing labour costs, the losses in competitiveness – though having eased in relation to 2000 – remained signifi-

TABLE IV.2

**Specialisation and relative dependence indices  
vis-à-vis Germany, France and Italy**

	1991	2000
<b>EXPORTS (a):</b>		
<b>High-technology industries</b>	<b>52.1</b>	<b>44.4</b>
Aircraft	34.9	27.0
Pharmaceutical products	66.3	55.9
Office machinery and computers	86.6	58.1
Electronic equipment	56.1	48.1
Surgical and precision instruments	32.0	38.6
<b>Medium/high-technology industries</b>	<b>102.5</b>	<b>103.7</b>
Machinery and electrical equipment	80.7	86.6
Motor vehicles	169.8	162.4
Chemical industry	56.1	58.3
Railway and other transport equipment	60.5	168.5
Machinery and mechanical equipment construction	76.0	73.6
<b>Medium/low-technology industries</b>	<b>142.2</b>	<b>151.8</b>
Oil refining	183.5	209.4
Rubber transformation and plastic materials	140.0	173.3
Other non-metallic mineral products	155.8	188.5
Boats	344.6	173.4
Metallurgy and manufacture of metallic products	120.2	116.9
<b>Low-technology industries</b>	<b>98.0</b>	<b>114.4</b>
Various manufactures	94.0	107.3
Wood, cork, paper, graphic art and publishing	102.8	117.7
Food, beverages and tobacco	95.1	110.6
Textiles, clothing, leather and footwear	100.3	119.6
<b>TOTAL MANUFACTURES</b>	<b>100.0</b>	<b>100.0</b>
<b>IMPORTS (b):</b>		
<b>High-technology industries</b>	<b>98.4</b>	<b>76.1</b>
Aircraft	78.7	58.4
Pharmaceutical products	87.2	87.7
Office machinery and computers	107.5	65.0
Electronic equipment	101.8	88.4
Surgical and precision instruments	110.8	78.1
<b>Medium/high-technology industries</b>	<b>116.8</b>	<b>115.6</b>
Machinery and electrical equipment	138.3	100.5
Motor vehicles	104.2	135.9
Chemical industry	89.0	79.2
Railway and other transport equipment	180.3	115.2
Machinery and mechanical equipment construction	146.6	136.0
<b>Medium/low-technology industries</b>	<b>94.2</b>	<b>112.0</b>
Oil refining	71.6	104.3
Rubber transformation and plastic materials	140.8	166.4
Other non-metallic mineral products	86.9	79.5
Boats	103.5	193.8
Metallurgy and manufacture of metallic products	89.0	99.4
<b>Low-technology industries</b>	<b>83.4</b>	<b>92.0</b>
Various manufactures	107.5	105.4
Wood, cork, paper, graphic art and publishing	87.7	93.7
Food, beverages and tobacco	81.3	88.6
Textiles, clothing, leather and footwear	74.9	88.7
<b>TOTAL MANUFACTURES</b>	<b>100.0</b>	<b>100.0</b>

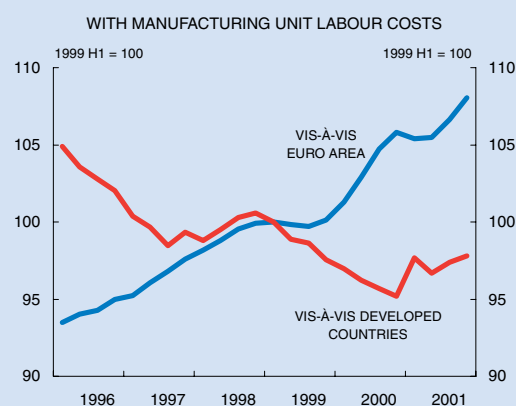
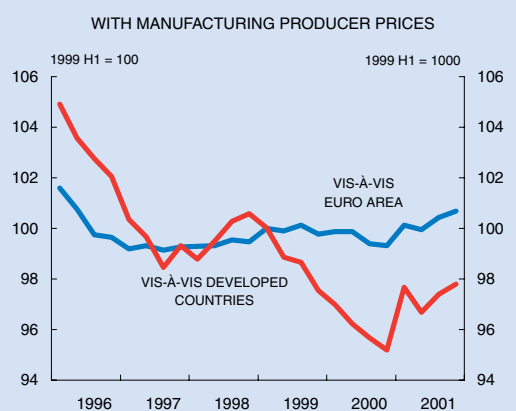
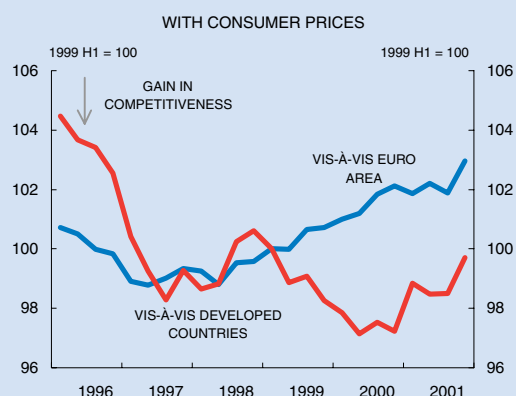
Sources: OECD and Banco de España.

(a)  $IER_i = [X_{iespa\tilde{n}a}/X_{mespa\tilde{n}a}]/[X_{igrupo}/X_{mgrupo}] * 100$ , where  $X_i$  are exports of branch  $i$ ,  $X_m$  are total exports of manufactures.

(b)  $IDR_i = [M_{iespa\tilde{n}a}/M_{mespa\tilde{n}a}]/[M_{igrupo}/M_{mgrupo}] * 100$ , where  $M_i$  are imports of branch  $i$ ,  $M_m$  are total imports of manufactures.

CHART IV.13

## Competitiveness indices for Spain (a)



Source: Banco de España.

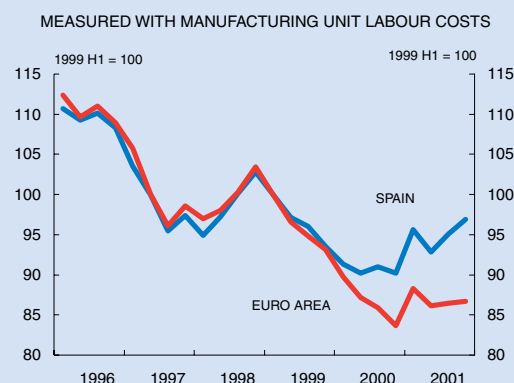
(a) An increase in the index denotes a loss in competitiveness, and vice versa.

cant. The performance of unit labour costs was essentially due to the bigger increases in compensation per employee in Spain compared with those in the euro area.

As earlier discussed, in 2001 the competitiveness indices vis-à-vis the non-euro area developed countries generally showed losses in competitiveness. This was due to the combination of worsening price differentials (which narrowed slightly never-

CHART IV.14

## Competitiveness indices for Spain and for the euro area (a) (b)



Sources: Banco de España and European Central Bank.

(a) An increase in the index denotes a loss in competitiveness and vice versa.

(b) Competitiveness indices for Spain vis-à-vis the group of non-euro developed countries and competitiveness indices for the euro area vis-à-vis a limited group of countries comprising: United States, Japan, Switzerland, United Kingdom, Sweden, Denmark, Greece (until December 2000), Norway, Canada, Australia, Hong Kong, Korea and Singapore.

theless compared with the previous year) and the strengthening of the euro. True, the gains in the nominal component of these indices in the two years prior to 2001 allowed a certain competitive advantage to be sustained over these countries. But the persistent differential growth of prices and, above all, of costs, is slowly eroding this edge. Moreover, in 2001 there was a smaller difference in the growth of Spanish export prices by economic area. This would appear to indicate that, faced with the extreme weakness of foreign demand, Spanish exporters eased up on setting different margins in different markets, an habitual practice when the depreciation of the euro had enabled higher price rises to be set outside the euro area. However, it could still be seen that relative prices vis-à-vis the developed countries increased more than vis-à-vis the euro area.

To conclude, when comparing the competitiveness indices of Spain and of the euro area, compiled on the basis of manufacturing unit labour costs, it can be seen that although both types of indices followed a similar pattern of behaviour in 2001, losses in competitiveness were more marked in the case of Spain. Further, manufacturing unit labour costs stabilised in the euro area, whereas they increased in Spain. Once more, this is due to the differing behaviour of compensation per employee, which advanced relatively more in Spain in 2001 (see Chart IV.14).

#### IV.7. GENERAL GOVERNMENT ACTIVITY

The goal of a balanced budget initially envisaged for the overall general government sector (see Table IV.3) was achieved in 2001. The primary balance, for its part, posted a surplus of 3.1% of GDP, two-tenths of a point up on the previous year, while public debt as a proportion of GDP stood at 57.2%, below the Maastricht Treaty threshold of 60%.

The deficit of the State and its agencies was 0.4% of GDP, slightly above the initially budgeted figure of 0.3%, but an improvement on the forecast of 0.5% in the latest Updated Stability Programme (2001-2005). The Social Security System, for which a surplus of 0.3% of GDP had initially been projected (0.5% of GDP in the Updated Stability Programme), ran a surplus of 0.8% of GDP, enabling a contribution of €1,803 million to be made to the Social Security reserve fund, a figure far higher than budgeted (€541 million). Territorial government, however, for which a balanced budget had been forecast, posted a deficit of 0.4% of GDP, one-tenth of a point more than in 2000. This deficit was attributable in its entirety to the autonomous (regional) governments, since the local government tier maintained a balanced budget. Significantly, 2001 is the second year in which the regional governments have deviated considerably from the budgetary targets set in the related Stability Programme.

In National Accounts terms, total revenue increased by 7% in 2001, slightly above nominal GDP. However, and unlike the previous year, the relative weight of overall tax revenue in GDP diminished, while the growth of non-tax revenue was higher. Total general government spending once again grew less than nominal GDP, whereby its weight in relation to the economy as a whole diminished, albeit to a lesser extent (two-tenths of a percentage point) than a year earlier, when the related reduction was eight-tenths of a point. The reduction in spending in 2001 was due both to primary current expenditure and to interest payments, while the share of capital expenditure in GDP climbed significantly.

The reduction in the weight of tax revenue was due to the weak growth of taxes on production and imports, while income and wealth tax as a proportion of GDP remained unchanged and social security contributions increased substantially, outgrowing

	1998	1999	2000	2001
<b>Total revenue</b>	<b>39.4</b>	<b>40.1</b>	<b>39.9</b>	<b>40.0</b>
Current revenue	38.0	38.6	38.9	38.9
<i>Taxes on production and imports</i>	11.1	11.7	11.7	11.4
<i>Taxes on income and wealth</i>	10.2	10.2	10.5	10.5
<i>Social contributions</i>	13.0	13.1	13.3	13.5
<i>Other revenue (a)</i>	3.7	3.6	3.3	3.5
Capital revenue	1.4	1.4	1.1	1.1
<b>Total expenditure</b>	<b>42.0</b>	<b>41.1</b>	<b>40.3</b>	<b>40.1</b>
Current expenditure	36.8	35.8	35.3	34.9
<i>Final consumption expenditure</i>	17.5	17.4	17.4	17.3
<i>Social benefits in cash</i>	12.8	12.4	12.3	12.2
<i>Actual interest payments</i>	4.3	3.5	3.3	3.1
<i>Subsidies</i>	1.1	1.2	1.1	1.1
<i>Other transfers</i>	1.2	1.2	1.3	1.2
Capital spending	5.1	5.4	4.9	5.1
<i>Gross capital formation (b)</i>	3.3	3.5	3.3	3.5
<i>Other expenditure</i>	1.8	1.9	1.7	1.7
<b>Net lending (+) or borrowing (-)</b>	<b>-2.6</b>	<b>-1.1</b>	<b>-0.3</b>	<b>0.0</b>
MEMORANDUM ITEM:				
Primary balance	1.7	2.5	2.9	3.1
Gross debt	64.6	63.1	60.4	57.2
Sources: INE, Ministerio de Hacienda and Banco de España.				
(a) Includes fixed-capital consumption.				
(b) Includes acquisitions of non-produced, non-financial assets.				

nominal GDP. The growth in income and wealth tax was 6.9%, although the data available show their main components to have trended unevenly. There was a substantial increase in personal income tax (12.9% in respect of revenue raised) and a virtually zero increase in corporate income tax. The latter, in addition to the fall in corporate earnings, would be indicative of a step-up in the process of pension fund externalisation by companies and an improvement in the tax treatment of dividends and capital gains arising on investment abroad.

The increase in the tax base associated with the notable vigour of employment and of Social Security registrations was a determining factor of the growth of personal income tax revenue in 2001. The potential increase in revenue-raising capacity for this tax and the free play of fiscal drag in respect of the schedule may also have contributed to this outcome. Conversely, there was an appreciable decline in indirect tax, the share of which in GDP was three-tenths of a point down as a result of the

slowdown in its growth rate from 8.3% in 2000 to 3.9% in 2001. This significant deceleration was due above all to VAT (in line with the slowdown in consumption and imports and with the tax deductions for the agricultural and transport sectors), the revenue for which grew by 3.8% against 8.7% the previous year. The increase in the case of excise duties was also weak (3.5% in terms of revenue raised), given the freezing of certain tax rates, particularly so regarding taxes on hydrocarbons.

Revenue relating to social security contributions held at a high growth rate in 2001 (8.6% against 9.7% in 2000), a sign of the positive behaviour of the number of Social Security registrations. Lastly, non-tax revenue trended very favourably owing especially to the higher-than-expected ordinary profits of the Banco de España, to the charge levied for use of the radioelectric spectrum (applied for the first time in 2001) and to something of a pick-up in capital transfers from European funds.

Under primary current spending, final consumption expenditure increased by 6%, slowing significantly from the rate of 7.5% the previous year. The main component of final consumption expenditure (general government employee compensation) increased relatively moderately by 5.1%, somewhat down on the figure of 5.6% for 2000. The data available relate this slowdown to general government employee compensation rather than to changes in the number of public-sector employees in 2001. Social transfers in kind acquired on the market (associated essentially with health-care and education spending) also moderated, as did inputs (purchases of goods and services), largely attributable in this latter case to the local government budgetary outturn.

Social benefits in cash increased by 6.3% in 2001, with their weight in GDP diminishing slightly, having slowed from 6.6% in 2000. This reflects the moderate growth of the number of pensions, which may be expected to hold stable for several years, in keeping with the fact that the less numerous generations born during the Civil War and the immediate post-war period are reaching retirement age. Conversely, spending on unemployment benefits increased considerably in 2001. This was partly the result of the numbers of unemployed registered with INEM (with an increase of 0.1% in 2001, taking as a reference the previously employed non-farm registered unemployed, compared with a decline of 4.5% in 2000), and partly of the considerable increase in the re-

placement ratio relating to unemployment benefits. Regarding this latter point, although there have been no legislative amendments bearing on the conditions for qualifying for these benefits, the strong decline in long-term unemployment and the reduction in the proportion of temporary employees of factors which help explain the rise and the replacement ratio. Overall, the number of unemployment benefit beneficiaries climbed by 5.9% in 2001, against a 2.7% decline the previous year.

Interest payments by general government showed slight growth of 1.4% in 2001, meaning a fresh fall of two-tenths of a point in the interest on public debt/GDP ratio. This decline has been easing since 2000, evidencing how the downward trajectory of the average interest rate paid on public debt has run its course. That said, the weight of interest is expected to continue falling in the coming years owing to the decline in the public debt/GDP ratio.

Capital expenditure increased considerably in 2001, with its growth rate rising to 11.3%, translating into an increase of two-tenths of a point in terms of its weight in GDP. The increase was due above all to public investment, which climbed by 13.1%. This rate is not strictly comparable to that recorded in 2000, since this last year included (with a negative sign) the proceeds obtained through the concession of the UMTS mobile telephony licences. Stripping this effect out, the growth of public investment in uniform terms would have been 10.3% in 2001, against 4.4% in 2000. Consequently, even with this adjustment, the increase in public investment in 2001 should be viewed as substantial.

In sum, the highlight of the budgetary outturn in 2001 was the achievement of a balanced budget against the background of a somewhat sharper than initially envisaged economic slowdown, but one consistent, as seen, with favourable employment developments. The fiscal impulse indicators, with all the caveats that should be applied to analyses based thereon, show that the fiscal policy stance in 2001 was slightly restrictive (see Box 1.4). Significantly, however, no additional discretionary budget adjustment measures were taken during the year, and there was, moreover, a substantial increase in public investment. This was possible first, due to the general restrictiveness of fiscal policy applied in recent years, which particularly affects certain expenditure headings such as government consumption; and further, to

TABLE IV.4

**Balance of payments: summary table  
% of GDP**

	1996	1997	1998	1999	2000	2001
<b>RECEIPTS:</b>						
<b>Current account</b>	<b>28.3</b>	<b>31.3</b>	<b>32.0</b>	<b>31.9</b>	<b>35.0</b>	<b>35.7</b>
Goods	16.9	19.0	19.0	18.7	20.7	20.2
Services	7.3	7.9	8.4	8.9	9.6	10.0
<i>Tourism</i>	4.5	4.8	5.1	5.4	5.5	5.6
<i>Other services</i>	2.8	3.1	3.3	3.5	4.1	4.3
Income	2.3	2.3	2.5	2.1	2.7	3.4
Current transfers	1.8	2.1	2.2	2.2	2.0	2.2
<b>Capital account</b>	<b>1.3</b>	<b>1.3</b>	<b>1.2</b>	<b>1.3</b>	<b>1.0</b>	<b>1.0</b>
<b>PAYMENTS:</b>						
<b>Current account</b>	<b>28.2</b>	<b>30.9</b>	<b>32.5</b>	<b>34.2</b>	<b>38.5</b>	<b>38.3</b>
Goods	19.5	21.4	22.5	23.8	26.9	25.6
Services	3.9	4.3	4.7	5.1	5.6	5.8
<i>Tourism</i>	0.8	0.8	0.9	0.9	1.0	1.0
<i>Other services</i>	3.1	3.5	3.8	4.2	4.6	4.8
Income	3.3	3.5	3.8	3.7	4.2	5.0
Current transfers	1.4	1.6	1.6	1.7	1.8	1.9
<b>Capital account</b>	<b>0.2</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	<b>0.1</b>
<b>BALANCE:</b>						
<b>Current account</b>	<b>0.1</b>	<b>0.5</b>	<b>-0.5</b>	<b>-2.3</b>	<b>-3.4</b>	<b>-2.6</b>
Goods	-2.7	-2.4	-3.5	-5.1	-6.2	-5.4
Services	3.4	3.6	3.7	3.8	4.0	4.2
<i>Tourism</i>	3.7	4.0	4.2	4.5	4.6	4.6
<i>Other services</i>	-0.4	-0.4	-0.5	-0.7	-0.6	-0.4
Income	-1.0	-1.2	-1.3	-1.6	-1.5	-1.6
Current transfers	0.4	0.5	0.6	0.5	0.3	0.3
<b>Capital account</b>	<b>1.1</b>	<b>1.1</b>	<b>1.1</b>	<b>1.2</b>	<b>0.9</b>	<b>0.9</b>
<b>MEMORANDUM ITEM:</b>						
Overall balance on current and capital account	1.1	1.6	0.6	-1.2	-2.6	-1.8

Source: Banco de España.

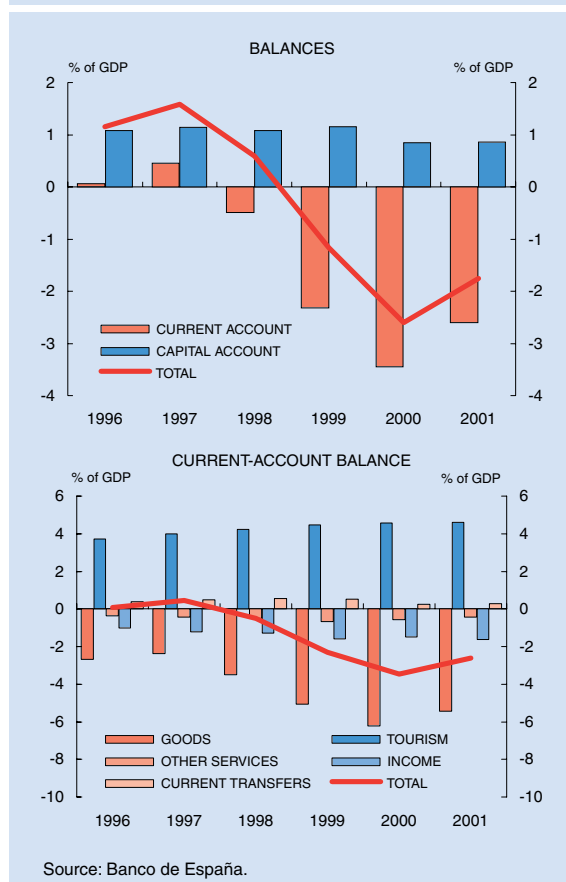
the decline by two-tenths of a point in interest payments as a proportion of GDP (when this proportion was expected to be maintained) and the slight increase in the weight of revenue (both non-tax revenue and tax receipts most directly related to employment), which contributed to achieving a balanced budget in 2001.

#### IV.8. THE BALANCE OF PAYMENTS

In 2001, the balance of payments posted a cumulative deficit on current and capital account of €11.4 billion, equivalent to -1.8% of nominal GDP,

CHART IV.15

**Balance of payments on current and capital account**



compared with -2.6% in 2000. The improvement is due to a smaller trade-balance deficit and to a sizable increase in the surplus on the balances of services and, to a lesser extent, of transfers, which offset the deterioration in the income balance (see Table IV.4 and Chart IV.15).

The deficit on the trade balance, which had reached a cyclical peak in 2000, declined by 1% in 2001 to -5.4% of GDP. The nominal growth of both receipts and payments eased (to 4.2% and 1.7%, respectively), due to the appreciable slowdown in the volume of trade and to price developments. As analysed in the previous sections, the sluggishness of real exports was essentially due to the halt in the growth of world trade, set against a loss of competitiveness of the Spanish economy. The growth of real imports also diminished, in line with the slackness of final demand, which was particularly acute in the case of capital investment and industrial output. There was a notable improvement in the terms of trade owing to the heavy falls in import prices, particularly those of energy products.

The surplus on services rose to 4.2% of GDP (4% in 2000). There was an increase of 11.9% in the surplus on trade in services, which was attributable to the improvement in the tourism balance (7.9%) and to a significant reduction in the deficit on other services (20%). Tourism receipts and payments grew by 8.5% and 11.7%, respectively. And although both items slowed substantially as from Q2, the deceleration steepened in the wake of the events on 11 September. As regards the two countries that are the main source of tourists for Spain, numbers from Germany slipped back and the increase in visitors from the United Kingdom was smaller. Conversely, tourists from France and Italy rose notably. Other non-tourist services held firm in respect of both receipts and payments. As in previous years, mention should be made of the favourable performance of sectors related to information, communications and corporate services. The buoyancy hitherto characterising these sectors continued.

The deficit on the income balance worsened in 2001 to -1.6% of GDP (-1.5% in 2000). Flows of both receipts and payments increased considerably (35.5% and 29.5%, respectively). In terms of institutional sectors, there was a notable increase in the

receipts of other resident sectors (growth of 74%, up on 2000) and of the credit sector (15%, which was however only half that for the previous year). In respect of payments, the rates of increase for these sectors and, to a lesser extent, for the general government sector were higher than those in 2000.

Finally, the balances on current and capital transfers stood, in terms of GDP, at 0.3% and 0.9%, respectively, similar to the previous year. Both flows improved as a result of the increase in funds from the EU, although these increases were less than expected. Indeed, a portion of these flows was in compensation for the delays incurred in 2000; as this was the first year of a new period of financing (2000-2006), there were lags in the drawing up of the related programmes.

On balance of payments statistics, the Spanish economy's net borrowing in 2001 declined to €11.4 billion (against €15.81 billion in 2000). This may have been due to the mild recovery in the economy's saving ratio, coupled with a concurrent marginal decline in the investment rate. The following chapter analyses in detail how this deficit position has been financed.

## CHAPTER V

# SPANISH FINANCIAL FLOWS, MARKETS AND INTERMEDIARIES



As mentioned in the foregoing chapters of this Report, the year 2001 was marked, in Spain and most of the industrialised economies alike, by the slowdown in activity. The deceleration was linked largely to a series of global shocks (the rise in oil prices, the crisis in the technology sector, the September 11 attacks, etc.) which, in combination, prompted a widespread climate of uncertainty on the financial markets. Significantly, however, compared with similar episodes in the past, international financial systems in general, and the Spanish system in particular, evidenced a greater capacity to withstand these circumstances, thereby contributing to tempering their effect on the different economies' growth.

The diminished buoyancy of activity in Spain in 2001 did not, as on past occasions, translate into a sharp slowdown in the funds obtained by households and firms to finance their spending decisions. Indeed, spurred on by generous monetary conditions, the financing received by these sectors grew at around 16%. Though somewhat down on previous years, this rate is high when viewed in the light of the Spanish economy's cyclical position. On provisional information available on 2002 Q1, this variable has, at slightly over 15%, continued growing at the same rate as in 2001 Q4.

As might be expected in an environment such as that described, Spanish corporations raised a lesser volume of funds via the equity markets, on which trading and prices were adversely affected by the climate of greater uncertainty. However, the issuance of fixed-income securities was boosted somewhat, particularly by financial corporations, and this bore favourably on activity in the secondary market for this type of instrument.

Nonetheless, it was mainly financing raised through bank credit which most contributed to sustaining the spending level of Spanish corporations and, in particular, households. In this respect, the increases in house-purchase loans (above 16% for the year as a whole) and in consumer loans (the year-on-year rate of which was in excess of 22% at end-2001) are particularly notable. As a result, credit institutions once again played a crucial role in channelling financial flows in Spain. The strength of their traditional domestic business (albeit against a background of heightening competition) enabled them to meet the increases in provisioning requirements in connection with the so-called statistical provision and with the events in Argentina without their profit and loss accounts being excessively impacted. In fact, the growth of Spanish institutions' profits eased in relation to previous years but was still higher than many of their main international competitors.

The financial assets acquired and the liabilities incurred vis-à-vis non-residents amounted to 10.3% and 12.2% of GDP, respectively. These figures were substantially down on 2000 (which was probably an exceptional year), but comparable with those for 1998 and 1999, which were propitious to the growth of capital flows.

Admittedly, in the light of these data, it may be said that the growth of financing appears to have contributed to easing the depth and, possibly, the duration of the slowdown in activity in Spain. Set against this, however, it should not be forgotten that Spanish households and non-financial corporations continued to increase their levels of debt last year both in absolute terms and compared with their income or their financial assets. As a propor-



tion of household gross disposable income, household debt climbed four percentage points to close to 77%. The debt/gross operating surplus ratio for corporations, meanwhile, increased from 342% to 380%.

The financial position of Spanish households and corporations remains, in any event, healthy and, as discussed previously in this Report (see Box I.1), debt levels are on a comparable footing with those for the euro area on average. The recent increase in levels is, moreover, based on favourable expectations about the future growth of the Spanish economy. But even under these conditions, this does not prevent the rise in a sector's debt level involving greater relative exposure for it in the face of potential shocks. For instance, in the case of households, given the weight of real estate assets in their total wealth, a potential correction in house prices (which have grown by 37% in real terms over the last four years – see Box V.1) might weaken their financial position. In the case of corporations, the key risk factors are probably those associated with increasing international expansion, which have seen companies' assets vis-à-vis the rest of the world double in terms of GDP in less than three years. In these circumstances, the degree of relative vulnerability of the private sector's financial position might influence to some extent the speed at which consumption and investment may be expected to recover in a fresh cyclical upturn.

## **V.1. FINANCIAL FLOWS IN THE SPANISH ECONOMY**

### **V.1.1. The capital account of the institutional sectors**

On National Accounts figures, the Spanish economy's net borrowing declined to 1.9% of GDP in 2001, compared with 2.5% in 2000. This reduction was a result both of the pick-up in national saving and of a lower share of the resident sectors' total investment in output (see Table V.1 and Chart V.1). By sector, general government attained a balanced budget, the outcome of an increase of five-tenths of a point of GDP in its gross saving, despite the slight increase in its investment, as discussed in the previous chapter. The trend of public saving was a result of a containment of current expenditure in virtually all its components, while the share of current revenue in GDP held at the previous year's level.

The net lending of households stood, as in 2000, at 0.3% of GDP, and household saving and residential investment as a percentage of GDP practically repeated the levels of the previous year. Lastly, the net borrowing of Spanish corporations fell by two-tenths of a point of GDP to 2.2%, although the behaviour of financial and non-financial corporations differed. The former saw their net lending increase to 1.2% of GDP (half a point up on the previous year), while the latter witnessed a fresh rise in their net borrowing to 3.4% of GDP.

### **V.1.2. Financial flows in the Spanish economy**

The financial accounts of the Spanish economy contain information on financing flows and financial investment between the different institutional sectors, thereby providing a view of the channels through which agents' consumption and real investment are financed and of the instruments in which their saving materialises. They thus provide a different set of information from the non-financial accounts, but one which nevertheless reflects the same economic reality, since agents adopt their spending and financing decisions simultaneously. Furthermore, the financial accounts enable the balance-sheet position of the Spanish economy's various sectors to be analysed. In many cases this position proves vital for understanding and evaluating agents' spending (and debt) decisions. The following sections analyse recent developments in the main financial flows on the basis of the information provided by the financial account. The balance-sheet position of the private sector will be addressed in section V.4.

### **V.1.3. Financial flows of households and non-financial corporations**

The net financial saving ("net financial transactions" according to ESA 95 terminology) of households and private non-profit institutions serving households (NPISHs) picked up moderately in 2001 in terms of GDP to 1.3% (see Table V.2), thereby breaking the declining trend recorded since 1995. However, this figure masks different patterns in the first and second half of the year. Until mid-2001, the recovery in household net financial saving was relatively intense, spurred by a generalised downward revision of growth expectations, by households'

## Recent house price developments in Spain

In recent years both the price of housing and the credit extended to households for house purchases have grown sharply. This greater volume of debt means that households, especially those which have bought their house recently (and, along with them, the banks that have granted these loans) are more exposed not only to a potential increase in interest rates or to a less positive than expected change in their income, but also to a possible fall in the value of this real asset. Bearing in mind that real estate assets account for approximately 70% of total Spanish household wealth and are used as collateral for loans representing around 40% of the total credit extended by Spanish banks, analysis of house prices is of particular importance for assessing the economic situation in a country.

The accompanying chart shows the course of recent house prices deflated by the CPI, both in Spain and in a sample of developed countries. Two points stand out in this chart. First, the presence, in general, of a long-term rising trend in the relative price of housing, the intensity of which varies from country to country. And second, the presence of sizeable fluctuations in the short and medium run.

Behind the long-term trend of prices in the various countries are probably factors such as the high income elasticity of real estate goods, the increase in the quality of housing, demographic patterns or the limited volume of land available. The short- and medium-term fluctuations, for their part, are the results of characteristics proper to the housing market, such as the slow adjustments by supply, the existence of sizeable transaction costs and the potential feedback effects of price changes. First, property price increases give rise to a wealth effect that stimulates investment in real assets. Moreover, they prompt expectations of fresh future increases which fuel the demand for housing for speculative purposes.

In Spain's case, the increase in the relative price of housing has, as the chart shows, been very sharp, especially in recent years. Several factors help explain this increase. These include most notably: the singular decline in interest rates as a result of convergence towards the euro area; income growth; the high relative preference for owner-occupied housing (favoured by its tax treatment) and for investment in tangible assets; rigid land-use market regulations; the rise in the population of household-forming age and in immigration; and the relative weight of residential tourism. Nonetheless, it cannot be ruled out that these structural factors may prove insufficient to justify the increase in its entirety, which might entail the risk of a possible future correction. In fact, following the phase of strong house-price growth in Spain between 1984 and 1991, there was a decline in these prices in real terms of 15% in the three following years (plus a further 3% until 1997), although in nominal terms prices fell only during the first two years (by 1.7%).

That said, the current phase of strong growth in house prices displays some different characteristics, although both periods coincide with phases of vigorous GDP growth. The phase in the second half of the eighties was more intense and prolonged (see chart): between 1984 and 1991, the average relative prices of housing grew by 124% in real cumulative terms (12% per annum on average), while this growth was 37% in the last four years (8% in annual average terms). Further, although, in relation to average household gross disposable income, house prices in 2001 were 4% above their 1991 level, mortgage loan interest rates had fallen by somewhat over 10 percentage points, while their average life tended to lengthen (see Table V.4). Other differences between both periods relate to the bigger volume of new houses built in the current cycle and to the growing significance of the second-residence market in Spain, both for nationals and foreigners.

However, although the current expansionary phase has so far been less accentuated and the housing affordability indicators more favourable, it cannot be ruled out that a possible rise in interest rates, given growing household indebtedness, or a less favourable than expected trend in household income may ultimately trigger mechanisms leading to a correction of the current price of housing. In addition, the firming of low inflation rates following Spanish EMU membership makes it unlikely that any future adjustment in the relative price of housing will take place, as occurred in the past, without a significant change in nominal housing prices.

## International comparison

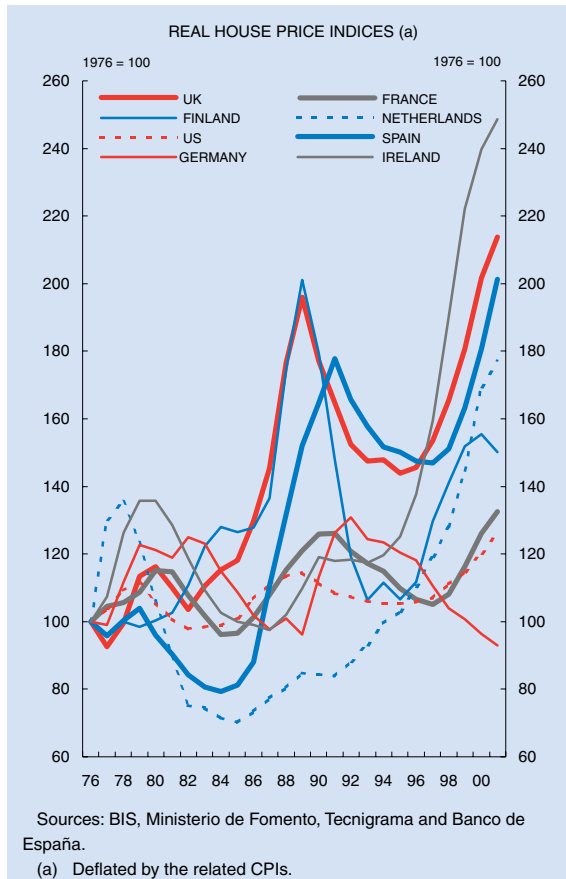


TABLE V.1

**Use of income, capital and financial accounts. National economy**  
**Breakdown by sector**

% of GDP

	1996	1997	1998	1999	2000	2001
<b>1. Gross disposable income</b>	<b>99.6</b>	<b>99.5</b>	<b>99.3</b>	<b>99.0</b>	<b>98.9</b>	<b>98.8</b>
General government	16.7	18.0	18.7	20.3	20.9	21.3
Financial institutions	2.0	1.7	1.7	1.4	2.0	2.5
Non-financial corporations and households and NPISHs	81.0	79.8	78.9	77.4	75.9	75.0
<i>Households and NPISHs</i>	<i>69.1</i>	<i>68.1</i>	<i>67.2</i>	<i>66.1</i>	<i>64.8</i>	<i>64.4</i>
<i>Non-financial corporations</i>	<i>11.8</i>	<i>11.7</i>	<i>11.7</i>	<i>11.3</i>	<i>11.1</i>	<i>10.6</i>
<b>2. Consumption</b>	<b>77.6</b>	<b>76.9</b>	<b>76.7</b>	<b>76.8</b>	<b>76.6</b>	<b>76.0</b>
General government	17.9	17.5	17.5	17.4	17.4	17.3
Households and NPISHs	59.6	59.3	59.3	59.4	59.2	58.7
<b>3. Gross national saving (1-2)</b>	<b>22.1</b>	<b>22.6</b>	<b>22.6</b>	<b>22.2</b>	<b>22.3</b>	<b>22.7</b>
General government	-1.2	0.4	1.2	2.9	3.5	4.0
Financial institutions	1.6	1.3	1.5	1.0	1.4	1.8
Non-financial corporations and households and NPISHs	21.7	20.8	19.9	18.4	17.3	16.9
<i>Households and NPISHs</i>	<i>9.9</i>	<i>9.1</i>	<i>8.2</i>	<i>7.1</i>	<i>6.2</i>	<i>6.3</i>
<i>Non-financial corporations (a)</i>	<i>11.8</i>	<i>11.7</i>	<i>11.7</i>	<i>11.3</i>	<i>11.1</i>	<i>10.6</i>
<b>4. Gross capital formation (b)</b>	<b>20.8</b>	<b>21.0</b>	<b>22.1</b>	<b>23.3</b>	<b>24.8</b>	<b>24.6</b>
General government	3.7	3.6	3.8	3.9	3.9	4.0
Financial institutions	0.6	0.6	0.5	0.5	0.7	0.6
Non-financial corporations and households and NPISHs	16.6	16.8	17.9	18.9	20.2	20.0
<i>Households and NPISHs</i>	<i>4.9</i>	<i>4.8</i>	<i>5.2</i>	<i>5.5</i>	<i>5.9</i>	<i>6.0</i>
<i>Non-financial corporations</i>	<i>11.7</i>	<i>12.0</i>	<i>12.7</i>	<i>13.4</i>	<i>14.3</i>	<i>14.0</i>
<b>5. Net lending (+) or borrowing (-)</b>						
<b>of the nation (3-4)</b>	<b>1.2</b>	<b>1.6</b>	<b>0.5</b>	<b>-1.1</b>	<b>-2.5</b>	<b>-1.9</b>
General government	-4.9	-3.2	-2.6	-1.1	-0.3	0.0
Financial institutions	1.0	0.7	1.0	0.5	0.7	1.2
Non-financial corporations and households and NPISHs	5.1	4.0	2.1	-0.5	-2.8	-3.1
<i>Households and NPISHs</i>	<i>5.0</i>	<i>4.3</i>	<i>3.0</i>	<i>1.6</i>	<i>0.3</i>	<i>0.3</i>
<i>Non-financial corporations</i>	<i>0.2</i>	<i>-0.3</i>	<i>-1.0</i>	<i>-2.1</i>	<i>-3.1</i>	<i>-3.4</i>
<b>6. Net financial transactions (7-8)</b>	<b>1.2</b>	<b>1.6</b>	<b>0.5</b>	<b>-1.1</b>	<b>-2.5</b>	<b>-1.9</b>
General government	-4.9	-3.2	-2.6	-1.1	-0.3	0.0
Financial institutions	1.0	0.7	1.0	0.5	0.7	1.2
Non-financial corporations and households and NPISHs	5.1	4.0	2.1	-0.5	-2.8	-3.1
<i>Households and NPISHs</i>	<i>5.2</i>	<i>4.5</i>	<i>3.3</i>	<i>2.0</i>	<i>0.9</i>	<i>1.3</i>
<i>Non-financial corporations</i>	<i>-0.1</i>	<i>-0.5</i>	<i>-1.2</i>	<i>-2.5</i>	<i>-3.8</i>	<i>-4.4</i>
<b>7. Financial transactions (assets)</b>	<b>43.1</b>	<b>43.2</b>	<b>49.6</b>	<b>51.9</b>	<b>58.5</b>	<b>47.4</b>
General government	3.7	0.4	1.4	1.8	2.1	-0.2
Financial institutions	20.2	21.3	24.4	22.8	19.9	22.0
Non-financial corporations and households and NPISHs	19.2	21.4	23.8	27.4	36.5	25.6
<i>Households and NPISHs</i>	<i>9.1</i>	<i>9.9</i>	<i>9.8</i>	<i>9.6</i>	<i>8.9</i>	<i>7.8</i>
<i>Non-financial corporations</i>	<i>10.1</i>	<i>11.5</i>	<i>14.0</i>	<i>17.8</i>	<i>27.6</i>	<i>17.7</i>
<b>8. Financial transactions (liabilities)</b>	<b>41.9</b>	<b>41.6</b>	<b>49.2</b>	<b>53.0</b>	<b>61.0</b>	<b>49.2</b>
General government	8.6	3.6	4.0	2.8	2.5	-0.1
Financial institutions	19.2	20.6	23.5	22.3	19.2	20.7
Non-financial corporations and households and NPISHs	14.1	17.4	21.7	27.9	39.3	28.6
<i>Households and NPISHs</i>	<i>3.9</i>	<i>5.4</i>	<i>6.5</i>	<i>7.6</i>	<i>8.0</i>	<i>6.5</i>
<i>Non-financial corporations</i>	<i>10.1</i>	<i>12.0</i>	<i>15.3</i>	<i>20.3</i>	<i>31.3</i>	<i>22.1</i>

Sources: INE and Banco de España.

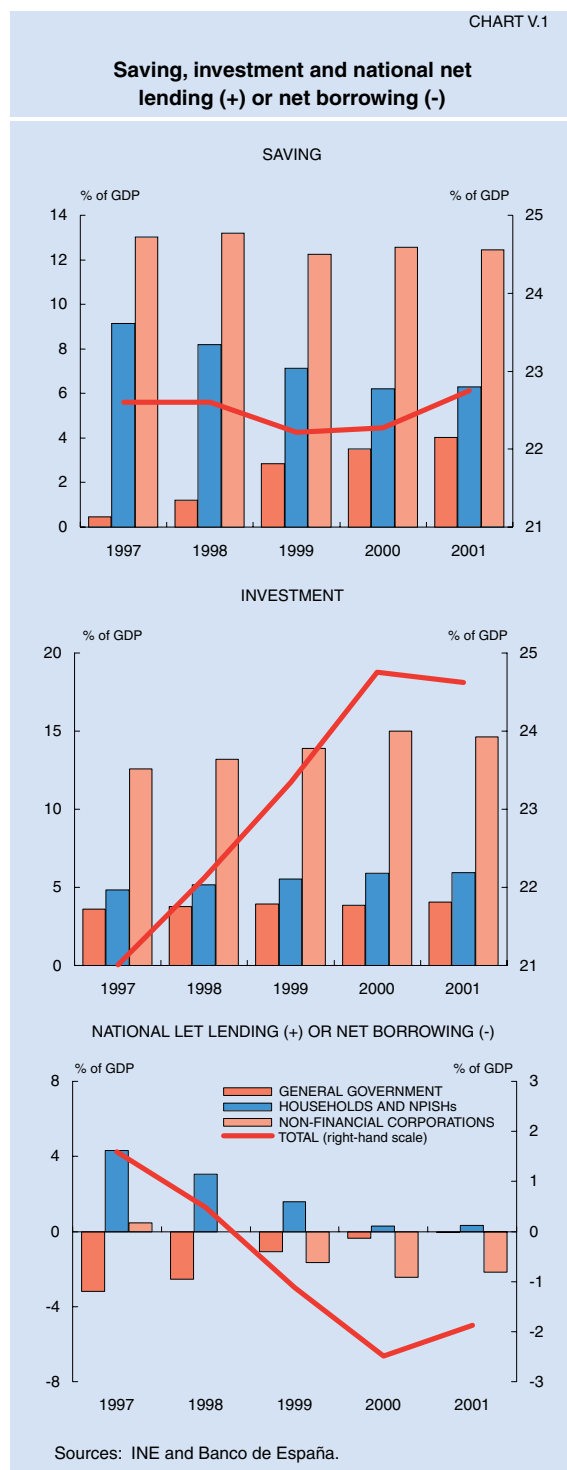
(a) Includes the adjustment for the change in the net share of households in pension fund reserves, adding for households' saving and subtracting for that of financial institutions and non-financial corporations.

(b) Includes the change in stocks and net acquisitions of valuables and of non-financial non-produced assets (added) and net capital transfers (subtracted).

need to reconstitute assets following the deterioration in their financial wealth in 2000 and by the uncertainty prevailing over the foreseeable course of their disposable income.

Nonetheless, during the second half of the year, the pick-up in net financial saving in terms of GDP came to a halt, despite the fact there were no significant changes in growth expectations and that uncertainty heightened in the wake of the September 11 attacks (thereby accentuating the fall in stock market prices). One factor that might help us understand this behaviour of saving is the progressive reduction in lending interest rates over the course of the year, against a background in which investment in real assets has continued to offer a high relative return as a result of the prolonged growth in house prices (see Chart V.3 and Box V.1). Indeed, house-purchase loans increased in 2001 by 16.5% year-on-year. However, the relative buoyancy of private consumption, which ultimately outpaced GDP in the second half of the year, suggests the presence of additional factors, including possibly the implications of the then-imminent introduction of euro-denominated notes and coins.

Component by component, the acquisition of financial assets in terms of GDP held on the mildly declining trend marking its course since 1998 (see Chart V.2). In parallel, there was a restructuring of household portfolios in favour of more liquid and less risky assets. Thus, cash and cash equivalents accelerated slightly (see Table V.3), despite the substantial reduction in cash holdings ahead of the peseta/euro changeover. Time deposits, although they continued to attract a sizable portion of household saving, increased to a lesser extent than the previous year. They were probably affected by the greater demand for shares in money market funds which, as a result of their improved tax treatment in 2000, advanced notably during 2001. Net subscriptions of fixed-income funds also initiated a recovery last year, albeit with much more moderate intensity than money market funds. Conversely, redemptions of shares in equity and international funds were high. Lastly, contributions to pension and insurance schemes, though they increased less than in the two preceding years, continued to grow at a higher rate. On the liabilities side, the new financing obtained by the households and NPISHs sector fell slightly during 2001 in terms of GDP (see Chart V.2 and Table



V.3), owing to the slowdown in bank credit, which is the main source of financial resources for households.

With regard to non-financial corporations, the net balance of their financial transactions (which reflects the gap between gross capital formation and gross saving in the sector) continued to fall in 2001 to -4.4% of GDP (see Table V.2), despite the slack-

TABLE V.2

## Net financial transactions and inter-sectoral flows

% of GDP

	NET FINANCIAL TRANSACTIONS					
	1996	1997	1998	1999	2000	2001
<b>National economy</b>	<b>1.2</b>	<b>1.6</b>	<b>0.5</b>	<b>-1.1</b>	<b>-2.5</b>	<b>-1.9</b>
<b>Non-financial corporations and households and NPISHs</b>	<b>5.1</b>	<b>4.0</b>	<b>2.1</b>	<b>-0.5</b>	<b>-2.8</b>	<b>-3.1</b>
Non-financial corporations	-0.1	-0.5	-1.2	-2.5	-3.8	-4.4
Households and NPISHs	5.2	4.5	3.3	2.0	0.9	1.3
<b>Financial corporations</b>	<b>1.0</b>	<b>0.7</b>	<b>1.0</b>	<b>0.5</b>	<b>0.7</b>	<b>1.2</b>
<b>General government</b>	<b>-4.9</b>	<b>-3.2</b>	<b>-2.6</b>	<b>-1.1</b>	<b>-0.3</b>	<b>0.0</b>
	INTER-SECTORAL FLOWS (a)					
	1996	1997	1998	1999	2000	2001
<b>Households and NPISHs</b>	<b>5.2</b>	<b>4.5</b>	<b>3.3</b>	<b>2.0</b>	<b>0.9</b>	<b>1.3</b>
Vis-à-vis:						
Credit institutions (b)	-2.7	-6.7	-4.4	0.2	-0.1	-1.5
Institutional investors (c)	8.8	10.8	7.5	0.8	0.4	4.2
<b>Non-financial corporations</b>	<b>-0.1</b>	<b>-0.5</b>	<b>-1.2</b>	<b>-2.5</b>	<b>-3.8</b>	<b>-4.4</b>
Vis-à-vis:						
Credit institutions (b)	-0.3	-3.2	-4.3	-3.8	-6.7	-3.8
Rest of the world	0.4	1.7	0.9	-0.8	1.7	-1.9
<b>General government</b>	<b>-4.9</b>	<b>-3.2</b>	<b>-2.6</b>	<b>-1.1</b>	<b>-0.3</b>	<b>0.0</b>
Vis-à-vis:						
Credit institutions (b)	-0.4	1.4	1.4	1.4	2.2	-2.5
Institutional investors (c)	-5.9	-3.9	-2.6	1.7	3.9	2.6
Rest of the world	-0.2	-2.0	-1.1	-4.4	-6.0	-1.7
<b>Rest of the world</b>	<b>-1.2</b>	<b>-1.6</b>	<b>-0.5</b>	<b>1.1</b>	<b>2.5</b>	<b>1.9</b>
Vis-à-vis:						
Credit institutions (b)	0.9	2.8	7.1	2.0	5.2	3.9
Institutional investors (c)	-0.9	-2.5	-6.3	-3.6	-5.7	-4.7
Non-financial corporations	-0.4	-1.7	-0.9	0.8	-1.7	1.9
General government	0.2	2.0	1.1	4.4	6.0	1.7

Source: Banco de España.

(a) A positive sign denotes the extension of financing to the counterpart sector. A negative sign denotes financing from the counterpart sector.

(b) As defined by the First Banking Directive.

(c) Insurance corporations and collective investment undertakings.

ness of private productive investment. As discussed in the previous chapter, this was due to lesser generation of internal funds.

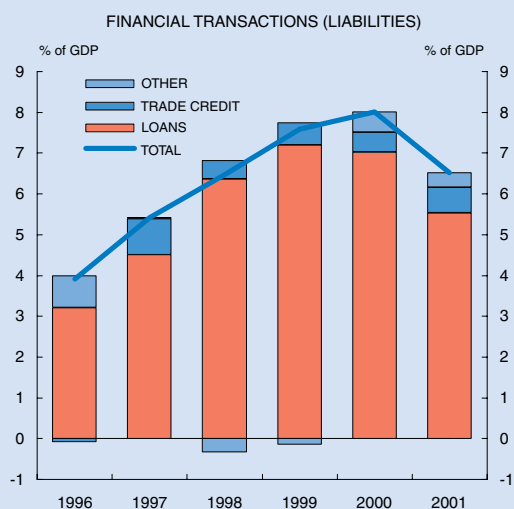
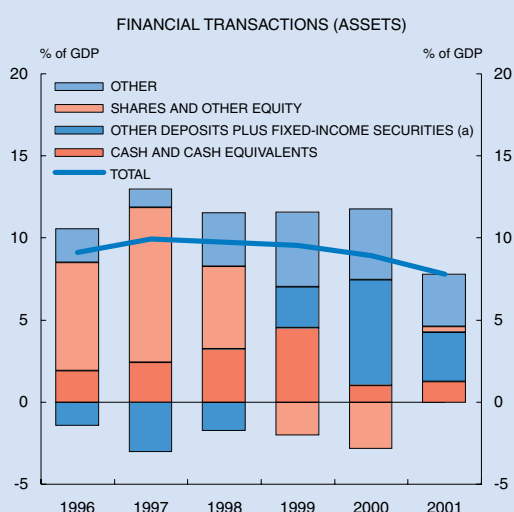
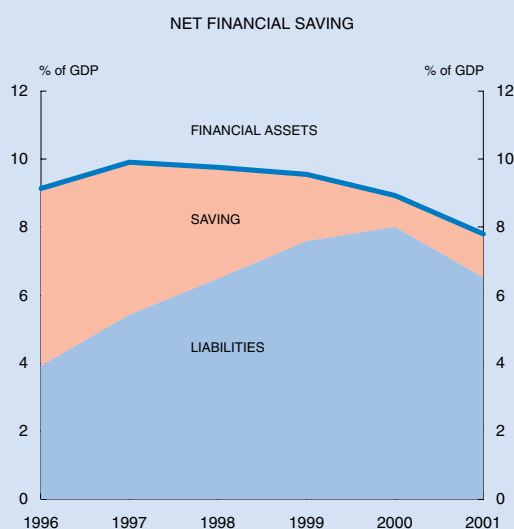
If regard is had not only to gross capital formation but also to permanent financial investment abroad (proxied by the equity portfolio), the gap between the overall investment and gross saving of non-financial corporations, i.e. the financing gap, narrowed considerably last year owing essentially to the moderation of the international expansion process in which Spanish corporations have been involved (see Chart V.4). Notwithstanding, the financing gap remained wide (around 8% of GDP), in excess of the pattern seen in the years prior to the period 1999-2000,

which saw the concentration of significant investment by certain major Spanish corporations abroad. Probably contributing to this was the growing relative weight of financial flows from Spanish parent companies towards their non-resident subsidiaries.

The slowdown in investment abroad led to lower net acquisitions of financial assets by non-financial corporations (see Table V.3 and Chart V.4). Further, the acquisition of shares in domestic corporations fell, while net investment in other financial assets was scarcely changed overall.

Despite the lesser buoyancy of their real and financial investment, the financing of corporations con-

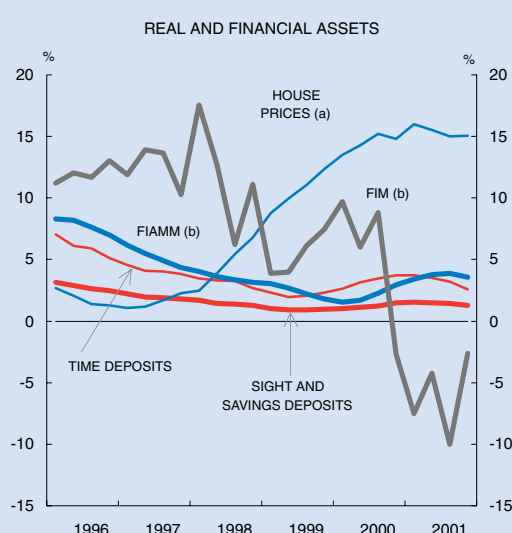
CHART V.2

**Financial transactions of households and NPISHs**

Source: Banco de España.

(a) Not including unpaid accrued interest, which is included under "Other".

CHART V.3

**Yields**

Source: Banco de España.

(a) Year-on-year growth.

(b) Cumulative 12-month return.

tinued to require a substantial volume of funds (see Table V.3 and Chart V.4). Thus, although the increase in liabilities in 2001 was, in terms of GDP, lower than that recorded the previous year, it was above the related increases observed throughout the nineties. The slowdown in internal funds, along with the maintenance at high levels of more permanent financial investment, is the main factor behind this behaviour. Box V.2 analyses in greater detail the most significant changes in non-financial corporations' investment and financing flows in recent years.

Compared with the previous year, the lesser accumulation in liabilities in 2001 essentially took the form of a lower issuance of shares and other equity which, however, rose to a significant amount, as discussed in greater detail in section V.2. Conversely, funds obtained from resident credit institutions, from foreign loans and via the issuance of fixed-income securities declined only slightly in terms of GDP (see Table V.3). This was somewhat more marked in the case of financing from resident credit institutions aimed at business sectors which, in 2000, had most resorted to bank financing: construction and services.

**V.1.4. General government financial flows**

The net balance of general government financial transactions in 2001 was zero. This achievement of

TABLE V.3

**Non-financial corporations and households and NPISHs**  
**Financial transactions**

% of GDP

	Non-financial corporations			Households and NPISHs		
	1999	2000	2001	1999	2000	2001
<b>Net financial saving</b>	<b>-2.5</b>	<b>-3.8</b>	<b>-4.4</b>	<b>2.0</b>	<b>0.9</b>	<b>1.3</b>
<b>Financial transactions (assets)</b>	<b>17.8</b>	<b>27.6</b>	<b>17.7</b>	<b>9.6</b>	<b>8.9</b>	<b>7.8</b>
Cash and cash equivalents	0.7	0.9	1.6	4.5	1.0	1.2
Other deposits (a)	-1.4	1.0	0.5	2.1	6.1	3.4
Securities other than shares	1.1	0.4	0.2	0.5	0.4	-0.3
Shares and other equity	8.2	14.1	4.2	-2.0	-2.9	0.3
Of which:						
<i>Shares in mutual funds</i>	<i>0.2</i>	<i>-0.3</i>	<i>0.0</i>	<i>-2.2</i>	<i>-3.4</i>	<i>0.8</i>
<i>Rest of the world</i>	<i>6.5</i>	<i>10.9</i>	<i>3.7</i>	<i>0.4</i>	<i>-0.4</i>	<i>-0.1</i>
Insurance technical reserves	0.3	0.3	0.3	3.3	3.4	2.8
Credit and other	9.0	10.8	10.9	1.2	1.0	0.4
<b>Financial transactions (liabilities)</b>	<b>20.3</b>	<b>31.3</b>	<b>22.1</b>	<b>7.6</b>	<b>8.0</b>	<b>6.5</b>
Securities other than shares	0.4	-0.5	0.0			
Shares and other equity	5.1	12.3	3.9			
Loans	8.4	11.2	10.6	7.2	7.0	5.5
Of which:						
<i>Credit institutions</i>	<i>4.8</i>	<i>6.7</i>	<i>6.1</i>	<i>6.5</i>	<i>6.8</i>	<i>5.0</i>
<i>Rest of the world</i>	<i>3.0</i>	<i>3.5</i>	<i>3.6</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
Trade credit	6.2	8.2	7.7	0.5	0.5	0.6
Insurance technical reserves and other	0.1	0.2	-0.1	-0.2	0.5	0.4

Source: Banco de España.

(a) Does not include saving deposits since these are included under cash and cash equivalents.

a balanced budget marked a historical milestone in general government conduct (see Chart V.5 and Box I.4). The balanced budget was the combined outcome of a surplus on Social Security and a moderate central and territorial government deficit.

In step with the headway in fiscal consolidation, the issuance of marketable securities held on the declining trend of recent years. Thus, the net issue of short-term securities remained negative, while that of long-term securities, though positive, continued to decline. As a result, the share of long-term debt in overall general government securities rose by three percentage points last year (to 88% at end-2001) and the average life of government debt increased to almost 6 years. Notably, such general government budgetary discipline was rewarded, in December, with the decision by Moody's to raise the Spanish public debt credit rating to that of maximum solvency. This is having a positive bearing on the cost of general government financing, as the yield gap between the German *bund* and Spanish bonds has narrowed by around 10 basis points.

Analysis of the sectoral origin of the funds obtained by general government in 2001 highlights the increase in net financing received from credit institutions. By contrast, the relative weight of net flows from the rest of the world diminished (though they remained positive) and the holdings of resident institutional investors (mutual funds, insurance companies and pension funds), which continued with the net divestment of their public assets, given the growing internationalisation of their debt portfolios. Significantly, February saw the commencement of the monthly Treasury liquidity tenders, through which the State assigns on a daily basis to credit institutions most of their liquid balances, which were previously held in their entirety at the Banco de España.

#### V.1.5. Investment and foreign financing of the Spanish economy

The net balance of financial transactions of the Spanish economy with the rest of the world stood at -1.9% of GDP in 2001, signifying lower net borrowing

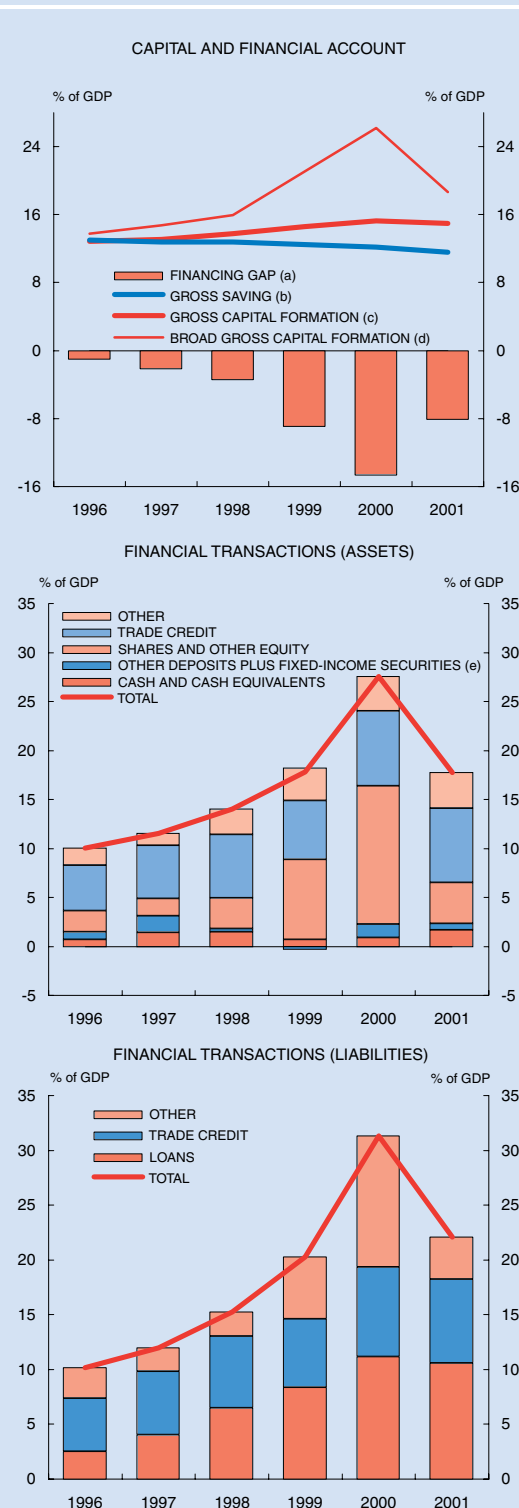


than the previous year (see Table V.4). There was also a simultaneous reduction in the volume of lending and deposit financial transactions with non-residents, though these remained at a high level. Chief among the reasons for this reduction in financial activity with the foreign sector is the greater uncertainty over the outlook for the main developed economies, along with some emerging economies, which painted a rather unfavourable picture for the growth of international capital flows. The military conflict which followed the September 11 attacks and the economic and political crisis in Argentina contributed to exacerbating this uncertain panorama. The Spanish economy, which is increasingly integrated into the global economy, was naturally affected by these processes. In any event, it should be stressed that in previous years there was an exceptional volume of foreign transactions linked to strategic purchases.

The Spanish economy's investment in foreign financial assets fell from 24.4% of GDP in 2000 to 10.9% of GDP in 2001, owing essentially to the lower amount of acquisitions of shares and other equity (which fell in terms of GDP by something more than 11 percentage points). All sectors of the Spanish economy contributed to this reduction, which was particularly sharp in the case of corporations, whose financial investment in terms of GDP declined by over 7 percentage points. The information available on the regional distribution of Spanish investment in the rest of the world indicates that the EU was the main focal point in 2001 for most net capital flows in the form of direct investment. The financing of investee companies situated abroad (included under *Loans* in Table V.4) diminished only slightly in relation to 2000. At the same time, investment in securities other than shares climbed significantly due to the behaviour both of credit institutions, which showed a greater preference for fixed-income securities than in previous years, and of institutional investors.

The Spanish economy's liabilities against the rest of the world increased in 2001 by an amount which, in terms of GDP, was less than in the two preceding years. The rising trend marking this variable in the second half of the nineties was thus interrupted. Among the reasons (in addition to those previously indicated) for these flows from abroad easing off is a phenomenon specific to the Spanish economy: the significant decline in the volume of external financing received by resident credit institutions, brought about by the Treasury's liquidity tenders. These appear to

CHART V.4  
Financial transactions of non-financial corporations



Source: Banco de España.

- (a) Financial resources that cover the gap between permanent real and financial investment and gross saving.
- (b) Includes capital transfers.
- (c) Includes, in addition to GKF, stockbuilding.
- (d) Calculated incorporating foreign equities.
- (e) Not including unpaid accrued interest, which is included under "Other".



TABLE V.4

## Financial transactions of the nation

% of GDP

	1996	1997	1998	1999	2000	2001
<b>Net financial transactions</b>	<b>1.2</b>	<b>1.6</b>	<b>0.5</b>	<b>-1.1</b>	<b>-2.5</b>	<b>-1.9</b>
<b>Financial transactions (assets)</b>	<b>6.5</b>	<b>9.6</b>	<b>12.3</b>	<b>14.8</b>	<b>24.5</b>	<b>10.9</b>
<b>Gold and SDRs</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.0</b>	<b>0.0</b>
<b>Cash and deposits</b>	<b>1.3</b>	<b>1.3</b>	<b>3.2</b>	<b>1.7</b>	<b>2.8</b>	<b>-2.6</b>
Credit system	0.0	-1.5	0.0	3.7	2.5	-2.8
Other resident sectors	1.3	2.7	3.2	-2.0	0.4	0.1
<b>Securities other than shares</b>	<b>3.3</b>	<b>3.5</b>	<b>3.4</b>	<b>2.8</b>	<b>3.8</b>	<b>7.1</b>
Credit system	2.8	1.9	-1.4	-0.9	-0.3	2.0
Other resident sectors	0.5	1.6	4.7	3.7	4.1	5.1
<b>Shares and other equity</b>	<b>1.0</b>	<b>2.9</b>	<b>4.3</b>	<b>9.8</b>	<b>15.1</b>	<b>3.7</b>
Credit system	0.0	0.5	0.4	0.7	1.7	-0.1
Other resident sectors	1.0	2.4	3.9	9.0	13.4	3.8
Of which:						
Non-financial corporations	0.9	1.7	2.2	6.5	10.9	3.7
<b>Loans</b>	<b>0.9</b>	<b>1.9</b>	<b>1.4</b>	<b>0.7</b>	<b>2.7</b>	<b>2.7</b>
Credit system	0.0	0.8	0.2	-0.2	0.5	0.8
Other resident sectors	0.9	1.1	1.2	0.9	2.2	1.9
<b>Financial transactions (liabilities)</b>	<b>5.3</b>	<b>8.0</b>	<b>11.8</b>	<b>15.9</b>	<b>27.0</b>	<b>12.7</b>
<b>Deposits</b>	<b>3.4</b>	<b>4.4</b>	<b>5.9</b>	<b>4.1</b>	<b>6.7</b>	<b>2.8</b>
Of which:						
Credit system	3.4	4.4	5.9	4.1	6.8	2.8
<b>Securities other than shares</b>	<b>0.5</b>	<b>2.2</b>	<b>1.0</b>	<b>5.4</b>	<b>7.0</b>	<b>3.1</b>
Credit system	0.1	0.2	0.2	0.9	0.8	0.6
General government	0.4	2.1	1.0	4.3	5.7	1.6
Other resident sectors	0.0	0.0	-0.2	0.2	0.5	0.9
<b>Shares and other equity</b>	<b>1.0</b>	<b>1.0</b>	<b>2.9</b>	<b>3.9</b>	<b>9.1</b>	<b>3.5</b>
Credit system	0.1	-0.2	0.1	0.3	1.7	0.5
Other resident sectors	0.9	1.2	2.8	3.6	7.4	3.0
<b>Loans</b>	<b>1.0</b>	<b>1.2</b>	<b>2.2</b>	<b>3.8</b>	<b>4.5</b>	<b>4.4</b>
General government	0.0	-0.1	0.1	0.1	0.1	0.1
Other resident sectors	1.0	1.2	2.1	3.7	4.4	4.3
<b>Other, net (a)</b>	<b>-0.6</b>	<b>-0.8</b>	<b>-0.2</b>	<b>-1.4</b>	<b>-0.3</b>	<b>-1.1</b>

Source: Banco de España.

(a) Includes the asset item which covers insurance technical reserves.

have provided resident financial institutions with resources they would previously raise abroad. As a result, this sector's liabilities against the rest of the world increased by 2.8% of GDP, compared with an average figure over the past five years of 5% of GDP.

## V.2. SPANISH FINANCIAL MARKETS

As in most developed economies, Spanish financial markets in 2001 were marked by an intense

shift in activity on both the primary and the secondary markets from equities to fixed-income. Against a backdrop of heightened uncertainty over future economic developments and corporate earnings, and given the progressive slide in listed share prices, investors were not prepared to bear additional risks. As a result, the cost of financing for corporations through capital increases became greater. Set against this, the fixed-income markets met a greater proportion of Spanish financial and non-financial corporations' borrowing requirements. However,

### Financing and investment of non-financial corporations

During the last expansionary phase, private productive investment in Spain increased at a rate which, on average, was lower than that of the previous cyclical upturn. By contrast, foreign direct investment by non-financial corporations grew sharply, far outpacing its historical pattern up to the first half of the nineties. Thus, in the recent period, a substantial portion of the sector's permanent investment has taken the form of investment abroad (see Chart A).

The rapid growth of investment in the second half of the nineties gave rise to a significant increase in corporations' financial requirements. Although funds generated within businesses held over these years at a higher level than those of the period 1988-91 (see adjoining table), they were insufficient to finance the rapid increase in gross capital formation and in financial investment abroad. Consequently, the sector had to resort increasingly to external contributions from financial markets and intermediaries (see Chart A). The greater resort to external financing in the recent period has been further fuelled by the reduction in the real cost of borrowed funds (interest-bearing debt), which gave rise to a substantial decline in corporations' financial expenses as from 1993 (see Chart B). However, the structure of corporations' external borrowings has not changed significantly. Bank credit extended by resident institutions continues to play a predominant role and foreign loans are of increasing importance, while the issuance of fixed-income securities remains residual.

A significant rise in the level of debt may, at least potentially, influence corporate investment decisions. Firstly, it may bear on the cost of financing for corporations, since it raises the insolvency risk premium, thereby affecting the cost of (or indeed the possibility of resorting to funds for) undertaking new investment plans. Likewise, it may influence the speed of recovery of gross capital formation at a time when the cycle is turning, insofar as it may lead investment projects to be postponed so as to avoid further growth in debt and further deterioration of the net worth situation. Moreover, greater dependence on external borrowings generally places corporations in a more vulnerable position, making them more susceptible to investors' (whether debtors or shareholders) loss of confidence.

In sum, a higher proportion of external financing requires of non-financial corporations greater efficiency in business management and the adoption of strategies that contribute to holding up the confidence of intermediaries and investors. In this respect, there has in the recent period been a significant influx of stable funds via the issuance of shares and other equity, which has increased corporations' capital and has thus contributed to bolstering their balance sheet, offsetting in part the effects derived from the greater level of debt. Hence, although in terms of GDP the growth of share issues has been lower than that of external financing, the ratio of the latter to the former (i.e. the leverage ratio) has declined moderately.

	% of GDP		
	Average 1988-1991	Average 1992-1996	Average 1997-2001
<b>1. Resources</b>	<b>19.6</b>	<b>16.0</b>	<b>24.9</b>
Internal resources			
(Gross saving)	11.9	12.3	12.3
Other resources	7.7	3.7	12.5
Borrowed funds	7.1	1.7	8.1
<i>Credit from resident credit institutions</i>	5.4	1.3	5.7
<i>Foreign loans</i>	0.8	0.8	2.4
<i>Fixed-income securities</i>	0.9	-0.4	0.0
Shares	1.4	1.5	4.2
Other liabilities	-0.8	0.5	0.3
<i>Trade credit</i>	-1.3	-0.2	0.2
<i>Other</i>	0.6	0.8	0.0
<b>2. Other financial assets</b>	<b>3.6</b>	<b>1.6</b>	<b>4.7</b>
<b>3. Net resources</b>	<b>16.0</b>	<b>14.5</b>	<b>20.2</b>

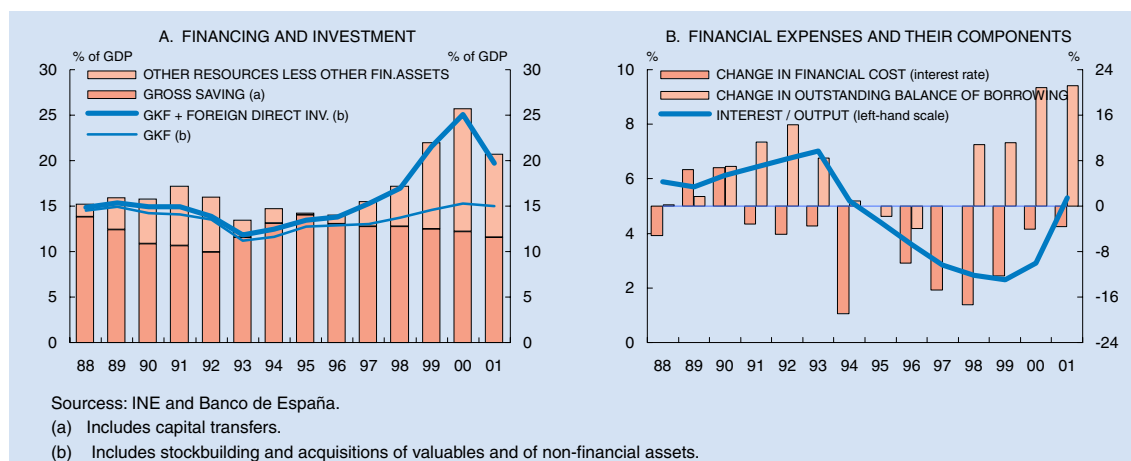
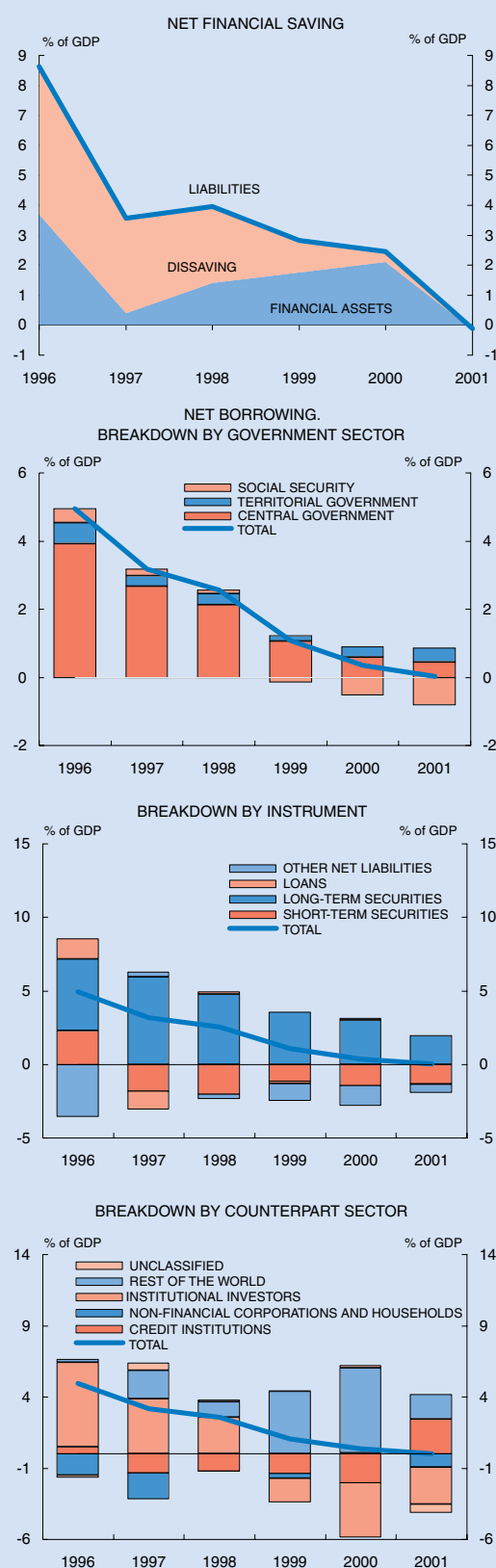


CHART V.5

### General government financial transactions



Source: Banco de España.

the total volume of funds routed through the Spanish markets declined once again in 2001, while the maintenance of high – though likewise declining – issues by Spanish corporations' subsidiaries abroad continues to highlight the challenges Spanish markets face in a setting of growing internationalisation and heightening competition.

#### V.2.1. The primary markets

Activity on the Spanish primary markets in 2001 differed greatly from 2000. Compared with a net equity issue of €32.5 billion in 2000, last year saw only €4.9 billion issued (see Table V.5). Among the causes contributing to this were the impact of adversely trending prices, greater economic uncertainty generally and the decline in the volume of acquisitions of non-resident companies by Spanish firms, these operations tending in many cases to be financed via capital increases.

The smaller volume of financing from the equity markets was partly offset by an increase in the issuance of debt securities, albeit without reaching the levels recorded in 1999. Nonetheless, the behaviour of the various sectors in terms of issuance activity differed greatly.

As discussed in Section V.1, the general government sector saw the culmination of the fiscal consolidation process, enabling it to reduce its net issues on securities markets. In 2001, these accounted for less than 20% of total resident net fixed-income issues, although they still account for 74% of the total outstanding balance.

In the private sector, by contrast, corporations with a high credit rating took advantage of the low interest rate levels to significantly increase their financing on the primary fixed-income markets, especially via the issuance of long-dated securities. Thus, 43% of total net issues and 60% of long-term securities took place in the final quarter of the year, when interest rates had perhaps reached their lowest levels in the current cycle. However, these issues were, in the main, by financial institutions, since the net issue of long-term debt by non-financial corporations was negative, amounting to only €1.3 billion in the case of short-term debt.

Large corporations continued to issue a high volume of securities on international markets via their

TABLE V.5

## Issuance and public offerings of marketable securities

€ m

	1998	1999	2000	2001
<b>Net issuance by residents (a)</b>	<b>27,966</b>	<b>58,154</b>	<b>47,505</b>	<b>33,393</b>
Fixed income	20,841	48,839	14,965	28,537
<i>State</i>	<i>12,364</i>	<i>13,583</i>	<i>10,688</i>	<i>3,856</i>
<i>Territorial government</i>	<i>1,387</i>	<i>1,662</i>	<i>1,166</i>	<i>759</i>
<i>Credit institutions</i>	<i>3,850</i>	<i>24,810</i>	<i>-1,774</i>	<i>12,686</i>
<i>Other financial firms</i>	<i>3,211</i>	<i>5,280</i>	<i>5,689</i>	<i>9,986</i>
<i>Non-financial corporations (b)</i>	<i>29</i>	<i>3,504</i>	<i>-804</i>	<i>1,250</i>
Equities	7,125	9,315	32,540	4,856
<i>Credit institutions</i>	<i>4,034</i>	<i>812</i>	<i>9,979</i>	<i>2,223</i>
<i>Other financial firms</i>	<i>-46</i>	<i>291</i>	<i>735</i>	<i>323</i>
<i>Non-financial corporations</i>	<i>3,137</i>	<i>8,212</i>	<i>21,826</i>	<i>2,310</i>
<b>Public offerings</b>	<b>11,240</b>	<b>5,042</b>	<b>3,074</b>	<b>3,085</b>
Privatisations	10,857	772	0	696
Other	383	4,270	3,074	2,389
MEMORANDUM ITEMS:				
<b>Net issuance by foreign subsidiaries</b>	<b>13,089</b>	<b>21,221</b>	<b>32,845</b>	<b>23,234</b>
Financial institutions	12,235	11,734	21,695	11,886
Non-financial corporations	854	9,487	11,150	11,348

Sources: CNMV and Banco de España.

(a) Includes issuance by residents, in both domestic and foreign currency.

(b) Short-term issuance is commercial paper registered with the CNMV.

subsidiaries abroad, reflecting perhaps the greater difficulties or relative costs entailed by issues on the Spanish market. But this affected only seven issuers, and the remaining Spanish non-financial corporations appear to continue to depend almost exclusively on intermediated financing. Among financial institutions, savings banks, which were more expansionary than banks in terms of granting credit, were particularly active in issuing long-term fixed-income securities and in the securitisation of assets, principally mortgage-backed instruments. The net issue of securitised bonds and notes in 2001 was almost double that attained in the two previous years. As a result, these securities channel funds equivalent to 4% of the total credit granted by Spanish institutions and 24% of the total outstanding balance of private fixed-income securities. Securitisation is thus contributing tellingly to the growth of private fixed-income markets in Spain, whose level of development is, however, still limited.

### V.2.2. Secondary market activity

Activity on the secondary markets in 2001 (see Table V.6) was influenced by the same factors that

affected the primary markets. The volume of share trades on the Spanish stock markets fell by 9.7%, while there was strong growth in the trading of public debt (18% in the Book-Entry System and 42% on the stock markets) and of private fixed-income securities (42% on the AIAF market).

The fall in share trades was in line with that seen on other international markets, but in contrast to the marked growth the previous year (69%). In addition to the factors discussed previously, this difference is due to the strong correction in technology stock prices in the first half of 2000. In this respect, the Spanish *Ibex Nuevo Mercado* (New Market), on which companies associated with the new technology industries are quoted, underwent a 56% decline in turnover, which alone accounts for two-thirds of the total decline. Conversely, trading in the *Latibex* segment grew by 43%, although this was merely a residual part of the market (less than 0.02% of total trading, despite the increase in the number of quoted companies and in capitalisation). During 2002 Q1 the same pattern as the previous year has prevailed, with trading on the Spanish stock markets falling off by 3.6%.

TABLE V.6

## Turnover on secondary and derivatives markets

€ m

	1998	1999	2000	2001
<b>Public-debt book-entry market (a)</b>	<b>13,870,974</b>	<b>13,109,675</b>	<b>13,788,917</b>	<b>16,237,439</b>
Spot (b)	2,242,008	1,817,465	1,585,460	2,041,091
Repo	11,604,279	11,254,309	12,186,364	14,173,002
Forward (b)	24,687	37,901	17,093	23,346
<b>AIAF fixed-income market (b)</b>	<b>43,120</b>	<b>86,269</b>	<b>99,826</b>	<b>141,509</b>
Commercial paper	7,935	25,284	46,425	97,801
Ordinary and asset-backed bonds and mortgage certificates	28,761	58,572	52,189	41,488
Matador bonds	6,424	2,413	1,212	2,220
<b>Stock exchange: fixed-income (b)</b>	<b>53,148</b>	<b>44,718</b>	<b>39,692</b>	<b>56,049</b>
State debt	603	160	73	50
Territorial government debt	51,791	42,858	38,723	55,105
Other	754	1,700	896	894
<b>Stock exchange: equities</b>	<b>261,276</b>	<b>291,975</b>	<b>492,980</b>	<b>445,379</b>
<b>MEFF derivatives markets (c)</b>	<b>2,668,336</b>	<b>966,975</b>	<b>678,406</b>	<b>499,951</b>
Fixed-income	2,111,985	378,065	109,785	29,050
Short-term	1,125,442	20,262	335	0
Medium and long-term	986,543	357,803	109,450	29,050
Equities	556,351	588,910	568,621	470,901
Ibex 35	549,329	574,109	536,416	435,384
Stock options	7,022	14,801	32,205	35,517

Sources: AIAF, MEFF, Spanish stock exchanges, CNMV, Federation of European Securities Exchanges and Banco de España.

(a) Only includes transactions with State securities.

(b) Nominal turnover.

(c) Turnover is expressed in monetary units and has been obtained by multiplying the number of contracts traded by their size.

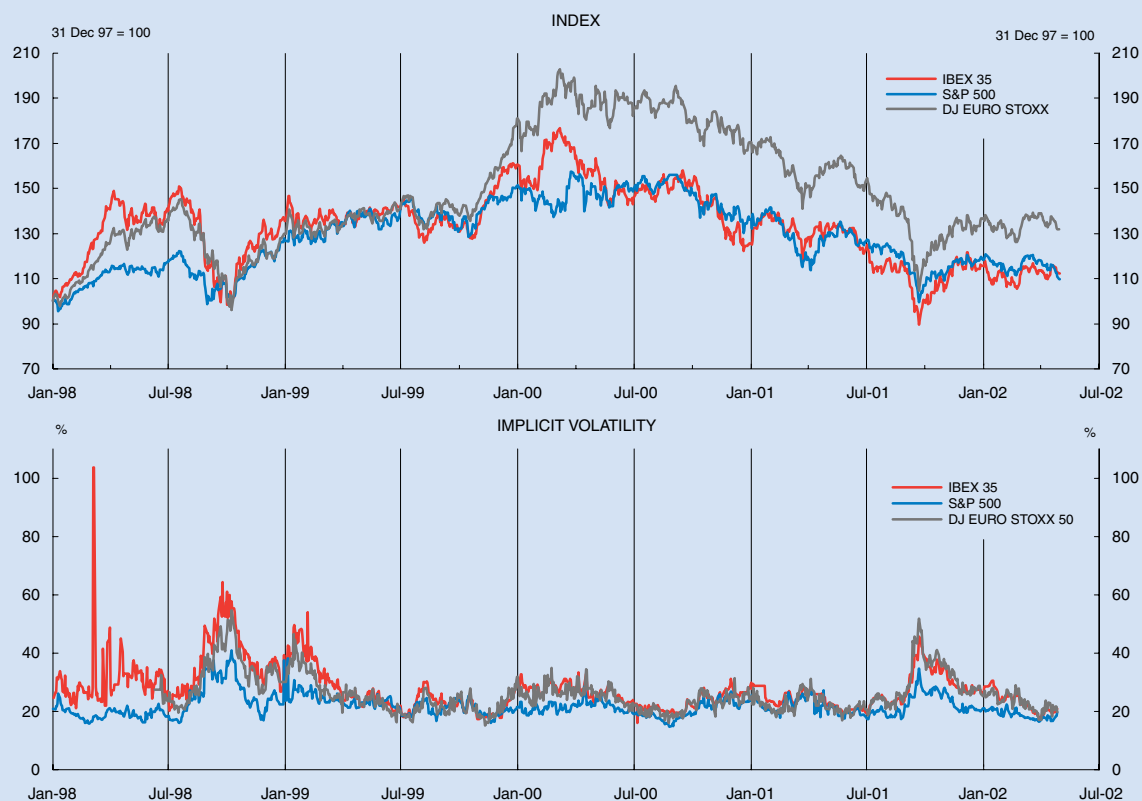
As mentioned, turnover on the Spanish book-entry debt market grew significantly in 2001. Unlike the previous year, the increase was in all operations and not only in debt repos. One of the factors that may have been influential in this increase in trading (in addition to the shift by investors from equities to fixed-income instruments) has been the start-up of Spanish Treasury liquidity tenders, as financial institutions wishing to have access to this liquidity must ensure the return thereof by means of repos on public debt securities. In any event, the opening months of 2002 have seen a fall (in year-on-year terms) in the trading of these instruments.

As regards the AIAF private fixed-income market, turnover reached a new high, with an increase of 42% on the previous year. Growth was even greater in 2001 Q4 (102%) and this has continued into the first quarter of the current year (149%), essentially due to the growth of commercial paper trades.

The Spanish derivatives markets remained those most adversely affected by international competition. Overall, the turnover on MEFF fell by 28% in relation to the previous year, with the trading of interest rate contracts virtually negligible. Owing to their recent emergence, individual share options are the only instruments to have posted positive year-on-year growth rates over the year as a whole.

The ongoing internationalisation and integration of domestic financial markets continued in 2001. The management companies of the Spanish markets continued to develop new links with international markets, while integration of the domestic markets deepened. In this connection, the company "Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros SA" was incorporated, combining all the existing quotation, trading, clearing and settlement systems in Spain. The inception and structure of this company are explained in Box V.3.

## Stock price indices



Sources: Madrid Stock Exchange, Bloomberg and Banco de España.

As regards the role of non-resident investors, these continued divesting, in net terms, from the Spanish stock markets for an amount somewhat higher than that of the previous year. Nonetheless, in terms of activity they continued to account for somewhat more than half (54%) of the total traded volumes. On the book-entry government debt market, the outright portfolio of non-resident investors grew once more in 2001, rising from 36% of the total outstanding balance at end-2000 to 40% twelve months later.

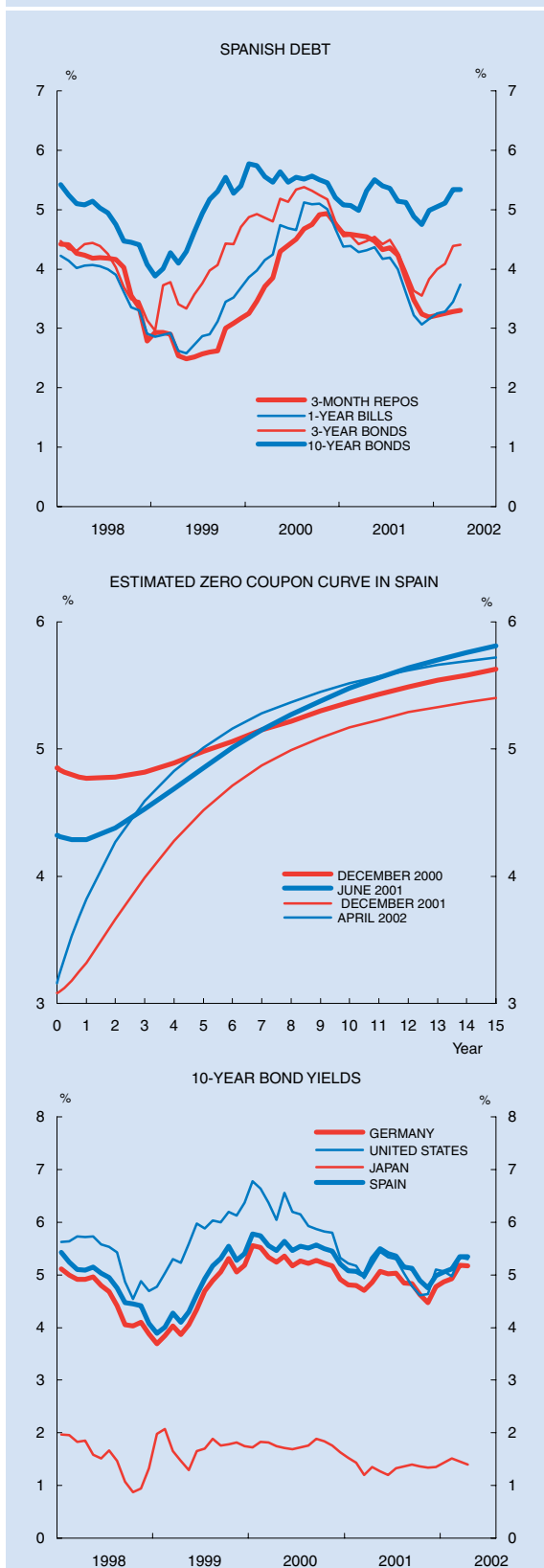
### V.2.3. Secondary market prices

Prices on the Spanish stock markets and on the main international markets held on a declining trend practically throughout 2001 (see Chart V.6). Adding to the adverse consequences of the end of the investment euphoria for new technology stocks was the worsening during the year of the outlook for the world economy, a deterioration exacerbated by the September 11 attacks on United States. The

Ibex 35 reached its low on September 21, with a cumulative decline of 28.7% since the end of 2000, and the volatility implicit in options on this index increased to levels similar to those observed during the autumn 1998 crisis (see Chart V.6). Subsequently, however, quoted share prices rallied, thanks to an easing of international political uncertainty and to the emergence of the first signs of a possible recovery in the world economy during 2002. In the final months of 2001 and in the opening months of the current year, however, bad news once more came to bear in relation to the earnings of many companies, the bankruptcy of certain corporations (some of which particularly prominent), political uncertainty in the Middle East and, in the case of Spain, the impact of the Argentine crisis on the results of certain national corporations.

Over the year as a whole, and for the second year running, both the Ibex 35 and the Madrid Stock Exchange General Index posted declines of 7.8% and 6.4%, respectively. Nonetheless, these falls were less than a year earlier and than those on oth-

CHART V.7

**Government debt yields (a)**

Source: Banco de España.  
(a) Monthly averages.

er international markets such as the US S&P 500 (down 13%) or the European broad Dow-Jones Euro Stoxx (which fell by 19.7%). The better performance of Spanish share prices, which partly offsets the adverse result the previous year, is no doubt due to the lesser incidence in Spain of some of the factors that have borne on the downtrend in international stock markets. Thus, the economic slowdown has been milder in Spain's case than in the euro area and the United States, and the decline in corporate earnings has also been more moderate in Spain. As to the impact of the Argentine crisis, although it has adversely affected certain large Spanish concerns with interests in the area, it has to date been limited, in line with the relative weight of business in Argentina in the overall activity of these companies.

Sector by sector, the fall in the Madrid Stock Exchange General Index reflects the poor performance of the two main groups, namely banking and communications, which accounted for 49.6% of total market capitalisation at end-2000 and which posted falls of 10.3% and 13.2%, respectively, in 2001. The other sectors improved in relation to 2000, particularly so in the case of investment (+41.5%), construction (+25.5%) and consumption (+16%). The *Ibex Nuevo Mercado* index declined by 20%.

On the Spanish public debt market, yields trended – as has been habitual in recent years – closely in line with those of other European markets, such as Germany's (see Chart V.7). In turn, the German market also ran closely in parallel in 2001 to the US market. Nonetheless, as previously indicated, Moody's upgrading of Spain's credit rating provided for a virtually immediate reduction of around 10 basis points in the Spanish/German sovereign debt spread.

In step with changes in the ECB's monetary policy, short-term interest rates fell markedly during the year (more significantly so as from September 11), while long-term interest rates did so to a much lesser extent. Consequently, the slope of the yield curve (see Chart V.7) increased significantly during the year. In the closing months of 2001 and the early months of 2002, the slope increased even more further to the increase in long-term interest rates arising from the improved expectations about the pick-up in global activity.

The reduction in public debt interest rates during 2001 also fed through to the market for private



debt, where risk premia (see Chart V.8) held at around their end-2000 levels (at around 20 basis points for the three-month yield and around 70 basis points for the 10-year yield), albeit with sizeable fluctuations over the course of the year. As stated, these credit spreads were conducive, against a background of low interest rates, to the relative resort by corporations to fixed-income securities issues.

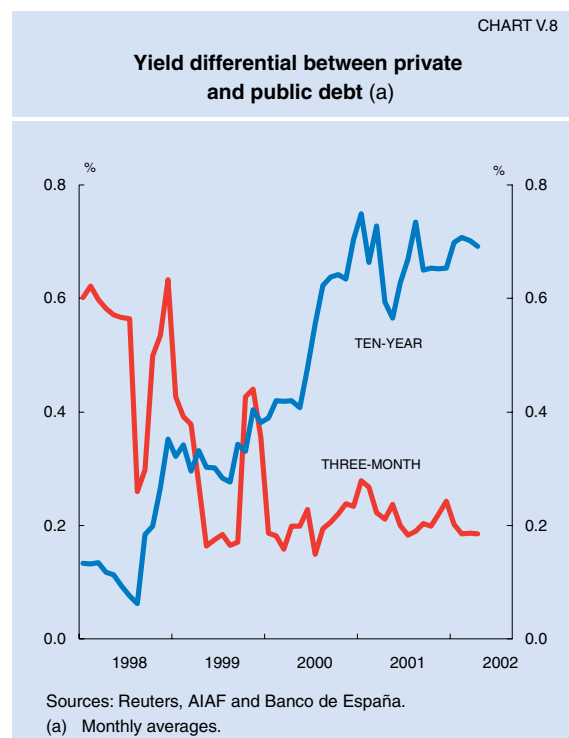
### V.3. SPANISH FINANCIAL INTERMEDIARIES

The climate of greater uncertainty and the performance of securities markets also had a significant impact on the activity of Spanish financial intermediaries in 2001. Their international activity, which had grown substantially in previous years, was adversely affected; their financial flows (on the assets and liabilities sides alike) with non-residents declined in terms of GDP by half in relation to 2000. In any event, exchanges were still above pre-1998 levels, while the gross positions of the various intermediaries vis-à-vis the rest of the world remain high.

Fewer financial flows with the rest of the world were offset by continuing high activity in the domestic market. Despite the economic slowdown, households and non-financial corporations continued to demand a high volume of financing, which was met thanks to the growth of the credit granted by deposit money institutions. Furthermore, the moderate pick-up in household financial saving (discussed in section V.1) had a favourable bearing on the activity of resident institutional investors.

#### V.3.1. Deposit money institutions

The international expansion by certain major Spanish deposit money institutions in recent years has raised their exposure to economic events unfolding in the rest of the world, in general, and in certain regions in particular. In this respect, the year 2001 posed a substantial problem for the Spanish banking system owing to the slowdown in the world economy and to the difficulties undergone by certain Latin American countries and, most especially, by Argentina. However, Spanish institutions appear to be satisfactorily overcoming this unfavourable turn to international economic circumstances. Contributing to this has been both the lim-



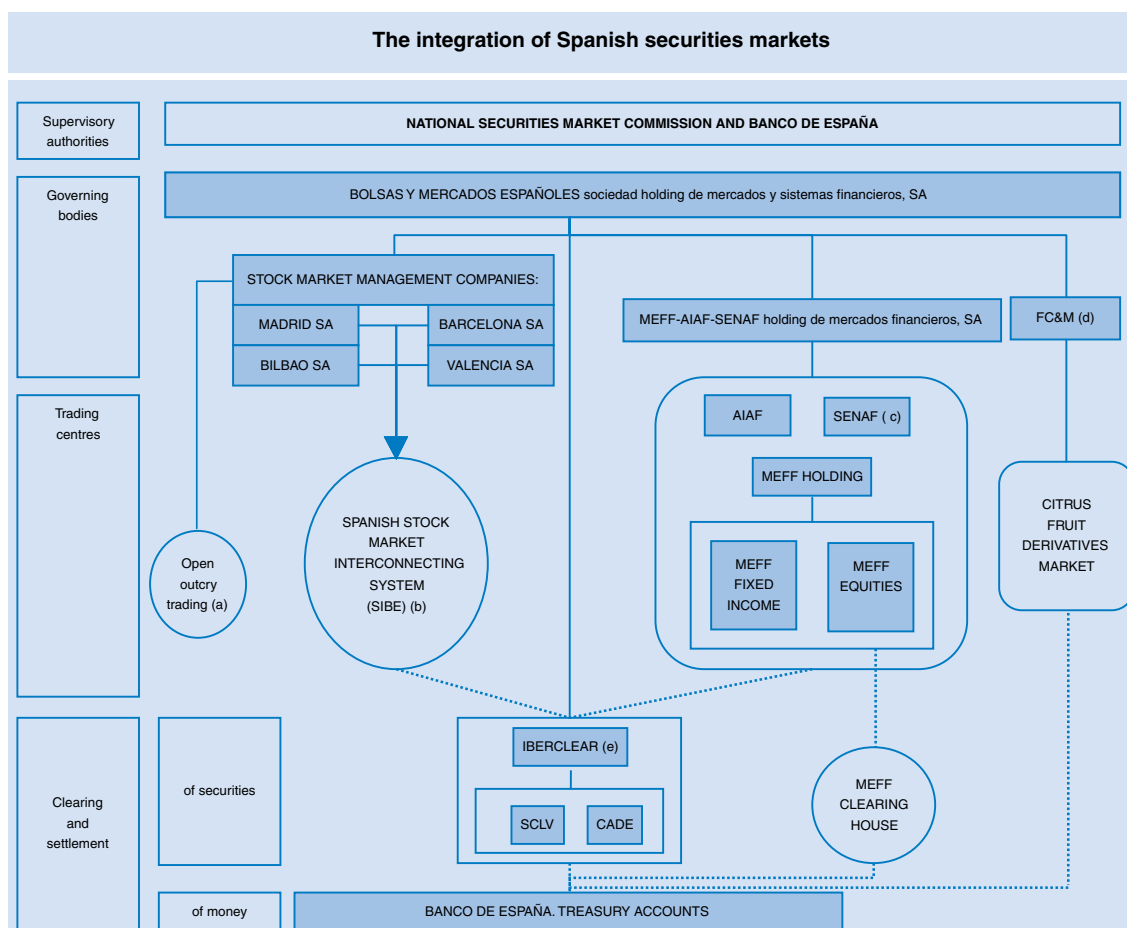
ited participation by Spanish banks in the investment banking business and the relative resilience of the domestic market. Moreover, the effects of the problems in certain Latin American economies have been at least partly offset by the favourable results obtained in other countries. In any case, heightened global uncertainty prompted a slowdown in the international expansion of Spanish banks' business. The total assets of the consolidated groups of Spanish deposit money institutions grew by only 7.3%, due precisely to the decline in business abroad (–9%), which nonetheless accounted for somewhat more than one-fifth of total assets and of earnings before tax at the end of the year.

As regards the business of individual resident deposit money institutions, average assets grew by 11.2%, in line with the pattern of recent years. That said, in relation to off-balance sheet activity, particular mention should be made of the reduction in fees for services relating to the securities markets, consultancy and marketing of financial products (although in this latter case the fall in fees for the commercialisation of investment funds was partly offset by growth in fees linked to the commercialisation of instruments such as insurance and pension funds). The expansionary trend of business in Spain was consistent with a sharper fall in the number of bank agencies of overall deposit money institutions than in 2000. This was the outcome of the downsizing that has followed major bank mergers, and of

### The integration of Spanish securities markets

In recent years European financial markets in general, and Spanish markets in particular, have been subject to far-reaching changes that have contributed to modifying their structures and operations and giving greater prominence to the role of negotiable securities in international portfolios and financial flows. The source of these changes must be sought in the combination of financial disintermediation, globalisation of financial exchanges, institutionalisation of saving and improved communication and information disclosure systems, along with the spur that the process leading to economic and monetary union has entailed.

In Spain, as in other countries, these changes are crystallising in an institutional process of securities market integration. The process has been lengthy and laborious, owing to the initial fragmentation of the securities trading and settlement systems in our country. As regards listing and trading, the background to the process may be taken back first to April 1998, with the signing of the protocol agreement for the development of the fixed-income markets by the heads of the four stock market management companies, the SCLV (Securities Clearing and Settlement Service) and the CNMV (National Securities Market Board). In June 1999, the securities agency Infomedas created SENAF as an electronic public debt trading system and, later, in October 2000, the AIAF (Spanish Securities Deal-



Source: Banco de España.

(a) Stock market fixed-income traded under the open outcry system is currently settled at stock market management companies.

(b) Equities, fixed-income and warrants are traded in the SIBE.

(c) "Blind" trading system for book-entry government debt.

(d) Mercado de futuros y opciones sobre cítricos S.A. (Citrus fruit futures and options market company).

(e) IBERCLEAR is the commercial name of the company "Promotora para la gestión de los sistemas españoles de liquidación SA", which at present does not yet have legal authorisation for the settlement of securities.

### The integration of Spanish securities markets (cont'd)

ers' Association) took a 60.1% stake in SENAF, bringing about the first integration of fixed-income trading systems into a single corporate platform (1).

Subsequently, in July 2001, the fixed-income and financial derivatives markets were integrated via the creation of the company "MEFF-AIAF-SENAF Holding de Mercados Financieros, SA", which consolidated the SENAF spot trading platform, the MEFF derivatives trading platform, the AIAF-ECN Internet-based trading platform and the MEFF system for the management of the derivatives CCP (Clearing House).

With respect to clearing and settlement, the SCLV and the Banco de España CADE (Central de Anotaciones de Deuda Española, the Public Debt Book-Entry System) merged into a single entity called "Promotora de la sociedad de gestión de los sistemas españoles de liquidación, SA", which is better known under its commercial name IBERCLEAR. This company, until it is legally incorporated as an entity that can officially perform the bookkeeping function (2), aims to unify public and private fixed-income and SCLV-administered equities and CADE general government bonds settlement systems through the use of the CADE platform and technical procedures. In line with this project, all securities admitted to listing on the AIAF market joined the CADE technical platform in February 2002. That concluded the first step of the project to integrate securities registration, clearing and settlements systems in Spain. The fixed-income securities (mainly regional government debt) admitted to listing on the Spanish stock markets continue to be traded and settled under the clearing and settlement systems of the stock market management companies.

Finally, in February 2002 the trading platforms and the clearing and settlement systems existing in Spain were integrated by means of the incorporation of "Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A.". This new company directly or indirectly owns the shares and participations of the companies that manage the fixed-income secondary markets, the equities and derivatives markets (including the Valencia commodities market), and the securities registration, clearing and settlement systems.

As the accompanying figure shows, the final result is the vertical integration of Spanish financial markets. This integration is at an ownership level initially, and will be at the operational level once technical conditions are harmonised. The grouping of the different stages of the financial services production process (i.e. from listing and trading through to clearing and settlement) will provide for a significant cut in costs and a greater rationalisation of services, while being conducive to an improved return on invested own funds. In sum, all these developments should lead to the greater efficiency of Spanish markets and to an improvement in their competitive position on the international stage.

(1) Later, in February 2001, this trading platform was re-named SENAF.SON as an organised trading system to which members of other countries' markets are given access.

(2) Current legislation entrusts accounting and private fixed-income and equity securities clearing and settlement responsibility to SCLV.

the gradual petering out of the geographical expansion strategy pursued by savings banks, credit co-operatives and certain medium-sized banks.

The slowdown in the Spanish economy last year was accompanied by a significant decline in interest rates, which fed through to bank rates. The synthetic lending rate of banks and savings banks declined by 1.5 percentage points (p.p.) in 2001, stabilising at around 4.9% in the opening months of 2002. This reduction was similar to that in the three-month in-

terbank interest rate (1.6 p.p.). The synthetic deposit rate fell by 0.8 p.p., almost half the related reduction in the lending rate. As a result, the margin on banks' new business narrowed. This lower reduction in the deposit interest rate was partly due to the heightened competition to raise deposits, driven by the aggressive strategies of those banks operating mainly through the Internet.

Analysis of the balance sheets of deposit money institutions reveals that, on the asset side, the

growth of business was routed, as in prior years, in the expansion of credit to the private non-financial sector (see Table V.7). Although there was a slowdown in 2001 in step with the greater relative weakness of activity, lending to households and non-financial corporations grew at rates that were still high (see Chart V.9). Including both credit investment in the true sense of the term and financing via the acquisition of fixed-income securities, total credit extended by Spanish deposit money institutions to the resident private sector commenced 2001 growing at a year-on-year rate of 17.8%. This rate progressively fell during the year to 11.5% in December. In the early months of 2002, however, the growth rate does not appear to have fallen further, meaning the growth in credit has been clearly higher than that in corporate and household income, with the subsequent additional increase in their rates of indebtedness.

Component by component, the slowdown was more evident in the case of credit extended by banks under the unsecured-loan category. Mortgage loans, however, continued to grow in late 2001 at a year-on-year rate of 18.6%, basically as a consequence of the rise in credit to households for house purchases (16.5% in December 2001). The strong increase in mortgage loans means their weight in total credit to the resident private sector has risen to 50% (62% at savings banks). Credit granted at floating rates expanded more than that extended at fixed rates, accounting for 65% of the total (73% at savings banks). Notably, too, in the second half of the year credit to households slowed more than that to non-financial corporations.

The factors behind credit outgrowing activity are undoubtedly complex. On the demand side, the behaviour of households and corporations is probably underpinned by favourable expectations about future developments in the Spanish economy and, therefore, about income. On the supply side, growing competition between banks and the current low levels of loan defaults (lower than in the previous slowdown – see Chart V.9) may also be playing a relevant role. It should be remembered, however, that late loan payments usually emerge with a lag in relation to the cyclical slowdown. Lastly, it should also be mentioned that the rise in real estate wealth, resulting from the strong increase in house prices (see Box V.1), has contributed to boosting both the demand for and supply of credit.

On the liabilities side, the growth of net own funds and of customer deposits has allowed a more stable financing of the credit extended (see Chart V.10). Thus, the sum of debt securities and non-resident accounts payable (in which funds raised via securities issued by subsidiaries abroad are also included) has grown significantly, but more moderately than last year. Meanwhile, the net resort to the interbank market has been slightly negative, allowing for something of a reduction in the net debit position of Spanish banks (from 4.7% to 3.8% of total assets, in annual average terms).

Notable under customer deposits is the growth of funds raised from general government (68%, signifying an increase of €13.4 billion), due essentially to the effects of the Treasury liquidity tenders. As indicated, it was in fact the obtaining of financing through this channel which allowed institutions to reduce their resort to financing on the international interbank markets.

With regard to resident private-sector deposits, the increase in previous years in deposits with an agreed maturity was reversed considerably in 2001 owing to the fall in interest rates and to competition from investment funds. The latter were favoured by the June 2000 tax reform, in which the minimum holding period for capital gains to be taxed at a flat rate of 18% was cut from two years to one. However, the fall in interest rates boosted the growth of sight and savings deposits (to an annual rate of 14.3%), adding to which was the impact of the lower demand for cash associated with the proximity of the changeover from peseta- to euro-denominated notes and coins. Overall, total resident private-sector deposits increased by 12.1% during 2001, a rate similar to that of the previous year. Significantly, the financial institutions operating principally through the Internet continued to increase their market share (1.4% in December 2001) and contributed 7% to the total growth of deposits during the year (5.1% in 2000).

Turning to the analysis of the profit and loss account for the sector, the earnings before tax of Spanish deposit money institutions as a whole posted a very modest increase in 2001 (2.7% at the consolidated level and –1.2% in the case of individual resident deposit money institutions), after having grown the previous year. But this performance is the result, above all, of the high provisioning institutions had to make (see Table V.7). This is partly in

TABLE V.7

**Deposit money institutions**  
**Structure of balance sheet and profit and loss account**

% of average total assets

	Total (a)		Banks		Savings banks	
	2000	2001	2000	2001	2000	2001
<b>ASSETS:</b>						
Cash and central banks (b)	1.5	1.4	1.4	1.3	1.7	1.5
Interbank market assets (c)	17.3	16.2	20.7	19.5	12.7	11.7
Lending	52.7	53.4	48.2	47.9	58.8	60.7
<i>General government</i>	2.8	2.5	2.7	2.4	3.0	2.7
<i>Other resident sectors</i>	46.5	47.5	40.6	40.7	54.6	56.4
<i>Non-residents</i>	3.4	3.4	4.9	4.8	1.2	1.5
Securities portfolio	20.5	21.1	20.9	22.5	20.5	19.7
<i>Of which:</i>						
<i>Government debt</i>	8.8	8.3	7.9	7.7	10.4	9.3
<i>Equities</i>	6.0	6.8	6.6	8.0	5.4	5.3
Other assets (d)	7.9	8.0	8.8	8.7	6.1	6.4
<b>LIABILITIES:</b>						
Banco de España	1.5	1.2	1.7	1.3	1.2	1.2
Interbank market liabilities (e)	22.2	19.9	29.9	26.8	11.2	10.5
Customer funds	58.8	60.0	49.1	50.7	72.6	72.7
<i>Asset repo sales to customers</i>	7.6	7.1	6.8	6.6	9.2	8.3
<i>Creditors: general government</i>	1.9	2.9	1.8	3.1	2.0	2.5
<i>Creditors: other resident sectors</i>	38.1	38.2	26.4	26.2	55.0	53.6
<i>Creditors: non-residents</i>	8.2	8.7	11.3	11.7	3.6	4.6
<i>Debt securities</i>	3.0	3.2	2.8	3.0	3.6	3.7
Own funds, special reserves and subordinated financing	11.3	12.8	11.5	13.9	10.8	11.1
<i>Of which:</i>						
<i>Subordinated financing</i>	2.7	2.7	3.2	3.2	2.1	2.1
Other liabilities (f)	6.3	6.3	7.8	7.8	4.2	4.2
<b>PROFIT AND LOSS ACCOUNT:</b>						
(+) Interest income	5.24	5.58	5.32	5.73	5.10	5.33
<i>Of which:</i>						
<i>Dividends</i>	0.37	0.62	0.41	0.88	0.33	0.28
(-) Interest expenses	3.07	3.14	3.51	3.47	2.44	2.70
<b>Net interest income</b>	<b>2.17</b>	<b>2.44</b>	<b>1.81</b>	<b>2.26</b>	<b>2.65</b>	<b>2.63</b>
(+) Commissions	0.71	0.66	0.77	0.70	0.63	0.60
(+) Profits on financial operations	0.11	0.06	0.15	0.06	0.06	0.06
<b>Gross income</b>	<b>2.99</b>	<b>3.16</b>	<b>2.72</b>	<b>3.02</b>	<b>3.34</b>	<b>3.29</b>
(-) Operating expenses	1.91	1.80	1.72	1.62	2.19	2.04
<b>Net income</b>	<b>1.08</b>	<b>1.35</b>	<b>1.01</b>	<b>1.40</b>	<b>1.15</b>	<b>1.25</b>
(-) Write-downs and provisions	0.34	0.61	0.28	0.74	0.44	0.41
(+) Other income	0.23	0.12	0.15	0.12	0.37	0.11
<b>Pre-tax profit</b>	<b>0.96</b>	<b>0.86</b>	<b>0.88</b>	<b>0.78</b>	<b>1.07</b>	<b>0.95</b>
<b>MEMORANDUM ITEM:</b>						
Pre-tax profit (as a % of own funds)	16.0	13.6	15.5	12.5	17.2	15.7
Average total assets (EUR bn)	1,042	1,158	628	685	378	431
Year-on-year growth rate (%)	9.9	11.1	7.4	9.2	13.9	14.1

Source: Banco de España.

(a) Banks, savings banks, and credit co-operatives. Total turnover figures, including banks' foreign branches but not subsidiaries, refer to all the institutions existing in each period.

(b) Cash, central banks (except BE repos) and ECB.

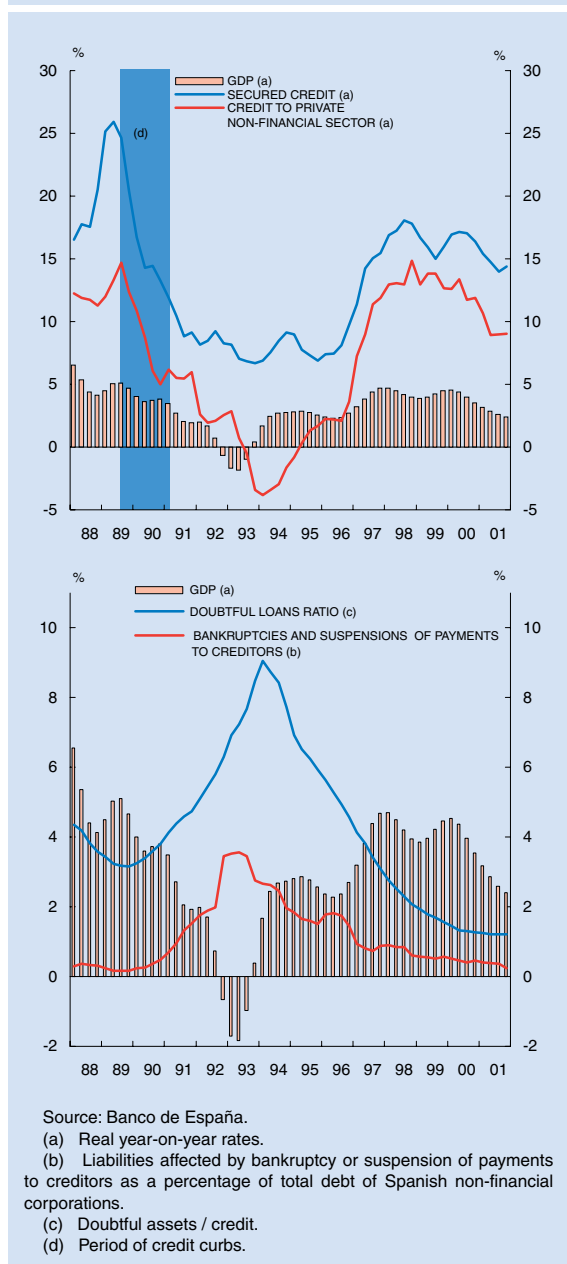
(c) Credit and savings institutions (forward accounts, repos and securities lending) and repo purchases from the BE.

(d) Premises and equipment, sundry accounts and other assets with credit and savings institutions.

(e) Credit and savings institutions (forward accounts, repos and creditors on short sales).

(f) Sundry accounts and other liabilities with credit and savings institutions.

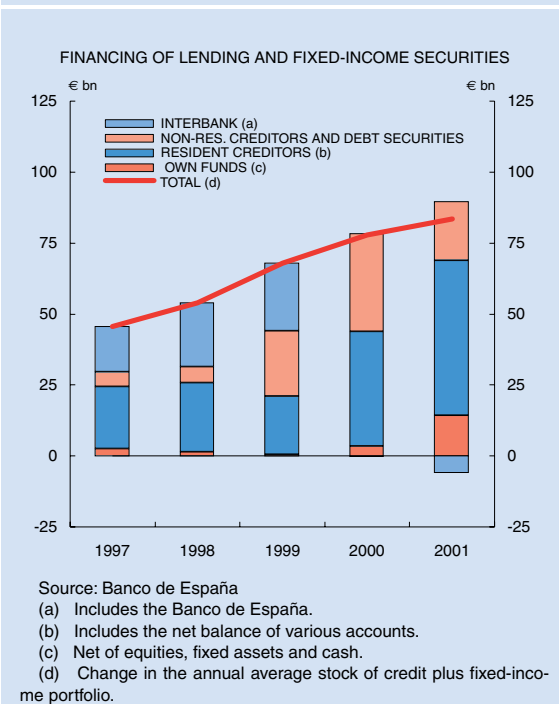
CHART V.9

**Credit, doubtful loans and business cycle.**

response to the application of the statistical provision throughout the year (as opposed to only half the year in 2000), but is due above all to the provisions certain institutions made to cover their exposure in Argentina.

The net interest margin grew substantially, despite the narrowing of the spread between the synthetic lending and deposit rates for new business. This was due to the expansion of business and to the maintenance of the gap between average yields and costs. However, in the individual accounts (shown in Table

CHART V.10

**Deposit-money institutions**

V.7) all the commercial banking margins – including even the net income margin – are distorted as a result of the heavy increase in 2001 in the dividends received by a large institution, which is subsequently offset by greater provisions. By excluding the results of the variable-yield portfolio and adjusting costs accordingly, commercial banks' net interest income would have risen from 1.75% of total assets in 2000 to 1.81% in 2001, with growth in absolute terms of 11.1% rather than the figure of 36.7% that is derived from the non-adjusted data.

The favourable performance of net interest income offset the lower growth of commission for securities market services and the decline in commercial banks' income on financial transactions. Moreover, the increase in operating expenses (which was moderate at banks and sharper at savings banks and credit co-operatives) was in all cases less than that in the gross income margin. Accordingly, all groups of institutions improved in terms of efficiency, although this headway was much more significant at banks.

### V.3.2. Institutional investors

There was a significant pick-up in the net volume of funds raised by institutional investors in

TABLE V.8

## Funds raised by other financial intermediaries

EUR m

	1998	1999	2000	2001	2001 Balances (a)
<b>Total (b)</b>	<b>35,467</b>	<b>10,642</b>	<b>3,178</b>	<b>17,040</b>	<b>295,088</b>
Pension funds					
<i>Net contributions (c)</i>	<i>2,692</i>	<i>3,026</i>	<i>6,454</i>	<i>6,738</i>	<i>43,829</i>
Life assurance					
<i>Premiums net of claims (d)</i>	<i>4,610</i>	<i>8,065</i>	<i>10,941</i>	<i>10,462</i>	<i>69,936</i>
Mutual funds					
<i>Net share purchases</i>	<i>28,165</i>	<i>-449</i>	<i>-14,217</i>	<i>-161</i>	<i>181,322</i>
<i>FIAMM</i>	<i>-12,268</i>	<i>-7,229</i>	<i>-10,172</i>	<i>9,390</i>	<i>43,830</i>
<i>FIM</i>	<i>40,433</i>	<i>6,780</i>	<i>-4,046</i>	<i>-9,551</i>	<i>137,492</i>

## MEMORANDUM ITEM:

Deposit money institutions: change in accounts payable

<i>Other resident sectors</i>	<i>14,968</i>	<i>21,282</i>	<i>52,424</i>	<i>55,174</i>	<i>560,503</i>
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Sources: Banco de España, CNMV, INVERCO, Dirección General de Seguros and ICEA.

(a) Balances to December. Net asset value in the case of funds, and mathematical provisions in the case of insurance.

(b) Sum of contributions, premiums and net share purchases.

(c) In-house estimate based on the change in the net asset value and annual yield of the funds.

(d) The 2001 figure is provisional (based on ICEA estimates).

2001 (see Table V.8). Nonetheless, this was still below that recorded in the period 1996-98 and did not prevent the liabilities of pension funds, collective investment undertakings and insurance companies from continuing to lose weight in relation to those of deposit money institutions. Moreover, instruments related (mainly) to long-term retirement-provision saving continued to show a very different trend from other collective investment instruments.

The flows intended for pension funds and life assurance policies are, by their very nature, more stable and are linked to structural factors related to demographic trends and expectations about public benefit provision systems. In 2001, net contributions both to pension funds and to life assurance policies consolidated the relatively high levels reached the previous year. Boosting this was the ongoing externalisation of companies' pension commitments (this process is scheduled for completion by November this year) and the improved tax treatment of these instruments. In terms of the stock of saving under administration, both the net asset value of pension funds and the mathematical provisions for life assurance policies grew by 16%. However, in the case of life assurance, a strong deceler-

ation in unit-linked insurance (where the investment component is greater than the provision element) combined with an equally significant increase in guaranteed-return insurance policies.

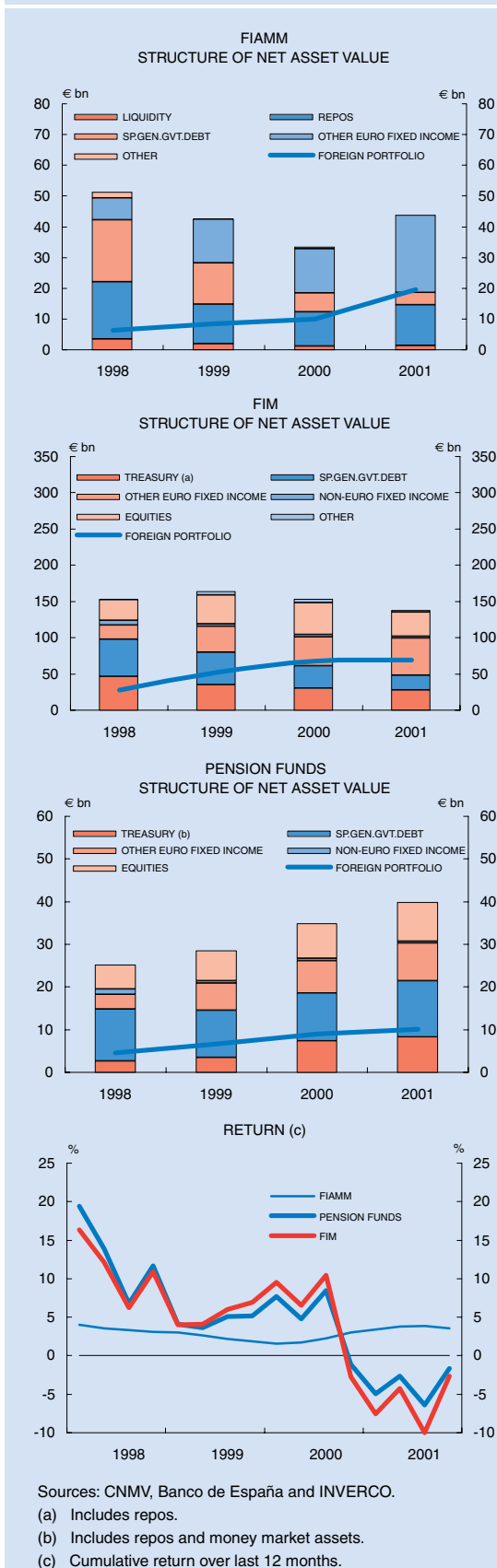
The net asset value of mutual funds declined by 2.6% in 2001. This was less of a contraction than the previous year and came about as a result of developments in opposing directions in securities funds and money market funds (1). Thus, against a background of negative returns on money market funds and of uncertain expectations about share prices on international stock markets, new investors showed a clear preference for funds with a less risky profile. As a result, money market funds had positive net subscriptions for the first time in recent years. As for securities funds, there were net

(1) The fall is less (0.7%) if collective investment undertakings (close-end and open-end investment companies), foreign institutions with a commercial presence in Spain and real estate investment funds are included. This was due to the growth of SIM-CAV (33%), whose growth in recent years (linked, owing to the characteristics of the product, to that of private banks) continued in 2001. At the end of the year, savings placed in these institutions accounted for 9% of the total net asset value of investment funds. By contrast, the volume of assets of foreign institutions with a commercial presence in Spain fell back by 11% after several years of strong growth.



CHART V.11

### Institutional investors



redemptions in mixed and equity funds, although net subscriptions were positive in the case of short- and long-term fixed-income funds and guaranteed fixed-income funds. Hence, the last three categories of funds accounted for 44% of the total net assets value of securities funds in December 2001.

In step with the behaviour of shareholders and with price developments, the weight of equity instruments in the net asset value of securities firms diminished (see Chart V.11) from 29% to 24.5%, with a greater decline in shares issued by non-residents than in those quoted on domestic markets. As to fixed-income instruments, mutual funds continued to jettison Spanish public debt and to purchase euro-denominated fixed-income assets issued by non-residents. Overall, the weight of the foreign portfolio in total assets continued to increase (44.5% in money market funds and 50.3% in securities funds). Despite the greater volume of issues of private fixed-income securities on the Spanish securities markets, there was no significant increase in the relative weight of these assets in mutual funds' portfolios.

The breakdown of the portfolio held by pension funds remained very stable, with the weight of equity instruments holding at 21%, and that of foreign assets at 23%.

#### V.4. THE NET WORTH POSITION OF THE PRIVATE NON-FINANCIAL SECTOR

The financing and financial investment decisions and the trend of financial asset prices described in the foregoing sections entailed a fresh increase in the relative indebtedness of the private non-financial sector during 2001. Although the rate of expansion of financing to this sector moderated over the course of the year, its growth was still clearly higher than that of financial wealth and income.

In the case of households, the growth of financing and financial asset price developments meant that their net financial wealth declined by around six percentage points of GDP. And this despite the fact (as discussed in the previous section) that stock market prices rallied in the final quarter of the year after the September 11 effects (see Chart V.12). Nonetheless, the total net worth of this sector was favoured, as in previous years, by the marked in-

## Recent developments in the household financial burden

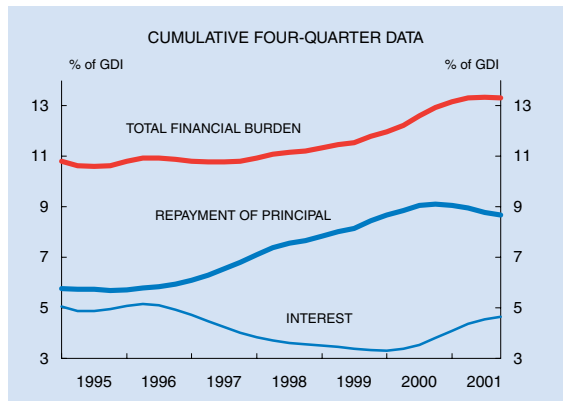
Indebtedness entails a financial burden in the form of regular interest and principal payments which depend on three components: the outstanding balance of the debt, the interest rate applied and the period over which the debt is to be repaid. In the case of Spanish households, each of these factors has trended differently in recent years.

Household debt has expanded strongly and, at the end of 2001, its value was close to 77% of gross disposable income (GDI). The growth in household liabilities was relatively sharper for loans intended for house purchases. This form of credit entails a relatively more moderate financial burden than other uses such as, for example, consumption, as it is generally secured by a real asset which allows the interest rate applied to be lower and the loan repayment term to be longer. Moreover, the environment of greater nominal stability characterising the Spanish economy, owing to EMU membership, has made for a significant contraction in interest rates of over 50% in the past 10 years. Further, lower inflation levels and the subsequent reduction in interest rate risk have allowed repayment terms to be lengthened, further reducing the regular payments associated with debt. The improvements in credit institutions' lending portfolio risk management techniques and the heightened competition among such institutions may also have contributed to the lowering of loan interest rates and to longer repayment terms.

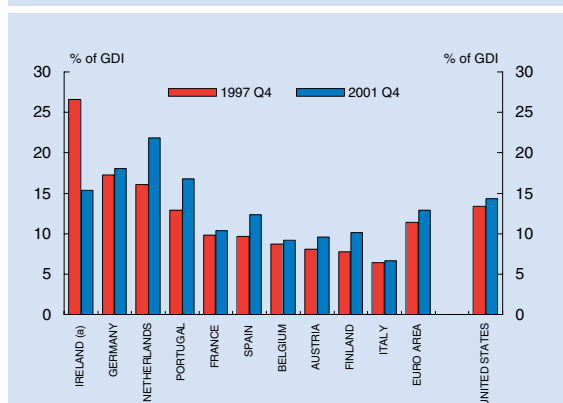
Bearing in mind the breakdown of household debt by credit use (housing, consumption and other uses) and by original repayment maturity, and considering a relevant interest rate for each of these categories, it is possible to estimate the average financial burden borne by Spanish households as a whole. According to this estimate, the greater debt taken on by Spanish households has meant a moderate increase in the average financial burden from 11% of GDI in 1994 to 13.3% in 2001 (see Chart A). This growth has been concentrated in the last three years, when the expansion of debt was relatively intense and the downward trend of interest rates had run its course, following Spanish EMU membership. As might be expected, regular debt repayment instalments have grown sustainedly since 1994, rising to 8.7% of GDI in 2001. However, and despite greater debt, interest payments have fallen from 5.7% of GDI in 1994 to 4.6% in 2001, after having bottomed out in mid-1999. In comparison with other countries (1) over the 1998-2001 period, the household financial burden in Spain – as in the Netherlands and Portugal – showed a more pronounced increase than in the other euro area countries (see Chart B). In Spain's case, unlike the Netherlands or Portugal, this behaviour involves convergence towards the average euro area levels.

According to this estimate, therefore, the strong increase in Spanish household debt has not to date involved a similar increase in the attendant average financial burden for the sector as a whole, although it has naturally raised the sensitivity of household financial expenditure to the future course of interest rates. It should be stressed that, most probably, the distribution of the financial burden among the different Spanish household income or job-related segments will be far from homogenous.

## A. Financial burden: interest and repayment of principal



## B. Financial burden: international comparison

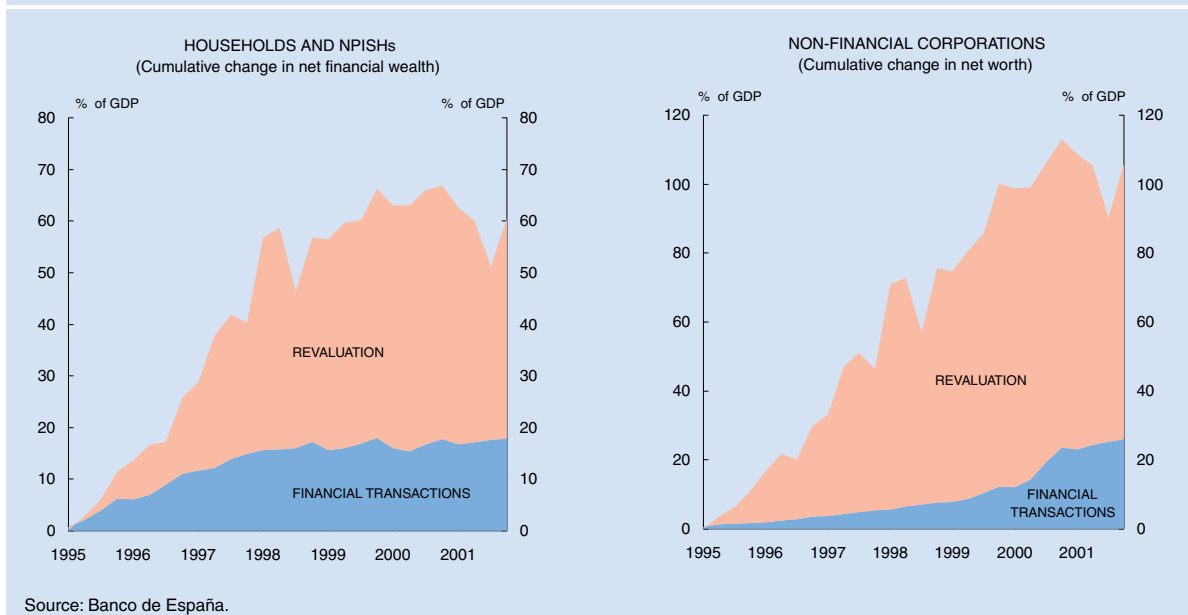


Sources: ECB, Federal Reserve and Banco de España.

(a) The first figure is for 1998 Q4.

(1) These estimates should be interpreted with all due caution. In estimating the household financial burden in euro area countries, regard is had solely to credit from monetary financial institutions, and the assumptions on repayment maturities are similar for all the countries. In the United States, this indicator is compiled by the Federal Reserve on the basis of information on individual mortgage and personal loans.

### Net-worth position of households and NPISHs and non-financial corporations



crease in the price of its main component, namely housing, which exceeded 15% in 2001.

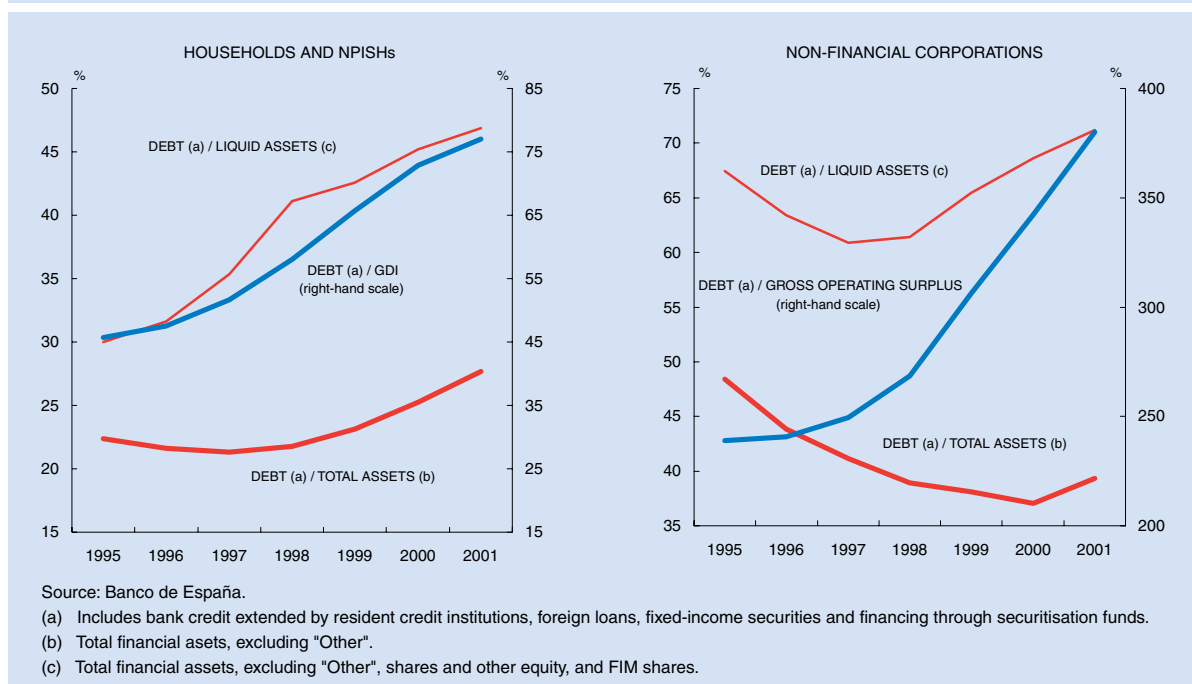
Likewise, household holdings of financial assets shifted towards a lower-risk profile. Thus, at the end of 2001, cash, deposits and shares in fixed-income money-market and securities funds accounted for 40.1% of the household financial portfolio, compared with 37.8% in 2000. The weight of the value of insurance technical reserves increased in the portfolio, in line with the trend of recent years, rising to 13.8% of total financial assets in 2001. The value of direct equity holdings and shares in mutual funds other than fixed-income money market and securities funds fell, accounting for 31% and 6.5%, respectively, of the sector's portfolio at the end of 2001.

As a result of the foregoing, household debt ratios increased once more in 2001 (see Chart V.13). In terms of their gross disposable income, the fact credit outgrew income prompted a rise in the ratio between both variables of close to four percentage points to almost 77%, a similar level to the average for the euro area and below that for US and UK households. As a proportion of total assets, household debt rose from 25% to 28%, while a greater demand for less risky instruments explains why, in terms of the more liquid assets, the rate of indebtedness should have increased less (by about two percentage points), to around 47%.

The aggregate net worth position of households, however, remains sound. Along with the shift towards lower-risk assets, it should be noted that the rise in debt has not translated into a comparable increase in the household financial burden. This is due to the effects derived from the lengthening of average repayment terms and from the low level of interest rates (see Box V.4). Indeed, the default ratio in the sector held in 2001 at a low level. However, the growing weight of real estate wealth in the sector's total assets, and of mortgage debt in its overall liabilities, means it is more exposed in relative terms to future house price developments.

Non-financial corporations saw the value of their net wealth decrease, thereby breaking the trend of recent years (see Chart V.12). In particular, the growth of borrowed funds continued affecting the net worth position of this sector. During 2001, the value of its debt, measured by the outstanding balance of bank loans and fixed-income issues, amounted to 379% of the sector's gross operating surplus, against 342% in 2000 (see Chart V.13). In terms of the portfolio of lower-risk financial assets, this ratio stood at 71.2% compared with 68.7% the previous year. The growth in debt was greater than that for the euro area on average. As a result, Spanish corporations continue to converge rapidly on the average level of the euro area which, in terms of

## Debt ratios



GDP, stood at around 74%(71% in Spain). For the second year running, the greater levels of debt took the form of an increase in the sector's financial charges (interest payments over the gross operating surplus), which might ultimately exert some influence on its future investment plans. By type of financial instrument, and although the main component of corporate debt is credit from resident institutions (accounting for around 65%), foreign loans have played an increasingly important role in recent years. At the end of 2001, foreign debt represented around 25% of corporations' borrowed funds (compared with 17% in 1994).

As with households, corporations show a healthy net worth position overall, reinforced in recent years by a significant influx of stable funds raised through the issuance of shares and other equity. Such soundness notwithstanding, the increase in the sector's debt has raised its relative vulnerability to shocks that may affect the profitability of ongoing investment projects. In particular, there has been a notable increase in the exposure to and favourable developments in the external environment, against a background in which, in terms of GDP, Spanish non-financial corporations' assets vis-à-vis the rest of the world have increased by 25 percentage points over the last three years.

# ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA

2001

## INTRODUCTION

The annual accounts of the Banco de España (“the Bank”), as established by Article 29.1 of its internal rules, comprise the balance sheet, the profit and loss account and the notes on the accounts. The accounts, pursuant to the provisions of the same article, have been prepared in accordance with the Bank’s internal accounting rules. These rules follow generally accepted accounting principles, adapted to the special characteristics of the operations and functions of a central bank. They also comply, in all applicable aspects, with the accounting criteria and valuation rules established for the European System of Central Banks (ESCB), as required by Article 26.4 of the Statute of the ESCB, relating to standardisation of accounting principles and practices in the Eurosystem.

The annual accounts of the Banco de España have been subject, in accordance with the provisions of Articles 29 and 32 of its internal rules, to audit by the Internal Audit Department and to review by the Accounts Review Committee, appointed for the purpose by a resolution of the Governing Council of the Banco de España of 22 December 2000. The accounts have also been audited by independent external auditors, as stipulated by Article 27 of the Statute of the ESCB.

Under the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of Autonomy of the Banco de España, it is for the government, upon proposal by the Minister of the Economy, to approve the balance sheet and accounts of the Bank, which will be

sent to Parliament (*Cortes Generales*) for informational purposes. The Governing Council of the Bank, under the provisions of Article 21.1 (g) of the aforementioned Law, is responsible for formulating the Bank’s accounts.

Unless otherwise indicated, the figures refer to millions of euro. For ease of comparability, 2000 figures are also given on the basis of the new structure of the balance sheet, profit and loss account and accounting standards applied in 2001, as described in the relevant explanatory notes. It should be pointed out that the discrepancies that may, on occasions, be observed between the breakdowns in the notes and the figures in the balance sheet and profit and loss account arise from the rounding of the former.

This document presents the accounts for the year 2001. Section I includes the balance sheet and profit and loss account; Section II, the notes on the accounts, with the valuation criteria used and explanatory notes on the most important aspects of the balance sheet and profit and loss account; and Section III, in compliance with Article 4.2 of the Law of Autonomy, details the contributions made to the Deposit Insurance Funds and the loans and transactions agreed on other than an arm’s-length basis or which in any other way entail a loss of profit or losses for the Bank, giving estimates of the amount of such loss of profit or losses.

Finally, the reports of the external auditors and of the Banco de España Accounts Review Committee on the annual accounts presented in Sections I-III are included in Annexes I and 2.

## I. BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

### Balance sheet of the Banco de España as at 31 December 2001

(€ m)

	Note number	2001	2000
<b>ASSETS</b>			
<b>1. Gold and gold receivables</b>	<b>1</b>	<b>5,300.90</b>	<b>4,931.16</b>
<b>2. Claims on non-euro area residents denominated in foreign currency</b>		<b>33,357.00</b>	<b>32,757.26</b>
2.1. Receivables from the IMF	2	1,958.01	1,727.80
2.2. Balances with banks and security investments, external loans and other external assets	3	31,398.99	31,029.46
<b>3. Claims on euro area residents denominated in foreign currency</b>		<b>0.03</b>	<b>0.06</b>
<b>4. Claims on non-euro area residents denominated in euro</b>		<b>0.00</b>	<b>0.00</b>
4.1. Balances with banks, security investments and loans		0.00	0.00
4.2. Claims arising from the credit facility under ERM II		0.00	0.00
<b>5. Lending to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>4</b>	<b>10,546.69</b>	<b>16,142.87</b>
5.1. Main refinancing operations		8,477.22	14,309.62
5.2. Longer-term refinancing operations		2,069.47	1,821.47
5.3. Fine-tuning reverse operations		0.00	0.00
5.4. Structural reverse operations		0.00	0.00
5.5. Marginal lending facility		0.00	0.00
5.6. Credits related to margin calls		0.00	11.78
<b>6. Other claims on euro area credit institutions denominated in euro</b>		<b>2.57</b>	<b>1.97</b>
<b>7. Securities of euro area residents denominated in euro</b>		<b>0.00</b>	<b>0.00</b>
<b>8. General government debt denominated in euro</b>	<b>5</b>	<b>10,380.90</b>	<b>11,006.79</b>
<b>9. Intra-Eurosystem claims</b>	<b>6</b>	<b>29,603.01</b>	<b>45,724.81</b>
9.1. Participating interest in ECB		444.68	444.68
9.2. Claims equivalent to the transfer of foreign reserves		4,446.75	4,446.75
9.4. Other claims within the Eurosystem (net)		24,711.58	40,833.38
<b>10. Items in course of settlement</b>	<b>7</b>	<b>398.84</b>	<b>7.45</b>
<b>11. Other assets</b>		<b>6,549.31</b>	<b>7,837.63</b>
11.2. Tangible and intangible fixed assets	8	234.39	225.64
11.3. Other financial assets	9	3,572.04	3,443.84
11.4. Off-balance sheet instruments revaluation differences	10	0.00	188.18
11.5. Accruals and deferred expenditure	11	727.27	929.90
11.6. Sundry	12	2,015.61	3,050.07
<b>TOTAL ASSETS</b>		<b>96,139.25</b>	<b>118,410.00</b>



**Balance sheet of the Banco de España as at 31 December 2001 (cont'd)**

(€ m)

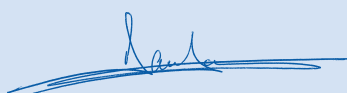
	Note Number	2001	2000
<b>LIABILITIES</b>			
<b>1. Banknotes in circulation</b>	<b>13</b>	<b>46,227.56</b>	<b>57,198.32</b>
<b>2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro</b>	<b>14</b>	<b>12,273.21</b>	<b>8,391.21</b>
2.1. Current accounts (covering the minimum reserve system)		12,272.85	8,385.21
2.2. Deposit facility		0.00	6.00
2.3. Fixed-term deposits		0.00	0.00
2.4. Fine-tuning reverse operations		0.00	0.00
2.5. Deposits related to margin calls		0.36	0.00
<b>3. Other liabilities to euro area credit institutions denominated in euro</b>	<b>15</b>	<b>2,451.79</b>	<b>0.00</b>
<b>4. Debt certificates issued</b>		<b>0.00</b>	<b>0.00</b>
<b>5. Liabilities to other euro area residents denominated in euro</b>		<b>13,289.66</b>	<b>30,238.29</b>
5.1. General government	16	12,238.04	29,298.24
5.2. Other liabilities	17	1,051.62	940.05
<b>6. Liabilities to non-euro area residents denominated in euro</b>	<b>18</b>	<b>61.74</b>	<b>24.63</b>
<b>7. Liabilities to euro area residents denominated in foreign currency</b>		<b>20.52</b>	<b>3.72</b>
<b>8. Liabilities to non-euro area residents denominated in foreign currency</b>		<b>298.12</b>	<b>453.67</b>
8.1. Deposits, balances and other liabilities	19	298.12	453.67
8.2. Liabilities arising from the credit facility under ERM II		0.00	0.00
<b>9. Counterpart of special drawing rights allocated by the IMF</b>	<b>20</b>	<b>425.65</b>	<b>418.35</b>
<b>10. Intra-Eurosystem liabilities</b>		<b>0.00</b>	<b>0.00</b>
10.2. Liabilities related to promissory notes backing the issuance of ECB debt certificates		0.00	0.00
10.3. Other liabilities within the Eurosystem (net)		0.00	0.00
<b>11. Items in course of settlement</b>	<b>21</b>	<b>90.07</b>	<b>385.32</b>
<b>12. Other liabilities</b>		<b>1,666.94</b>	<b>1,599.84</b>
12.1. Off-balance-sheet instruments revaluation differences	22	67.30	0.00
12.2. Accruals and deferred income	23	604.70	917.53
12.3. Sundry	24	994.94	682.31
<b>13. Provisions</b>	<b>25</b>	<b>3,868.40</b>	<b>3,864.79</b>
<b>14. Revaluation accounts</b>	<b>26</b>	<b>10,667.56</b>	<b>10,068.62</b>
<b>15. Capital and reserves</b>		<b>4.54</b>	<b>4.54</b>
15.1. Capital	27	1.37	1.37
15.2. Reserves	28	3.17	3.17
<b>16. Profit for the year</b>	<b>29</b>	<b>4,793.49</b>	<b>5,758.70</b>
<b>TOTAL LIABILITIES</b>		<b>96,139.25</b>	<b>118,410.00</b>

Profit and loss account of the Banco de España for the year ending 31 December 2001

(€ m)

	Note number	2001	2000
Interest income	1	4,010.60	4,540.61
Interest expense	2	-966.07	-919.57
<b>Net interest income</b>		<b>3,044.53</b>	<b>3,621.04</b>
Realised gains/losses arising from financial operations	3	2,048.07	2,494.67
Write-downs on financial assets and positions	4	-85.16	-7.00
Transfer to/from provisions for foreign exchange rate and price risks		0.00	0.00
<b>Net result of financial operations, write-downs and risk provisions</b>		<b>1,962.91</b>	<b>2,487.67</b>
Fees and commissions income		13.91	16.03
Fees and commissions expense		-1.66	-1.46
<b>Net income from fees and commissions</b>	<b>5</b>	<b>12.25</b>	<b>14.57</b>
<b>Income from equity shares and participating interests</b>	<b>6</b>	<b>181.27</b>	<b>1.75</b>
<b>Net result of pooling of monetary income</b>	<b>7</b>	<b>2.02</b>	<b>1.85</b>
<b>Other income</b>	<b>8</b>	<b>75.02</b>	<b>41.23</b>
<b>TOTAL NET INCOME</b>		<b>5,278.00</b>	<b>6,168.11</b>
Staff costs	9	-182.59	-174.76
Administrative expenses	10	-66.96	-51.97
Depreciation of tangible and intangible fixed assets	11	-18.50	-16.60
Banknote production services	12	-166.97	-68.13
Other expenses		-1.43	-1.39
<b>TOTAL OPERATING EXPENSES</b>		<b>-436.45</b>	<b>-312.85</b>
<b>Transfers and additions to other funds and provisions</b>	<b>13</b>	<b>-48.06</b>	<b>-96.56</b>
<b>PROFIT FOR THE YEAR</b>	<b>14</b>	<b>4,793.49</b>	<b>5,758.70</b>

Countersigned by  
The Governor,



JAIME CARUANA

The Comptroller,



ANTONIO ROSAS

## II. NOTES ON THE ACCOUNTS

### II.1. VALUATION CRITERIA

#### 1. Basic principles

The following accounting principles have been applied:

- economic reality and transparency;
- prudence;
- recognition of post-balance-sheet events;
- materiality;
- the accruals principle;
- consistency and comparability.

#### 2. Basis of accounting

The accounts have been prepared on an historical cost basis, except in the case of marketable securities, gold and the foreign currency position, which are valued at market prices. Transactions in assets and liabilities are reflected in the accounts on the basis of the date on which they are settled.

As an exception to the application of the general historical cost criterion it should be pointed out that, on 31 December 1998, at the time the ESCB was established and in application of the harmonised accounting standards established for the European System of Central Banks, gold, domestic and foreign securities and foreign currencies were valued at the prices and exchange rates then prevailing, without recognising profits, in the event of unrealised gains, and with a charge to the profit and loss account in the case of unrealised losses. These unrealised gains are subsequently credited to the profit and loss account, when the sale of the asset in question takes place or, under certain conditions, when unrealised losses arising at a later date can be netted against them.

The specific valuation criteria applied to each of the assets and liabilities specified were the following:

##### *Gold*

Gold is recorded at its purchase price, which is determined by the cash amount paid, including all

the expenses inherent in the transaction.

The cost of sales is obtained by applying the daily LIFO method. In the event that the cash to be paid or received is specified in a foreign currency, it is translated into euro at the mid-market exchange rate two business days before the settlement date.

On the last day of each month stocks are valued at the market price of a troy ounce of fine gold supplied by the European Central Bank, with the appropriate accounting adjustments, without changing the average book price

Unrealised losses existing at the end of the year are taken to the profit and loss account and the average book price is modified. Such losses are considered irreversible.

Sales of gold against foreign currency under repurchase agreements are recorded as off-balance-sheet items, with no effect on the balance sheet. The foreign currency received by way of consideration is recorded on the assets side, with the obligation to repay it being recorded simultaneously on the liabilities side. Possible differences arising between gold delivered spot and that received forward are recorded as if there had been an independent outright sale or purchase, at the time of maturity of the transaction.

##### *Special drawing rights*

SDRs and the net IMF position are valued at the year-end SDR market exchange rate.

##### *Foreign securities*

Foreign securities are recorded at the purchase price, which is determined by the cash amount paid, after deducting any accrued gross coupon.

The cost of foreign securities sold or redeemed is determined by the average book price of the security in question.

Foreign securities are revalued monthly, in line with market price. This revaluation is carried out without any netting of unrealised gains and losses on different security codes. Gains and losses (with the exception of losses at year-end) are reflected in

adjustment accounts and credited or debited, respectively, to revaluation and expense accounts, with both cancelled at the end of the following month.

Losses existing at the end of the year are taken to the profit and loss account. Their amount is credited directly to the securities account, and the average book price – and therefore the internal rate of return – of the security code concerned is modified. Such losses are considered irreversible, not being cancelled at the end of the following month.

Any premiums, discounts and coupons that have accrued but are not due are recorded in accruals accounts, using the internal rate of return of each security code for their calculation.

The above references to purchase and market prices shall, in relation to securities denominated in foreign currency, be understood to refer to the currency concerned, these amounts being translated into euro, as stipulated below.

#### *Foreign currencies*

Purchases are recorded at the purchase price in euro. Purchases and sales of foreign currencies against euro are valued at the exchange rate agreed in the transaction. Where foreign currencies are bought and sold against other foreign currencies the euro valuation is at the mid-market exchange rate of the currency sold on the contract date.

The cost in euro of foreign currency sold is calculated using the daily LIFO method.

On the last day of each month stocks are valued at the mid-market exchange rate, with the relevant adjustments, without changing the average book price. Losses existing at the end of the year, for each currency, are taken to the profit and loss account, and the average book exchange rate changed. Such losses are considered irreversible.

#### *Foreign banknotes*

The same criteria are applied as indicated above for convertible currencies.

#### *Repurchase agreements involving securities*

Reverse repurchase agreements involving securities are recorded on the assets side of the balance sheet as collateralised outward loans for the amount of the loan. Securities acquired under reverse repurchase agreements are not revalued or included in the securities portfolio.

Repurchase agreements involving securities are recorded on the liabilities side of the balance sheet as an inward deposit collateralised by securities. The balance sheet shows the deposits and the value of the items given as collateral. Securities sold under this type of agreement remain on the balance sheet of the Banco de España and are treated as if they remained part of the portfolio from which they were sold. Repurchase agreements involving securities denominated in foreign currencies have no effect on the average cost of the currency position.

#### *Doubtful debtors*

Where there is any reasonable doubt over the recovery of an asset it is recorded in a separate account and the relevant provision set aside.

#### *Loans to financial institutions and balances with EU central banks*

These are valued at their nominal amount.

#### *Special loans to the State and the Social Security System*

Special loans granted to the State that are referred to in transitional provision seven of Law 21/1993 on the State budget for 1994, and those granted to the Social Security System that are envisaged in transitional provision six of Law 41/1994 on the State budget for 1995, are valued at their nominal amount, in accordance with the ESCB's harmonised rules.

#### *Book-entry domestic State securities*

The criteria used to record and value book-entry domestic State securities are the same as those indicated above for foreign securities.

### *Participating interests in institutions and other entities*

Participating interests in national and/or international institutions, including the participating interest in the ECB, are valued at their purchase price.

### *Tangible and intangible fixed assets*

In general, fixed assets are valued at the purchase price, which includes any non-deductible VAT paid and all additional expenses that may arise until they are in operation. Fixed assets whose cost is less than EUR 120 are recorded as expenses in the year in which they are acquired.

Annual charges for depreciation are calculated on the basis of the estimated economic life of the various assets using the straight-line method. Land and items forming part of the Bank's art collection are not considered to be depreciable assets. Depreciation is carried out on a monthly basis, starting from the month following that of the date the asset is recorded in the accounts or put into operation. Assets paid for out of the Beneficent-Social Fund (*Fondo de Atenciones Benéfico Sociales*) are considered automatically depreciated.

Relevant expenses relating to projects due to be in effect for several years may be capitalised and depreciated over a maximum period of four years.

In 2001, the depreciation percentages applied to the various fixed assets were the same as those applied in 2000, and were as follows:

	%
• Land and buildings	2
• Facilities	6
• Furniture and office equipment	
— Libraries	10
— Furniture	10
— Office machines other than computer equipment	20
— Machines for the treatment of banknotes and coins	20
— Computer equipment	25
— Other machines and equipment	20
• Transport equipment	20
• Computer applications	33
• Art collection	0

Purchases of silver are recorded at the purchase price. At year-end the stocks are revalued at the London market US dollar price of a troy ounce on that date, translated into euro at the prevailing exchange rate. This revaluation is carried out only in

the event that the amount so obtained is less than the book value.

### *Banknotes*

Banknotes in circulation are recorded on the liabilities side of the balance sheet at their face value, and their purchase cost is recorded as an expense in the relevant year.

### *Recognition of income and expenses*

Income and expenses are recognised in the period in which they accrue.

Realised gains and realised and unrealised losses are taken to the profit and loss account. The average cost method is used to calculate the purchase price of individual items sold. In the case of unrealised losses on any item at year-end, its average cost is reduced in line with the end-of-year market price and/or exchange rate.

Unrealised gains are not recognised as income, but are transferred to a revaluation account.

Unrealised losses are taken to the profit and loss account if they exceed previous revaluation gains recorded in the corresponding revaluation account, and are not reversed in subsequent years against new unrealised gains. Unrealised losses in any one security or currency or in gold are not netted against unrealised gains in other securities or currencies.

Premiums or discounts arising on issued and purchased securities are calculated and shown as interest income or expenses and amortised over the remaining life of the securities concerned, according to the internal rate of return method.

### *Pension scheme*

Contributions to an external pension fund by employees who, having joined the Bank after 31.1.1986, are eligible to and do participate in the Pension Scheme, are established at 6.5% of the so-called "regulating salary", consisting of the salary items determined in the Scheme Rules. The amounts contributed by the Bank are recog-

nised as a current expense in the year to which they relate.

### Off-balance-sheet positions (1)

Foreign exchange forward transactions, forward legs of foreign exchange swaps and other currency instruments involving an exchange of one currency for another at a future date, are included in the net foreign currency positions in order to calculate foreign exchange gains and losses.

Interest rate futures are revalued on an item-by-item basis and treated in a similar manner to securities.

Profits and losses arising from off-balance-sheet instruments are recognised and treated in a similar manner to on-balance-sheet instruments.

### Post-balance-sheet events

Assets and liabilities are adjusted to reflect events that occur between the annual balance sheet date and the date on which the Governing Council formulates the financial statements if such events materially affect the condition of assets and liabilities.

## 11.2. NOTES ON THE BALANCE SHEET

### 1. Gold and gold receivables

The Banco de España's gold holdings amount to EUR 5,300.90 million, consisting of 16,829 million troy ounces of fine gold valued at EUR 314.99 per ounce (2). This amount is EUR 369.74 million higher than at end-2000 as a result of the rise in the market price of gold during the year (at end-2000 the price per ounce was EUR 293.01), the number of ounces having remained unchanged during the year, except for slight differences arising from deposit and swap transactions.

(1) The net position under foreign exchange forward transactions and swaps, and the foreign-exchange gains and losses generated by such position are shown in the balance sheet under items 11.4 on the assets side and 12.1 on the liabilities side, depending on their sign.

(2) One troy ounce is equal to 31.1035 grams.

### 2. Receivables from the IMF

These include: a) drawing rights within the reserve tranche (EUR 1,502.98 million) which include the net IMF position (EUR 1,502.98 million) and the euro tranche position and its balancing account (EUR 2,840.21 million, with a positive and negative sign); b) special drawing rights (EUR 397.71 million), and c) other claims (EUR 57.32 million). In total, receivables from the IMF rose by EUR 230.20 million, with respect to end-2000, due to various factors. Notable among them were operations carried out through the IMF, basically aid to other countries and loan extensions, which involved a net increase of EUR 270.14 million, while lower unrealised gains on stocks of SDRs involved a reduction of EUR 39.94 million. There was no change in Spain's IMF quota during 2001.

### 3. Balances with banks and security investments, external loans and other external assets

This item includes balances with banks, loans and other claims on non-euro area residents denominated in foreign currency. Their total amount is EUR 31,398.99 million, with the following breakdown:

(EUR millions)		
Type of asset	2001	2000
Balances with banks	735.06	446.07
Security investments (3)	30,432.89	30,353.62
External loans and other external assets	238.81	239.70
Loan provisions	-11.95	-14.57
Non-euro area banknotes	4.18	4.64
<b>TOTAL</b>	<b>31,398.99</b>	<b>31,029.46</b>

At end-2001, 99.98% of the balances with foreign banks, loans denominated in foreign currency and security investments were denominated in US dollars.

Under "external loans and other external assets" are included, inter alia, certain assets, to the value of EUR 11.95 million, considered to be of doubtful recovery. Country-risk and other provi-

(3) At year-end 2001, repurchase agreements were constituted over part of the USD-denominated securities portfolio, with a market value of USD 414.15 million. These repurchase agreements were conducted under automated security lending contracts with the depositors of these securities. Automated security lending contracts allow the depository to lend the securities to a third party in overnight operations under the limits established in the contract.

sions have been established in respect of these assets for their full amount.

The increase in this item (EUR 369.53 million) was basically due to the net effect of the factors listed in the following table:

(EUR millions)	
Breakdown of the change	
Net sales of foreign currency	-2,628.84
Decline in the outstanding gold swaps position at year-end	-140.46
Decline in the market price of foreign securities	-67.48
Increase in the market exchange rate	1,009.24
Results obtained from the sale of securities and futures	362.01
Foreign-currency-denominated interest income	1,835.50
Other	-0.44
<b>TOTAL</b>	<b>369.53</b>

#### 4. Lending to euro area credit institutions related to monetary policy operations denominated in euro

This includes euro-denominated lending to euro area financial institutions, for the conduct of monetary policy. Most of this lending is in the form of main refinancing operations.

The amount as at end-2001 is 34.67% down on 2000 (EUR 10,546.69 million in 2001, as against EUR 16,142.87 million in 2000). Also, the average daily flow of financing extended during the year was down 6.04%, from EUR 14,591.41 million in 2000 to EUR 13,709.67 in 2001. This decrease was primarily connected with the reduction in the Treasury's deposits with the Banco de España from February 2001 (see Note 16), which entailed a decline in the financing requirements of credit institutions.

In compliance with the provisions of Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994, it is hereby stated that in 2001 no loans were granted to financial institutions other than on an arm's-length basis.

#### 5. General government debt denominated in euro

##### a) State

Loans which, by virtue of their respective laws of creation, were granted to the State prior to the entry into force of Law 21/1993 of 29 December 1993 on

the State budget for 1994. Transitional provision seven of this Law states that the terms and maturities originally established in such loans shall be maintained and, in the absence thereof, they shall be repaid on a straight-line basis within twenty-five years, by means of annual payments as from 1999.

The outstanding balance as at 31 December 2001 of the loans granted to the State amounted to EUR 8,845.06 million, broken down as follows:

(EUR millions)			
	31.12.2001	Repayment	31.12.2000
Treasury. Law 3/1983 special account	2,245.39	97.63	2,343.02
Treasury. Law 4/1990 special account	5,905.78	347.40	6,253.18
Subrogation under loans to Tabacalera, S.A. (Law 31/1991)	—	12.90	12.90
Credits arising from subscription for participating interests, contributions and quotas in international agencies	693.89	40.81	734.70
<b>TOTAL</b>	<b>8,845.06</b>	<b>498.74</b>	<b>9,343.80</b>

The change was solely due to repayments made during the year, as specified in the above table.

##### b) Social Security System

This item (EUR 1,535.84) corresponds to the outstanding amount of two loans granted to the Social Security System under Law 41/1994 of 30 December 1994 on the State budget for 1995. The first includes the principal of another loan granted to this institution, which was not paid on its maturity, of EUR 1,539.19 million, and the second includes the interest due but not paid on the previous loan to 31.12.1994, amounting to EUR 501.90 million. The repayment of the first loan, by means of twenty annual instalments starting in 2000, is treated in the same way as established for the repayment of special loans granted to the State, referred to above. The loan for interest due to 31 December 1994 is being repaid on a straight-line basis over ten years, the first instalment having been made on 31 December 1995.

EUR 76.96 million of the reduction in the balance of this item in 2001 (EUR 127.15 million) corresponds to receipt of the second repayment instalment on the loan of EUR 1,539.19. The remaining EUR 50.19 million corresponds to receipt of the seventh repayment instalment on the loan of EUR 501.90 million. The amount of this payment was recovered by means of set-off against some of the



amounts due to the Social Security System in respect of interest payable on its interest-bearing accounts with the Banco de España.

## 6. Intra-Eurosystem claims

### a) Participating interest in ECB

The fully paid-up subscription of the Banco de España to the capital of the ECB amounts to EUR 444.68 million, which is equal to a share of 8.8935% in such capital. This percentage, which remained unchanged during the year, corresponds to the Banco de España, in accordance with the capital key established by the European Commission on the basis of Spain's population and GNP.

### b) Claims equivalent to the transfer of foreign reserves

Pursuant to Article 30 of the Statute of the ESCB/ECB, the Banco de España transferred foreign reserve assets to the value of EUR 4,446.75 million to the ECB at the beginning of 1999. These claims are equivalent to this transfer.

Until 2001, inclusive, these claims were subject to a possible reduction of up to 20% in their initial value, in the event that the European Central Bank were to incur unrealised losses caused by exchange rate differences relating to the reserve assets that could not be covered either with its reserves or through appropriation of the monetary income for the year pooled by the participating NCBs. In 2001, it was not necessary to use this means of covering unrealised losses, as the ECB made a profit.

### c) Other claims within the Eurosystem (net)

The balance of EUR 24,711.58 million reflects the position of the Banco de España vis-à-vis the ECB, in respect of the transfers issued and received through TARGET, both with the banks of the Eurosystem and with the non-participating NCBs. It also includes the net position vis-à-vis the ECB in respect of the contribution and reallocation of monetary income (4) and the balances held with the Eurosystem NCBs through correspondent accounts, the latter constituting an insignificant part of the total.

(4) Note 7 on the profit and loss account explains the nature and content of the monetary income for the year 2001.

In relation to the transfers made through TARGET, it should be pointed out that, from 30 November 2000, the balances arising from such transfers vis-à-vis the Eurosystem banks, as well as the rest of the European Union banks, were netted and replaced by a single balance vis-à-vis the ECB, the latter (EUR 24,709.68 million) being almost the entire amount of this item of the balance sheet.

As regards the claims on the ECB arising from the process of pooling and redistribution of monetary income between the Eurosystem central banks, as at end-2001 they amounted to EUR 2.02 million, this being the result of a contribution of monetary income of EUR 1.67 million and a reallocation to the Banco de España of EUR 3.69 million.

## 7. Items in course of settlement

Totalling EUR 398.84 million, they correspond basically to bills and documents in the process of being cleared (EUR 389.21 million), as a consequence of 31 December 2001 having been declared a non-business day for clearing purposes.

## 8. Tangible and intangible fixed assets

Their balance totalled EUR 234.39 million at end-2001, of which EUR 423.75 million corresponded to their cost and EUR 189.36 to accumulated depreciation.

The two tables below show this item broken down into its components, together with their cost or valuation and accumulated depreciation.

(EUR millions)

Cost or valuation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 2001	233.42	74.71	12.67	81.46	402.26
Acquisitions	1.42	15.74	17.56	3.44	38.16
Disposals	1.29	5.75	9.32	0.31	16.67
31 December 2001	233.55	84.70	20.91	84.59	423.75

(EUR millions)

Accumulated depreciation	Property and facilities	Furniture and equipment	Fixed assets under construction	Other fixed assets	Total
1 January 2001	99.54	61.38	—	15.70	176.62
Change during the year	8.30	1.96	—	2.48	12.74
31 December 2001	107.84	63.34	—	18.18	189.36

The Bank's holdings of silver, valued at EUR 28.48 million, are included under "Other fixed assets" and were unchanged from 2000.

## 9. Other financial assets

Of the total amount of this item, 99.9% corresponds to the portfolio of book-entry domestic State securities, in which the Banco de España has EUR 3,571.12 million invested, EUR 127.89 million more than a year earlier. This increase is basically due to a net purchase of securities (EUR 89.77 million), as well as to the net unrealised gains recorded at year-end (EUR 54.82 million), partly offset by the reduction in implicit interest accrued (EUR –16.67 million).

## 10. Off-balance-sheet instruments revaluation differences

See Note 22 on the balance sheet.

## 11. Accruals and deferred expenditure

Of the total balance of this group of accounts (EUR 727.27 million), the main components are interest accrued but not yet received on securities, deposits and other assets denominated in foreign currency (EUR 314.77 million), on book-entry domestic State securities (EUR 143.33 million), on the claims equivalent to the transfer of foreign reserves (EUR 165.74 million) and on the net balance of claims within the Eurosystem arising from transfers made through TARGET (EUR 66.90 million).

## 12. Sundry

The most significant component is the transfer made to the Treasury on 2.11.01 of EUR 2,258.36 million, equivalent to 70% of the Bank's recorded profits accrued to 30 September 2001.

The other most important item is the net position of the Banco de España vis-à-vis the SNCE (the National Electronic Clearing System) in respect of documents presented and received for clearing that were pending settlement which, as at 31 December 2001, amounted to EUR –408.80 million, as a con-

sequence of that day having been declared a non-business day for clearing purposes.

## 13. Banknotes in circulation

The breakdown of banknotes in circulation by denomination at 31.12.2001 is as follows:

(EUR millions)		
Denomination	2001	2000
ESP 1,000	1,269.49	1,514.74
ESP 2,000	2,444.00	2,994.34
ESP 5,000	15,250.03	18,837.69
ESP 10,000	27,437.15	33,887.42
Held by other ESCB banks	–173.11	–35.87
<b>TOTAL</b>	<b>46,227.56</b>	<b>57,198.32</b>

The stock of banknotes in circulation was down 19.2% on end-2000. This reduction, which occurred in the second half of 2001, was basically related to the euro cash changeover from 1 January 2002.

As a consequence of the resolutions adopted by the Governing Council of the ECB in its Decision of 6 December 2001 (ECB/2001/15) on the issue of euro banknotes, from 2002, 8% of all euro banknotes in circulation shall be assigned monthly to the ECB. The counterpart of this adjustment shall be recorded as an "intra-Eurosystem liability relating to the issue of banknotes"

The remaining 92% of the euro banknotes in circulation shall be assigned to the NCBs, also on a monthly basis, so that each NCB shows in its balance sheet that part of the euro banknotes issued corresponding to it in accordance with its paid-up share in the capital of the ECB. The difference between the value of euro banknotes assigned to each NCB, in accordance with this accounting system, and the value of euro banknotes put into circulation shall also be recorded as an "intra-Eurosystem claim/liability relating to the issue of banknotes".

## 14. Liabilities to euro area credit institutions related to monetary policy operations

The overall balance of the different types of deposit held by credit institutions with the Banco de España totalled EUR 12,273.21 million at end-2001. The increase with respect to the previous year was concentrated in current accounts (covering the

minimum reserve system), which rose from EUR 8,385.21 million at 31.12.00 to 12,272.85 million at 31.12.01. The large year-end balance was a consequence of the need to pay for one third of the frontloaded euro banknotes and coins on the first business day of 2002. The average balance during 2001 was EUR 10,401.04 million, 15.4% higher than in 2000 (EUR 9,009.71 million).

#### 15. Other liabilities to euro area credit institutions denominated in euro

At 31 December 2001, this item only included cash deposits of credit institutions of EUR 2,451.79 million to secure that part of the euro banknotes and coins frontloaded up to that date not covered by the existing loan agreements with securities pledges.

These deposits have been cancelled during 2002, as the frontloaded euro banknotes and coins were paid for, in accordance with the linear debiting model (5) approved by the Governing Council of the ECB at its meeting of 20 July 2000.

#### 16. Liabilities to other euro area residents denominated in euro. General government

This item includes the deposits held by general government with the Banco de España. The outstanding balance at year-end was EUR 12,238.04 million, which breaks down as follows:

	(EUR millions)	
	2001	2000
Central government (State)	2,793.60	22,907.41
Treasury current account	394.98	20,536.27
Other central government agencies and similar bodies	2,398.62	2,371.14
Territorial government	80.21	149.79
Regional (autonomous) governments, administrative agencies and similar bodies	76.45	140.89
Local government	3.77	8.90
Social security funds	9,364.23	6,241.04
<b>TOTAL</b>	<b>12,238.04</b>	<b>29,298.24</b>

(5) In short, the linear debiting model has involved debiting the credit institutions on 2 January with one-third of the total sum of banknotes and coins frontloaded to 31 December 2001, the remaining two-thirds being debited in equal amounts on 23 and 30 January 2002.

The significant decline in the balance of this item (EUR 12,238.04 million at end-2001, compared with EUR 29,298.24 million at end-2000) was basically due to the large decrease in the balances held by the Treasury at the Bank, which was slightly offset by the increase in the balance of the Social Security System accounts.

The reduction in the balances of the Treasury was due to the agreement reached with the latter in accordance with the recommendations of the ECB to stabilise the effects on Eurosystem liquidity of Treasury deposits at the NCBs. Pursuant to this agreement, since February 2001, Treasury balances have been transferred daily to credit institutions.

#### 17. Liabilities to other euro area residents denominated in euro. Other liabilities

Included here are the current accounts of financial institutions other than credit institutions, such as the Deposit Insurance Funds, other financial intermediaries associated with securities markets settlement, other intermediaries in the debt book-entry market, etc., as well as the current accounts of employees and pensioners and other accounts of legal entities classified in "other resident non-financial sectors". The balance at end-2001 was EUR 1,051.62 million, an increase of EUR 111.57 million on end-2000, basically due to the increase in the balances of the current accounts of State bodies (both autonomous agencies and business entities).

#### 18. Liabilities to non-euro area residents denominated in euro

This item basically includes the balances of euro accounts held by International agencies and central banks that do not belong to the Monetary Union. The total of EUR 61.74 million was 37.11 million higher than a year earlier.

#### 19. Liabilities to non-euro area residents denominated in foreign currency. Deposits, balances and other liabilities

Of the total of these liabilities (EUR 298.12 million at end-2001), 99.80% corresponds to debts

arising under repurchase agreements relating to the management of the foreign-currency reserves of the Banco de España. The amount of this item fell by EUR 155.55 million.

## 20. Counterpart of special drawing rights allocated by the IMF

This item, totalling EUR 425.65 million, includes the counterpart of the special drawing rights allocated to Spain in proportion to its IMF quota.

## 21. Items in course of settlement

Of the total balance of this group of accounts (EUR 90.07 million), EUR 78.32 corresponds to transfers ordered by credit institutions pending payment at year-end. These transfers also account for most of the decrease with respect to 2000 (EUR 255.35 million out of a total of EUR 295.25 million).

## 22. Other liabilities. Off-balance-sheet instruments revaluation differences

This item includes the amount of the net creditor position with respect to foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When this position is a debtor one, as was the case in 2000, it is recorded under the same heading in item 11.4 of the assets. The end-2001 balance, EUR 67.3 million, is the net value of the forward transactions and currency swaps outstanding as at that date.

## 23. Other liabilities. Accruals and deferred income

The most significant items of this sub-group of accounts (with an overall balance of EUR 604.70 million) are interest accrued but not yet paid on remunerated current accounts (with a notable amount of EUR 354.16 million corresponding to the Social Security System) and ordinary and pre-system profits (EUR 229.29 million). The latter are attributable to the sale of foreign currencies under forward transactions outstanding at year-end, such profits being considered unrealised until the transactions mature and are executed.

## 24. Other liabilities. Sundry

The most important components of this sub-group of accounts are those relating to contributions payable to the Banco de España employee social welfare scheme (*Mutualidad de empleados*), which amounted to EUR 361.13 million, down EUR 18.36 million on the previous year; “settled credit interest pending allocation”, corresponding to a loan to the Social Security System, with a balance at year-end of EUR 150.57 million, down 50.19 million on the previous year (6); and “other liability transactions pending application”, totalling EUR 386.96. The latter are items that have not yet been credited to their corresponding accounts.

## 25. Provisions

With the exception of country-risk provisions, which are presented in the balance sheet in the form of adjustments to the values of the assets concerned, provisions are recorded under this item, with the following breakdown:

	(EUR millions)	
	2001	2000
For liabilities and charges	100.54	96.92
For exchange rate risks -		
Pre-system account	3,767.58	3,767.58
For other risks	0.28	0.29
<b>TOTAL</b>	<b>3,868.40</b>	<b>3,864.79</b>

The most important provision, unchanged during the year, relates to pre-system exchange rate risks. It was created by a resolution of the Executive Commission of 26 January 1999 to cover future exchange rate risks affecting the external reserves of the Banco de España and possible contingencies in respect of unrealised losses on reserves transferred to the European Central Bank.

The slight increase in the provision for liabilities and charges was basically due to greater accuracy in the calculation of the provision to cover assistance for death and retirement established in Article 190 of the Bank's Employment Rules.

The ECB posted a profit in 2000, so that there was no need to set aside any amount to cover its losses.

(6) This loan is referred to in Note 5 (b) above.

## 26. Revaluation accounts

These accounts represent revaluation reserves arising from unrealised gains on financial assets and liabilities. Their breakdown is as follows:

(EUR millions)

Type of account	2001	2000
<b>Pre-system revaluation accounts</b>	<b>3,879.02</b>	<b>4,137.23</b>
Due to exchange rate differences	980.19	1,177.74
Due to price differences	2,898.83	2,959.49
Gold	2,565.53	2,565.67
Securities denominated in foreign currencies	11.55	41.48
Book-entry public debt	321.75	352.34
<b>Ordinary revaluation accounts</b>	<b>6,788.54</b>	<b>5,931.39</b>
Due to exchange rate differences	4,949.37	4,536.43
Due to price differences	1,839.17	1,394.96
Gold	1,154.81	784.95
Securities denominated in foreign currencies	588.42	570.76
Book-entry public debt	95.94	39.25
<b>TOTAL</b>	<b>10,667.56</b>	<b>10,068.62</b>

The difference between the pre-system and ordinary revaluation accounts is that the former record the unrealised gains existing at end-1998 (immediately before the start of Stage Three of EMU) and the latter those arising since that date.

The decline of EUR 258.21 million in the balance of the pre-system revaluation accounts in 2001 has the following breakdown:

(EUR millions)

Pre-system revaluation accounts	Breakdown of the change in 2001		Total
	Due to the realisation of capital gains in sales and redemptions	Due to netting against unrealised capital losses	
Due to exchange rate differences	197.55	—	197.55
Due to price differences	60.66	—	60.66
Gold	0.14	—	0.14
Securities denominated in foreign currencies	29.93	—	29.93
Book-entry public debt	30.59	—	30.59
<b>TOTAL</b>	<b>258.21</b>	<b>—</b>	<b>258.21</b>

The balance of the ordinary revaluation accounts increased by EUR 857.15 million, with the following breakdown:

Breakdown of change	EUR millions
Due to exchange rate differences	412.94
Due to price differences	444.21
Gold	369.85
Securities denominated in foreign currencies	17.66
Book-entry public debt	56.70
<b>TOTAL</b>	<b>857.15</b>

## 27. Capital

The capital of the Banco de España, constituted in accordance with the provisions of Royal Legislative Decree 18/1962 of 7 June 1962, totalled EUR 1.37 million and remained unchanged during the year.

## 28. Reserves

Included in this item, which remained unchanged during the year, is the amount of capital, reserves and profits arising from membership in 1973 of the former Spanish Foreign Currency Institute in the Banco de España.

## 29. Profit for the year

The net profit for the year, having deducted the transfer to the Beneficent-Social Fund (EUR 9.61 million), amounted to EUR 4,793.49 million, 16.8% down on 2000. Of this amount, EUR 2,258.36 million was paid to the Treasury on 2.11.01, in accordance with Royal Decree 1746/1999 of 19 November 1999.

The following amounts corresponding to the profit for 2000 were also paid to the Treasury during the year.

- On 1.02.01, EUR 2,303.91 million, in order to reach 90% of the profit for 2000 (EUR 5,758.70 million).
- On 10.08.01, when the Balance Sheet and Profit Loss Account for the year 2000 had been approved by the Council of Ministers, EUR 575.87 million, representing the rest of the profit for 2000.

The details of the various components of the profit for 2001 are given in Section II.3 below, relating to the profit and loss account.

## II.3. NOTES ON THE PROFIT AND LOSS ACCOUNT

### I. Interest income (7)

This item includes income from interest accrued

(7) The figures for interest income and interest expense in 2000 reflect the criterion used in 2001 whereby the negative interest on foreign-exchange forward and swap transactions is recorded as a financial expense.

on the main assets of the Banco de España. It was made up, in 2001 and 2000, as follows:

(EUR millions)

	Foreign currency		Euro		Total	
	2001	2000	2001	2000	2001	2000
Securities	1,659.58	1,999.66	175.04	170.74	1,834.62	2,170.40
Other assets	183.94	224.88	1,992.04	2,153.90	2,175.98	2,378.78
<b>TOTAL</b>	<b>1,843.52</b>	<b>2,224.54</b>	<b>2,167.08</b>	<b>2,324.64</b>	<b>4,010.60</b>	<b>4,549.18</b>

As regards the interest on foreign-currency investments (EUR 1,843.52 million), the majority (EUR 1,692.14 million, equivalent to 91.78%) arose from investments denominated in US dollars, which had an average balance of USD 26,264.40 million and an average yield of 5.6%. In turn, the majority of this interest on US dollar investments (EUR 1,643.42 million) relates to investments in fixed-income securities denominated in that currency. The rest of the interest (EUR 151.38 million) arose from much less significant investments in SDRs, Canadian dollars, etc.

The reduction in US-dollar income with respect to 2000, was basically due to the decline in the average balance of investments in fixed-income securities, which fell from USD 27,451.68 million in 2000 to USD 24,903.44 million in 2001, and to a lower average yield (6.3% in 2000 and 5.7% in 2001).

As for the interest on euro-denominated investments (EUR 2,167.08 million), it arose from the following assets:

(EUR millions and %)

Assets	Average investment	Amount	Average yield in 2001
Loans to institutions related to monetary policy operations	13,709.67	610.87	4.4 %
Net position with European central banks	27,457.90	1,209.68	4.4 %
Claims equivalent to the transfer of foreign reserves	4,446.75	165.74	3.7 %
Book-entry debt portfolio	3,545.74	175.04	4.9 %
Other	—	5.75	—
<b>TOTAL</b>	<b>49,160.06</b>	<b>2,167.08</b>	<b>4.3 %</b>

The decline in euro-denominated interest income was a result of the decrease in the average balance of investments (EUR 56,054.04 million in 2000), partly offset by a slight increase in their average yield, which rose from 4.1% to 4.3%.

## 2. Interest expense

This item includes expenditure on the interest accruing on liabilities, which breaks down as follows:

(EUR millions and %)

	Average financing	Interest expense		Average cost in 2001
		2001	2000	
Remuneration of minimum reserves	10,401.04	452.47	369.55	4.3%
General government deposits	10,716.31	456.31	407.91	4.3%
Certificates issued by the Banco de España	—	—	99.44	—
Liabilities denominated in foreign currency	652.45	29.49	41.09	4.5%
Other euro- and foreign-currency-denominated liabilities	—	27.80	10.15	—
<b>TOTAL</b>		<b>966.07</b>	<b>928.14</b>	

The increase in the expense compared with the previous year (EUR 37.93 million) was primarily due to the increase in the average cost of financing received, and also to the increase in the average level of the minimum reserves and of the deposits held by the Social Security System. This was partly offset by a decrease in expense due to the transfer to credit institutions, from February, of the balances of accounts held by the Treasury, and by the disappearance of debt certificates issued by the Banco de España in September 2000.

## 3. Realised gains/losses arising from financial operations

This item includes the profits and losses arising from dealing in financial assets. In 2001, there was a net realised gain of EUR 2,048.07 million, basically arising from the following sources:

— Foreign exchange gains upon the sale of foreign currency totalling EUR 1,656.05 million, of which EUR 252.07 million corresponded to the realisation of unrealised gains already existing at 31.12.1998 and the rest, EUR 1,403.98 million, to the realisation of those arising in 2001.

Of the total of EUR 1,656.05 million, EUR 1,383.01 million (83.5%) arose from the sale of US dollars. The other gains basically related to the net sale of Canadian dollars (EUR 200.55 million), SDRs (EUR 73.90 million) and other foreign currencies (EUR -1.41 million).

— The net gains arising from price movements, on the sale of foreign securities, amounted to EUR 389.83 million, mostly corresponding to the sale of US dollar-denominated securities (EUR 376.80 million).

Of the total of EUR 389.83 million, EUR 29.92 million corresponds to the realisation of unreal-



ised gains existing as at 31.12.1998, and the rest, EUR 359.91 million, to gains arising and realised during 2001.

Compared with the previous year the net profit on these transactions has fallen by EUR 446.6 million owing basically to the decrease in foreign exchange gains, partly offset by an increase in gains arising from price movements

- The decrease in foreign exchange gains of EUR 750.94 million basically arose from the lower volume of sales of US dollars, which had a negative effect on the result of EUR 894.55 million. This was partly offset by higher profits obtained on the sale of Canadian dollars (EUR 198.99 million). The rest of the decrease (EUR 55.38 million) was due primarily to the movement of the euro exchange rate against the US dollar and the SDR.
- The increase in gains arising from price movements (EUR 296.26 million) basically arose on the sales of US-dollar-denominated fixed-income securities due to the increase in their market prices.

#### 4. Write-downs on financial assets and positions

This item includes that part of the loss arising from exchange rate depreciation in the foreign currency position, as well as from the fall in the price of gold and of securities denominated in foreign currency, that cannot be netted against unrealised gains arising from previous years.

The balance of this item at year-end was EUR 85.16 million (EUR 78.16 million higher than in 2000), of which 99.99% corresponded to the depreciation recorded in US dollar-denominated fixed-income securities since mid-November.

#### 5. Net income from fees and commissions

This basically includes income and expenses arising from fees for banking services and the like (transfers, negotiation of cheques, custody and administration of securities, telephone service for securities transactions, etc.). It may be broken down as follows:

	(EUR millions)			
	Income		Expenses	
	2001	2000	2001	2000
Foreign operations	0.56	4.07	-1.17	-1.15
Domestic operations	13.35	11.96	-0.49	-0.31
<b>TOTAL</b>	<b>13.91</b>	<b>16.03</b>	<b>-1.66</b>	<b>-1.46</b>

The only significant change from 2000 was the reduction in the commissions received on foreign operations, owing to the income recorded in 2000 arising from a guarantee given by the Banco de España on a loan granted by the Bank for International Settlements to Brazil.

#### 6. Income from equity shares and participating interests

This basically reflects the share of the Banco de España in the profits obtained by the ECB. In addition it includes the dividends paid on the participating interest of the Banco de España in the capital of the Bank for International Settlements.

Of the total amount recorded (EUR 181.27 million), EUR 179.37 million corresponds to the distribution in 2001 of the ECB's profit for the year 2000.

#### 7. Net result of pooling of monetary income

According to Article 32.5 of the Statute of the ESCB/ECB, the monetary income of the national central banks, accruing in the performance of the ESCB's monetary policy function, shall be allocated to such banks in proportion to their paid-up shares in the capital of the ECB. The Governing Council of the ECB, in its meeting of 3 November 1998, decided to calculate monetary income for the period 1999-2001 by the application of a reference rate to the liability base, defined for this purpose as all the central bank's deposit liabilities to credit institutions, without including banknotes. The reference rate used is the marginal rate of the latest main refinancing operation and is applied on a daily basis to the liability base of each national central bank.

The table below shows the breakdown of the net result for the Banco de España of the pooling of monetary income in 2001.



(EUR millions)	
Items	December 2001
Monetary income contributions to the Eurosystem	-1.67
Reallocation of monetary income to the Banco de España	3.69
<b>Net result of monetary income pooled</b>	<b>2.02</b>

As the ECB made a profit in 2001, it was not necessary to apply monetary income to cover ECB losses.

## 8. Other income

This includes the profits arising on book-entry public debt, as well as other diverse income of an exceptional nature. It may be broken down as follows:

(EUR millions)		
Description	2001	2000
Profit on the sale of book-entry public debt	—	—
Pre-system profit on book-entry public debt	30.59	17.69
Extraordinary profit	43.20	22.45
Sundry	1.23	1.09
<b>TOTAL</b>	<b>75.02</b>	<b>41.23</b>

The existence of a pre-system profit on book-entry public debt is a result of the gains corresponding to the debt repaid during the year.

Under the extraordinary net profit (EUR 43.20 million), the following items are notable:

- Profits of EUR 53.16 million, basically arising from the receipt from the Social Security System of interest accrued in previous years (EUR 50.19 million).
- Losses arising from the withdrawal of banknotes from circulation (EUR 4.44 million) and from the increase in the provision to cover the assistance for death and retirement established in Article 190 of the Bank's employment rules (EUR 3.72 million).

The extraordinary profit was EUR 20.75 million higher than in 2000 owing, above all, to the smaller losses arising from special transfers (EUR 94.82 million) (basically the extraordinary contribution to the Bank's employee pension scheme in respect of past services and the establishment of the provision mentioned in the previous paragraph, in 2000 in both cas-

es), partly offset by the extraordinary income received in 2000 from the IMF (EUR -34.78 million) and the exchange of more banknotes withdrawn from circulation in 2001 (EUR -42.11 million).

## 9. Staff costs

This item, which amounts to EUR 182.59 million, includes the salaries and other emoluments of the Bank's staff (EUR 132.58 million), Social Security contributions (EUR 31.56 million), expenses of a social nature (EUR 15.97 million) and contributions to the pension scheme (EUR 2.48 million).

## 10. Administrative expenses (8)

This item includes expenditure arising from the purchase of current assets, as well as diverse services received during the year. The most important were office expenses (including IT costs), which amounted to EUR 26.94 million, and costs relating to premises (especially maintenance), which amounted to EUR 13.65 million.

It breaks down as follows:

(EUR millions)		
Description	2001	2000
Office expenses	-26.94	-20.63
Property expenses	-13.65	-12.66
Transport and communications	-4.82	-4.65
Security	-5.52	-5.18
Training and grants	-1.68	-1.32
Sundry operating expenses	-13.54	-6.73
Taxes	-0.81	-0.80
<b>TOTAL</b>	<b>-66.96</b>	<b>-51.97</b>

## 11. Depreciation of fixed assets

Included here is the cost of the estimated depreciation of the Bank's fixed assets, which breaks down as follows:

(EUR millions)		
Description	2001	2000
Depreciation of property	-8.78	-8.85
Depreciation of transport equipment	-0.12	-0.09
Depreciation of furniture and office equipment	-7.30	-5.69
Depreciation of computer applications	-2.28	-1.78
Other depreciable expenses	-0.02	-0.19
<b>TOTAL</b>	<b>-18.50</b>	<b>-16.60</b>

(8) Given that there is no explicit provision for taxes in the harmonised ESCB profit and loss account format, these are included in this item.

## 12. Banknote production services

This amount (EUR 166.97 million) corresponds to payments made by the Banco de España to purchase banknotes from the National Mint. The increase (EUR 98.84 million) was attributable to the larger volume of euro-denominated banknotes supplied by the National Mint, the higher unit cost of the EUR 10, 200 and 500 banknotes and the purchase of euro banknotes for an amount of EUR 9.85 million from the contingency reserve set up by the ECB.

## 13. Transfers and additions to other funds and provisions

These totalled EUR 48.06 million and basically included expenses arising from payment commitments to the Banco de España Employee Social Welfare Scheme (EUR 41.74 million), the decrease in the country-risk provision to cover 100% of the loans extended under the bilateral agreement with Cuba (EUR –5.11 million) and the contribution to the Beneficent-Social Fund (EUR 9.61 million).

## 14. Profit for the year

As detailed and explained in the preceding notes, the net profit for 2001 amounted to EUR 4,793.49 million, 16.8% down on the previous year.

As detailed in the table below, of this amount, pursuant to Royal Decree 1746/99, EUR 2,055.78 million was paid to the Treasury on 1.02.02. This was the amount necessary, taking into account the advance payment made on 2.11.01 of EUR 2,258.36 million, to make a total payment of 90% of the Bank's profit for the period ending 31.12.01.

(EUR millions)		
1. Profit for the year 2001		4,793.49
2. Payments to the Treasury:		
— on 2.11.2000, 70% of profits as at 30.9.2001	2,258.36	
— on 1.2.2001, the additional amount necessary to reach 90% of the profit for the year ending 31.12.2001	2,055.78	4,314.14
3. Profit pending payment to the Treasury (9)		479.35
<b>TOTAL (2 + 3)</b>		<b>4,793.49</b>

(9) The remaining amount due shall be paid to the Treasury when the annual accounts for 2001 have been approved by the Government.

## III. SPECIFIC INFORMATION REQUIRED BY ARTICLE 4 OF THE LAW OF AUTONOMY OF THE BANCO DE ESPAÑA

### I. Contributions made by the Bank to the Deposit Insurance Funds (Article 4.2 of the Law of Autonomy of the Banco de España of 1 June 1994)

The contribution of the Banco de España to the Deposit Insurance Funds is regulated by Article 3 of Royal Decree 18/1982, according to the wording established by additional provision seven of Royal Legislative Decree 12/1995 of 28 December 1995 and Royal Decree 2606/1996 of 20 December 1996, which implemented the legal regime for such funds.

The latter Royal Decree established that the Deposit Insurance Funds may only exceptionally be supplemented by contributions from the Banco de España, the amount of which shall be fixed by Law. In 2001 the Banco de España made no contributions whatsoever to the Deposit Insurance Funds.

### 2. Loss of profit

The table below shows the loans outstanding in 2001 with interest rates below the reference rates used, in order to estimate the loss of profit for the year pursuant to the provisions of Article 4.2 of Law 13/1994 of 1 June 1994 of autonomy of the Banco de España.

(EUR millions and %)

Average balances on loans outstanding in 2001 with interest rates below the reference rates				
Title	Estimated average balance in 2001	Interest rate received (%)	Reference interest rate (%)	Estimated loss of profit
Net State debt	7,469.03	0.00	4.32	322.66
Loans to the Social Security System	1,662.65	0.00	4.32	71.83
Home loans and repayable advances to employees	129.62	1.96	4.32	3.06
Home loans	110.58	2.30	4.32	2.24
Repayable advances	19.04	0.00	4.32	0.82
<b>TOTALS</b>	<b>9,261.30</b>	<b>0.03</b>	<b>4.32</b>	<b>397.55</b>

Included under the heading "net State debt" is the average balance during the year, on a daily basis, of the special loans granted to the State before 1994 and the deposits held by the Treasury with the Banco de España, when there is a net balance in favour of the latter.

As regards the loans to the Social Security System, transitional provision six of Law 41/1994 of 30 December 1994 on the 1995 State budget, when establishing the conditions for repayment of certain

loans to the Social Security System, provided that no interest shall accrue on such loans as from 1 January 1995.

Finally, home loans and advances to employees correspond to those granted under the collective agreements with them signed by the Banco de España.

The reference rate used to estimate the loss of profit is the monthly average of the interest rate on main refinancing operations during the year.

## ANNEX

### I. REPORT OF THE EXTERNAL AUDITORS

#### AUDITORS' REPORT ON THE ANNUAL ACCOUNTS

The Governor and Governing Council of the Banco de España

We have audited the annual accounts of the Banco de España, comprising the balance sheet as at 31 December 2001, the profit and loss account and the notes on the accounts for the year then ended. The Governing Council of the Bank is responsible for the preparation of the accounts. It is our responsibility to express an opinion on the annual accounts taken as a whole based on our audit conducted in accordance with generally accepted auditing standards, which require examination, by means of selective tests, of the documentation supporting the annual accounts and evaluation of their presentation, of the accounting principles applied and the estimates made.

For purposes of comparison, the attached annual accounts present, in addition to the 2001 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 2001 annual accounts. Our unqualified audit report on the 2000 annual accounts was issued on 31 May 2001.

In our opinion, the 2001 annual accounts present a true and fair view, in all material respects, of the net worth and financial position of the Banco de España as at 31 December 2001, and of the net profit from its operations in the year then ended, and contain the sufficient necessary information for their proper interpretation and comprehension, in conformity with the accounting principles and standards referred to in Section II.I of the notes on the accounts, based on the accounting rules established for the member central banks of the European System of Central Banks, which are consistent with those applied the previous year.

Pricewaterhouse Coopers Auditores, S.L.

[signed]

José Wahnón Levy  
Partner

3 June 2002

## 2. REPORT OF THE ACCOUNTS REVIEW COMMITTEE

We the undersigned, José Manuel González-Páramo Martínez Murillo, Eduardo Bueno Campos and Jaime Requeijo González, members of the Governing Council of the Banco de España and of the Accounts Review Committee appointed by the Governing Council, were given the task of reviewing the accounts of the institution for the year 2001.

By virtue of this mandate, the Accounts Review Committee has analysed the operations of the Banco de España. This examination basically involved: 1) studying the Annual Accounts of the Banco de España for the year 2001, prepared by the Internal Affairs Department of the Banco de España; 2) studying the audit of the balance sheet and profit and loss account of the Banco de España for 2001,

conducted by the Internal Audit Department; 3) studying the documentation requested by the members of this Committee from the independent external auditors; 4) interviewing the senior managers of the independent external audit firm; and 5) making proposals for the modification, correction or clarification of various matters, all of which have been satisfactorily incorporated in the Annual Accounts by the Control and Accounting Department.

The basic conclusion of our report is that from the analysis carried out of the examination and accounting procedures, of the accounting records and of the internal controls carried out, it can be inferred that the Annual Accounts for the year 2001 give a true and fair view of the net worth and financial position of the Banco de España.

31 May 2002



JOSÉ MANUEL GONZÁLEZ-PÁRAMO  
MARTÍNEZ-MURILLO



EDUARDO BUENO CAMPOS



JAIME REQUEIJO GONZÁLEZ

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## COMPOSITION OF THE GOVERNING BODIES OF THE BANCO DE ESPAÑA

## Governing Council

### *GOVERNOR*

Jaime Caruana

### *DEPUTY GOVERNOR*

Gonzalo Gil

### *COUNCIL MEMBERS*

Eduardo Bueno  
José M. González-Páramo  
Joaquín Muns  
Juan Muñoz  
Jaime Requeijo  
Julio Segura

### *DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY*

(No vote on monetary policy issues)

Gloria Hernández

### *VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION*

(No vote on monetary policy issues)

Juan Jesús Roldán

### *DIRECTORS-GENERAL OF THE BANK*

(Without a right to vote)

José L. Malo de Molina  
Francisco J. Aríztegui  
Pedro Pablo Villasante  
José M.<sup>a</sup> Roldán  
José M.<sup>a</sup> Viñals

### *SECRETARY*

(Without a right to vote)

José R. del Caño

### *REPRESENTATIVE OF THE BANK'S PERSONNEL*

(Without a right to vote)

Isabel Gutiérrez

## Executive Commission

### *GOVERNOR*

Jaime Caruana

### *DEPUTY GOVERNOR*

Gonzalo Gil

### *COUNCIL MEMBERS*

José M. González-Páramo  
Julio Segura

### *DIRECTORS-GENERAL*

(Without a right to vote)

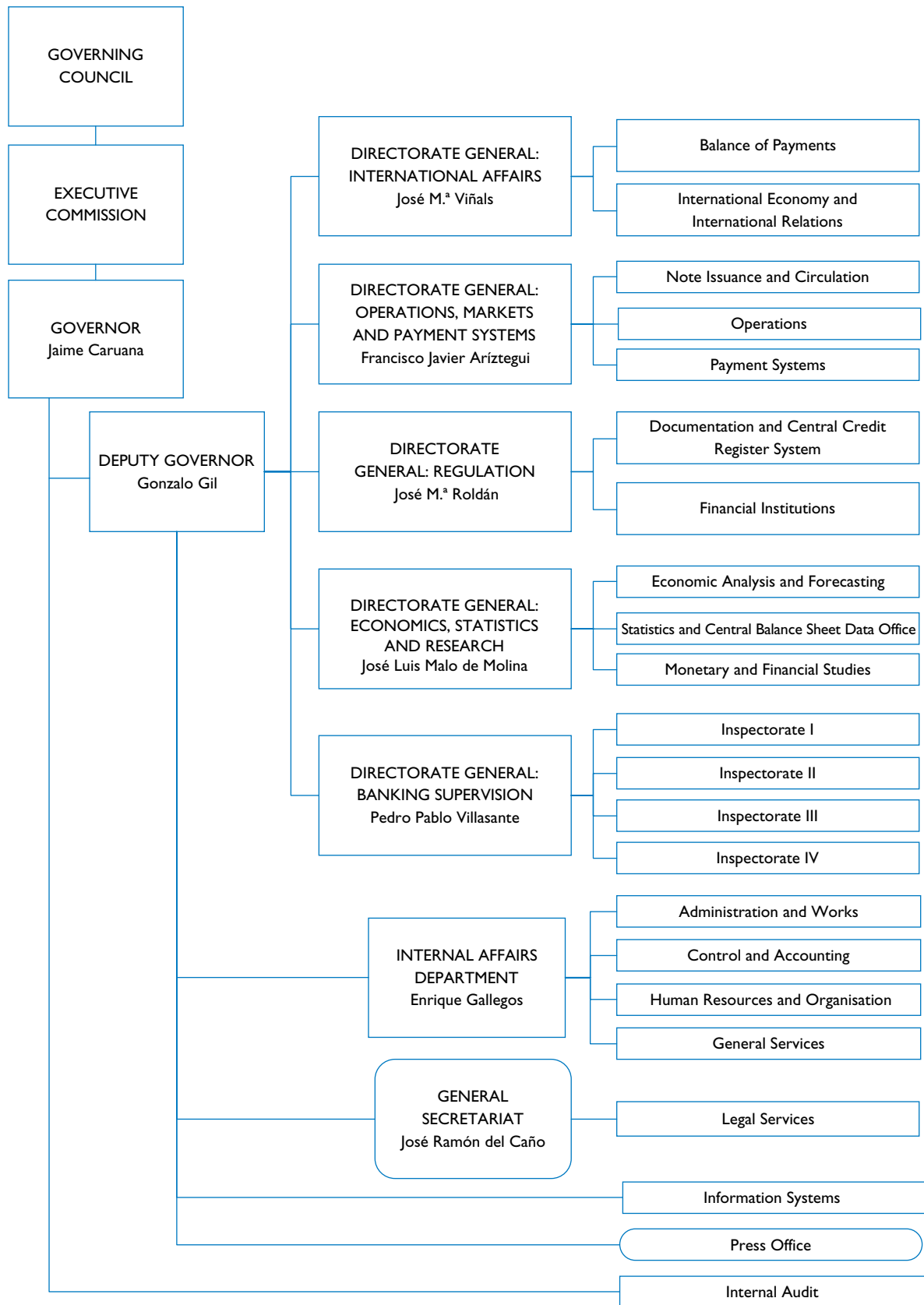
José L. Malo de Molina  
Francisco J. Aríztegui  
Pedro Pablo Villasante  
José M.<sup>a</sup> Roldán  
José M.<sup>a</sup> Viñals

### *SECRETARY*

(Without a right to vote)

José R. del Caño

## GENERAL ORGANISATION CHART





BANCO DE ESPAÑA  
PUBLICATIONS

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FINANCIAL ACCOUNTS OF THE SPANISH  
ECONOMY (bilingual Spanish/English edition)  
(annual)

THE SPANISH BALANCE OF PAYMENTS  
(in Spanish and English) (annual)

CENTRAL DE ANOTACIONES EN CUENTA  
(annual)

BOLETÍN ECONÓMICO (monthly)

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BOLETÍN ESTADÍSTICO (monthly)

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CENTRAL DE BALANCES. RESULTADOS ANUA-  
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NO FINANCIERAS (annual monograph)

CIRCULARES A ENTIDADES DE CRÉDITO

CIRCULARES DEL BANCO DE ESPAÑA. RECO-  
PILACIÓN (four-monthly)

REGISTROS DE ENTIDADES (annual)

ESTABILIDAD FINANCIERA (half-yearly)

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