ANNUAL REPORT 2003

BANCO DE ESPAÑA

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ABBREVIATIONS

AIAF	Association of Securities Dealers
BCBS	Basel Committee on Banking Supervision
BE	Banco de España
BIS	Bank for International Settlements
CBSO	Central Balance Sheet Data Office
CCR	Central Credit Register
CEMLA	Center for Latin American Monetary Studies
CEPR	Centre for Economic Policy Research
CNE	Spanish National Accounts
CNMV	National Securities Market Commission
CPI	Consumer price index
DGS	Directorate General of Insurance and Pension Funds
EAGGF	European Agricultural Guidance and Guarantee Fund
ECB	European Central Bank
ECCO	ECB External Communications Committee
ECOFIN	Council of the European Communities (Economic and Financial Affairs)
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
EONIA	Euro overnight index average
EPA	Official Spanish Labour Force Survey
ERDF	European Regional Development Fund
ESA 79	European System of Integrated Economic Accounts
ESA 95	European System of National and Regional Accounts
ESCB	European System of Central Banks
EU	European Union
EUROSTAT	Statistical Office of the European Communities
FASE	Financial Accounts of the Spanish Economy
FDI	Foreign direct investment
FIAMM	Money market funds
FIM	Securities funds
GDI	Gross disposable income
GDP	Gross domestic product
GFCF	Gross fixed capital formation
GNP	Gross national product
GVA	Gross value added
HICP	Harmonised index of consumer prices
IADB	Inter-American Development Bank
ICT	Information and communications technology
IGAE	National Audit Office
IMF	International Monetary Fund
INE	National Institute of Statistics
INVERCO	Association of Collective Investment Institutions and Pension Funds
LIFFE	London International Financial Futures Exchange
MEFF	Financial Futures and Options Market
MEFF RF	Fixed-income derivatives market
MEFF RV	Equity derivatives market
MFIs	Monetary financial institutions
MMFs	Money market funds
MROs	Main refinancing operations
NCBs	National central banks
NPISHs	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
PPP	Purchasing power parity
QNA	Quarterly National Accounts
SCLV	Securities Clearing and Settlement Service
SDRs	Special drawing rights
SMEs	Small and medium-sized enterprises
TARGET	Trans-European Automated Real-time Gross settlement Express Transfer system
TFP	Total factor productivity
ULCs	Unit labour costs
VAT	Value added tax
XBRL	Extensible Business Reporting Language

COUNTRY AND CURRENCY ABBREVIATIONS

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

BE	Belgium	EUR (euro)
DK	Denmark	DKK (Danish krone)
DE	Germany	EUR (euro)
GR	Greece	EUR (euro)
ES	Spain	EUR (euro)
FR	France	EUR (euro)
IE	Ireland	EUR (euro)
IT	Italy	EUR (euro)
LU	Luxembourg	EUR (euro)
NL	Netherlands	EUR (euro)
AT	Austria	EUR (euro)
PT	Portugal	EUR (euro)
FI	Finland	EUR (euro)
SE	Sweden	SEK (Swedish krona)
UK	United Kingdom	GBP (pound sterling)
JP	Japan	JPY (Japanese yen)
US	United States	USD (US dollar)

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.
Q1, Q4	Calendar quarters.
H1, H2	Calendar half-years.
bn	Billions (10^9).
m	Millions.
bp	Basis points.
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.

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COMPOSITION OF THE GOVERNING BODIES OF THE BANCO DE ESPAÑA

Overview

1 Introduction

During 2003 and in 2004 to date, the Spanish economy has continued its gradual expansion, in step with the notable improvement in the global economic situation and despite the relative flatness of the euro area. The same factors that made the Spanish economy considerably resilient to the previous phase of cyclical weakness have enabled it to face the international upturn that has been taking root and spreading over the past year from a relatively favourable position.

The pick-up has been led by the vigour of domestic demand in the United States and has progressively spread to most geographical areas, in a climate of diminishing uncertainty and recovery on international financial markets. However, certain major imbalances have been amplified, including most notably the swollen US budget and current-account deficits, whose necessary correction raises doubts about the soundness of the international recovery. In turn, certain factors of geopolitical instability persist.

The euro area's difficulties in joining the upturn, despite its maintaining financial conditions conducive to the expansion of spending, primarily reflect the persisting lack of consumer and investor confidence. This is related to the hesitant progress in introducing the necessary structural reforms and to the deterioration, in some countries, of public finances, which has called into question the effectiveness of the fiscal rules in the euro area. In keeping with the strategy designed by the Eurosystem, monetary policy has been adapted to the lessening of inflationary pressures – eased by the appreciation of the euro – and to the sluggishness of domestic demand by means of interest-rate cuts to historically low levels. Nonetheless, the support monetary policy can provide to bolstering the recovery depends on the contribution debt fiscal policies and structural reforms can make in improving agents' confidence.

The performance of the Spanish economy has been comparatively favourable, as manifest in its drawing closer once again to the average per capita income of the euro area countries. Underpinning this have been the expansionary impulses that continue to stem from the adoption of a regime of macroeconomic stability which, strengthened by budgetary discipline, has provided a sustainable environment of low interest rates. These conditions have continued to be propitious to expanding corporate and household expenditure, which has also been reinforced by high employment generation, the increase in purchasing power arising from lower inflation, the reduction in certain taxes, the rise in the value of real and financial assets, and the multiplier effects of investment spending on infrastructure.

The buoyancy of domestic demand has been driven by monetary conditions that have remained very generous given that the Spanish economy is ahead in the cycle, and that have only been tempered by the appreciation of the euro. Private-sector borrowing continued to expand at a very high rate, showing signs of even accelerating in the case of financing to households, which has contributed to sustaining house-price rises. Private consumption and investment in construction have remained the main drivers of the expansion. Meantime, investment in equipment, though it has emerged from its contractionary phase, has grown sluggishly and hesitantly, while net external demand has continued to act restrictively on growth. In parallel, the inflation rate has fallen as a result of the effects of the appreciation of the euro and the reversal of some of the phenomena that had exerted upward pressure in the past, thereby allowing differentials with the euro area countries to be cut.

The course followed by the Spanish economy in the recent past attests to its having the appropriate bases for continuing real convergence over the coming years. Nonetheless, the prolongation of a growth pattern based on low interest rates remaining in force over a long period of time, with the composition of demand underpinned above all by private consumption and construction, may pose certain risks in respect of long-term continuity which economic policy should forestall sufficiently in advance. These risks are mainly related to the financial position of the private sector – particularly households – which, following the rapid growth of its level of debt, has become more sensitive to changes in interest rates and in the prices of real and financial assets. The risks also pertain to competitiveness, which may be affected in the long run if productive investment and technological innovation fail to become more dynamic or if the persistence of rigidities in certain markets were to hamper cost and price formation.

To ensure the long-term sustainability of the current favourable growth prospects, economic policy should promote a move towards a growth pattern in which productive investment and exports have a greater weight, contributing further to the financial equilibrium of households and firms, and to reinforcing competitiveness. In this connection it will be vital to strengthen the stabilising role of budgetary policy and push through structural reforms geared to increasing the economy's flexibility and efficiency.

This chapter, which gives an overview of recent economic developments, is divided hereafter into three sections. Section 2 tackles the challenges the euro area faces to better harness the international upturn. Section 3 analyses the foundations of the Spanish economy's new expansionary phase. And the final section addresses what is needed to project into the long run the favourable growth prospects of the current situation.

2 European challenges in the face of the global economic expansion

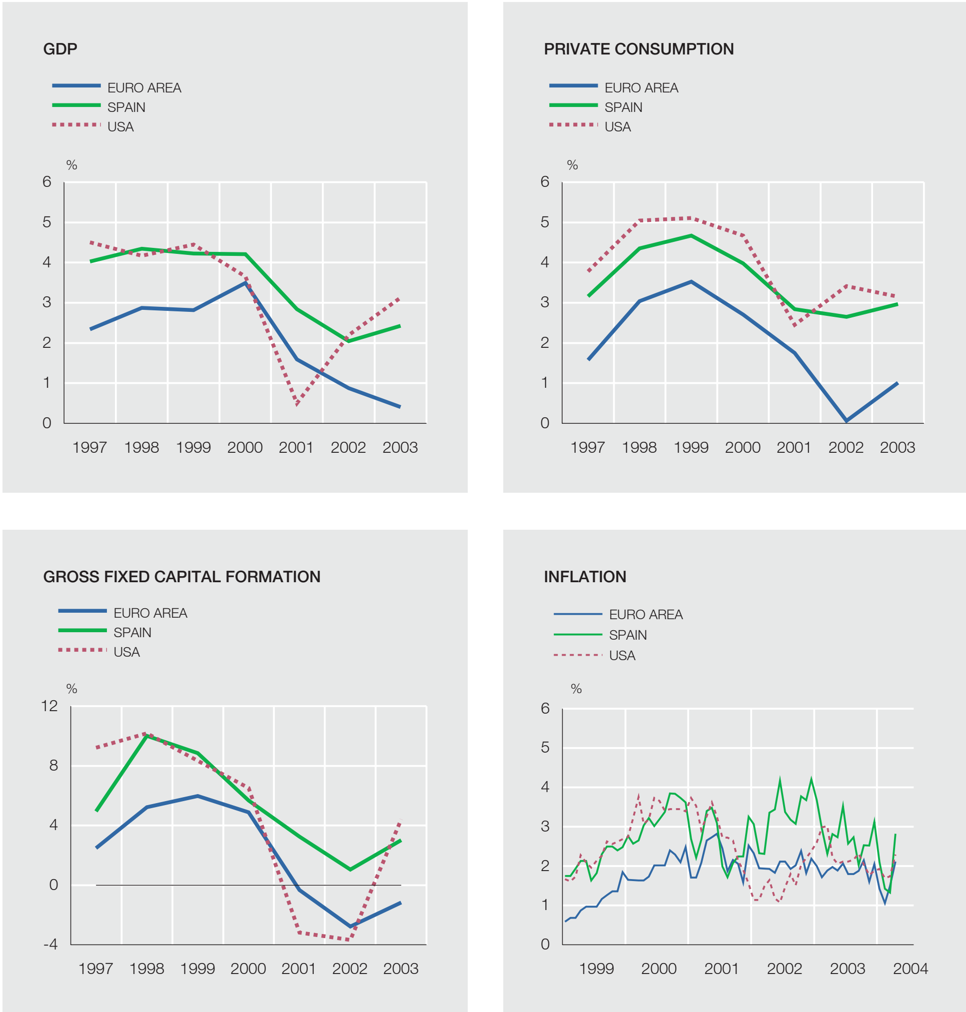
In 2003 the recovery in the world economy initiated the previous year firmed and spread to the main geographical areas, with the exception of the euro area, which posted growth of only 0.4% (see Chart I.1). The favourable performance of the world economy was linked to the abatement of international political uncertainty, to the adoption of expansionary economic policies and to the sound performance of the financial markets. In connection with the latter, stock market indices rose significantly following the losses incurred in the preceding two years, and yield spreads on corporate bonds narrowed, reflecting the improved outlook for corporate earnings. Likewise, the interest rates on public debt held at very low levels, following a similar trajectory in Europe and the United States, despite the changes in exchange rates during the year.

The containment of inflation was a common feature to all the industrialised economies, despite the increase in the cost of the main commodities. The factors behind this behaviour are, however, not the same in each case. Thus, in the United States and the more dynamic Asian economies, the easing off of price rises was particularly assisted by surging productivity. Conversely, in Europe, the appreciation of the euro played a more prominent role against a background of sluggish demand. In Japan, deflationary tendencies persisted, albeit less sharply so than in previous years.

The US economy sustained relatively high growth of slightly over 3%. Contributing to this was the ongoing expansion of private consumption, impelled by tax cuts and intense mortgage refinancing, which placed the household saving ratio at a very low level. In the second half of the year investment rebounded significantly, following a long period of continuous reductions in the stock of plant capacity. Employment, however, remained fairly weak. Productivity was substantially buoyant throughout the year. The increase in aggregate demand drove imports,

GDP, PRIVATE CONSUMPTION, GFCF AND INFLATION (a)
Percentage change on year ago

CHART I.1



SOURCES: Eurostat and national statistics.

a. Percentage change on year ago of harmonised prices in Spain and the euro area, and of the consumer price index in the United States.

thereby contributing to the expansion of other economies, especially in south-east Asia, which benefited from the maintenance of relatively depreciated exchange rates in real terms.

The emerging economies contributed substantially, albeit heterogeneously, to the acceleration in global growth in 2003. Asia – and the Chinese economy in particular – was the most dynamic region. There was a marked expansion of over 9% in China, entrenching the trend of recent years which is enabling this country to assume an increasingly important role in international trade and finance. Against the background of highly expansionary demand-side policies, Japanese GDP also posted a far higher increase last year than the average for the past decade, assisted by the improved financial health of its business sector. Adding to the continuing sound performance of the external sector seen in previous years was a recovery in investment, which boosted domestic demand, while private consumption remained slack owing to the fact that deflationary trends have been overcome only to a limited extent. In any event, the structural weaknesses assailing the Japanese economy add elements of vulnerability to its incipient recovery. The greater buoyancy of the industrialised economies and continuing low interest rates also provided for an improvement in the export markets and in the financial conditions of the Latin-American economies, making for a pick-up in the region, although the patterns from country to country remain very diverse.

Despite the favourable performance of the main economies, with the exception of the euro area, the pattern of recovery in the world economy includes certain factors of risk for its sustainability. Thus, the economic dynamism of the United States in recent years has been driven by factors whose expansionary effects cannot be maintained continuously. This is the case of the exceptional easing of monetary policy and of tax cuts. The deterioration in household and public-sector balance sheets, which has accompanied the operation of these factors, has been manifest in an increase in the current-account deficit to a level of over 5% of GDP. The borrowing requirements of the US economy cannot continue growing indefinitely, so the prospects of global economic growth taking root will depend on how this imbalance is corrected.

In this respect, the events witnessed on international markets since the second half of 2003 have highlighted the difficulties of absorbing, in an orderly fashion, global imbalances exclusively via changes in exchange rates or in the interest rates quoted on debt markets. The exchange rate of the dollar depreciated significantly in 2003 and in the opening months of 2004, principally in its bilateral relationship with the euro and, to a lesser extent, with the yen, while it has remained relatively stable against the other south-east Asian countries' currencies, irrespective of their exchange rate regime. The asymmetry in the price of the dollar has curtailed its impact on the correction of the imbalances between the main areas. This is because the US deficit is concentrated in countries with highly dynamic economies whose currencies have scarcely appreciated, while the economies whose competitiveness has most worsened – such as the euro area – are encountering difficulties growing and are maintaining a relatively balanced current-account position. Adjustment by this means restricts the possibilities of an orderly correction of global disequilibria and might hinder continuing worldwide growth.

In parallel, despite the appreciable increase in US demand for external funds to offset the domestic saving shortfall and, in particular, to finance the swollen budget deficit, long-term interest rates held at very low levels until 2004 Q2, when they began to rise. This paradoxical behaviour is due in part to most of the south-east Asian countries pursuing a policy to defend their exchange rate stability; in the process they built up strong reserves, having invested particularly in US Treasury instruments. Admittedly, this exchange rate policy has made the financing of the US trade deficit easier. But it also hinders its correction, since the purchase of US securities by these central banks under attractive conditions for the issuer ultimately finances their exports to the United States. However, it would not seem likely that this singular *modus operandi* can be maintained indefinitely. If the current-account deficit is not corrected, it cannot be ruled out that the attractiveness of the United States as a destination for public or private investment may diminish, which might ultimately disrupt international foreign exchange and financial markets.

It is difficult, under the current conditions, to ensure the orderly workings of the markets and the gradual correction of imbalances if headway is not made in containing US public-sector borrowing requirements; in adopting policies that provide in all countries for adjusting exchange rates to the fundamentals of each economy; and in overcoming the obstacles that inhibit growth in the least dynamic areas.

The euro zone area is among those areas experiencing most difficulty joining the world economic upturn. The main cause of its persistently sluggish economic activity is the slackness of internal spending, weighed down by the successive declines in productive investment since 2001 and subdued private consumption, which grew by scarcely 1% last year. Moreover, the appreciation of the euro has impacted the area's net external sales, particularly in 2003 Q4, after several years' losses in export share in the global market.

The depressed tone of internal demand contrasts with the maintenance of conditions which are, in principle, propitious to its expansion. Thus, adding to low nominal and real interest rates (short- and long-term alike), which held close to their lowest levels for the past decades, was the notable rally last year on stock markets and the narrowing of corporate bond yield spreads. At the same time, household disposable income was bolstered by the behaviour of employment, which was more favourable than in other phases of deceleration, and by the tax cuts applied in certain countries. Along these same lines, the improved international environment has contributed to increasing European companies' external demand, alleviating the contrary effect of the appreciation of the euro.

There are, however, some specific factors which might explain in part the slackness of consumption over the past two years. One such case is households' perception of inflation being higher than it really is, which continues to reflect the extended influence of the reactions prompted by the changeover to the euro. Likewise, the fall in investment has been linked to poor corporate earnings and to the restructuring processes undertaken by certain major companies. Yet these factors alone do not suffice to explain the scant momentum of private-sector spending when relatively favourable conditions are in place, a fact which evidences the important role weak consumer and investor confidence is playing. In this respect, the increase in the European household saving ratio in recent years is telling. Given the lower opportunity cost of consumption and the soundness of the household wealth position, this behaviour appears to indicate above all households' caution due to the uncertainty with which they perceive the future course of their income. The sluggishness of the components of business confidence indices in respect of future business expectations reflects, despite the recent improvement, the presence of a similar phenomenon in the case of non-financial corporations.

It is not easy to pinpoint the factors underlying economic agents' weak confidence, which is restricting the European economies' capacity to react even at a time at which international buoyancy is on the up. The benefits Europe should obtain in the coming years as a result of a deeper and broader unified economic space, without barriers hampering the efficient allocation of resources and with a common currency across much of the area, will not be perceptible in their entirety for some time, coming to light at different times in different countries. This prompts a degree of uncertainty among economic agents and no doubt affects their decisions. But there are also other factors linked to structural fragility that are eroding expectations that income from wages and from capital can increase continuously. Hence, while in recent years wage restraint and the sound performance of employment have been observed, the workings of the labour markets remain beset by rigidities in wage formation and in employment adjustment that are eroding its efficiency. Likewise, and more generally, the lack of flexibility in certain sectors of the European economy, particularly compared with the United States, encourages inertia in the behaviour of both price and quantity variables. And although these tend to smooth the scale of cyclical fluctuations, they ultimately have an adverse bearing on productivity growth, impairing the efficiency and growth potential of the economy (see Box I.1).

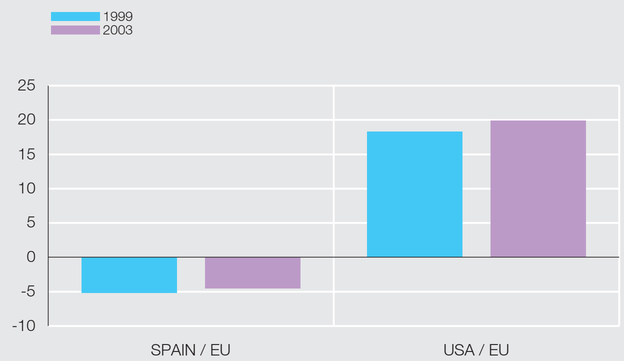
Monetary policy has adjusted to the gradual reduction in inflationary pressures and to the situation of weak demand. The rates on the ECB's main refinancing operations fell during 2003 by 75 bp, having stood since June at 2%. Given the actual rate of inflation and the expectations about its future course as reflected in surveys and indexed financial instruments, the situation prevailing since then points to real short-term interest rates practically at zero. That means that the monetary policy stance is of a far more expansionary nature than in similar cyclical phases in almost all the countries currently making up the euro area. However, when – as at present – the economy's lack of momentum is largely due to gloomy expectations and to persisting structural problems, the monetary authorities' capacity to influence agents' spending deci-

To achieve full employment in 2010 and strengthen social cohesion, the strategic goal set by the European Union (EU) in the Lisbon European Council of March 2000 was “to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”. To attain this goal, the priorities set were to implement better policies for the information society and R&D, step up structural reform for competitiveness and innovation, complete the internal market, invest in human capital and combat social exclusion, all in a sound macroeconomic framework. These broad guidelines were translated into quantitative targets for 2010 set in the Lisbon European Council itself and in subsequent summits, including most notably that in Barcelona in 2002. Although in recent years the European authorities have renewed these commitments, the progress to date has been clearly insufficient and only a determined reform drive will take the EU nearer to meeting these targets by 2010.

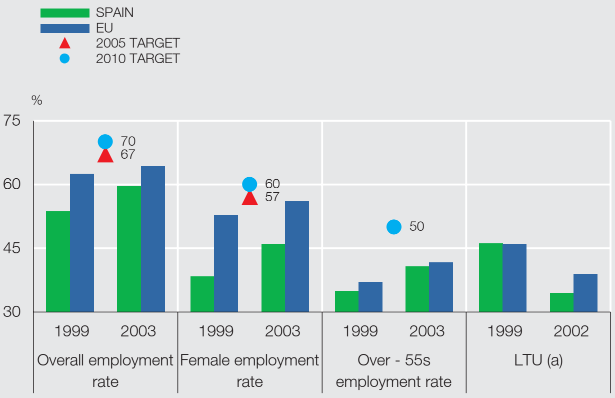
In the labour market, diverse goals were set with a view to raising the employment rate to 70% by 2010. In the case of women and the population aged 55 to 64, the employment rate targets were 60% and 50%, respectively. The progress to date has been uneven in terms of both the goals and the countries. Achievements include the creation of 6 million jobs since 1999, with an outstanding contribution from Spain, the country where jobs have grown most strongly (up by 1.4 million). Employment has performed relatively favourably in the recent economic slowdown, perhaps partly because of the flexibility that has gradually been introduced into European labour markets. Across the different cohorts, there have been notable improvements in long-term unemployment and in the female employment rate (see Chart 2). In Spain, moreover, mention should be made of the significant increase in the employment rate of those aged over 55, where the gap between Spain and the EU average has practically been closed, although the area is far from its 50% employment rate goal for this group. Despite these improvements, European employment growth continues to be excessively weak.

Regarding the single market, various strategic network markets (telecommunications, postal services, electricity, gas and rail freight) have been totally or partially opened up to competition. In this respect, Spain’s relative situation is positive, especially in the energy sector, since electricity and gas were completely opened up to competition on 1 January 2003, i.e. somewhat more than four-and-a-half years earlier than the deadline agreed at European level.

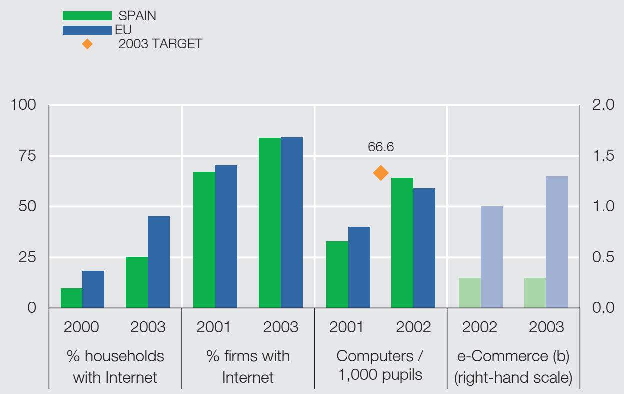
1. PRODUCTIVITY GAP WITH RESPECT TO EU



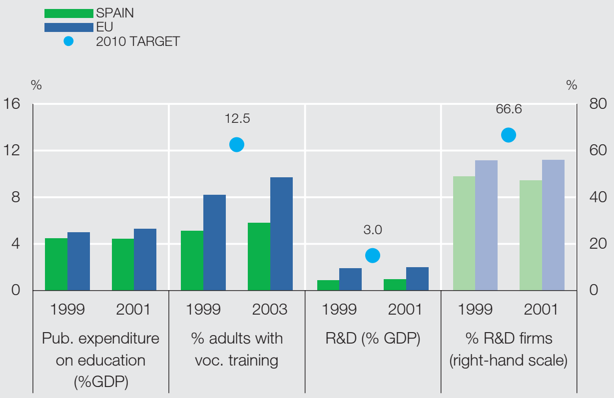
2. LABOUR MARKET



3. INTERNET PENETRATION AND ICT USAGE



4. INVESTMENT IN KNOWLEDGE SECTOR



SOURCE: European Commission.

a. Incidence of long-term unemployment rate.
b. Proportion of corporate revenue from electronic commerce.
c. Percentage of adults (25-64) who have received training in the four weeks before the survey.

AN ASSESSMENT OF THE PROGRESS MADE BY THE EU AND SPAIN ON THE LISBON AGENDA (CONT'D)

BOX I.1

As regards improvements in the diffusion and use of information and communication technologies and in investment in knowledge sectors (research, innovation, education and training), progress has been modest (see Chart 3 and 4). The commitment to raise R&D spending to 3% of GDP, two-thirds of which should be financed by the private sector, is far from being achieved. Progress has also been limited in public spending on education and in Spain expenditure in this area has even fallen off. Given the target set for 2010, the progress made in adult participation in learning and continuous training has also been insufficient. As regards the information economy, the penetration of the Internet in the various spheres of society has proceeded apace in recent years, so that now practically all firms and schools and a not insignificant proportion of households are connected.

The European authorities agree that the strategy of reform designed in the EU is the right way to increase social welfare in the medium and long term. Delays in reform should therefore be avoided by exercising stricter control over the degree of implementation of the recommended measures. This, however, is complicated given the difficulty in obtaining accurate statistics on the phenomena it is wished to measure. In this regard the Brussels European Council in March 2004 highlighted the importance of monitoring the progress by the various countries in implementing reform and of having them share their experience so as to identify the best practices in different fields. This would also help to identify the areas in which reform is most pressing, which will be very useful in 2005 when the first in-depth assessment is made of the progress in achieving the goals on the Lisbon agenda.

sions is limited. What does then become very important is maintaining confidence in price stability, since this is a vital ingredient for achieving sustained growth.

The overall fiscal policy stance was practically neutral, whereby worsening public finances primarily reflected the deterioration in cyclical conditions. Nonetheless, in some European countries this deterioration signified a failure to comply with the budgetary stability rules and highlighted the constraints on the stabilising potential of fiscal policy if the starting point for action is an unhealthy fiscal position. The public budget is generally an effective tool for smoothing cyclical fluctuations through the operation of its built-in stabilisers. In the European countries, these mechanisms are reinforced by the progressivity of tax systems and the weight of social spending of a cyclical nature. However, expansionary discretionary conduct beyond these mechanisms may have limited influence on economic activity, especially when a climate of uncertainty over the future course of income prevails. In this respect, the outcome of the recent deterioration in budget deficits and public debt coupled with the growing perception of the difficulties faced by the public pension and health systems in withstanding the challenges posed by population ageing may be as follows: that intentioned expansionary actions contributing to the generation of budget deficits are received with mistrust and, as has occasionally occurred, encourage precautionary saving more than they do consumption.

The current European situation illustrates the importance of prioritising the attainment of balanced budgets that allow the automatic stabilisers to operate, without incurring excessive deficits. This should moreover be considered as a common objective of the euro area member states, since not all the costs associated with the uncertainty generated by fiscal indiscipline are borne exclusively by the states whose governments induce or tolerate it. Therefore, it is particularly important to maintain fiscal rules, such as those in the Treaty on European Union and in the Stability and Growth Pact, and that all countries should observe the procedures laid down, this notwithstanding the potential study of formulas to refine the economic content of the rules in force or their application in practice.

The constraints on demand-side policies make it all the more necessary to introduce reforms that give flexibility to the European economy's adjustment mechanisms, that are conducive to an efficient use of available resources and that provide the right incentives to develop and refine productive processes. These reforms are not only needed to increase the economy's potential output, but also to reinforce confidence and thereby indirectly support agents' readiness to consume and invest. The pressing need for these reforms contrasts with the muted moves being made to implement them. Over the past year some governments have made headway in approving substantial legal reforms, particularly in the labour market, health and pensions areas. However, the pace at which the challenges identified at the Lisbon and Barcelona European summits are being pursued is, in general, clearly insufficient to successfully meet the objectives set.

Possibly, however, the improvement in the economic climate will provide a more conducive setting for reform drives. Indeed, in the second half of 2003 the euro area economy gathered steam and, in Q4, this saw a recovery in gross fixed capital formation which increased for the first time after a lengthy period of successive declines. This performance mainly reflects favourable developments in the external environment and progress in the restructuring of corporate balance sheets. In this connection, companies might already be achieving a financial position that will allow them to take advantage of low borrowing costs to increase their investment. Foreseeably, if these developments are accompanied by a gradual improvement in consumer and business confidence and there is no disruption on foreign exchange markets, the recovery in the euro area initiated in mid-2003 may firm in the second half of 2004. The data for 2004 Q1 confirm this path of recovery.

In any event, at what is a complex juncture institutionally speaking, Europe must address the far-reaching changes induced by the momentum of globalisation and by the advances in European integration, the latest expression of which has been the accession of ten new Member States in May this year. This historical event will certainly entail significant changes in the EU's current economic and political framework. In the economic field, the enlargement should provide for greater dynamism based on the changes brought about by the harnessing of new comparative advantages and a more efficient allocation of resources within a bigger single market. These changes will mean further steps in the delocalisation of certain types of activity, a process already under way. To harness the opportunities arising and to assimilate such extensive changes smoothly, Europe must promote policies that equip its economies with greater levels of flexibility and competitiveness, pushing through the structural reforms needed to successfully tackle the challenges posed by the single market. In parallel, enlargement will require a strengthening of the rules governing economic decision-making in the EU, and appropriate clarification of the role each European institution must play.

3 The foundations of the Spanish economy's new expansionary phase

After reaching a relatively mild cyclical trough in the second half of 2002, the Spanish economy moved into 2003 on a new expansionary path, underpinned by the sound growth of domestic demand. Although the recovery is also proving to be of moderate intensity, it contrasts with the environment of sluggish internal demand and slowing activity that characterised the European economy for much of last year. As a result, the growth differential between Spain and the euro area widened considerably (see Chart I.1). In parallel, the reduction in the Spanish inflation rate has seen the inflation differential with the euro area narrow, alleviating the problems associated with its persistence.

In 2003 Spanish GDP increased by 2.4%, almost 0.5 pp up on the previous year, while the growth of domestic demand was 3.3% (see Table I.1 and Chart I.2). Both the slowdown in GDP and in domestic demand witnessed in 2001 and 2002 and the recovery seen last year were related to the cyclical behaviour of investment in equipment and of exports of goods and services, the latter being linked in turn to developments in the external environment. Private consumption and investment in construction, for their part, posted more stable growth rates during this period. Indeed, these two components continued to be the basic underpinning of the expansion of output in 2003, with general government demand also proving dynamic. The expansion of activity has remained characterised by high employment creation.

MAIN INDICATORS OF THE SPANISH ECONOMY

TABLE I.1

%

	1998	1999	2000	2001	2002	2003
REAL CONVERGENCE INDICATORS: (Spain/EU) (a)						
Per capita GDP at current prices (in EU-15 PPPs)	81.0	83.5	83.4	84.3	86.1	87.4
Per capita GDP (b)	82.0	82.9	83.0	83.6	84.2	85.3
Apparent labour productivity	*94.6*	*94.2*	*93.4*	*93.4*	*93.5*	*93.5*
Employed as proportion of total population	*84.4*	*85.7*	*86.5*	*86.9*	*87.4*	*88.6*
Population aged 16-64 / total population	*102.7*	*102.7*	*102.9*	*103.0*	*103.0*	*103.0*
DEMAND AND OUTPUT AT CONSTANT PRICES (c)						
Private consumption	4.4	4.7	4.0	2.8	2.6	3.0
Government consumption	3.7	4.2	5.1	3.6	4.4	4.6
Gross capital formation	10.7	9.0	5.3	2.9	1.1	3.2
Fixed capital in equipment	*14.5*	*7.8*	*4.7*	*-1.2*	*-5.4*	*1.9*
Fixed capital in construction	*7.8*	*9.0*	*6.1*	*5.8*	*4.2*	*3.7*
Exports of goods and services	8.2	7.7	10.0	3.6	0.0	4.0
Imports of goods and services	13.2	12.6	10.6	4.0	1.8	6.7
Gross domestic product	4.3	4.2	4.2	2.8	2.0	2.4
EMPLOYMENT, WAGES, COST AND PRICES (c)						
Total employment	4.1	3.7	3.6	2.4	1.5	1.8
Compensation per employee	2.7	2.7	3.7	3.8	3.9	4.2
Unit labour costs	2.5	2.1	3.1	3.4	3.3	3.6
GDP deflator	2.4	2.8	3.5	4.2	4.4	4.2
Consumer price index (12-month % change)	1.4	2.9	4.0	2.7	4.0	2.6
Consumer price index (annual average)	1.8	2.3	3.4	3.6	3.5	3.0
Consumer price differential with the euro area (HICP) (d)	0.7	1.1	1.2	1.0	1.3	1.0
SAVING, INVESTMENT AND FINANCIAL BALANCE (e)						
Resident sectors: saving (f)	23.5	23.6	23.3	23.5	23.9	24.0
General government (f)	*0.3*	*2.3*	*2.3*	*3.0*	*3.4*	*3.9*
Resident sectors: investment	23.3	24.6	25.7	25.7	25.5	26.0
General government	*3.3*	*3.5*	*3.1*	*3.3*	*3.5*	*3.5*
Resident sector: domestic net lending (+) or net borrowing (-)	0.2	-1.0	-2.5	-2.2	-1.6	-2.0
General government	*-3.0*	*-1.2*	*-0.9*	*-0.4*	*0.0*	*0.3*
General government gross debt	64.6	63.1	61.2	57.5	54.6	50.8
MONETARY AND FINANCIAL INIDICATORS (g)						
ECB weekly intervention rate	—	2.7	4.0	4.3	3.2	2.3
Ten-year government bond yield	4.1	3.7	5.1	4.3	3.9	2.8
Synthetic bank lending rate	5.9	4.9	5.9	5.8	4.9	4.0
Madrid Stock Exchange General Index (DEC 1985 = 100)	817.7	894.4	994.8	853.4	723.6	706.4
Dollar/euro exchange rate (h)	1.1	1.1	0.9	0.9	0.9	1.1
Nominal effective exchange rate vis-à-vis developed countries (i)	100.4	98.7	95.8	96.3	97.1	100.0
Real effective exchange rate vis-à-vis developed countries (j)	99.4	99.1	97.7	98.9	101.4	106.5
Nominal effective exchange rate vis-à-vis the euro area (i)	100.1	100.0	100.0	100.0	100.0	100.0
Real effective exchange rate vis-à-vis the euro area (j)	99.1	100.4	102.3	102.9	104.2	106.0
Cash and cash equivalents	12.1	12.7	4.4	6.8	10.5	12.1
Liquid assets (k)	1.7	2.4	8.1	9.6	8.6	8.7
Household total financing	19.3	19.6	17.3	12.3	15.6	18.7
Non-financial corporations: total financing	14.5	19.4	18.7	18.1	13.3	14.2

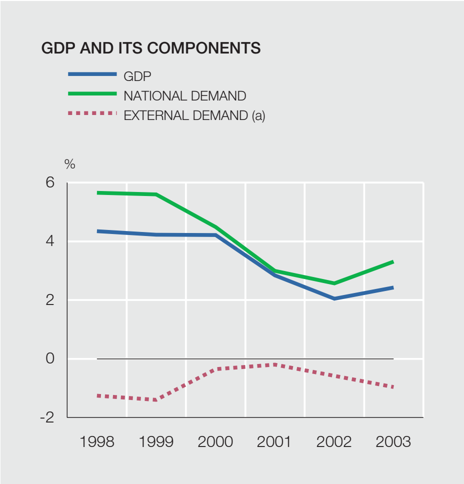
SOURCES: INE, Intervención General del Estado and Banco de España.

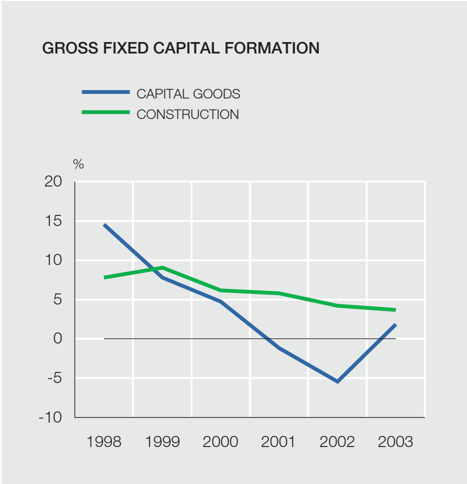
a. EU=100.
b. Calculated using series at constant 2002 prices in EU PPPs.
c. Rates of change.
d. Differentials calculated using the Eurostat series with information to December 2001, before methodological changes were introduced.
e. Levels as percentages of GDP.
f. Includes net capital transfers received.
g. Annual average levels for the Stock Exchange General Index, 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.

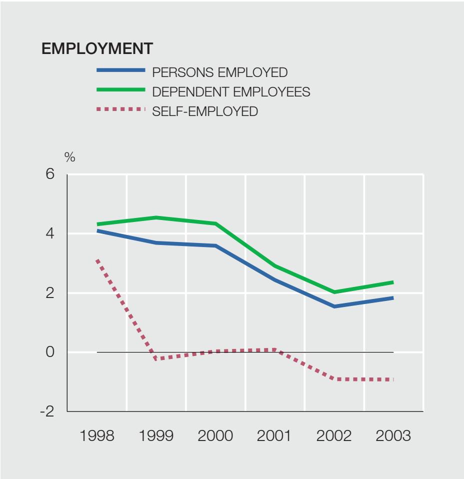
GDP, GFCF AND EMPLOYMENT

CHART I.2

Percentage change on year ago







SOURCE: INE

a. Contributions to GDP growth

The factors underlying the renewed growth of the Spanish economy have largely been a continuation of those that cushioned the slowdown and of those, in sum, that have upheld its comparatively high growth since EMU entry. The expansionary effects arising from the move to a regime of macroeconomic stability, which combines the maintenance of a low inflation rate and moderate inflation expectations with low interest rate levels and a healthy budgetary position, have continued to operate.

Certain features of the recent economic situation have helped prolong the influence of these factors during 2003 and in 2004 to date. Thus, adding to the interest rate cuts applied by the Eurosystem was the rise in households' financial wealth, induced by the rise on stock markets as from the summer. Both factors contributed to upholding what was a more marked expansionary tone of monetary and financial conditions in Spain – owing to its higher inflation rate and the fact it is ahead in the cycle – than in the euro area as a whole. And this was only partly offset by the appreciation of the euro. Reflecting the generosity of these financial conditions was credit to households and firms, which continued growing at a very high rate. This was especially so for households, where the pace of increase stepped up, while lending to companies eased to some extent, although still posting significant increases.

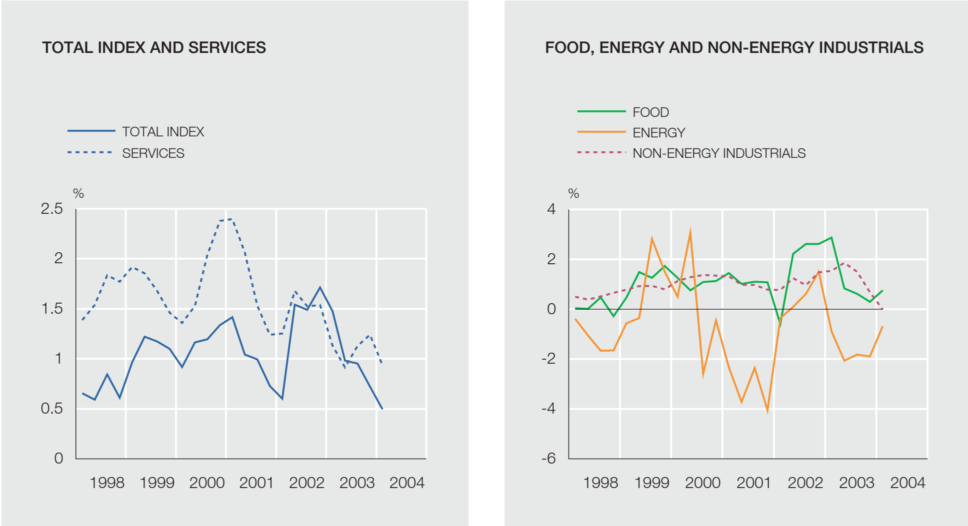
During last year fiscal policy continued to be a factor of macroeconomic stability. After a balanced budget was attained in 2002, the general government accounts posted a surplus of 0.3% of GDP in 2003. There was also a fresh reduction in the general government debt ratio to 50.8%, thereby providing for most comfortable compliance with the commitments entered into under the Stability and Growth Pact. These results were mainly achieved thanks to a fresh reduction in interest charges on public debt and to high revenue takings for certain taxes, essentially indirect taxes. The stabilising effect of these factors was compatible, however, with measures aimed at upholding economic activity. The personal income tax reform fuelled the growth of household disposable income, while government consumption and public investment continued to increase apace, albeit at a lower rate than in previous years in the case of investment.

One of the features that has added most soundness to the expansion in domestic demand in past years has been the intensity of employment creation. Last year, heightened economic buoyancy also translated into a bigger increase in employment, which grew by 1.8%, 0.3 pp up on 2002. The characteristics of the employment generated illustrate some of the features accompanying its expansion. The number of permanent-contract wage-earners increased at a similar rate to that of previous years, while the cyclical upturn gave fresh momentum to temporary employment, where hiring arrangements are more flexible. For the year on average, however, temporary employees as a proportion of total employees dipped slightly to 30.6%. The behaviour of employment also differed greatly across the productive activities, with the adjustment in employment in manufacturing contrasting with its expansion in services. Labour supply continued to increase notably, as a result of the rise in the population of working age – with a significant contribution by immigration – and, to a greater extent, of the increase in the participation rate, especially among females. Notwithstanding, the unemployment rate, which had risen in 2002, ceased to move on a rising trend and turned downwards, posting an average level of 11.3% of the labour force.

This notable job creation coincided with a rise in wages. Influential in this latter respect was the relatively high inflation rate with which the previous year ended – around 4% – and the activation of wage indexation clauses which, as is known, introduces a degree of upward inertia. Average wage settlements in 2003 stood at 3.5%, compared with 3.1% the previous year and above the reference of 2% adopted in the collective bargaining agreement for the year. This behaviour, once the effect of indexation clauses and other labour costs was incorporated, gave rise to an increase in average labour costs of around 4%.

Despite the acceleration in wage costs, the inflation rate underwent, as earlier indicated, a notable downward correction in 2003 which continued into early 2004. It has rebounded in recent months, in step with the rise in oil prices against the background of a somewhat more stable euro. The annual average increase in the CPI fell by 0.5 pp last year (to 3%), but the cut in its 12-month rate in December was even sharper, ending the year at 2.6%, almost 1.5 pp down on the end-2002 figure. Various factors came into play in this adjustment. Some were the outcome of the stripping out of the index of temporary increases in 2002, such as the one-off upward effects accompanying the introduction of the euro in the first half of 2002, or past increases in certain administered prices, such as that of tobacco. Others reflected the influence of factors conducive to containing price rises, such as the easing of pressures on food prices, the slowdown in energy prices brought on by the trend in oil prices and, generally, the restraining influence of the appreciation of the euro on the price of imports and of other goods subject to competition from foreign products. Indeed, the decline in import prices helped square a moderate trend in final prices with an acceleration in unit labour costs, without unit operating margins being squeezed.

SPAIN/EURO AREA INFLATION DIFFERENTIALS (a) CHART I.3



SOURCES: Eurostat and national statistics.

a. Percentage change on year ago of harmonised prices in Spain and the euro area, and of the consumer price index in the United States.

The improvement in inflation allowed for a narrowing of the inflation differential with the euro area by 1 pp, approximately, to 0.7 pp at end-2003, the level at which it was holding last April (see Chart I.3). Although the main factors providing for the containment of inflation were common to the whole area, they bore more on Spain, which was starting from a higher rate. Further, in certain countries in the area there were tax rises (on tobacco and on certain energy products) which were not matched in Spain, and the heavy pressures in respect of food prices that arose in Europe mid-year were more tempered in Spain. In turn, the appreciation of the euro and the decline in oil prices in euro may have had a bigger immediate effect via the energy component of the Spanish CPI. In any event, the reduction in the differential has been chiefly in tradeable goods, which would be a reflection of the greater convergence of inflation rates with the euro area in products with more open markets and, therefore, a growing sensitivity to competitive forces. This behaviour tends to alleviate the potential problems of competitiveness that may arise from the persistence of the inflation differential and mitigates one of the biggest risks facing the Spanish economy in the euro area. However, the improvement in the differential will not hold if it is based above all on a squeezing of business margins in the sectors most exposed to competition.

The foregoing environment – one of job creation, wage rises, the correction of the inflation rate, lower direct taxes, low interest rate levels and rises on the securities markets – provided the necessary base for household expenditure to expand again in 2003. Disposable income grew by 2.8% in real terms, somewhat down on the increase in 2002. But the mild recovery in financial wealth, which became more robust in the second half of the year, and the increase in non-financial wealth, which grew at a similar rate to that of the two previous years, driven by the sizable growth of house prices, supported consumer spending. This variable increased by 3%, 0.4 pp up on the preceding year, meaning the saving ratio held stable. Residential investment spending also posted vigorous growth and, although household lending capacity picked up somewhat, the financing extended to this sector grew once again at a very high rate, entailing a fresh increase in the household debt ratio.

The increase in residential investment and, above all, the momentum of civil engineering works continued to uphold the growth of investment in construction which, though somewhat less buoyant than the previous year, stood at 3.7% in 2003. Investment in equipment picked up, mainly as a result of impetus in the second half of 2002, and it posted an increase of 1.9% in 2003, compared with an estimated decline of 5.4% the previous year. Although this profile is consistent with the upturn in the economy, the period of sluggish investment in equipment dating back to 1999-2000 has not yet been put behind, and such weakness has highlighted the muted response by this spending component to what are relatively favourable monetary, financial and demand-growth conditions.

The scant investment momentum of prior years was linked to the internationalisation drive by Spanish corporations, which shifted part of their capital spending abroad, mainly to Latin America. Subsequently, this was exacerbated by the political and economic instability characterising the international stage from end-2001, which checked corporate expansion plans in a generalised fashion. The debt taken on by companies to finance foreign investment – and other types of expansion programmes such as those undertaken in certain network industries – and the scant return obtained, to date, on some of these sizable investments obliged corporations to pursue restructuring processes, which had an adverse bearing on capital goods purchases. In 2003 the effects of these processes began visibly to take the form of greater funds generated and lower financing requirements, but the improvement in growth expectations, diminishing uncertainty and favourable financial conditions did not make for a sufficiently strong rise in corporate investment. The appreciation of the euro may have had a contractionary effect, but this would not appear to be sufficient to account for the weakness of the recovery. Accordingly, it may be deduced that adjustment processes are not over and that certain factors of uncertainty remain.

As regards Spanish investment abroad, the effects of the crisis in certain Latin American economies, which put the internationalisation model followed by the major Spanish companies to the test, have been confined to reduced earnings in the case of the companies involved. These had to withstand substantial provisions and capital losses. However, no important effects on trade flows have been detected, there has been no comparative deterioration in Spanish capital market conditions and nor has the speculation about a possible reduction in the availability of domestic financing materialised. Generally, the companies concerned have continued to grow at a high rate, in such a way that, with the worst of the crisis behind, they are in a healthy financial position, having retained their regional diversification strategy.

Finally, the negative contribution of net external demand to GDP growth in 2003 –which, at 1 pp, was more intense than in 2002 – was accompanied by a widening of the trade deficit and the nation's borrowing requirement, which stood at 2% of GDP. The performance of the external sector came about despite the fact that goods exports picked up significantly, leading to an increase in their market share in both the euro area and in other markets. Outside the euro area, exporting firms pursued a policy of cutting their prices in euro strongly to offset the exchange rate appreciation, while in the euro area, where export prices were more stable, the favourable results were linked to the sales of specific products such as cars. The rise in merchandise sales abroad was countered, however, by the flatness of tourism receipts in real terms, following their heavy fall-off in 2002, and by the increase in imports, whose domestic penetration capacity stepped up on the back of their having gained in competitiveness.

Overall, the Spanish economy continued moving in 2003 towards a gradual expansion. Ahead in the cycle, it has been increasingly taking up the international economic recovery, exhibiting greater vigour than the euro area. The trends to date in 2004 confirm the prolongation of this trajectory, with moderately higher growth rates underpinned by robust consumption and construction and greater opportunities for regenerating investment in capital goods, though this latter variable remains subject to uncertainty. Exports, meanwhile, have so far proven able to withstand the appreciation of the euro without losing market share. The terrorist bombings of 11 March, though they may have been reflected in the odd spending component such as tourism, are not likely to have a lasting effect on the foregoing trends. Turning to prices, the process of slowdown was interrupted as a result of the pressure being exerted by imported commodity prices (energy and non-energy alike). It should be sought to ensure that these price increases, which are largely transitory, are not ultimately incorporated into the economy's income formation (wages and margins) process.

4 The determinants of sustainable economic growth

Recent developments in the Spanish economy confirm the existence of solid foundations for gradual expansion over the next few years, albeit probably at a more moderate pace than during the last cycle, assuming that there are no unexpected shocks. However, certain characteristics of the current pattern of growth, based on a sharp reduction in financial costs and primarily driven by the strength of consumption and construction, pose certain risks to the economy's dynamism. A model of expansion of these characteristics, when perpetuated over time, may lead to the appearance of difficulties that jeopardise the financial equilibrium of households and firms and the competitiveness of the economy. These difficulties, if not properly tackled in good time, may make it difficult to sustain the rates of growth necessary to continue closing the gap in welfare still separating Spain from the euro area average. This section explores, first, the extent of the risks relating to the emergence of macroeconomic and financial imbalances and, second, the extent of those that may impinge on medium-term competitiveness. It then goes on to discuss some of the implications of these risks for the formulation of economic policy.

As indicated above, the looseness of the financial conditions that have been prevailing in Spain has resulted in firms and especially households borrowing heavily to sustain their spending. Credit to households was growing at a rate of around 19% at the end of 2003 (up 3 pp from a year earlier), and this rate continued to rise in the first few months of 2004. The household debt ratio – credit/gross disposable income (GDI) – has risen above 90% and is now slightly higher than the euro area average, having doubled since the mid-1990s. It is, however, still at some distance from the levels in other countries such as the United States and the United Kingdom.

However, the trend decline in financial costs and the gradual extension of maturities have enabled the burden associated with this greater debt to be kept within moderate limits; in 2003, as a percentage of GDI, it was barely 20% higher than in 1995. Also, the aggregate gross (financial and non-financial) wealth of households expanded at a high rate in this same period, so that the growth of consumption and residential investment has been compatible with households, at the aggregate level, maintaining a robust financial position. That said, a pattern of behaviour in which a growing part of spending is financed by future income can only be maintained temporarily as part of an adjustment process, like that seen in the Spanish economy, from a situation of high interest rates and financial uncertainty to a sustainable environment of macroeconomic stability. Foreseeably, following this phase, the sector will reduce its rate of debt, thereby avoiding the risk of running up financial imbalances that might impinge on their spending decisions.

Regarding the potential significance of this source of risks for the sustaining of demand, the financial position of households and, therefore, their spending decisions are probably now more sensitive than in the past to changes in interest rates and in the prices of equities and of housing. The uniqueness of the current financial conjuncture in recent economic history makes it rather difficult to assess the precise effects that possible changes in the variables referred to might have on the buoyancy of consumption and investment (see Box I.2). However, certain features of the current

In recent years the Spanish economy has been subject to numerous transformations which may have affected the sensitivity of economic activity to changes in monetary and financial conditions. In particular, the greater competitiveness and flexibility of the financial system and the consolidation of a stable macroeconomic environment have made it easier for economic agents to access external financing, widening the range of investment possibilities open to them. These developments may have helped to increase the effects that any changes in interest rates have on consumption and investment in a variety of ways.

First, the easier access to credit has enabled agents' spending decisions to depend less on their current income, so that firms and households have fewer constraints on how they distribute those decisions over time. By contrast, the decisions of consumers and firms are now more strongly influenced by agents' estimates of the welfare or benefits resulting from a choice at a given moment instead of at a later one. That is to say, consumption and investment will become more sensitive to their *opportunity costs* (substitution effect or user cost effect) and, therefore, to changes in interest rates.

Second, the increase in private-sector indebtedness has meant that household income and corporate earnings are more strongly affected by changes in the cost of financing the debt taken on, which impacts their direct spending capacity and their ability to obtain additional loans to finance that spending. In the case of households, these changes in the *income* effect have probably tended to become more marked as a result of the sharp fall in the sector's saving capacity (which has reduced net interest receipts) in recent years and of the lower relative weight in household assets of instruments such as deposits, the return on which is tied to interest rates.

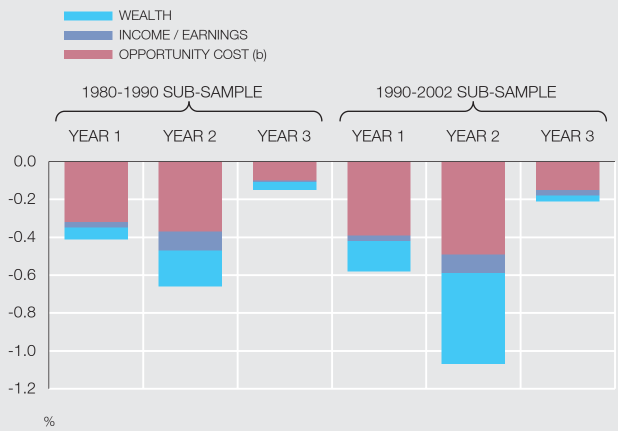
Finally, since a substantial portion of the credit extended, particularly that to households, is collateralised, the volume of available financing (and thus spending capacity) depends on the value of collateral available to borrowers. Moreover, non-marketable instruments such as cash and deposits have lost weight in agents' portfolios. Given that the price of real and marketable financial assets is negatively related to interest rates, the impact that interest rate movements have on demand might also have been heightened as a result of this *wealth effect*.

Merely for the purpose of illustrating the magnitude of these effects, the impact on GDP of a hypothetical 2 pp rise in short- and long-term interest rates for three years was simulated using two separate estimates of the quarterly model of the Spanish economy. The first uses only observations for the 1980s, while the second covers the period 1991-2002. The accompanying chart depicts, for each estimate, the changes in GDP growth caused by the rate increase in the three years following the shock. Also, the total impact is broken down into the contribution from the *opportunity cost* effect (which is the sum of the *substitution* effect on consumption and the *user cost* effect on investment), the income/earnings effect and the wealth effect. As can be seen in the estimate with the first sub-sample, the maximum impact on GDP is reached two years after the shock (-0.64 pp) and the most significant (and quickest acting) channel is *opportunity cost*, which in the first year accounts for 75% of the total effect, while the contribution of the *wealth* effect is limited. When the more recent sample is used, the effects of the shock are much larger, although the profile of the impact is unchanged and its maximum continues to be seen in the second year (-1.04 pp). By contrast, the *wealth* effect now becomes the most important influence in the second year, in line with the sharp growth of collateralised financing in the recent past.

Thus the changes seen in the composition of Spanish corporate and household balance sheets directly affect how monetary and financial shocks to consumption and investment are transmitted, and the potential impact of interest rate changes on economic activity is tending to increase in a way that is not insignificant.

EFFECT ON GROWTH OF A 2 PP RISE IN INTEREST RATES

CONTRIBUTIONS TO THE EFFECT ON GDP (a)



SOURCE: Banco de España.

a. Percentage points relative to base scenario.
b. Sum of user cost effect and substitution effect.

situation can be identified (with the obvious qualifications) which, along with the increase in the level of debt already referred to, must have helped to increase such sensitivity.

Thus, around 70% of outstanding loans to Spanish households in 2003 are directly related to house purchases. As is well known, this form of financing has increasingly tended to take the form of variable-rate loans with long repayment periods, so that the debt burden associated with them is significantly affected by any changes in the monetary policy stance. This sensitivity tends to be greater when, as at present, nominal interest rates and inflation are low. At the same time, the change in the composition of the portfolios of Spanish households during the last decade has been characterised by a gradual decline in the weight of cash and deposits in favour of shares, mutual funds shares, interests in pension funds and insurance. In this way, the relative weight of equities held, directly or indirectly, by households is practically double what it was at the beginning of the 1990s and is almost the same as that of cash and fixed-income instruments.

Also, owner-occupied housing represents more than three quarters of the total net wealth of Spanish households, a proportion that has been sustained in the recent past as a result of buoyant purchases and sharply increasing prices since 1997. From this viewpoint, the behaviour of house prices is very important. Although, as in the case of any asset, it is very difficult to judge the precise equilibrium level of house prices, available estimates suggest that houses have been somewhat overvalued in recent years, and that they remained so in 2003 since, according to the latest data published by the Ministerio de Fomento, prices rose by 17% that year. In fact, the supply of housing, although more flexible than in the past (as implied by the high rate of growth of new housing), has not been capable of fully satisfying the strong pressure that demand has continued to exert. However, it is to be hoped that, despite the uncertainty inherent in a situation like the one described, an early deceleration of prices may, as on previous occasions, bring the market back into balance in an orderly fashion, thereby avoiding reactions that might affect the spending capacity of the sector.

At the same time, it should be taken into account that the greater sensitivity of consumption and residential investment to changes in the financial position of the sector have been accompanied by a shrinking of the leeway available to absorb unfavourable developments without having to resort to a cut in spending or an increase in debt. The part of gross disposable income that households devote to saving, after interest and debt repayments, stood at 2% at the end of last year, 6 pp less than in the mid-1990s. Moreover, the possibility cannot be ruled out that for a significant percentage of Spanish households the buffer available is even smaller, since savings, debt and the aggregate debt burden are not uniformly distributed. However, sufficient information is not available to quantify this phenomenon precisely.

The debt ratios of Spanish non-financial corporations have also grown significantly in recent years and, as in the case of households, have reached the average level in the euro area rather rapidly. Likewise, the trend decline in financing costs has enabled the burden associated with the higher debt to remain at low levels. The total financing raised by firms grew in 2003 at a rate of around 14%. This aggregate behaviour coincided, however, with a restructuring of the balance sheets of the largest firms and a clear recovery in their results. Thus, the synthetic indicators, which (on the basis of disaggregated Central Balance Sheet Data Office data) enable the influence of the financial conditions on investment and employment to be summarised, show a certain improvement in the situation with respect to 2002 and, above all, testify to levels of financial pressure that are below the historical average.

In consequence, the financial position of firms, both when viewed from the aggregate standpoint and when the information available at a more disaggregated level is taken into consideration, is no obstacle to more vigorous investment in capital goods and employment. However, the levels of debt reached mean that corporations, like households, are more exposed to any increase in the costs of refinancing their liabilities or to an unfavourable change in their results and, therefore, the sensitivity of their spending decisions to the behaviour of the relevant financial variables has increased.

The financial situation of firms is, in principle, conducive to more vigorous investment in equipment which, along with exports, may bring about a gradual transition towards a more balanced pattern of growth. This vigour is essential to avoid the risk of prolonged weakness in this type of investment limiting long-term growth possibilities, by adversely affecting innovation and productivity, and thus the economy's competitiveness.

In this respect, it should be noted that the rate of growth of apparent labour productivity was once again very moderate in 2003 and that there were relatively heavy job losses in the industrial sector, which seem to reflect the impact of growing competitive pressures. The low productivity growth is doubtless related to the intensity of the job creation that has characterised the behaviour of the economy in recent years and that is apparent in the very moderate growth in the capital/labour ratio. These developments have been sufficient to enable progress to be made in absorbing the high rate of unemployment, but it should not be forgotten that total factor productivity growth has, at the same time, been subdued. It is difficult to estimate this variable precisely, but its low growth may mean that the incorporation of innovations into productive processes is having a limited effect on the economy's efficiency. In any case, the weakness of productive investment is not conducive to the adaptation of productive specialisation to an environment of mounting competitive pressures, like that faced by sectors in which Spain has traditionally had a comparative advantage, such as low-technology labour-intensive industries (which are facing increasing competition from emerging countries) and those in the medium-high technology bracket (the car industry, in particular), in which the central and eastern European countries offer major development potential.

The competitiveness of the economy may also be hampered by certain characteristics of the workings of factor and product markets that hinder efficiency in cost and price formation processes and introduce distortions into the allocation of resources. In the area of cost formation, the current system of collective bargaining leads to very similar wage settlements across sectors and enterprises, regardless of their cyclical situation and the degree to which they are exposed to competition. The ability of firms to pass these wage increases through to their prices and to maintain operating margins is much lower in those industries most exposed to foreign competition and in those with relatively weak demand, so that the profitability and competitiveness of firms in such industries may be eroded by the excessive uniformity of wage behaviour.

This point can be illustrated by analysing margins. The pronounced buoyancy of this variable at the aggregate level in recent years has been underpinned by vigorous increases in margins in construction and services (those sectors least exposed to foreign competition, in which demand pressure has been highest), although, in the case of services, there seems to have been a pause in this process in 2003. By contrast, in the industrial sectors (in which exporting firms are mainly located), margins recovered modestly after several years of declining profitability. However, it has been the difficulty of absorbing a further margin squeeze (once the positive effect on corporate profits of the fall in the debt burden had disappeared) that has possibly led to the employment reductions in the sector and to the moderation in unit labour costs through this channel. It seems, therefore, that export industries have had to resort to productivity increases generated by adjustments to their employment to regain competitiveness and profitability. This business strategy has enabled the presence of Spanish products in export markets to continue increasing, even in the context of a sharply appreciating euro, and has helped reduce the inflation differentials with Spain's main trading partners. But this form of adjustment cannot continue indefinitely, because the cost of the productivity gains that can be harnessed by reducing employment is a reallocation of factors that is contrary to the maintenance of a solid long-term competitive position.

The foregoing considerations and the experience in other countries (see Box I.3) tend to highlight the importance of having an economic policy that helps to reduce the risk that firms

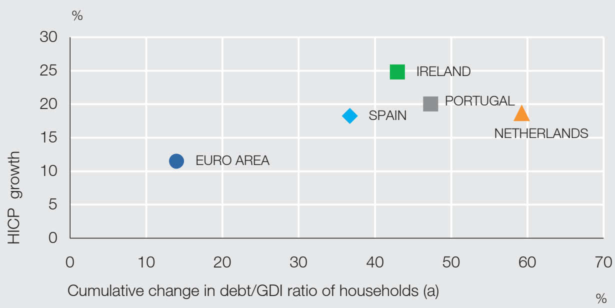
In a monetary union, the differences in member states' cyclical positions mean that the single monetary policy stance does not exert the same stabilising effect on every national economy. In the countries in which monetary and financial conditions are relatively easier, there is a higher likelihood of imbalances building up in the form of inflation differentials and of a surge in credit to the private sector. In the euro area, this situation has been observed recently in some countries, including Portugal, Spain, the Netherlands and Ireland (see Chart 1).

Macro-financial imbalances may end up affecting the buoyancy of economies. Thus, although they are not responsible for the cyclical change, they do seem to have played a not insignificant role in the sharpness of the recent economic slowdown in the Netherlands and Portugal. Both these countries were severely hit by the international crisis and still show no signs of recovering. This contrasts with the Spanish and Irish economies, which have proved to be more resilient and, although also slowing, have continued to show a positive growth differential relative to the euro area average (see Chart 2).

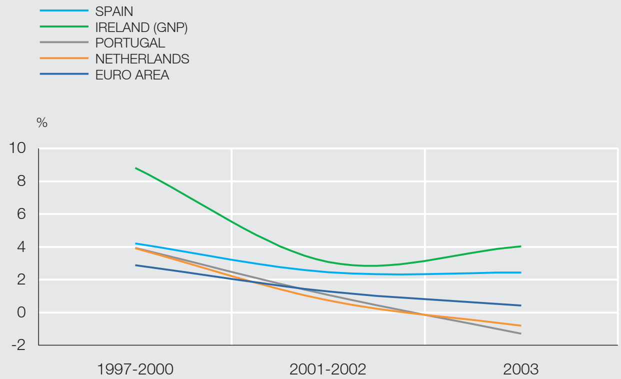
There are certain specific factors that enable us to understand why the performance of these countries has differed in recent times. First, the inflation differentials relative to the euro area caused a loss of competitiveness which, as measured by the real effective exchange rate in terms of unit labour costs, was relatively higher in Portugal and the Netherlands, where there was high wage pressure at the end of the expansionary stage (see Chart 3). In Portugal, moreover, this was reflected in a high current-account deficit which was among the largest in the industrialised countries (9% of GDP in 2000). In Ireland, however, the negative effect of inflation on competitiveness was offset by productivity gains.

In addition, there are also certain differences in the growth of private-sector debt, particularly that of households. In Ireland, Spain and Portugal, household indebtedness stood, in 1997, at levels that were lower than those of the euro area as a whole and its growth largely reflects structural factors relating to economic and monetary integration. In Portugal, however, borrowing was greater and by 1999 the debt-income ratio was higher than the euro area average. In the Netherlands, by contrast, household debt stood in 1997 at relatively high levels, above those of the area. Moreover, Dutch household consumption decisions were closely linked to the performance of asset prices (houses in particular), since a high proportion of mortgage

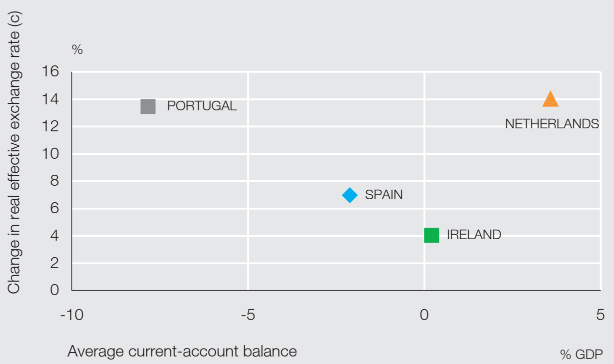
1. INFLATION AND HOUSEHOLD DEBT
1997 - 2003



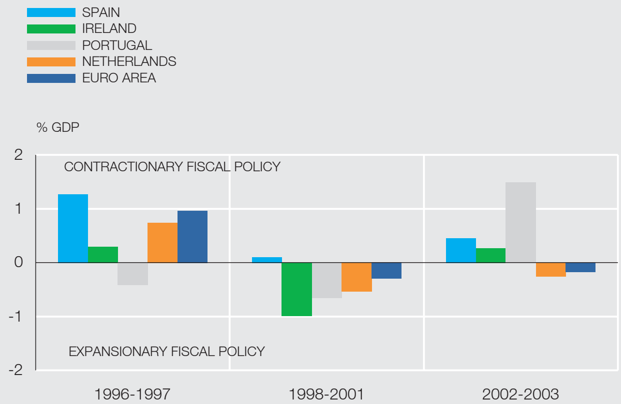
2. AVERAGE GROWTH OF REAL GDP (b)



3. COMPETITIVENESS AND CURRENT-ACCOUNT BALANCE
1997 - 2003 (b)



4. AVERAGE CHANGE IN CYCLICALLY-ADJUSTED PRIMARY DEFICIT (b)



SOURCES: ECB and European Commission

a. 2003 is an estimate. In the case of Ireland, only credit vis-à-vis MFIs is considered.
b. Spring forecast of the European Commission for 2003.
c. In terms of unit labour costs, in relation to 22 competitors. An increase denotes a loss of competitiveness.

MACRO-FINANCIAL IMBALANCES AND ECONOMIC SLOWDOWN IN SOME EURO AREA COUNTRIES BOX I.3

(CONT'D)

loans was linked to mortgage equity withdrawal through the renegotiation and obtainment of second mortgages.

Finally, the restrictive fiscal policy in Spain in the period 1998-2001 helped to offset the effect of the generous monetary conditions, unlike in the other countries analysed in this box (see Chart 4). In some, like Portugal, the lack of budgetary consolidation in the expansionary phase of the cycle not only contributed to worsening the imbalances but also obliged fiscal policy to adopt a pro-cyclical stance in the downturn, thereby aggravating the sharpness of the economic slowdown.

In short, the recent experience of the Netherlands and Portugal suggests that macro-financial imbalances fed by lax monetary conditions may have aggravated the economic slowdown. In such a setting, the fiscal policy stance may be an effective tool for limiting the extent of these imbalances and preventing them from ultimately affecting economic stability.

and households will suffer from financial imbalances and of a decline in the economy's competitiveness. More specifically, the sustainability of economic dynamism requires a fiscal policy capable of sufficiently offsetting the tensions generated by a monetary policy that is relatively lax for Spain's cyclical position, and progress on the reforms geared to increasing supply-side flexibility.

Since Spain joined the euro area, fiscal policy has borne the weight of macroeconomic stabilisation. The public finances have become increasingly favourable, moving into surplus in 2003, with public debt levels declining progressively further from the threshold of 60% of GDP. A significant contribution to this improvement has been made by institutional changes affecting the budgetary system, which have culminated in the entry into force of the Budgetary Stability Law in 2003 (see Box I.4). If monetary conditions do not change significantly, the upswing expected in the next few years may require a different fiscal stance from that of recent years. Other medium-term considerations, like the impact of an ageing population on public spending, also point in the direction of further budgetary consolidation. The intensity of the increase in spending that this generates will depend on a wide and complex set of variables, but even in the most favourable demographic scenario, with substantial increases in participation and employment rates, a very significant effort will be required to absorb it in the coming years. It will be essential to press ahead with pension reforms, in line with those in other European countries, to ensure the sustainability of the system, and to continue to consolidate public finances so as to increase the leeway available for future commitments. In parallel with this overall orientation, the aim should be to improve the quality of public finances, in terms of the composition of both expenses and revenues, so as to help stimulate the necessary productivity increases. A fiscal policy along these lines would be in keeping with the targets set for the EU by the Lisbon European Council in spring 2000, which were subsequently confirmed and specifically defined at Barcelona.

As is well known, the central aim of the Lisbon Agenda is to forge ahead with the structural reforms needed to boost job creation and productivity in the EU. Spain has made relatively good progress in these areas, in terms of employment and labour market participation and of the opening up to competition of various strategic network industries. However, headway has been moderate in relation to investment in knowledge industries and to productivity (see Box I.1 again).

The buoyancy of employment largely reflects the effectiveness of the reforms that have been implemented in recent years. Even so, there is still a high proportion of temporary employment which has adverse effects on productivity, due to the excessive turnover of labour and the

THE ROLE OF EXPENDITURE CONTROL IN BUDGETARY DISCIPLINE

BOX I.4

Comparative experience shows that successful budgetary discipline depends largely on appropriate institutional design. In particular, the proper working of the budgetary procedure is considered to be crucial for achieving fiscal discipline. In this respect, the changes made to budget outturn control mechanisms in Spain in recent years seem to have contributed significantly to the process of fiscal consolidation.

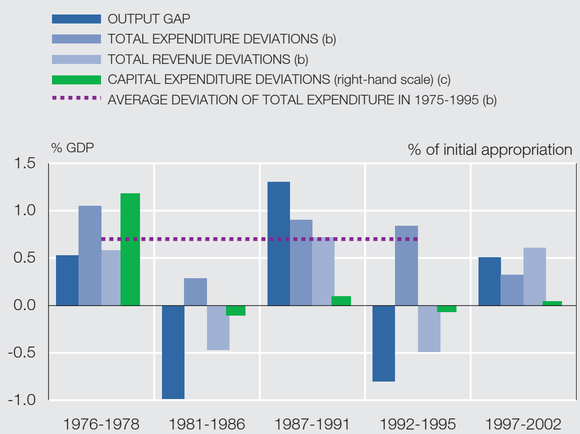
Before these disciplinary elements were incorporated, the State budget outturn frequently showed discrepancies between the projected figures and the final outturn for expenditure. In the period 1975-1995, budgetary deviations (defined as the difference between finally recognised and initially projected expenditure) stood, in annual average terms, at around 0.7% of GDP and 4.6% of the initial appropriation (see Chart 1). From 1996 onwards, by contrast, the inclusion in each year's State budget of various regulations to limit expenditure outturn enabled budgetary deviations to be significantly reduced. The average for the period 1997-2002 was below 0.3% of GDP (1.4% in terms of the initially approved appropriation).

Increased control over expenditure outturn may moreover be important not only as a mechanism for ensuring budgetary compliance, but also as an instrument conducive to the stabilising role of fiscal policy. It is notable in this respect that the largest budgetary deviations, as a percentage of GDP, occurred in economic expansions (the periods 1976-1978 and 1987-1991). This pro-cyclical behaviour was particularly apparent in items, such as public investment, over which greater discretionary power is held during the year. At the same time, these periods of greater economic buoyancy exhibited systematic positive deviations between the revenue finally raised and that projected in the Budget. In the last expansionary phase (1997-2002), however, increased control over the public expenditure outturn enabled the budgetary deviation in expenditure outturn to be held at moderate levels, despite revenue rising to far above the budgeted figure (see Chart 1).

The approval of the budgetary stability legislation which came into force last year and of the State Budget Law (the latter, among other things, implemented certain aspects of the former) introduced new disciplinary mechanisms. As regards expenditure control, under these laws a Parliamentary Plenary Session must approve in the first four months of each year the overall general government budgetary stability target and that for each of its agents for the following three years. It must further set the ceiling on expenditure in the State budget for the following year. This ceiling must include a contingency fund set at 2% of total State expenditure to cater for any non-discretionary expenditure requirements not envisaged in the initial budget that may arise in the budget outturn. In 2003, the first year of application of the budgetary stability laws, the State expenditure ceiling and the related contingency fund were set at €114.52 billion and €2.29 billion, respectively. The amount of the fund was in itself highly restrictive, since it represented nearly half the average value of the amendments to budgetary appropriations applied to State expenditure in recent years. As a result, the additions to appropriations were cut back again in 2003 to 0.2% of GDP (1% of the initial appropriation).

Despite the above-mentioned achievements in fiscal discipline, certain features of the budgetary deviations in recent years show that there is still some room for improvement in terms of the budget outturn. First, amendments to appropriations continued to be largely implemented via mechanisms less subject to Parliamentary control (extended and residual appropriations as opposed to extraordinary and supplementary appropriations). Second, purchases of goods and services continue to show very high deviations which, in terms of the initially approved appropriation, amounted to 22.9% on average in the period 1997-2003 (see Chart 2). Finally, the highly decentralised nature of public expenditure in Spain, along with the persistence of certain fiscal imbalances and deviations relative to the initial budgetary targets set by territorial governments, appear to make it necessary to extend the mechanisms for controlling budget procedures to these governments.

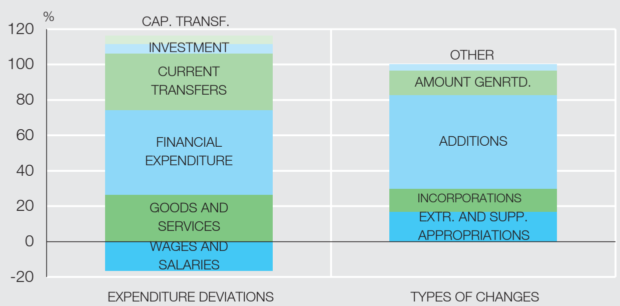
1. BUDGETARY DEVIATIONS OF EXPENDITURE AND REVENUE, AND BUSINESS CYCLE (a)



SOURCES: Ministerios de Economía y de Hacienda and Banco de España.

a. Yearly averages.
b. Percentage of GDP.
c. Percentage of initial appropriation.

2. STRUCTURE OF CHANGES IN APPROPRIATIONS. ANNUAL AVERAGE 1997-2003



lower incentives to invest in human capital, so that it is necessary to continue with reforms aimed at boosting stable employment. In the area of collective bargaining, as mentioned above, progress has been very modest; those aspects preventing the diversity in wage behaviour needed to reflect the sectoral differences in productivity and to avoid the elements of inertia that arise from a close relationship between wage increases and inflation have still to be modified.

Finally, action in two further areas needs to be given priority to ensure the sound working of the economy. First, the strong growth in the price of housing in recent years reflects, among other factors, restrictions on land supply that increase the pressure on prices. Town planning needs to be made more flexible and the procedures to make land available for building need to be accelerated in order to eliminate such restrictions. At the same time, the working of the rental market needs to be improved. Second, retailing laws still impose too many constraints on competition and business freedom, which may be distorting price formation in the sector and reducing its efficiency and dynamism. In both cases the regional governments have significant regulatory powers, so that the revision of these regulations must be done with a sufficient degree of co-ordination and, especially, with a view to ensuring market unity.

In short, the recent performance of the Spanish economy has shown that it is poised to continue along a path of gradual expansion, enabling it to converge towards the standards of progress and welfare characteristic of the more advanced European economies. For this path to be sustainable in the longer term it will be necessary for productive investment and exports to play a greater role as engines of growth, for the rate of growth of financing to the private sector to moderate and for the foundations of the economy's competitiveness to be strengthened. These are the challenges that must be addressed with the economic policy instruments, such as fiscal and supply-side policies, that remain under the control of the national authorities. The ability to project the currently favourable outlook into the longer term will depend on the capacity to maintain a sufficiently stabilising fiscal stance and to make decisive progress in achieving the targets set in the Lisbon Agenda.

The external environment of the euro area

1 A more vigorous and widespread recovery

As 2003 unfolded, the international economic recovery gathered momentum and its geographical base extended beyond the United States to span other industrialised countries and emerging economies. This favourable development was compatible with inflation holding at very low levels, despite the increases in commodity and oil prices. Firmer activity, which was accompanied by less uncertainty and improved conditions on international financial markets, continued to be supported by highly expansionary monetary and fiscal policies. Reflecting the differences between growth rates and between the economic policies pursued in the major areas were the increases in the main external imbalances and a notable depreciation of the dollar, particularly against the euro.

With the exception of the euro area, the major regions saw, to a greater or lesser extent, growth accelerate in 2003 (see Chart II.1). Among the main industrialised countries, the United States was the most dynamic economy, although Japan also picked up notably after several years of recession and slackness (see Table II.1). Among the emerging countries, there were high growth rates in Asia (with China to the fore), Russia and, to a lesser extent, central and eastern Europe. Although Latin America managed to emerge from the recession besetting it in 2002, it grew at a low rate (see Table II.2). Overall, the high dependence of world growth on the US economy, which has been a characteristic of recent years, has tended to lessen thanks to the buoyancy of China and other emerging Asian economies and to the recovery in Japan.

In the most dynamic economies the contribution of domestic demand was generally high and, compared with 2002, there was a shift towards a slightly greater contribution by investment and a slightly lesser one by private consumption, especially in the second half of the year. The pick-up in investment was partly possible thanks to the financial restructuring of companies in recent years, which has allowed new projects to be financed without the burden of excessive debt.

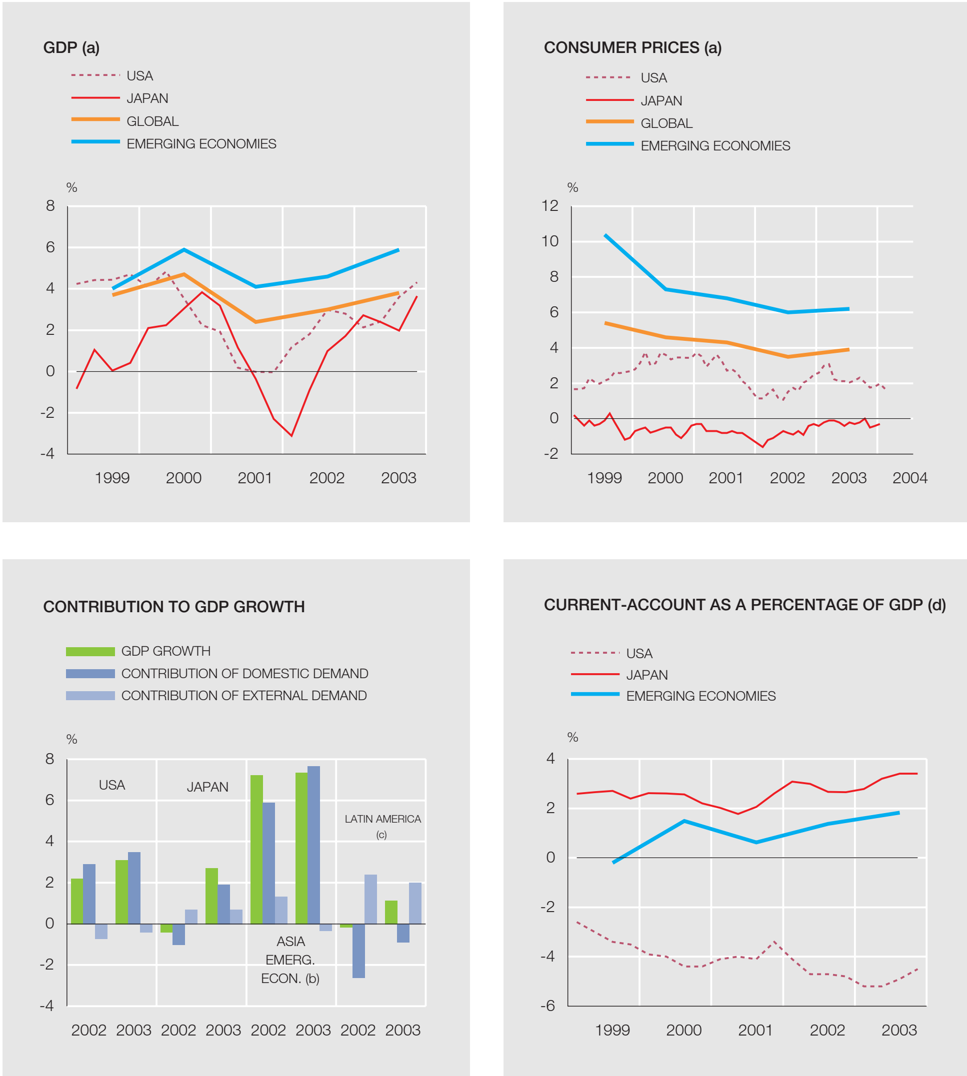
World trade grew by around 4% in 2003, thanks largely to the contribution of Asia. This figure was up from 2.9% in 2002, but still far off the average rate posted in the second half of the 1990s (8%). While the outlook for 2004 is favourable, there are doubts over whether the buoyancy of world trade can return in the medium term to the rates seen in the latter half of the 1990s. This is because there has been little progress in the Doha round multilateral negotiations and certain protectionist attitudes have even emerged.

In 2003 the current-account imbalances in the main regions generally tended to intensify (see Chart II.1): the US deficit continued to grow to almost 5% of GDP; the Japanese surplus widened to over 3%; the surplus of the emerging Asian economies held at around 4%; and the moderate European surplus (0.7%) eased slightly. The widening of the US external deficit was associated with the swift increase in the budget deficit and proved to be a determining factor in the sharp depreciation of the dollar in 2003, by 15% in nominal effective terms. The depreciation was especially marked against the euro (around 25% in the period from early 2003 to the lows in mid-February 2004), although this was partially corrected thereafter. The depreciation against the yen was more moderate (by around 15%, to the lows in late March 2004), and there were scarcely any changes against the Chinese and certain other Asian currencies.

Japan and certain emerging Asian economies, whose swollen current-account surpluses have been accompanied, in certain cases, by strong capital inflows, continued to check the appre-

GDP, ITS COMPOSITION, CONSUMER PRICES AND CURRENT-ACCOUNT BALANCE

CHART II.1



SOURCES: National statistics, Goldman Sachs and IMF.

a. Annual percentage change.
b. Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and China
c. Argentina, Brazil, Mexico, Chile, Colombia, Peru and Venezuela.
d. (+) surplus, (-) deficit

ciation of their currencies against the dollar by means of heavy intervention on the foreign-exchange markets. That fuelled an additional build-up in currency reserves in these countries, which currently hold around 60% of global reserves. As indicated in Chapter I, the recent depreciation of the dollar should help correct global imbalances. But the fact the depreciation has been against the currencies of economies, such as those in the euro area, with a relatively balanced external position that are having difficulty moving into the cyclical upturn, rather than against the currencies of countries with a strong surplus position in their external accounts and highly dynamic economies, raises doubts about the extent to which the recent trajectory of the currency markets can contribute effectively to correcting these imbalances. The G7 meetings in Dubai, in September 2003, and in Boca Raton, in February 2004, thus broached the need to increase the flexibility of exchange rate regimes as an adjustment mechanism for external imbalances in those countries which, like those in Asia, have maintained a high degree of exchange-rate rigidity against the dollar.

MAIN MACROECONOMIC INDICATORS OF THE UNITED STATES, JAPAN AND THE UNITED KINGDOM

BOX II .1

	1999	2000	2001	2002	2003	2003			
						Q1	Q2	Q3	Q4
UNITED STATES:									
GDP (a)	4.5	3.7	0.5	2.2	3.1	2.1	2.4	3.6	4.3
Private consumption (a)	5.1	4.7	2.5	3.4	3.1	2.3	2.5	3.7	3.9
Private investment (a)	8.3	6.5	-3.2	-3.7	4.4	1.1	2.4	6.1	7.9
External demand (b)	-1.0	-0.9	-0.2	-0.7	-0.4	0.8	-1.3	0.8	-0.3
General government financial balance (c)	0.9	1.6	-0.2	-3.3	-4.8				
CPI (a)	2.2	3.4	2.8	1.6	2.3	2.9	2.2	2.2	1.9
Current-account balance (c)	-3.1	-4.2	-3.9	-4.6	-4.9	-4.9	-5.0	-5.0	-4.9
Unemployment rate (d)	4.2	4.0	4.8	5.8	6.0	5.8	6.1	6.1	5.9
JAPAN:									
GDP (a)	0.2	2.8	0.4	-0.4	2.7	2.8	2.3	2.1	3.3
Private consumption (a)	0.2	1.0	1.7	0.9	1.1	1.1	1.0	0.1	2.2
Gross fixed capital formation (a)	-0.9	2.7	-1.1	-6.1	3.2	0.7	4.2	2.9	5.1
External demand (b)	-0.3	0.5	-0.7	0.7	0.7	0.7	0.4	0.8	0.9
General government financial balance (c)	-7.2	-7.4	-6.1	-7.1	-7.4				
CPI (a)	-0.3	-0.7	-0.7	-0.9	-0.3	-0.2	-0.2	-0.2	-0.3
Current-account balance (c)	2.6	2.5	2.1	2.8	3.2	2.8	2.8	3.0	3.2
Unemployment rate (d)	4.7	4.7	5.0	5.4	5.2	5.4	5.4	5.2	5.1
UNITED KINGDOM:									
GDP (a)	2.8	3.8	2.1	1.6	2.2	2.0	2.3	2.3	2.8
Private consumption (a)	4.6	4.4	3.1	3.4	2.8	2.6	2.4	3.1	3.2
Gross fixed capital formation (a)	1.6	3.6	3.6	1.8	2.6	3.6	1.6	2.2	2.9
External demand (b)	-1.0	-0.1	-0.6	-1.3	-0.4	-0.6	-0.5	-0.7	0.2
General government financial balance (c)	1.1	3.9	0.7	-1.6	-3.2				
CPI (a)	1.3	0.8	1.2	1.3	1.4	1.5	1.3	1.4	1.3
Current-account balance (c)	-2.7	-2.5	-2.4	-1.7	-1.7	-1.3	-1.2	-1.6	-1.7
Unemployment rate (d)	6.0	5.4	5.1	5.2	5.0	5.1	5.0	5.0	4.9

SOURCES: IMF, national statistics and European Commission.

a. Annual rate.
b. Contribution to the increase in GDP.
c. Percentage of GDP.
d. Percentage of labour force. Average for each period.

The oil price fluctuated sharply during the year, albeit on a rising trend that has been confirmed in the opening months of 2004. The war in Iraq prompted a rise and subsequent decline in the price of crude oil late in 2003 Q1. However, prices increased once again thereafter, rising to levels close to $30 per barrel in the closing months of the year as a consequence of the increase in worldwide demand for energy and of the supply cuts made by OPEC. As a result of these movements, the average price of oil in 2003 was 15% higher than in 2002, and it remained on a strongly rising trajectory in the early months of 2004. Commodity prices increased even more sharply (see Chart II.2), reaching their highest level for the last seven years in the opening months of 2004. This was linked on one hand to the weakness of the dollar and, on the other, to the increase in global activity, which has boosted the demand for commodities, especially in the most dynamic countries such as China.

Along with the more robust international recovery, financial markets generally trended favourably in a climate of extensive global liquidity and a greater readiness on the part of investors to assume risk (see Chart II.3). Nonetheless, in early 2003 geopolitical tensions continued to bear negatively on the markets, although they abated in late April. Over the year as a whole, stock markets in the main industrialised countries rose, moving more sharply upwards in most emerging markets. Meantime, long-term government bond yields reached their lowest levels for the past forty years in June, whereafter they rebounded slightly, with this movement inten-

EMERGING MARKETS: MAIN MACROECONOMIC INDICATORS

TABLE II.2

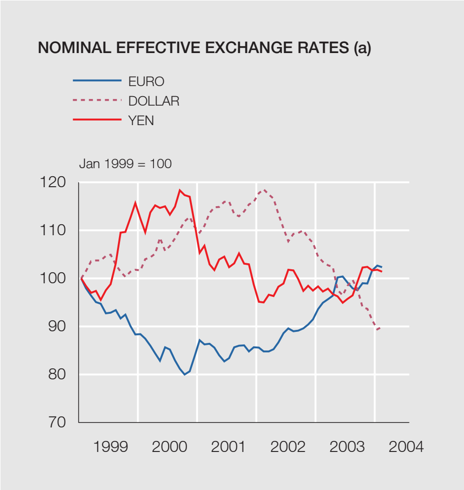
		1997	1998	1999	2000	2001	2002	2003
GDP (a)	ASIA							
	South Korea	5.0	-6.7	10.9	9.3	3.1	6.3	2.9
	China	8.8	7.8	7.1	8.0	7.5	8.0	9.1
	India	5.0	5.8	6.7	5.4	4.0	4.8	6.9
	Latin America							
	Argentina	8.1	3.8	-3.4	-0.8	-4.4	-10.9	8.7
	Brazil	3.3	0.1	0.8	4.4	1.3	1.9	1.5
	Mexico	6.8	5.0	3.6	6.6	-0.2	0.7	1.3
	EU CANDIDATE COUNTRIES							
	Hungary	4.6	4.9	4.2	5.2	3.8	3.3	2.9
	Poland	6.8	4.8	4.1	4.0	1.1	1.4	3.7
	Czech Republic	-0.8	-1.0	0.5	3.3	3.1	2.0	2.5
	RUSSIA	1.4	-5.3	6.3	10.0	5.1	4.7	7.3
INFLATION (b)	ASIA							
	South Korea	4.4	7.5	0.8	2.3	4.1	2.8	3.3
	China	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2
	India	7.2	13.2	4.7	4.0	3.8	4.3	3.9
	Latin America							
	Argentina	0.5	0.9	-1.2	-0.9	-1.1	25.9	14.7
	Brazil	6.9	3.2	4.9	7.1	6.8	8.4	15.0
	Mexico	20.6	15.9	16.6	9.5	6.4	5.0	4.6
	EU CANDIDATE COUNTRIES							
	Hungary	18.3	14.3	10.0	9.8	9.2	5.3	4.7
	Poland	14.9	11.8	7.3	10.1	5.5	1.9	0.8
	Czech Republic	8.5	10.6	2.1	3.9	4.8	1.8	0.2
	RUSSIA	14.7	27.8	85.7	20.8	21.6	15.8	13.7
GENERAL GOVERNMENT FINANCIAL BALANCE (c)	ASIA							
	South Korea	-1.7	-4.3	-3.3	1.3	0.6	2.7	0.8
	China	-0.8	-1.2	-2.1	-2.8	-2.6	-3.1	
	India	-8.7	-8.8	-9.9	-9.9	-10.5	-10.1	
	Latin America							
	Argentina	-1.5	-1.4	-2.6	-2.4	-3.2	-1.3	0.4
	Brazil	-6.3	-7.9	-10.0	-4.6	-5.2	-10.3	-3.7
	Mexico	-1.4	-1.2	-1.3	-1.1	-0.7	-1.1	-0.7
	EU CANDIDATE COUNTRIES							
	Hungary	-4.5	-6.3	-3.7	-3.0	-4.7	-9.5	-4.5
	Poland	-1.3	-3.2	-3.3	-3.5	-5.5	-6.7	-4.0
	Czech Republic	-1.9	6.6	-1.6	-4.5	-5.3	-7.1	
	RUSSIA	-7.0	-5.0	-1.7	2.7	3.0	0.6	1.0
CURRENT-ACCOUNT BALANCE (c)	ASIA							
	South Korea	-1.7	12.7	6.0	2.7	1.9	1.1	1.3
	China	4.1	3.3	1.6	1.9	1.5	2.8	2.1
	India	-0.7	-1.7	-0.7	-1.1	-0.2	1.0	0.4
	Latin America							
	Argentina	-4.1	-4.9	-4.2	-3.1	-1.7	10.1	5.7
	Brazil	-4.2	-4.2	-4.8	-4.1	-4.5	-1.9	1.0
	Mexico	-1.9	-3.8	-2.9	-3.1	-2.8	-2.2	-1.6
	EU CANDIDATE COUNTRIES							
	Hungary	-2.1	-4.9	-5.1	-6.2	-3.4	-4.1	-4.8
	Poland	-4.0	-4.2	-7.2	-6.1	-3.9	-2.6	-2.0
	Czech Republic	-6.7	-2.4	-2.8	-5.3	-5.7	-6.5	-6.4
	RUSSIA	0.0	2.7	12.8	18.0	11.0	8.5	9.0

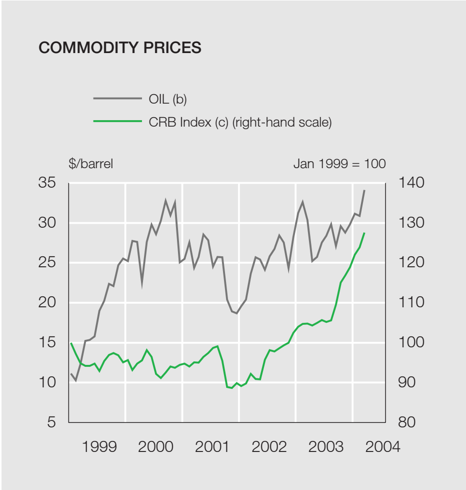
SOURCES: IMF and national statistics.

a. Percentage change on year ago.
b. Annual average rate of change of consumer prices.
c. Percentage of GDP.

EXCHANGE RATES AND COMMODITY PRICES

CHART II.2





SOURCES: National statistics, Federal Reserve and IMF.

a. Vis-à-vis developed countries. An increase (decrease) denotes an appreciation (depreciation).
b. Brent crude.
c. Commodity Research Bureau (Federal Reserve).

sifying as from April this year. The strong demand for government – especially US – bonds (arising in part from the investment of the foreign reserves built up by the Asian countries) has enabled public-sector financing costs to be kept at historically low levels. And although that is in line with continuing low actual and expected inflation rates, it runs counter to the increase in budget deficits, especially in the United States. Also of note is the prolongation of the high synchrony between the long-term interest rates of the main countries and economic areas during 2003, despite sharp fluctuations in their bilateral exchange rates.

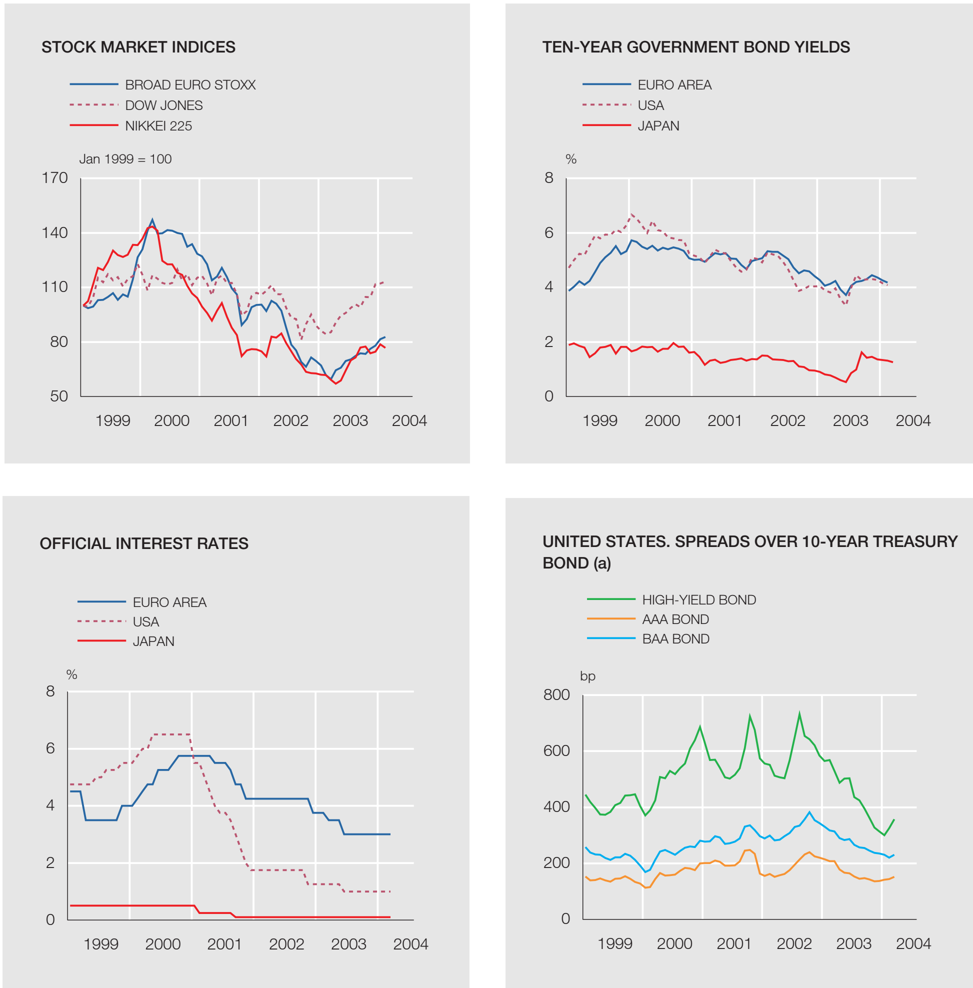
Against the aforementioned background of generous liquidity, the risk premia on private fixed-income securities tended to fall. This was further encouraged by the rise in corporate earnings, the decline in the number of business failures and, in general, fewer signs of fragility in financial systems. The spreads on emerging sovereign bonds followed a similar pattern, benefiting from a greater search for risk by institutional investors attracted by potentially higher yields (see Chart II.4). This trend was partially reversed, however, in early 2004. At the same time as sovereign spreads were narrowing in the emerging economies, capital flows towards this group of countries regained momentum. Nonetheless, although foreign direct investment grew substantially in Asia, net inflows of FDI fell in Latin America for the fourth year running, possibly because of the persisting doubts over the sustained recovery of growth in some of the countries affected by the crises of recent years in this region.

The most likely scenario for 2004 points to an acceleration in international economic growth, especially in the United States, and to continuing high rates in Asia. It is foreseen that the firmer tone of the recovery will continue to spread to those areas that are currently behind in the cycle. In turn, inflation rates are expected to remain under control, despite the rise in oil and other commodity prices. That said, certain Asian countries, such as China, and perhaps others in central and eastern Europe might experience some inflationary pressures.

The main risks to this central scenario are several. First, if measures are not taken to redress the US external deficit, a disorderly correction of the dollar on foreign exchange markets and/or a sizable increase in long-term interest rates may ensue, which could seriously jeopardise the international economic recovery. This is particularly important given that the greater pace

FINANCIAL MARKETS: INDUSTRIALISED ECONOMIES

CHART II.3



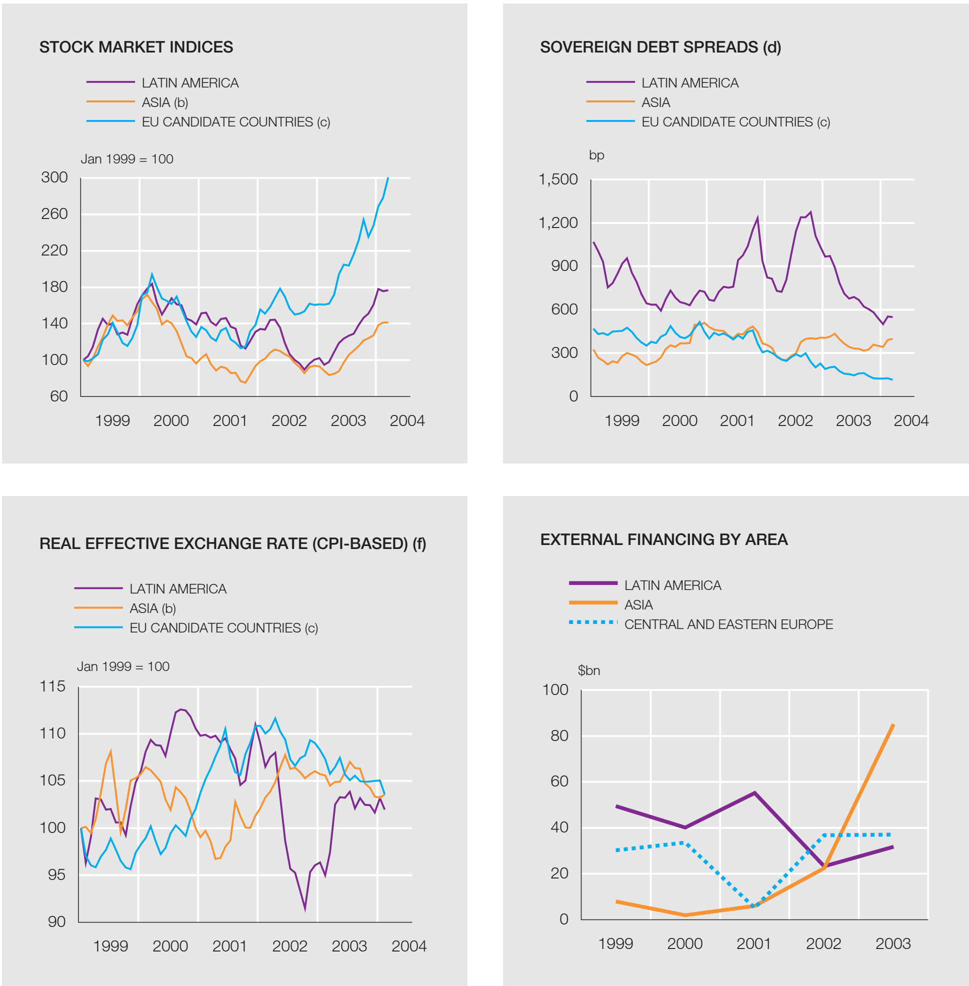
SOURCES: Banco de España and Bloomberg.

a. Moody's BAA and AAA industrial bonds, and Standard and Poor's B2-rated high-yield bond.

of economic activity in the United States and also in other regions has been partly driven by macroeconomic policies whose expansionary effects cannot be indefinitely prolonged. Consequently, one of the challenges currently facing the international economy is to make the transition to a more neutral monetary policy stance, allowing price stability to be maintained without impairing the outlook for recovery or disrupting financial market stability. Moreover, international political uncertainties, which have reared their head again in the opening months of 2004, might – if they heighten – have an unfavourable impact on agents' confidence and push oil prices upwards. And both these factors would have adverse effects on the course of recovery worldwide. Finally, all these risk factors might stem capital flows to the emerging countries, which would bear negatively on their activity, especially in those economies at a less advanced stage of recovery.

It is admittedly difficult for economic policies to mitigate the risks arising from international political tensions. But they can play a very important role in reducing the risks associated with the overall imbalances between the main regions and in improving the quality of the fundamentals in the emerging economies most sensitive to changes in international capital flows. In this respect, it should be recalled that the adjustment of exchange rates, while necessary, does not suffice per se to bring about more balanced growth and a sufficient correction of overall disequilibria. Rather, the internal policies of the main regions must be modified on both the demand

FINANCIAL MARKETS: EMERGING ECONOMIES CHART II.4



SOURCES: Banco de España, IMF, Morgan Stanley, JP Morgan and Bloomberg.

a. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
b. China, Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
c. Czech Republic, Hungary, Poland, Slovenia and Slovakia.
d. EMBI +.
e. Bulgaria, Hungary and Poland.
f. An increase in the index denotes a loss in competitiveness.

and supply sides. A less expansionary fiscal policy in the United States, accompanied by the reforms needed to boost growth in Europe and Japan and by a greater degree of exchange-rate flexibility in certain Asian economies, would be highly desirable. As regards the emerging economies, the application of stable macroeconomic policies and continuing economic and financial reform offer the best safeguards against any future reductions or changes in the direction of international capital flows.

2 The main industrialised economies

2.1 UNITED STATES

The hesitant behaviour of the main economic indicators in the first half of 2003 raised doubts over the soundness of the recovery in the United States, though these were dispelled in the second half of the year as the rate of increase of activity firmed. The ebbing of geopolitical tensions as from late April, the effects of retaining markedly expansionary fiscal and monetary policies and the absorption of the longest-lasting effects of the bursting of the stock market bubble in previous years were among the main determinants of the acceleration in growth last year, which allowed GDP to grow at a rate of 3.1% (2.2% in 2002). However, the US economy saw both its main imbalances – the budget deficit and the current-account deficit – worsen in

2003 (see Box II.1). The financing of the current-account deficit underwent a notable change, moreover; having been based mainly on direct investment and equity purchases by non-residents, it began to depend increasingly on the acquisition of private and public fixed-income securities (in the case of the latter, with the Asian central banks accounting for a significant proportion), thereby entailing an additional factor of vulnerability. In these circumstances, the private-sector saving ratio remained at a low level, owing mainly to the behaviour of households, since companies made a notable effort to restore health to their balance sheets.

Economic growth in 2003 was underpinned by the buoyancy of domestic demand, which contributed 3.5 pp to GDP growth, 0.5 pp up on 2002. External demand, meanwhile, subtracted 0.4 pp from GDP growth, compared with 0.7 pp the previous year. Among the domestic demand components, private consumption remained firm, although its rate of increase, at 3.1% per annum, was somewhat lower than in 2002. Tax cuts and the ongoing, intense mortgage refinancing induced by the low level of interest rates contributed to boosting private consumption. The main change in relation to 2002 in respect of the demand components was, however, the surge in fixed investment in the second half of the year, which grew by 4.4% in annual average terms, compared with its decline in the two previous years (see Table II.1). This improved performance is attributable to the residential, equipment and software investment components, whereas investment in non-residential construction held at a negative rate of change. The take-off in investment was pivotal for entrenching expectations of an economic recovery, since the general view was that the continuity of the pick-up largely hinged on investment taking over from private consumption as the driving force of demand.

Among the main determinants of the favourable performance of investment in 2003 were the following. First, a strong increase in corporate earnings which, measured as a percentage of GDP, rose to a historical high of 8% (see Chart II.5). Next, the rebuilding corporate balance sheets following the financial restructuring of recent years, meaning that companies' financing gap (investment less funds generated within the business) was negative and reached the lowest level of the last forty years. And finally, the low level of interest rates and, generally, the favourable financing conditions, which prompted both the rise on stock markets and the increase in prices on public and private fixed-income markets.

The growth base also broadened on the supply side as a result of more buoyant manufactures, whose sound performance complemented that of services. But one of the most characteristic features of the US growth pattern in 2003 was undoubtedly the strong 4.4% increase in productivity (4.9% in 2002), this rise being accompanied by particularly sluggish job creation (see Chart II.5).

It is true that the persistence of high productivity gains is a key factor in the diagnosis of the soundness of the recovery in the medium term. But the marked difference in terms of the behaviour of employment in the current and previous recoveries is a factor of potential vulnerability for private consumption and, in sum, for growth in the short term. It is significant, then, that in the current phase of recovery (between November 2001 and December 2003) non-farm employment should have fallen by 0.5%, while the historical average for changes in employment in upturns between 1954 and 1991 was an increase of 2.1%.

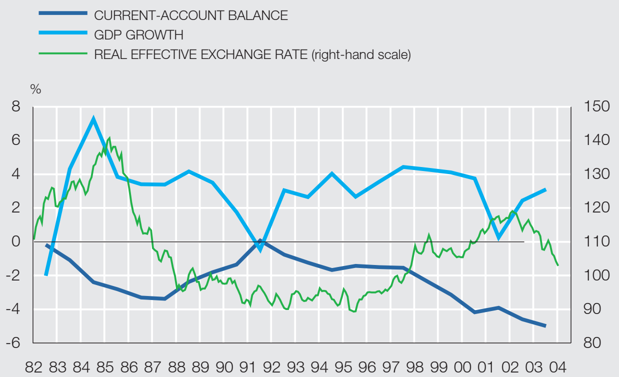
So far there appears to be no clear consensus about the causes of this sluggishness in the labour market, although several factors have been put forward. These include the surplus capacity generated by the boom in the second half of the 1990s, the subsequent re-absorption of which would have delayed companies' need for new hires; the delocalisation of industries and the subsequent structural change involving the discontinuation of production lines, which have so far

The US current-account balance has steadily deteriorated since 1991, reaching an estimated deficit of around 5% of GDP in 2003. At the same time, the net US international investment position, which had been positive until the 1980s (4% of GDP on average in that decade), has become increasingly negative, standing at –25% of GDP in 2003. Despite these developments, there has been no worsening in US financing conditions; on the contrary, long-term interest rates stood at historic lows in 2003. The development and integration of world financial markets has probably increased the capacity to finance current account deficits, especially in the more developed economies. And this factor may be reinforced in the case of the US economy by the fact that the dollar acts as the main international reserve currency. Nevertheless, there is a risk of a disorderly adjustment in the foreign exchange markets if the external imbalance continues and no economic policy measures are taken to redress it. This box compares the current situation with the restoration of external balance that took place in the US economy in the second half of the 1980s.

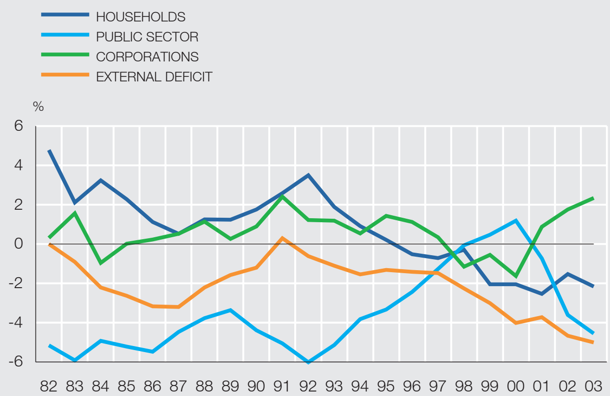
As may be seen in the first chart below, the United States ran a current-account deficit from 1982, which gradually widened to reach 3.5% of GDP in 1987. Between 1985 and 1987, the dollar fell by 27% in real effective terms, especially with respect to the countries that then had the largest trade surplus against the United States, declining by 60% against the German mark and 65% against the Japanese yen. This depreciation was partly driven by the concerted action of the main countries (the Plaza Accord). In the more recent episode, the dollar had by April 2004 depreciated by 12% in real effective terms from its high at the beginning of 2002 but, unlike in the 1980s, it hardly weakened against the currencies of the main countries that run a trade surplus with the United States, especially certain Asian countries. These countries, with their export-led growth model, have been pursuing very aggressive exchange rate policies to avoid their currencies appreciating against the dollar. This has led to a large-scale accumulation of currency reserves on the balance sheets of their central banks. At the same time, some of the countries against which the dollar depreciated most in this period had relatively low growth rates (especially Japan in 2002 and the euro area), while US growth has been running at higher rates, underpinned by vigorous productivity growth. That also contrasts with the situation in the 1980s, when Europe and Japan were growing strongly.

THE US EXTERNAL BALANCE AND REAL EXCHANGE RATE

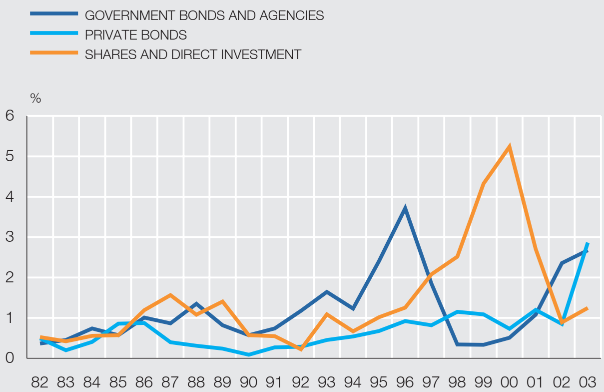
1. CURRENT BALANCE, GDP AND REAL EXCHANGE RATE



2. NET SAVING BY SECTOR (a)



3. FINANCING OF THE EXTERNAL DEFICIT



SOURCES: National statistics and IMF.

a. Percentage of GDP.
b. A decrease denotes dollar depreciation.

In the late 1980s, US households and firms increased their combined savings ratio (to 5% of GDP in 1991), thereby countering the effect of the increase in the government deficit, which reached 6% of GDP in 1992 (see second chart). In the recent period, by contrast, while firms are making a similar effort to that of the late 1980s, households, stimulated by highly expansionary economic policies, have recorded negative net saving and contributed to the growth of the external deficit. Recently, however, the most powerful contribution to the increase in the current-account deficit has been the growing fiscal deficit from 2001, which reached almost 5% of GDP in 2003, a similar level to that seen at the end of the 1980s. The fiscal deficit is currently the basic counterpart of the external deficit, whence the expression "twin deficits" to describe this phenomenon. As seen in the third chart, this has also affected how the current-account deficit is financed, with an increase in the acquisition of private and public bonds, as against the previous predominance of foreign direct investment and share purchases.

As regards the channels of adjustment for the external deficit, the historical evidence shows the basic factors that may, in combination, help to take the external deficit back to more moderate levels: domestic demand restraint in the United States, faster growth in the rest of the world and/or depreciation of the dollar in real effective terms.

The basic question is to what extent correction of the external imbalance is induced by changes in economic policy to re-establish greater symmetry between growth in the United States and in other areas or, instead, by a further depreciation of the dollar on the foreign exchange markets. On the available empirical evidence it is preferable for imbalances to be corrected by economic policy measures than by autonomous adjustment of the foreign exchange markets. That is because, given US import and export price elasticities, a further very substantial depreciation of the dollar would be required to take the external deficit to reasonable levels. Meanwhile, since it does not seem likely, at least in the short run, that the Asian countries will change their policies of maintaining exchange-rate stability vis-à-vis the dollar, such depreciation would have negative effects on the international economic recovery, particularly in the euro area.

Hence, the desirable solution to the US external deficit problem lies, first, in budget measures to enable a parallel reduction in the US fiscal deficit to more sustainable levels. These measures, however, should be accompanied by structural reforms in other areas, such as the euro area and Japan, to invigorate their economies and make higher import demand possible. Economic policy measures along the foregoing lines would be the best means of reducing one of the main risks threatening the international economic recovery.

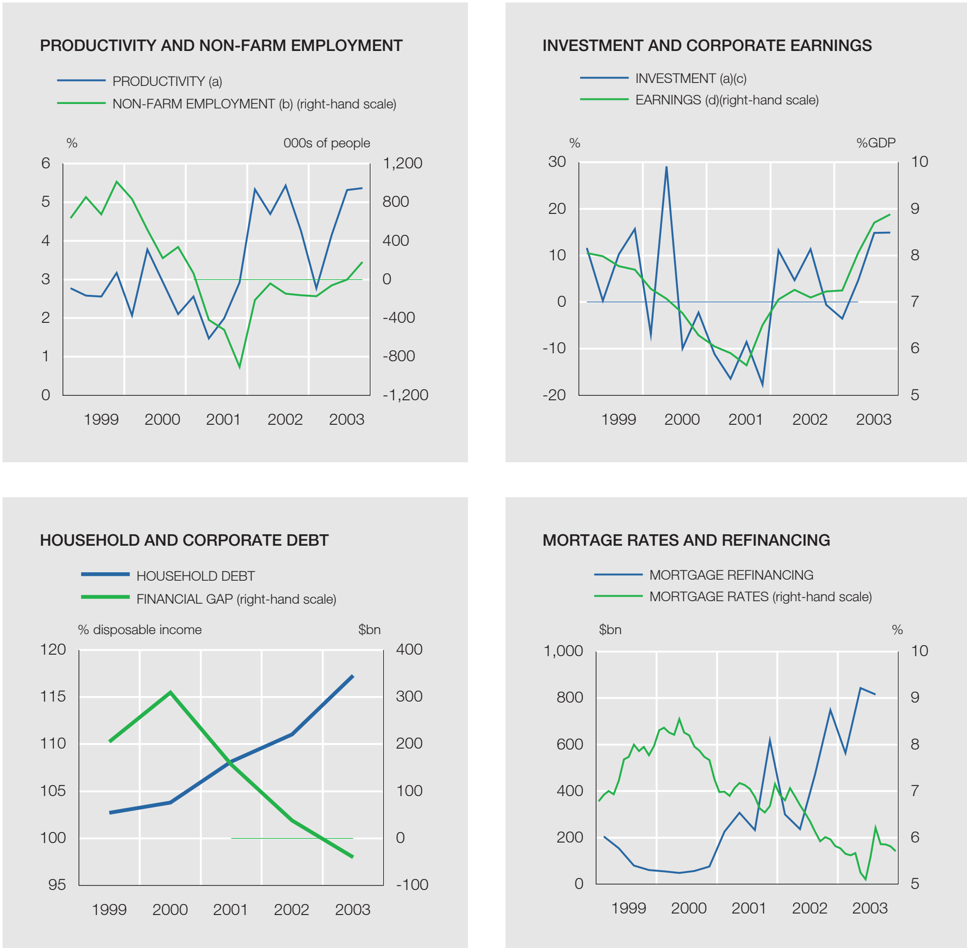
been insufficiently offset by other new lines; and a strong increase in non-wage labour costs in 2003 amid uncertainty and heightened competition. Also proposed, as a weightier explanation, has been the ability of many companies to meet growing demand through increases in productivity arising from technological improvements introduced during the expansionary phase, which would have restricted job creation in an environment in which uncertainty has not yet been fully dispelled. In early 2004, however, there have been signs of employment behaving more vigorously, especially since March, although it is still too soon to know whether this will continue.

The monetary policy stance was, for another year, clearly expansionary, as reflected by the negative real interest rates throughout the period. In June, the Federal Reserve cut its intervention rate by a further 25 bp to 1%, the lowest rate of the last forty years. Both the favourable performance of inflation, which ended the year at 1.9% despite the significant depreciation of the dollar, and the relative weakness of the labour market were conducive to a very accommodating monetary policy being maintained, in anticipation of a clearer and sustained recovery in growth. In any event, it is telling how the Federal Reserve contributed notably, through its communication policy, to regulating market expectations about the future course of interest rates. It did this by alerting them in the first half of 2003 to the existing though unlikely risk of deflation, subsequently signalling its readiness, as this risk waned, to hold interest rates stable over a relatively lengthy horizon in the absence of inflationary pressures. More recently, as evidence of a sound recovery in activity has become clearer, the financial markets have been discounting sharper and earlier interest rate rises, consistent with the change in tone of the Federal Reserve's messages.

Fiscal policy remained very expansionary in 2003. As a result, the budget deficit worsened further to 4.8% of GDP, from 3.3% in 2002, mainly as a result of some of the scheduled tax cuts being brought forward to 2003, the reductions in taxes on dividends and capital gains, and the

UNITED STATES
REAL AND FINANCIAL SECTOR INDICATORS

CHART II.5



SOURCES: National statistics and Datastream.

a. Annual percentage change.
b. Quarterly change, thousands of people.
c. Private fixed capital formation.
d. Domestic companies' earnings.

strong rise in military spending. The swollen fiscal deficit and, in particular, the outlook for financing it over the medium term are increasingly worrying, despite the fact that official forecasts envisage a progressive reduction in this deficit to 1.6% over the next five years. It would therefore be highly desirable for the measures needed to progressively reduce the budget deficit to be applied as vigour in the US economy takes hold. That would not only provide for a more balanced growth pattern in the United States but, by contributing to the reduction of the swollen external deficit, it would allow a more orderly correction of the global disequilibria in a climate of greater stability on international foreign exchange and financial markets.

2.2 JAPAN

The Japanese economy picked up notably in 2003. Sustaining highly expansionary demand-side policies, its GDP increased by 2.7%, against –0.4% in 2002. This was the highest growth rate in ten years of flatness and economic depression (GDP increased at close to 1% in annual average terms between 1992 and 2002), except during the upturns in the 1995-1996 period and in 2000, which were not sustained.

Overall, domestic demand contributed 1.9 pp to GDP growth (in contrast to the subtraction of 1 pp in 2002), while external demand made a positive contribution of 0.7 pp, similar to that of the previous year. The engines of growth were gross fixed capital formation, boosted by the improved financial position of companies, and exports. Private consumption posted moderate growth, influenced by the slackness of the labour market for much of the year, despite which the unemployment rate fell to 4.8% in December 2003, down from 5.4% a year earlier (see Table II.1). The sound behaviour of the external sector saw the current-account surplus widen to 3.2% of GDP, up from 2.8% in 2002, despite the notable appreciation of the yen against the dollar by around 15% from end-2002 to late March 2004.

Although the experience of failed recoveries in Japan in the past decade initially cast doubt on the continuity of the current expansion, there are certain signs that the pick-up might on this occasion be based on more robust foundations (see Chart II.6). These include most notably the strength of companies' financial position, which is at the root of the strong momentum of investment; some progress – albeit made with difficulty – in the restructuring of the banking industry; the concurrent improvement in the external environment, especially in the emerging Asian economies and in the United States; and the fact that, unlike at other junctures in the 1990s, the monetary authorities maintained highly expansionary monetary conditions and averted, through heavy interventions, a significant appreciation of the yen, although this stance appears to have become gradually more flexible during 2004 Q1.

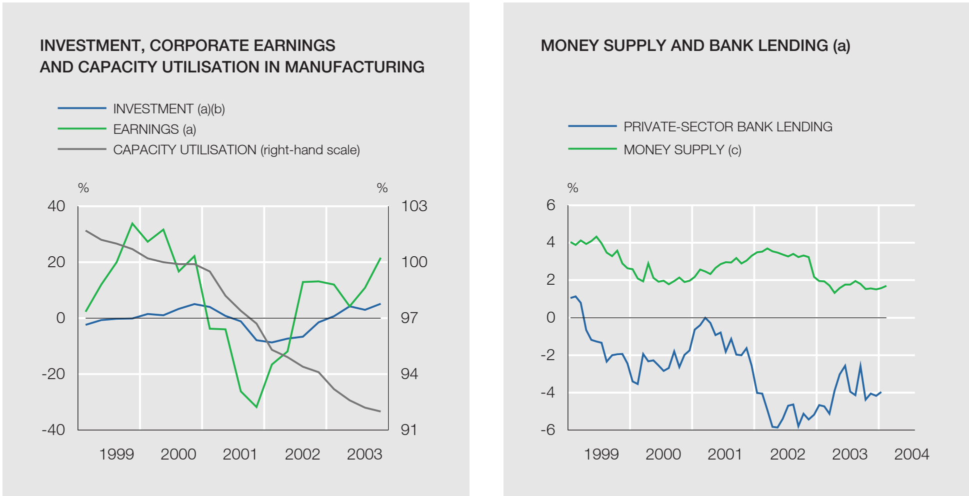
Against this background of more buoyant activity, some of the main price indicators reflected an easing of deflationary pressures. Among these are the CPI, whose annual average growth rate was –0.3% in 2003, compared with –0.9% in 2002, and wholesale prices, which highlighted the trend even more forcefully by easing from –2.1% on average in 2002 to –0.8% in 2003. Both price indices posted a 12-month growth rate of zero in March 2004. However, the GDP deflator, with a decline of 2.5% in 2003, did not trend so favourably, meaning that the risks associated with deflation must continue to be assessed with caution.

The expansionary stance of monetary policy was stepped up, mainly via quantitative and exchange rate mechanisms, while the zero interest rate policy was maintained. The Japanese central bank increased the liquidity provided to the banking system, it adopted measures to improve the transmission of monetary policy, such as the acquisition of commercial paper and the raising of the ceiling on its purchase of commercial banks' shares, and it intervened massively on the foreign exchange markets to prevent the appreciation of the yen against the dollar, especially following the G-7 meeting in Dubai in September. The volume of intervention reached a historical high in 2003 (about $175 billion for the year as a whole) and increased further in the opening months of 2004 ($100 billion more in January and February), although it has eased off notably in March and April. The money supply slowed significantly, against the backdrop of the ongoing contraction of bank credit (see Chart II.6).

Fiscal policy likewise remained expansionary, without significant changes on the previous year. The budget deficit continued rising, reaching 7.4% of GDP (against 7.1% in 2002), and gross public debt climbed to 155% of GDP, with no essential changes foreseeable a priori in 2004. In a climate of somewhat lower deflationary pressures, the trend of public debt and the still-delicate situation of the financial system are the main factors of uncertainty surrounding the firming of the current recovery in Japan. In this respect, while it is true that some headway in the restructuring of the financial sector was apparent in 2003, and duly reflected in a strong rise in stock market equity prices, certain substantial weaknesses remain. In particular, although the proportion of bad loans fell and balance sheets – mainly those of the major banks – were bolstered, the same was not the case for the regional banks, which are an important part of the banking system.

JAPAN
REAL AND FINANCIAL SECTOR INDICATORS

CHART II.6



SOURCES: National statistics and Datastream.

a. Annual percentage change.
b. Public and private capital formation.
c. M2 and certificates of deposit.

2.3 EU COUNTRIES OUTSIDE THE EURO AREA

In the United Kingdom, GDP grew by 2.2% in 2003, 0.6 pp up on 2002. The growth pattern was similar to that of the previous year, although with a slightly less negative contribution by external demand (see Table II.1). Domestic demand was once again the most buoyant component, contributing 2.6 pp despite private consumption moderating somewhat, while the contribution of external demand was a negative one of –0.4 pp, compared with the 1.3 pp it subtracted from GDP growth in 2002.

On the whole, economic policies remained relatively expansionary, despite the buoyancy of activity. That led to a deterioration in public finances (the budget deficit rose to 3.2% of GDP) and to the maintenance of interest rates at historically low levels, though this situation began to be corrected following the 25 bp rise decided on in November. Encouraged by the low interest rates, household debt continued to increase, reaching a new high of 130% of disposable income, and there was a fresh rise in property prices.

RPIX inflation (the Retail Price Index, excluding mortgage interest payments) stood at 2.8%, 0.6 pp up on 2002. The inflation target was changed in December from 2.5% for the RPIX rate to 2% for the new harmonised index of consumer prices, which increased to 1.4% in annual average terms, although there have been some signs of inflationary pressures in the opening months of 2004. A notable development in June 2003 was the negative assessment of the five tests set by the British government for euro entry, showing that a sufficient degree of convergence and flexibility to call a referendum on this question had still not been reached.

Elsewhere, in Sweden and in Denmark, there was a slowdown in growth in relation to 2002. This was largely due to the moderation of domestic demand during the first half of the year and, in the case of Denmark, also to the negative contribution of the external sector. The cyclical effect entailed a certain reduction in fiscal surpluses compared with 2002, although public finances remained sound. Inflation, meanwhile, eased in both countries. Sweden’s possibilities of adopting the euro were also set back following the “no” vote in its September referendum.

3 *The emerging economies*

3.1 ASIA

Taken as a whole, the emerging economies in Asia posted the highest growth rate in the world in 2003, at around 7% on average, compared with 6.2% in 2002. The economic recovery quickened substantially once the uncertainty associated with SARS and geopolitical tensions abated, largely thanks to the momentum provided by the Chinese economy, which absorbed imports from the rest of Asia while exporting to third countries. The economies of India, Indonesia and Thailand were notably buoyant, growing at a rate of around 5-7%, while growth in Hong Kong was 3%. Korea, Singapore and, to a lesser extent, Taiwan posted growth below that in 2002, although activity picked up in the second half of the year, underpinned by the improvement in exports and livelier private consumption.

On the prices front the general trend was one of stability, with the notable exception of China, where inflation accelerated rapidly in 2002 Q4 to 3.6% year-on-year in December. Behind this lay the strong expansion of the money supply, partly caused by the interventions to restrict the appreciation of the Chinese currency.

A key aspect of economic and financial developments in Asia in 2003 was the build-up of sizable trade surpluses. Combined with inward investment flows, these gave rise to upward pressures on the exchange rates of most Asian currencies. The resolve of the Asian countries' authorities to maintain an export-led growth model led them, in general, to attempt to counter the rising trend of their currencies against the dollar – even under theoretically floating rate regimes – via intervention on the foreign exchange markets, which prompted a substantial build-up in foreign currency reserves. This build-up was largely in the form of purchases of US government securities (see Box II.2), which eased the financing of the US budget and current-account deficits. However, this would have also set back the correction of the current-account deficit, deferring and increasing the risks entailed by this correction.

Chinese GDP growth in 2003 stood at 9.1%, underpinned by surging exports and investment. Investment quickened to an extent that might raise doubts about its sustainability, fuelled by foreign capital and domestic credit against a background of stable low interest rates. In turn, exports benefited from the international upturn and from the competitiveness of domestic products. To preserve this competitiveness, exchange rate policy was geared to maintaining the exchange rate of the renminbi against the dollar which, against a backdrop of heavy capital inflows, prompted a considerable increase in international foreign currency reserves to around $400 billion at the end of the year. A portion of these reserves was used in the restructuring of certain state-owned financial institutions, in order to advance the reform of the financial sector, which will have to withstand notable structural fragility in the coming years in an environment of foreseeably liberalised capital flows. In this respect, it should be recalled that since its accession to the World Trade Organisation, the weight of the Chinese economy in worldwide trade and finance has continued to grow apace. This has been seen in 2003 in aspects ranging from the impact of China on the increased demand for and prices of raw materials, to its prominent role as a recipient of foreign direct investment and a purchaser of US government securities (see Chart II.7).

Growth in the Indian economy, the second biggest in the area, quickened appreciably in 2003 to 7%. Inflation accelerated to a year-on-year rate of 5.3% in December 2003, compared with 3.2% a year earlier. Set against slightly expansionary monetary and fiscal policies, the rupee appreciated against the dollar like other Asian currencies. That led the central bank to intervene on the foreign exchange markets, thereby increasing its reserves, which stood at $100 billion at the end of the year. The Indian economy's integration into the global economy is also progressing, albeit at a slower pace than China.

3.2 LATIN AMERICA

The year 2003 saw a halt in the declining trend of capital inflows into the region that had prevailed since 1998. That made for a progressive improvement in financial conditions and translated into a considerable narrowing of sovereign spreads, notable stock market rises and an appreciation, in general, of exchange rates against the dollar (see Box II. 3). Foreign direct investment remained the main source of financing, although there was a lesser net inflow in this connection than a year earlier, while net portfolio investment was once again positive, after two consecutive years of outflows. The remaining flows, including bank loans, posted a much less marked net outflow than in 2002 (see Chart II.7).

Despite improved financial conditions and the brighter international economic situation, activity only showed more robust and widespread signs of recovery towards the end of the year, which may probably be attributed to the scale of the prior external adjustment and the tightening of macroeconomic policies that accompanied it. Thus, after marked sluggishness in the first half of the year, the growth of the main economies in 2003 as a whole stood at 1.3%, up on –0.2% in 2002 but still far off their potential growth. The positive figure was due virtually in its entirety to the buoyancy of the external sector (see Chart II.1). This growth did not suffice to avert a decline in per capita income levels in the region for the third year running.

During the second half of the year there was a widespread rise in activity. However, as was the case in the first six months, the rise was much sharper in those countries that had undergone serious crises the previous year, in particular Argentina, Uruguay and Venezuela, which achieved year-on-year GDP growth rates of close to 10% in Q4. Nonetheless, the delay with which the pick-up in growth came about in the two main economies, Brazil and Mexico, acted as a brake on the general outlook for the region.

In terms of components, the biggest contribution to GDP growth in 2003 was from external demand (1.9%, compared with –0.6% for domestic demand). This was especially the case in the first half of the year, given the strong recovery in commodity prices and the increase in global demand. As to domestic demand, neither private consumption – weighed down by high unemployment and the unfavourable course of wage income – nor investment showed clear signs of picking up. However, there were notable divergences in the behaviour of the domestic and external demand components in the different countries. Private investment, which had fallen by almost 3 pp as a proportion of GDP in the area as a whole since 1998 to below 16%, led the recovery in domestic demand in the second half of the year in countries such as Colombia and, to a lesser extent, Brazil, where private consumption was very depressed throughout the year. However, in countries such as Chile and Mexico the pace of recovery was very slow, running counter to the more buoyant performance of private consumption.

As regards external demand, exports grew soundly over the year, especially in Brazil. In Mexico, however, there was a considerable lag before its export capacity to the US was harnessed to the recovery there. Generally, import growth in the region moved on a gradually accelerating path during the year, which did not prevent a comfortable trade surplus of around 5% of GDP.

The impetus of exports enabled progress to be made in the external adjustment, whereby the Latin-American economies as a whole posted an estimated current-account surplus of around 1.1% of GDP. That is an infrequent occurrence for the region, where a surplus has been recorded on only four occasions in the past 20 years. Both the current-account surpluses and the resumption of capital flows enabled currency reserves to be rebuilt after they had diminished notably during the turbulence of the 2001-2002 period. Indeed, currency reserves in the region as a whole increased by more than $34 billion, up to an historical high.

Foreign exchange market developments have recently figured prominently on the international economic agenda, owing to the significant depreciation of the dollar against the euro during 2003 and in early 2004 and its relative stability against certain Asian currencies. This stability has been accompanied by a massive build-up of international reserves by Asian countries which, if Japan is included, currently hold around $2,000 billion (60% of total world currency reserves), $500 billion of which were accumulated in 2003.

The accompanying chart shows that the increase in reserves has been across the board, irrespective of the *de jure* exchange rate regime in each country, although those with a system of fixed exchange rates against the dollar (China and Malaysia) have seen the largest increase in international reserves as a percentage of GDP. As far as the accumulation of reserves and the movement of the exchange rate are concerned, there do not seem to be any very significant differences between those countries declaring that they follow a dirty-float regime and those declaring a free-float. To a greater or lesser extent, all of them appear to have limited the tendency for their currencies to appreciate, through intervention, which in many cases led to their reserves increasing by 2-6% of GDP in 2003. Although it is very difficult to draw conclusions from this chart regarding the effectiveness of the intervention, it gives the impression that Japan, which nominally has a free-float regime, managed to avoid a sharp appreciation of its currency (which rose by 10% in 2003), with a resulting increase in reserves, equivalent to almost 5% of GDP. The case of Korea is even clearer. Currency appreciation was completely avoided in 2003, while reserves of around 6% of GDP were accumulated.

This policy of accumulation of reserves has had, inter alia, the following important consequences for the world economy.

First, it has facilitated the financing of the US current-account and fiscal deficits. In fact, between 2000 and 2003 there was a change in the composition of the sources of financing of the US current-account deficit. At first, these were concentrated in flows of foreign direct investment and in the stock market. As these flows decelerated sharply, there was a shift towards public and private fixed-income assets. The accumulation of reserves by Asian central banks (the vast majority of which are denominated in dollars) has made them significant net purchasers of US Treasury bonds. This additional demand, however, may have put off the correction of the US external deficit, which would mean that the risks arising from such a correction have been deferred.

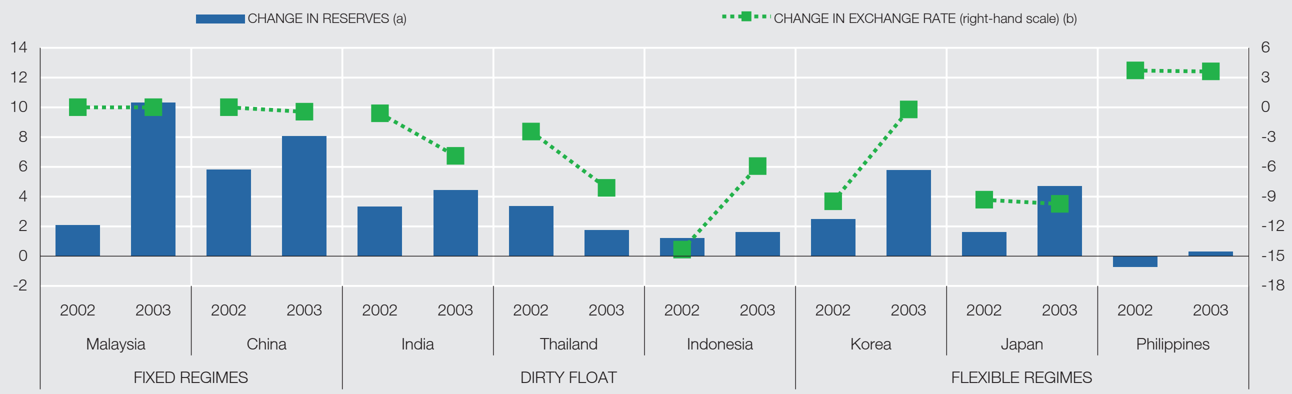
Second, although it is not easy to isolate the influence of the purchases of US government debt by Asian central banks from other factors, it appears that such purchases have contributed significantly to keeping US long-term interest rates at very low levels, especially at the intermediate terms. They have probably also helped to prevent the dollar from depreciating further.

Third, the rapid build-up in reserves and the difficulty for Asian central banks of completely sterilising them has led to an appreciable acceleration in the growth of the monetary base in a large number of countries. With the principal exception of Japan, where deflationary pressures (albeit reduced) are still relevant, this acceleration may, in the medium term, pose inflation risks, owing to the possibility of overheating in some of these economies.

Fourth, the stability of exchange rates against the dollar, practically irrespective of the *de jure* exchange rate regime, has helped to bolster the recovery in the growth of the Asian economies, which is largely based on external demand.

Finally, this situation and the resulting appreciation of the euro, not only against the dollar but also against the Asian currencies, have prevented a balanced distribution of the adjustment of the US external deficit. This, in turn, makes it difficult to achieve a more balanced pattern of growth across the main economic areas. Thus, the more dynamic economies, which account for the bulk of the US external imbalance, have experienced relatively small exchange-rate adjustments, while other areas further behind in the cyclical upswing and in external balance, like Europe, have seen a large part of the adjustment in the dollar exchange rate concentrated on their currencies.

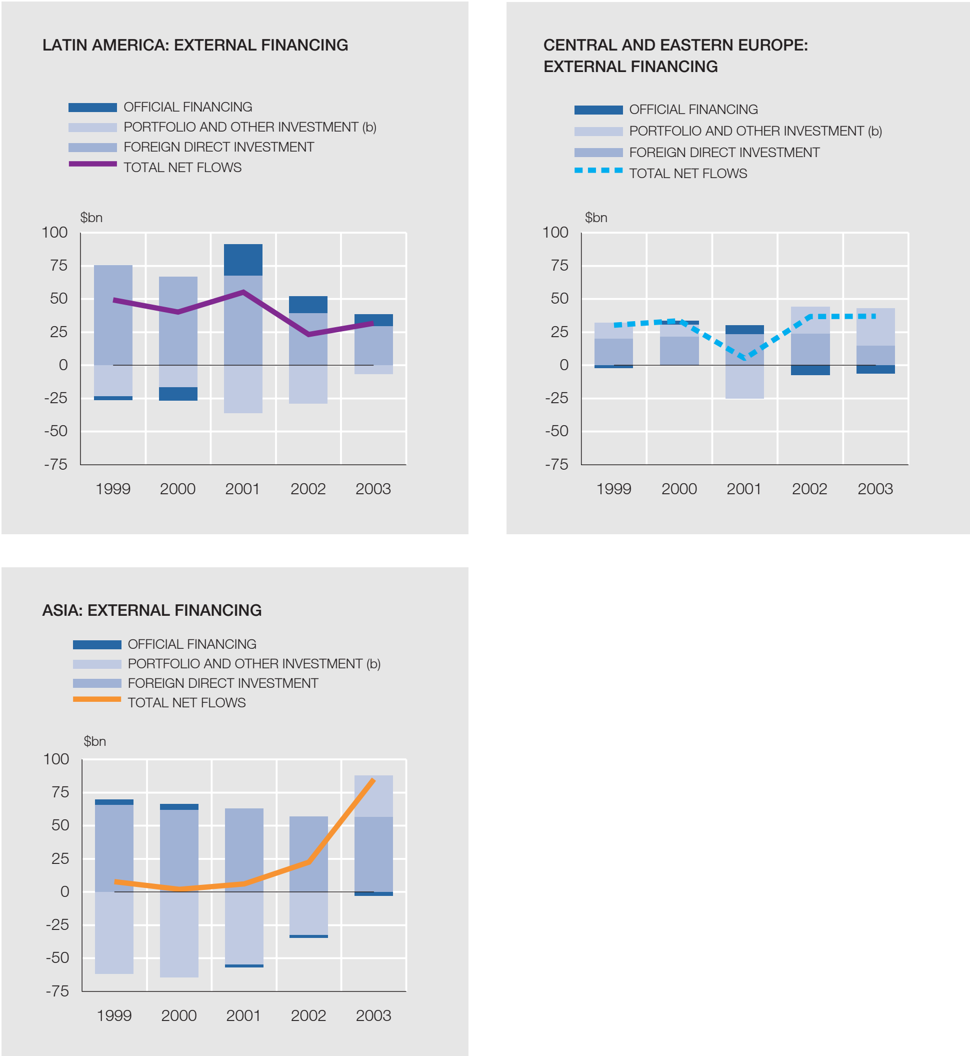
CHANGE IN RESERVES AND EXCHANGE RATE



SOURCES: IIF, Datastream and IMF.

a. Annual change in reserves, as a percentage of GDP.
b. Change in the exchange rate against the dollar (a positive sign denotes a depreciation).

EMERGING ECONOMIES: EXTERNAL FINANCING (a) CHART II.7



SOURCE: IMF.

a. Total net capital flows, in billions of dollars.
b. Includes bank loans.

Capital inflows gave rise to upward pressures on most Latin-American currencies, mainly in the first half of the year. The exception was the Mexican peso, which depreciated by 5% over the year as a whole and stabilised at around this level in early 2004. In aggregate terms it is estimated that the exchange rates of the Latin-American economies against the dollar appreciated by 8.4% in 2003 and 2004 Q1. In terms of the nominal effective exchange rate the figure was much more moderate, at 1.1%, given the sharp depreciation of the dollar against the currencies of other industrialised countries. These upward pressures on the Latin-American currencies were partly countered, during the second half of the year, by the active intervention and reserves-building policy pursued by most of the main central banks in the region. To the fore were the central banks of those countries which, like Brazil or Argentina, had seen their reserves erode during the foreign exchange turbulence of the previous years, although this phenomenon was also witnessed in economies that had maintained stability, such as Mexico. In Venezuela, the downward pressure on the bolivar in early 2003 and the heavy outflow of reserves led the authorities to set strict exchange controls in place from February onwards, which contributed to the collapse of domestic consumption and of imports.

The inflationary rebound in 2002 in most of the countries in the region was controlled during 2003, meaning the end-year 12-month growth rate for the area as a whole stood at 8%. Although this rate is high in comparison with the other emerging regions, it may be relatively favourably assessed if the scale of the exchange rate depreciations most of these countries underwent in 2002 is considered. In fact, this appears to confirm the success of flexible exchange rate regimes combined with direct inflation targeting (see Box II.4). The favourable trend of prices, against a background of exchange rate stability, has allowed an easing of monetary policy in a large number of countries, more sharply so at the beginning than at the end of the year, with the exception of Brazil. There, the downward interest-rate cycle only began in June because of uncertainty over the behaviour of inflation in the opening months of the year. However, thereafter interest rates were cut very sharply, with the benchmark interest rate falling by over 10 pp in the second half of the year to 16.25% at the beginning of 2004. Short-term interest rates in Argentina were also cut to below 3% in the opening months of 2004, a decline of over 12 pp.

Fiscal policies remained relatively tight, if regard is had to the weak cyclical position. This stance served to entrench the falling trend of budget deficits and to produce primary surpluses in most countries. Compared with the past, this was a key difference: in 2003, despite the greater availability and lower cost of external financing, fiscal positions were not generally more lax, which reflects a greater commitment by governments to fiscal stability. In aggregate terms, the total deficit shrank in 2003 to 2.2% of GDP, compared with 4.9% in 2002. Contributing to this improvement were both the fall in financing costs and the increase in the primary surplus, which stood at 2.8% in the region as a whole, 0.6 pp up on the previous year. Despite this fiscal discipline drive, the relatively high levels of debt in many countries remain one of the main factors of vulnerability facing the region.

While lessening the perception of financial instability, the favourable trend of sovereign spreads and of exchange rates and the improved financing conditions contributed only moderately to reducing financial vulnerability, which remains high in many cases. In turn, capital flows would appear recently to have not discriminated sufficiently between the fundamentals of the various economies, favouring to a similar degree even those countries showing greater signs of fragility. For these reasons, the stagnation of structural reforms, especially in the countries beset by crisis in previous years (with certain exceptions, such as Brazil), is a cause for concern. Consequently, it would be most advisable to take advantage of the current favourable financial and economic environment to re-launch reform. Such an undertaking would not only enhance resilience in the event of a fall-off or even reversal of capital flows, it is also a necessary condition for resuming satisfactory growth rates in the medium term.

An area where significant progress was made was that of trade integration, which was reactivated particularly in Mercosur via bilateral agreements. These included most notably the agreements between Chile and the EU in 2003 and between Chile and the United States in early 2004; the headway made between Central America and the United States (CAFTA); the strengthening of US general tariff concessions to the Andean countries; and the integration moves between Mercosur and the Andean Pact. Nonetheless, progress in the main trade agreement – the Free Trade Area of the Americas – was less than expected.

As regards specific developments, which varied across the main countries, in Brazil the impact of the adjustment and of the tightness of economic policies on activity lasted for most of the year, which accounts for GDP growth of virtually zero (–0.2%). Only the external sector showed any buoyancy, which placed the trade balance atypically in surplus, at 5.9% of GDP, and the current-account balance at 0.8%. The dispelling of the confidence crisis on international finan-

One aspect that has characterised developments on emerging financial markets since the end of 2002 has been the high correlation between the returns on sovereign bonds, irrespective of the credit rating of their issuers. Appreciation of this phenomenon has led to speculation that common external factors, such as higher global risk tolerance and US interest rates and growth, are gaining in importance relative to the specifics in each country, relating basically to their economic fundamentals.

Numerous studies[1] have analysed in detail the impact of economic growth in the United States and of US Treasury bond yields on sovereign spreads in Latin America. This would be a direct transmission channel for such common external factors, which would affect the solvency of Latin American countries, taking into account the close commercial and financial ties these countries have with the United States. Some more recent studies, however, have also analysed the existence of a second indirect channel through which US economic growth and US bond yields may influence Latin American sovereign spreads, i.e. through their impact on global risk tolerance which is, in turn, closely associated with such sovereign spreads. Global risk tolerance is a difficult concept to measure, given that it should reflect a wide set of factors, including the predisposition to assume risk, investors' financial position and the liquidity risk in financial markets. In the literature, this concept has been approximated inversely by the yield spread between high-yield US private bonds and US Treasury bonds.

This box considers, first, the impact of global risk tolerance on sovereign spreads in Latin America. The empirical results obtained from the analysis currently being conducted by the Banco de España[2] confirm that the explanatory power of global risk tolerance for sovereign spreads tends to be high and, generally, growing over time, although it varies from country to country and from period to period. Thus, it has greater explanatory power in countries with a higher credit rating or lower risk (Chile) and lower power in countries with a poorer credit rating or higher risk (Argentina, Ecuador, Venezuela). This result seems logical since, as the risk is high in this latter group of countries, sovereign spreads tend to depend more on the specific factors in each country, that is to say, on the fundamentals. In addition, risk tolerance is seen to lose explanatory power, relative to intrinsic factors, in periods of extreme volatility and sharp widening of spreads, such as the banking crises of 1994-1995 in Venezuela and in Mexico, of 1999-2000 in Ecuador and of 2001-2002 in Argentina.

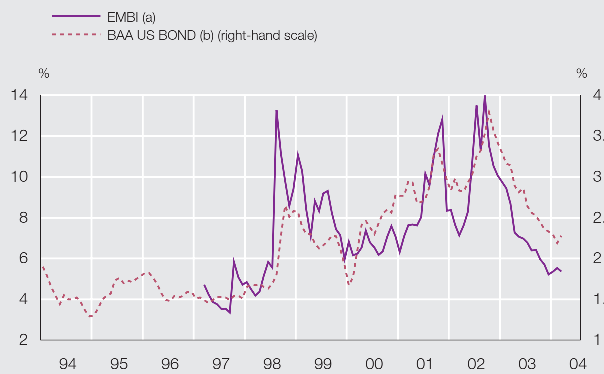
Second, the influence of two of the most important determinants of global risk tolerance (economic growth in the United States and US Treasury bond yields) on sovereign spreads in Latin America is considered.

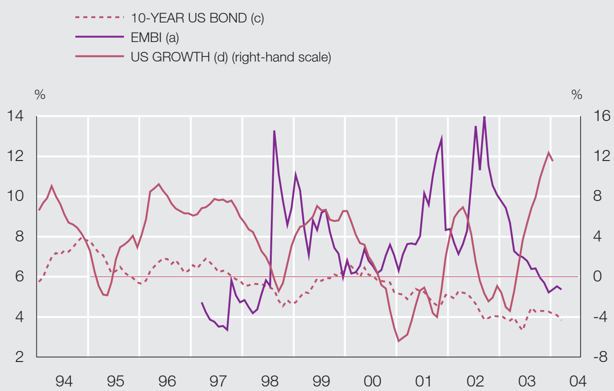
In this respect, it may be concluded from the empirical analyses currently being conducted that the effect of higher economic growth in the United States consistently reduces sovereign spreads across Latin American countries, both through the indirect channel (the increase in global risk tolerance), and through the direct one (the impact on the idiosyncratic part of the spread, or that related to the country's fundamentals). The results are significant in all cases except in those of Argentina and Ecuador, although for these countries they need to be taken with some caution, as both were in a situation of debt default during part of the sample period. As for the impact of US Treasury bond yields on sovereign spreads, the analy-

1. See B. Eichengreen and A. Mody (1998), "What Explains Changing Spreads on Emerging-Market Debt: Fundamentals or Market Sentiment?", NBER Working Paper No 6408, and S. Kamin and K. von Kleist (1999), "The Evolution and Determinants of Emerging Market Credit Spreads in the 1990s", BIS Working Paper No 68.

2. See A. García Herrero and A. Ortiz, "The Role of Global Risk Aversion in Explaining Latin American Sovereign Spreads", Working Paper (under revision), Banco de España.

SOVEREIGN SPREADS IN LATIN AMERICA, US INTEREST RATES AND ECONOMIC GROWTH





SOURCES: OECD, Bloomberg and Datastream.

a. Latin America EMBI sovereign spread.
b. Baa high-yield US bond interest rate.
c. Interest rate on ten-year US government bond.
d. OECD leading indicator of activity.

sis carried out is not conclusive. In particular, and contrary to the more usual results in the literature of the 1990s, it cannot be affirmed that a rise in US long-term rates increases the spreads on Latin American sovereign bonds. This ambiguous result may be explained by the existence of two effects with opposite signs that offset one another. On the one hand, a rise in US long-term rates increases the cost of financing in Latin America, which tends to worsen their fundamentals, especially those relating to debt sustainability (although the empirical analysis is only significant in Chile, Mexico, Peru and Colombia). On the other hand, however, the rise in US long-term interest rates may increase global risk tolerance if it reflects an improvement in the future growth outlook and not inflationary pressures. In the empirical analysis, this indirect channel is significant in all cases except Ecuador.

In short, global risk tolerance appears to have been a significant determinant of developments in the sovereign spreads of Latin American countries in recent years, generally increasingly so, especially in the case of countries with lower risk and during periods of stability. Economic growth in the United States is a key factor in the determination of sovereign spreads, both through its direct impact on US economic fundamentals and its indirect impact, by means of its influence on global risk tolerance. However, the analysis here finds the impact of US long-term interest rates to be much more ambiguous.

cial markets, supported by the authorities' commitment to reform, translated into a marked decline in sovereign spreads to the lowest levels of the past five years, and into a recovery in the real exchange rate. By no means unconnected with this was the posting of a primary surplus of 4.3% of GDP, which was possible thanks to the moderation of spending, as revenues fell in real terms. However, the high interest burden and meagre nominal growth led to a fresh increase in the public debt/GDP ratio to 58.2% at the end of the year.

In Mexico, GDP growth in 2003 did not exceed 1.3%. Despite the recovery in the US economy, activity only began to show signs of picking up in manufacturing output and in non-oil exports towards the end of the year. The export share to the United States fell once again in relation to that of the emerging Asian economies, prompting a debate about the loss of Mexico's international competitiveness and the potential adverse effects of the delay in approving the main structural reforms.

In Argentina, economic developments proved a surprise in respect both of the GDP growth rate (8.4%) and of combating inflation (2.7% year-on-year in December). This has probably to do not only with the prudent monetary policy implemented, but also the excess capacity in many sectors following the crisis in the preceding years and the grinding to a halt of credit. Although macroeconomic stability became gradually more entrenched during the year and a new financial programme was entered into with the IMF, structural reform generally advanced at a very slow pace and there was scarcely any headway in restructuring external debt until the opening months of 2004.

In Chile the economy grew by 3.3% in 2003, mainly as a result of the sound performance of private consumption. However, growth was still below potential which, combined with the appreciation of the peso, prompted inflation to fall notably in the second half of the year to 0.8% in January 2004. The substantial improvement in the inflation outlook led the Chilean central bank to cut its benchmark rate to an historical minimum of 1.75%.

Finally, both Colombia and Peru posted notable growth rates in 2003 of 3.7% (the highest since 1995) and 4%, respectively. Venezuela, however, whose GDP shrank by 9.2%, was assailed by the worst recession in its history, due partly to the effects of the general strike in late 2002, to the seizing up of the oil industry and to the setting in place of exchange controls. Finally, the Uruguayan economy, after the deep-seated crisis in 2002, saw growth last year of 2.5%.

The inflationary process in Latin America has had fundamentally fiscal roots, since seigniorage revenues have traditionally played a very important role in the financing of budget deficits. The pegging of a country's exchange rate limits its monetary autonomy and tends to reduce inflation. Unsurprisingly, then, in a context of high inflation, the stabilisation plans applied in Latin America between the late 1980s and the early 1990s had a more or less rigid exchange rate peg as their common denominator. Fixed exchange rate regimes are not only expected to lead to greater price stability, but also to result in a greater commitment on the part of fiscal authorities to balanced public finances, as their capacity to make use of seigniorage as a source of financing is restricted.

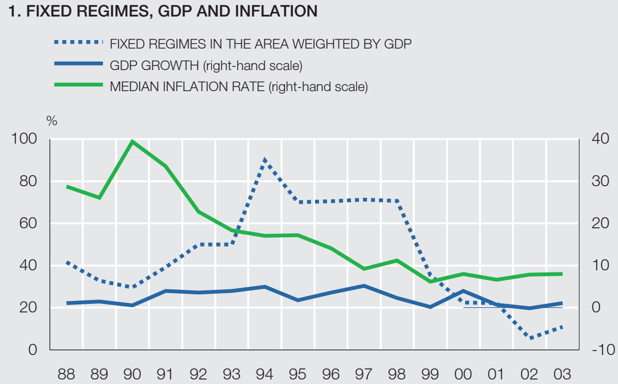
The adjoining chart shows how, during the period pegged exchange rate regimes were predominant, inflation in Latin America as a whole did indeed fall significantly. However, the impact on fiscal balances does not seem to have been favourable. On the contrary, in the early 1990s, the growing weight of fixed-rate regimes was accompanied by a deterioration in fiscal balances. Only since 1994, when the shift towards more flexible exchange rate policies began, have budget deficits been seen to be reduced and subsequently stabilised. All of which implies that the pegging of exchange rates was not conducive to fiscal discipline.

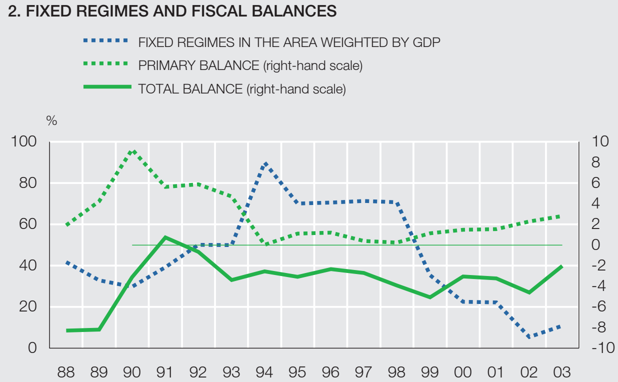
During the second half of the 1990s, as a consequence of the successive financial crises that beset the emerging countries, fixed exchange rate regimes were gradually abandoned in Latin America and there was a fairly widespread shift to floating regimes. Thereafter, the median inflation rate in the area held at moderate single-digit levels, despite the sharp currency depreciation in some countries in recent years. Moreover, in a setting of very low growth, the government deficit has only increased moderately and temporarily, and the area's primary surplus even shows a sustained upward trend. It can be affirmed, on the basis of this behaviour, that the transition to flexible exchange rate regimes in Latin America (in many cases traumatic, since it occurred amid serious crises) has with hindsight proven successful, since it has been accompanied by the consolidation of monetary and fiscal discipline.

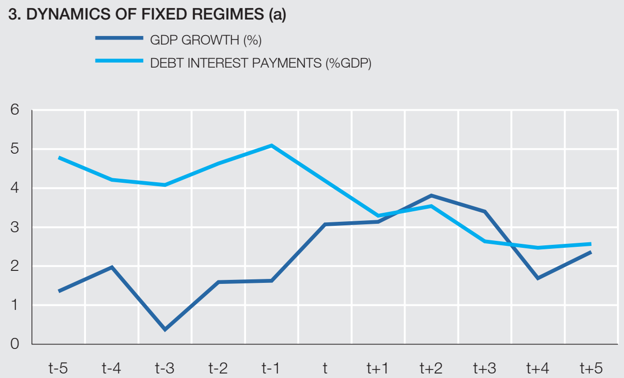
The satisfactory results in the fiscal area in the recent period of flotation, which contrast with those achieved when fixed exchange rates were predominant, may be explained by arguments that refute the fiscal discipline supposedly induced by fixed-rate regimes, the relevance of which has been explored empirically in a recent paper[1]. Rather, certain elements suggest that fixed exchange rates may, on

1. See E. Alberola and L. Molina (2003), "What Does Really Discipline Fiscal Policy in Emerging Markets? The Role and Dynamics of Exchange Rate Regimes", *Money Affairs*, 16, 2, and Working Paper No 0302, Banco de España.

EXCHANGE RATE REGIME AND MONETARY, FISCAL AND REAL VARIABLES IN LATIN AMERICA







SOURCES: IMF and author's calculations.

a. Point 1 refers to the moment the exchange rate is pegged. Whole-sample means.

the contrary, encourage laxer fiscal behaviour than floating regimes. Indeed, on one hand, the pegging of the exchange rate tends to attract external capital while, on the other hand, it boosts consumption and investment. As seen in the third chart, these effects lead to a reduction in the costs of financing the government deficit and to an economic expansion, respectively. In this way, fiscal authorities may finance greater public spending and fiscal discipline tends to be diluted in the absence of established fiscal institutions. This reasoning, moreover, is backed by the empirical evidence referred to: fixed-exchange rate regimes do not result in a significant improvement in government financial balances, primarily because they substantially reduce debt interest payments, which effectively entails a relaxation of the government's budget constraint and is conducive to less fiscal discipline. Finally, this lack of fiscal discipline ultimately contributes to the abandonment of the exchange rate peg itself, since the latter ends up being incompatible with the macroeconomic imbalances.

In sum, exchange rate anchors may help to achieve greater monetary stability but, as regards fiscal discipline, by providing for readier access to external financing, they may set in motion (especially in countries more dependent on foreign capital flows) a deterioration in public finances that ultimately undermines the sustainability of the fixed exchange rate regime itself. The external anchor may, in short, help the authorities pursue a policy of general commitment to fiscal discipline, but can never replace it, and may even lead to fiscal indiscipline.

3.3 EU CANDIDATE COUNTRIES AND OTHER EASTERN EUROPEAN ECONOMIES

The ten countries that joined the EU in May (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) sustained relatively high growth rates of around 3.5% last year, although budget and current-account deficits persisted. The strong recovery in Poland (the biggest of these economies, which grew by 3.7%) and the moderate rebound in the Czech Republic both contributed to offsetting the lower growth of countries such as Hungary, Slovakia and Slovenia, while it was the Baltic countries which maintained the highest rate of increase of GDP.

In most of these countries the main expansionary impulse stemmed from domestic demand, while the contribution of the external sector was generally slightly negative. This was the result of the forceful momentum of imports, since exports tended to trend favourably. The exceptions to this growth pattern were Poland and Slovakia, where external demand picked up strongly.

The disinflationary process witnessed over recent years continued in 2003, although inflation rates rose virtually across the board as from mid-year, and continued to do so in the opening months of 2004. This rebound was due, among other reasons, to the rise in food prices, to the liberalisation of certain administered prices and to the rise in indirect taxes. Within these general patterns there were notable differences between countries: whereas some, such as Poland, recorded an appreciable easing of their average inflation rate (in the case of the Czech Republic it even turned negative), in other countries such as Hungary (4.7%) inflation rates were considerably higher.

Turning to public finances, the fiscal deterioration was one of the most significant and worrying aspects of economic developments in these countries in 2003. This was not only due to the fact that, in the odd case, the budget deficit was higher than that of the previous year, but also and especially because there were significant deviations from the targets set. On average, budget deficits stood at around 5% of GDP, most with a high structural component. There were adverse and significant fiscal deviations in the Czech Republic and Hungary, while in Poland the deficit adhered to the figure of 4% of GDP foreseen, although the prospect for 2004 is that it will increase. Conversely, fiscal consolidation in the Baltic countries, among certain others, progressed notably, with moderate deficits or better-than-expected fiscal results being achieved. Overall, nominal convergence advanced in terms of inflation, but not as far as the performance of public finances was concerned.

The current-account deficit widened in most of these countries, the only exceptions being Poland (which reduced it from 3.5% of GDP in 2002 to 1.9% in 2003) and, above all, Slovakia (from 7.2% to 1.9%), thanks to the highly favourable performance of exports. In other countries, however, the buoyancy of domestic demand meant that external deficits increased to very high figures (5%-10%, and even higher), which might pose problems of medium-term sustainability in some cases. Nonetheless, factors such as the low levels of external debt, high currency reserves, the need for foreign saving to finance economic growth processes, heavy foreign direct investment inflows and the institutional stability stemming from the recent entry into the EU tend to qualify this concern.

The deterioration in the current-account and budget deficits gave rise to various pressures on exchange rates in certain countries, mainly in the second half of the year. In Hungary, following the minor devaluation of the forint's unilateral band against the euro in June, the central bank was obliged to raise its official rate by 600 bp in successive steps, in order to counter the pressures against its currency in the second half of the year. Despite a rise in interest rates, the forint's market rate against the euro depreciated by 10% over the year as a whole, while the Polish zloty fell 15% and the Czech koruna 2.5%, these depreciations having been partly reversed at the start of the current year.

Among the remaining emerging economies in the area, Turkey and Russia should be mentioned in view of their systemic importance. Turkish GDP grew by 5.5% in 2003 as a result of strong increases in consumption and investment. The appreciation of the Turkish lira enabled inflation to be reduced by almost half in 2002 and to below the 20% target at the end of the year. The sustainability of public debt remains the biggest challenge to the Turkish economy, owing to the vulnerability inherent in its short-term structure and its dependence on developments in interest rates and in the exchange rate, which means that sizable primary surpluses are needed.

Growth in the Russian economy quickened forcefully to 7.3%, amply exceeding the 2002 figure of 4.7%. The driver here was the external sector and investment, particularly in the oil industry, encouraged in part by the favourable trend of crude oil prices. In turn, the inflation rate fell to 12% in December 2003, in line with the central bank's target. Russia maintained a high current-account surplus of around 9% of GDP, similar to that in 2002. This stepped up the rate of accumulation of reserves, which currently stand at $73 billion. Finally, public finances showed a surplus of 1.3% of GDP.

1 Economic conditions in the euro area

In 2003, the euro area remained mired in the prolonged period of low economic growth which had begun two years earlier, characterised by GDP growth rates clearly below potential. Specifically, euro area GDP grew by only 0.4% last year, 0.5 pp below the rate posted in 2002 (Table III.1). In the first few years of this decade, the euro area and the other major economic regions were subjected to common shocks: an unstable international political environment, rising oil prices, the stock market crisis and the need for financial restructuring by firms following a period of heavy debt accumulation. However, the euro area has had the greatest difficulty in overcoming the impact of these developments, partly because of its sluggish private spending linked to weak consumer and business confidence.

Against this background, although demand-side policies have adopted an expansionary stance, they have been of limited effectiveness in strengthening economic agents' income expectations and, therefore, in increasing their propensity to spend. At the same time, the increasingly widespread perception of obstacles to sustained progress of the European economy coupled with scant reforming zeal have had an adverse effect on activity. In any event, an environment of macroeconomic stability with highly favourable conditions for economic activity seems to have taken root in the euro area. Conceivably, if there are no new shocks in the European or international environment, the euro area will sustain a path of recovery in the current year (in line with the improvement seen in 2004 Q1) up to rates close to those of potential growth, and an inflation rate compatible with the definition of price stability confirmed and clarified by the ECB in the review of its Monetary Policy Strategy in spring 2003.

1.1 ACTIVITY AND EMPLOYMENT

In 2003, the euro area posted very mediocre results in terms of annual average GDP growth, which stood at its lowest level since 1993. This weakness of activity was more marked in the first half of the year, when heightened international political uncertainty had an adverse impact on agents' confidence and trade. In the second half, the euro area economy showed greater buoyancy as financial conditions and the international environment improved, although the pace of recovery has so far been relatively modest.

Regarding the composition of growth, the negative contribution of 0.6 pp by the net external balance was attributable to the marked appreciation of the euro and, in the first half of the year, to the sluggishness of world trade (see Table III.1). Domestic expenditure continued to suffer from a notable lack of vigour, although its contribution to output growth was somewhat higher than in 2002. Finally, stockbuilding accounted for 0.3 pp of GDP growth.

Notable among the components of domestic demand was the slackness of private consumption, which remained flat from 2003 Q2 (see Chart III.1). In part, the weakness of consumption reflected the modest growth in disposable income which, despite the net transfers received from general government and sustained compensation per employee, was held back by the scant growth in employment. In addition, households did not significantly use their asset holdings or resort to credit to increase this component of their spending. Thus, it is estimated that the saving ratio barely fell in 2003, after rising markedly in the previous two years, despite low real interest rates and the positive wealth effects resulting from the stock market recovery since spring and from the house price rises in certain countries. This cautious attitude seems to reflect agents' scant confidence in their future income (see Box III.1).

EURO AREA: MAIN MACROECONOMIC INDICATORS (a) TABLE III.1

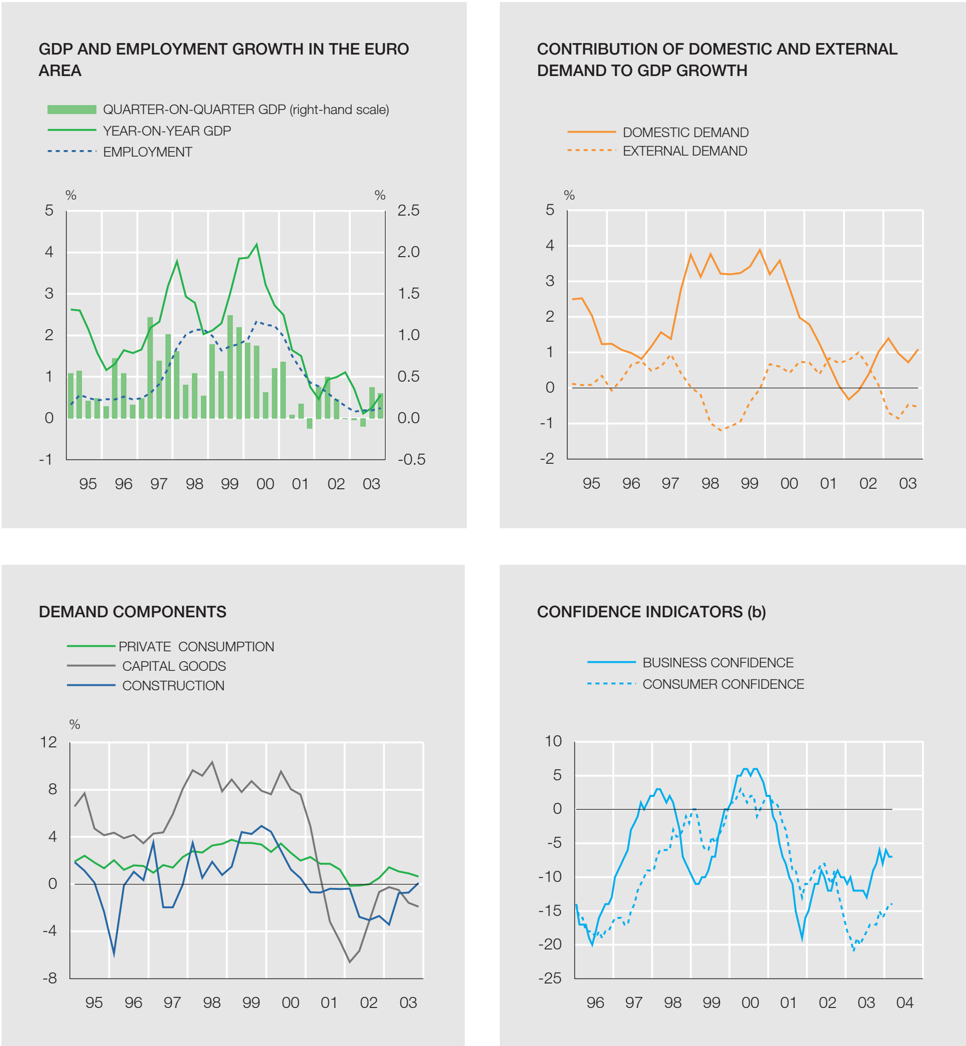
	2001	2002	2003	2003 Q1	2003 Q2	2003 Q3	2003 Q4
DEMAND AND OUTPUT							
Gross domestic product	1.6	0.9	0.4	0.0	-0.1	0.4	0.3
Domestic demand excluding stocks	1.4	0.0	0.8	0.2	0.1	0.2	0.2
Private consumption	*1.7*	*0.1*	*1.0*	*0.5*	*0.0*	*0.1*	*0.0*
Government consumption	*2.5*	*2.9*	*2.0*	*0.5*	*0.6*	*0.7*	*0.4*
Gross fixed capital formation	*-0.3*	*-2.8*	*-1.0*	*-0.8*	*-0.3*	*-0.2*	*0.6*
Exports	3.4	1.5	0.1	-1.3	-0.8	2.2	0.2
Final demand	1.6	0.6	0.8	-0.1	-0.2	0.6	0.6
Imports	1.7	-0.1	1.8	-0.4	-0.5	1.1	1.6
Contibutions to GDP growth (b)							
Domestic demand	0.9	0.3	1.0	0.4	0.0	-0.1	0.8
Change in stocks	*-0.5*	*0.2*	*0.3*	*0.2*	*0.0*	*-0.3*	*0.6*
External demand	0.7	0.6	-0.6	-0.4	-0.1	0.5	-0.5
PRICES AND COSTS (c)							
Consumer prices (annual average)	2.6	2.3	2.1	2.3	1.9	2.0	2.0
Final demand deflator	2.0	1.5	1.2	1.5	1.1	1.2	1.1
GDP deflator	2.4	2.5	2.1	2.0	2.2	2.2	2.1
Unit labour cost	2.6	2.2	2.2	2.0	2.7	2.4	1.7
Compensation per employee	2.8	2.5	2.4	2.5	2.6	2.5	2.1
Labour productivity	0.2	0.3	0.2	0.5	-0.1	0.1	0.3
GENERAL GOVERNMENT (d)							
Total expenditure	48.2	48.4	49.1				
Current expenditure	43.7	44.1	44.6				
Interest payments	*4.0*	*3.7*	*3.5*				
Public investment	2.5	2.4	2.6				
Total receipts	46.6	46.2	46.4				
Primary deficit (-)/surplus(+)	2.4	1.5	0.8				
Deficit (-)/surplus(+)	-1.7	-2.3	-2.7				
LABOUR MARKET							
Total employment	1.4	0.5	0.2	0.0	0.1	0.0	0.1
Unemployment (e)	8.0	8.4	8.8	8.7	8.8	8.8	8.8
BALANCE OF PAYMENTS (d)							
Current account	-0.2	0.8	0.4	0.2	-0.4	0.6	1.0
Capital account	0.1	0.2	0.2	0.1	0.1	0.2	0.4

SOURCES: ECB and European Commission.

a. Quarter-on-quarter rates, unless otherwise indicated.
b. Percentage points of the percentage change in GDP.
c. Year-on-year rates.
d. As a percentage of GDP.
e. As a percentage of the labour force.

Gross fixed capital formation contracted —for the third year running— by 1% in 2003, although this was less than in 2002. The cyclical fluctuations of this demand component are usually much more marked than those of demand as a whole, a feature which has sharpened in the latest economic cycle. Investment thus decreased from 21.6% of GDP in 2000 to 19.8% in 2003. The long duration and notable intensity of the installed capacity adjustment process has its roots in the downward revision of the expected return on investment projects and in the excess capacity built up in certain sectors in the previous expansionary phase. The impact of these factors has been heightened by the excessive indebtedness of certain large firms, which has forced them to use a high proportion of their cash flow to improve their financial position and, in the past year, by the poor performance of business margins as a result of the growth of unit labour costs and of ex-

EURO AREA: COMPOSITION OF GROWTH AND CONFIDENCE INDICATORS (a) CHART III.1



SOURCES: ECB, European Commission and Banco de España.

a. Annual percentage changes, unless otherwise specified.
b. Percentage balances.

change rate appreciation. However, the conditions for a pick-up in productive investment improved in 2003, mainly as a result of the sound performance of financial markets, reflected in narrowing corporate debt spreads and in rising stock market prices, which lowered the cost of capital. These factors, along with the progress in balance-sheet restructuring and the improvement in business confidence (linked to receding geopolitical uncertainty from April and growing buoyancy of external demand), were conducive to a profile of progressive recovery, which in Q4 brought a return to positive rates of change in investment.

Exports posted zero growth in 2003 as a whole. The weakness of this component of demand was basically due to the appreciation of the euro (see Box III.2). However, the increase in activity in the main geographical areas during 2003 saw foreign sales expand more in the second half of the year, which enabled this component to contribute more significantly to the recovery in euro area output in the closing months of the year. Meanwhile, imports expanded to a rate of 1.8%, as a result of the opposing effects of weak domestic demand and of cheaper foreign products due to euro appreciation. The outcome of these developments in

CAUSES OF THE SLACKNESS OF PRIVATE CONSUMPTION IN THE EURO AREA

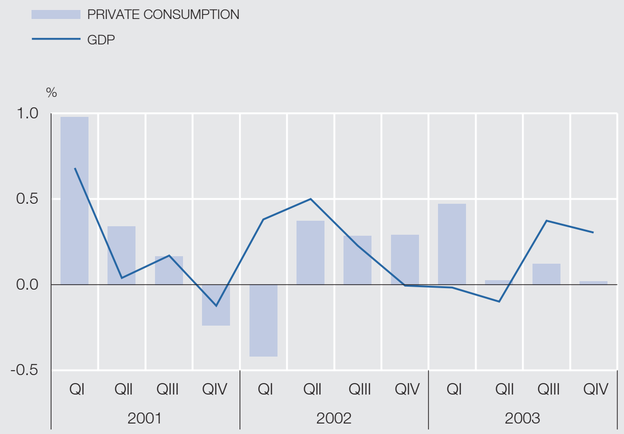
In 2001 and 2002, private consumption was somewhat slack. This was reflected in the saving ratio, which rose from 8.2% in 2000 to 10% in 2002, ending the downward trend that had prevailed in the 1990s. This behaviour contrasts with the permanent income hypothesis, according to which consumers reduce their saving during slowdowns in activity to smooth their pattern of consumption over time. Euro area private consumption continued to show signs of weakness in 2003, especially in the latter three quarters, during which its growth was almost flat (see first chart). This behaviour is relatively unusual, given the maintenance of employment and the favourable financial conditions prevailing, in the form of very low real interest rates. Furthermore, the support provided by the increase in real asset prices and the revaluation of financial assets during the year would be expected to have also helped boost household spending.

A confluence of a variety of factors may help explain the weakness of private consumption. First, the perception that the inflation rate was higher than it actually was, which took hold following the introduction of euro notes and coins in 2002, seems to have prevailed for some time. This may have contributed to agents underestimating the growth of their real disposable income, with the consequent disincentive to increase spending. Second, although total employment has been particularly resilient during the recent slowdown, there have also been significant job losses in some sectors, especially in manufacturing, and in certain countries, such as Germany. Possibly, these changes in the composition of employment by sector and country have some bearing on determining the ultimate behaviour of consumption; pessimism in the less dynamic areas may have led to a reduction in consumption that has not been offset by spending decisions in regions with higher growth. This effect may be relatively important, if it is taken into account that, in those countries that have been less buoyant, significant structural weaknesses have been highlighted which may have influenced agents' perceptions of the future behaviour of their wage income or the sustainability of the unemployment protection mechanisms, thereby boosting saving for precautionary motives (see second chart).

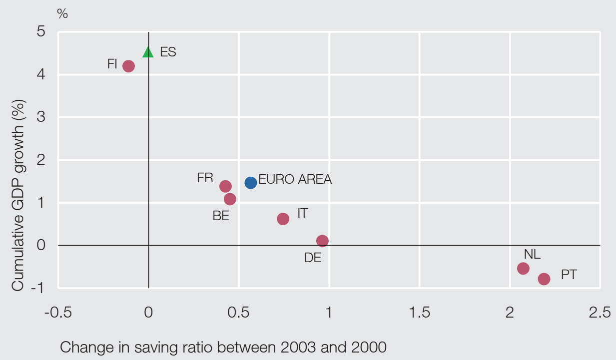
Also, the recent deterioration in the public finances of the euro area and the difficulties in applying and complying with the Stability and Growth Pact may have been interpreted by agents as clear symptoms of the need for reform of some of the basic aspects of the welfare state in Europe, in order to adjust to the aging population. Therefore, agents may have assumed higher taxes and lower disposable income in future, which may have boosted saving. In fact, the public deficit and the saving ratio have moved in parallel since the beginning of the 1990s (see third chart).

It therefore seems likely that the structural difficulties of the European economy, together with the problems in its public finances, have led to a loss of confidence among households that has proved more persistent than in similar cyclical phases in the past. In this respect, although consumer confidence indicators have improved in recent months, in 2003 they were at relatively low levels, below their historical average (as seen in the final chart).

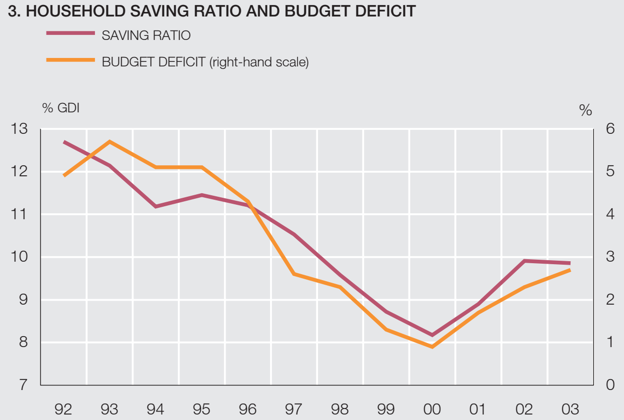
1. CONSUMPTION AND GDP GROWTH (a)



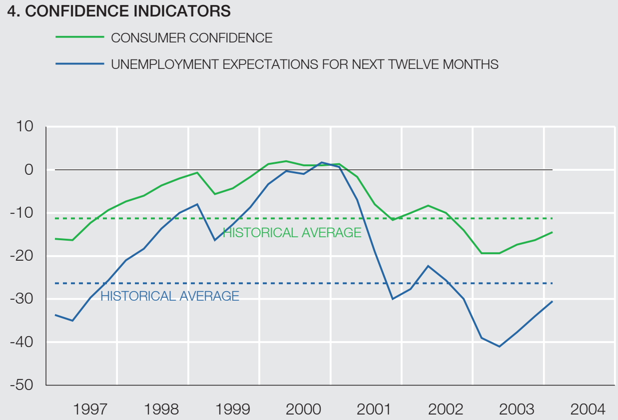
2. HOUSEHOLD SAVING RATIO AND GROWTH 2001-2003



3. HOUSEHOLD SAVING RATIO AND BUDGET DEFICIT



4. CONFIDENCE INDICATORS



SOURCES: Banco de España, ECB, European Commission, OECD and national statistics.

a. Quarter-on-quarter growth rates.

the area's trade flows was that the current-account surplus decreased by 0.5 pp to 0.4% of GDP. In terms of the financial account, this lower surplus was reflected in a decrease in net foreign direct investment outflows and in net external assets of monetary financial institutions (MFIs); at the same time, however, portfolio investment increased in the rest of the world.

In 2003 there was a further divergence in the growth rates of the countries in the area, due mainly to the dispersion in the contribution from domestic demand, which was greater than that of foreign demand (see Chart III.2). In particular, domestic demand in the two most buoyant economies in the area (Greece and Spain) showed notable strength, while the contribution from net trade did not depart significantly from the average for the area. By contrast, in the Netherlands and Portugal, which posted negative growth rates, private spending contracted sharply. As well as the factors specific to each country, there were common causes (analysed in Box I.3) at play here, such as the high level of private-sector indebtedness and the persisting effects of the loss of competitiveness in prior periods. Finally, the three largest economies in the area showed scant buoyancy in 2003, with rates of GDP expansion that were very low (France and Italy) or even slightly negative (Germany). France and Italy showed some similarities in their growth patterns, with a fairly large fall in net exports and a modest rise in household spending. By contrast, in the German economy, the external sector put in a better performance, while private consumption showed negative growth. Box III.3 analyses how the cyclical synchrony of the various European countries may be affected following the enlargement of the EU. Sectoral analysis of activity showed that, although the growth rate of value added in all sectors decreased in comparison with 2002, services underwent a somewhat sharper deceleration in 2003 than manufacturing and construction, in line with the weakness of domestic demand.

The unemployment rate rose by 0.4 pp in 2003 to 8.8% of the labour force, while the level of employment remained practically stagnant during the year. One of the features distinguishing the recent stage of low growth from other previous periods has been the limited sensitivity of employment to the slowdown in activity, which has given rise to scant productivity growth for three years running and, given the sustained rate of wage growth, to relatively high increases in unit labour costs. Initially, this behaviour may have been due in part to the desire of businesses not to adjust their workforces until the prevailing economic and political uncertainty eased, given the cost of shedding experienced labour. However, it could be that, among other factors, the rigidities persisting in European labour markets have played a significant role, as described in Box III.4.

The outlook for activity in the coming months is relatively favourable, in view of the growing buoyancy of world trade, the propitious financial conditions and the absence of significant macroeconomic and financial imbalances in the private sector. In this respect, the main European economies grew notably in 2004 Q1 at higher-than-expected rates. However, this positive picture for economic expansion includes certain elements of risk. In particular, the possibility that employment may respond weakly to the strengthening of activity (as occurred in the cyclical downturn) and the possible impact of the euro area economy's structural problems on agents' confidence are factors that cast some doubt on the future behaviour of household spending. Moreover, productive investment is possibly still somewhat constrained by the relatively high levels of corporate debt. Finally, there are still notable risks in the external environment deriving from the persistence of significant global imbalances and their possible implications for the foreign exchange and financial markets and from the uncertain future course of oil and other commodity prices.

After contributing around 0.5 pp to GDP growth in 2001 and 2002, the external sector deducted 0.6 pp from the expansion of output in the euro area in 2003. This fall in the contribution of the external sector is related to developments in the euro exchange rate which, in nominal effective terms, appreciated significantly between 2001 and 2003, by close to 18%. Analysis of the manufacturing sector is very relevant in any assessment of the effects of the appreciation, not only because manufactures represent a large part of all trade flows, but also because these goods are more sensitive to exchange rate movements and enable foreign trade to be analysed without the distortions introduced by changes in international commodity market prices.

Between end-2001 and end-2003, the period of sharpest euro appreciation, manufacturing exports to countries outside the euro area grew by 1.5%, which was less than the growth in total world exports (see first chart). Although this growth differential may be attributed to the appreciation of the exchange rate, it may also partly be a consequence of the declining trend in the share of euro area exports in world trade over the last decade. This trend, which is shared by other industrialised countries, is related to the emergence of new competitors on international markets, exploiting their comparative advantage in the production of certain goods based on lower costs or a greater availability of certain natural resources. On the imports side, sales of manufactures by the rest of the world to the euro area stagnated in 2002 and 2003 (see second chart). This decline is more difficult to reconcile with the trend in the determinants of these flows; along with the impact of exchange rate appreciation, which tends to lower the price of imports, it would be necessary to consider the expansion (albeit modest) in the final demand of the area in that period, which was 1.3%. In addition, developments in the euro exchange rate not only affect trade flows with the rest of the world, but also trade among euro area countries, in so far as other geographical areas compete for this trade too. Appreciation of the euro would therefore be expected to depress trade within the area. In fact, trade in manufactures between euro area countries fell by 3.4% between end-2001 and end-2003.

To assess to what extent the trade flows analysed have completely adjusted to the new level of the exchange rate it is essential to ex-

EURO AREA FOREIGN TRADE IN MANUFACTURES DURING THE PERIOD OF EURO APPRECIATION

SOURCES: ECB, Eurostat and IMF.

a. Change between 2001 and 2003, in annual average terms.
b. Sign changed.

amine the price-setting behaviour of importers and exporters. The third chart shows that euro area manufacturing exporters have chosen not to pass through in full the exchange rate appreciation to their prices in foreign currency, whereby the prices they receive in euro have fallen somewhat (by almost 4%). This has reduced the negative impact on the volume of their exports, at the cost of a squeeze on their margins (see the last chart). The use of exchange rate hedges may have helped relieve this reduction in the unit margin, but it is difficult to assess the size of this phenomenon owing to the paucity of statistical information. Given that the term of most hedging transactions is less than one year, however, the role that this mechanism may have been able to play will foreseeably have diminished as the appreciation continued. Also, the potential fall in import prices stemming from the rise in the exchange rate has been limited by the behaviour of exporters to the euro area; they have reduced their prices by only about a third of what the exchange rate appreciation would have permitted, which indicates that they have preferred to increase their margins instead of increasing their share in the markets of the area. Thus, despite the sharp change in the exchange rate, export and import prices have followed fairly similar paths. Unlike the prices of exports and imports with respect to the rest of the world, the prices of intra-euro area trade have not fallen, which may indicate that for some European firms it has not been possible to reduce their prices owing to the adverse effect on their margins.

In sum, although the appreciation of the euro has had some significant effects on activity in the area, the incomplete pass-through to export and import prices has limited this impact, as is reflected in a much smaller appreciation of the real effective exchange rate. The possibility that exporters of the rest of the world might cut their prices, and thus forgo part of their margin gain, and the difficulties that European firms may have in maintaining the lower prices of their products mean that this factor, which has reduced the impact of the appreciation, may only be temporary. In any event, the outlook for the recovery of the world economy, which will significantly outgrow final demand in the euro area, will help to offset the adverse effect of the appreciation of the euro on activity.

1.2 PRICES AND COSTS

In 2003, euro area inflation was characterised by notable inertia since, although the growth rates of the main price and cost indicators moderated somewhat, the decrease was limited if account is taken of the weakness of demand and the strong appreciation of the euro during the year. The causes of this downward stickiness shown by inflation include the impact of several transitory shocks such as food price rises (related to the unusually high summer temperatures in some euro area countries), rises in certain indirect taxes and administered prices and, finally, oil price hikes. But there are also other more persistent factors, such as the wage growth inertia seen in recent years, which may have played a role in the limited response of euro area prices to the scant buoyancy of economic activity.

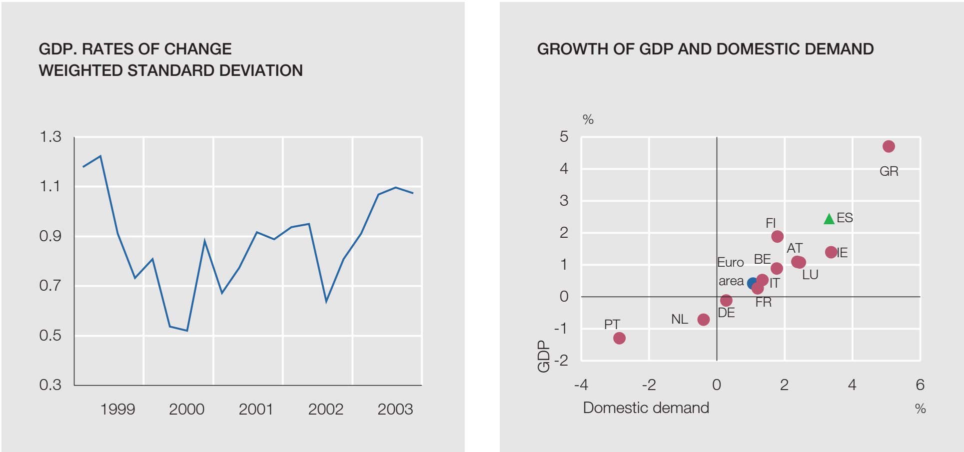
The growth of the final demand deflator slowed by 0.3 pp in 2003. As in the previous year, import prices again fell, albeit very moderately if regard is had to the sharp appreciation of the euro in 2003. Also, the growth rate of the GDP deflator slowed relative to 2002 as a result of the more moderate growth of unit net indirect taxes (which, although high, was lower than in 2002) and, above all, of the slower advance of the gross operating surplus per unit of output.

As pointed out above, the downward stickiness of euro area inflation is partly explained by the behaviour of labour costs. Compensation per employee scarcely responded to the cyclical downturn, showing a growth rate of 2.4%, only slightly less than in previous years. This, along with the scant headway made in labour productivity, meant that the increase in unit labour costs (ULC) was around 2%. As a result of the stabilisation of ULC growth and of the slowdown shown by the output deflator, business margins narrowed. This fall was perhaps sharper in the case of exporters, which, on available information, seem to have dealt with the loss of competitiveness due to exchange rate appreciation by not fully passing through its impact to the prices of their products.

The annual average growth of the harmonised index of consumer prices (HICP) of the euro area in 2003 was 2.1%, just 0.2 pp less than in 2002. As can be seen in Chart III.3, it was the

ECONOMIC PERFORMANCE BY COUNTRY IN 2003

CHART III.2



SOURCES: European Commission and Banco de España.

prices of processed food and energy that increased most. In particular, the rise at the beginning of the year was due to the high year-on-year growth rates of energy prices as a result of the marked oil price rise in the period preceding the outbreak of the Iraq war. In addition, the raising of certain indirect taxes, especially that on tobacco, in various euro area countries triggered a rise in processed food prices in the second half of the year.

Most notable among the other components was the performance of non-energy industrial goods prices, the growth rate of which decreased by nearly half to 0.8%, largely, it seems, as a result of the euro's appreciation. Inflation in the service sector decreased notably in the first half of the year to stand at a yearly average of 2.5%, down 0.6 pp on 2002. As a result, underlying inflation, measured by the rate of change of the CPI excluding unprocessed food and energy, decreased by 0.5 pp to an annual average of 2% and held, with slight fluctuations, at around this level throughout 2003, thereby illustrating the scant cyclical response by prices in the euro area.

The dispersion of inflation rates (measured in terms of the HICP) in the euro area countries declined slightly in 2003, although exhibiting a notable persistence. Thus the differentials between national rates and the euro area average had the same sign in 2003 as in 2002 in all countries except France and Luxembourg, where prices grew more than in the euro area as a whole. Moreover, these two countries were, along with Italy, the only ones to record a rise in inflation. The interaction between cyclical divergences and price and wage stickiness, action by authorities on indirect taxes and regulated prices, and the differences in the level of exposure to external shocks (due to movements in exchange rates or oil prices) are some of the factors that might explain the persistence of inflation differentials within the euro area.

2004 Q1 saw lower inflation, basically due to the gradual return of food prices to more moderate growth rates and, above all, to the falls, in year-on-year terms, in energy prices. The behaviour of this latter component mainly reflects a base effect, given the high rates of expansion at the beginning of 2003. It should, however, be mentioned that 2004 also commenced with oil prices rising sharply to relatively high levels, which might persist. This trajectory is explained by the cutback in production ordered by the OPEC from 1 April, the political tensions in Venezuela and the Middle East, the low oil stocks in the United States and the strength of world demand. Moreover, there is every indication that the appreciation of the euro has been passed through only partially in the case of import prices and to a very limited extent in the case of

The proper functioning of Monetary Union requires a certain similarity of the cyclical patterns of the member economies, to avoid excessive discrepancies arising between the common monetary policy and the needs of each participating country. Evidently, the greater the number and variety of economies belonging to the euro area, the more telling the appearance of persistent macroeconomic divergences will be. Accordingly, it makes sense to analyse the degree of cyclical synchrony between the euro area economies and to compare it with that observed between the countries that have joined in May this year, which may become part of the euro area in future.

A useful measure of cyclical synchrony is the correlation of the industrial production index across the various economies, this being a variable coincident with the business cycle that is available for a broad set of countries. However, simple correlations between levels of series may give rise to spurious results if such series are non-stationary. At the same time, the correlation of rates of growth does not enable the relationship between leads and lags in the series that are relevant to determining the degree of synchrony to be identified. To solve these problems, three alternative measures have been used to calculate the cyclical correlations across countries[1]. The first uses the correlation of the forecast errors of a VAR model, the second uses the spectral decomposition of the series and the third uses a similar methodology to that developed by the NBER to identify the peaks and troughs of business cycles. Despite the differences between these three methodologies they all give a similar view of the degree of cyclical synchrony across countries.

Table 1 shows the average correlations of the euro area countries with one another, with the enlargement countries and, as reference, with the United States, using the average of the three correlation measures mentioned above. Although the correlations observed are not very pronounced, they are all economically significant, given that they are drawn from the monthly growth rates of very volatile series. It can be seen that the average correlation between the countries of the euro area (0.35) is higher than that between the enlargement countries (0.23) and greater than the correlation between the euro area countries and the enlargement countries (0.16). Meanwhile, the United States has a higher average degree of synchrony with the euro area countries (0.28) than the enlargement countries.

Significantly, the high correlation between the euro area countries existed before monetary integration. The average correlation between the euro area countries between 1965 and 1989 is similar to that in the period 1990-2003. Accordingly, the functioning of Monetary Union might be thought to have been assisted by the presence of cyclical links between the euro area countries, which do not yet appear to be evident between the latter and the enlargement countries.

A simple regression analysis shows that the correlations between the European countries diminish with a set of variables that express the heterogeneity of the structural elements of the economies. Thus, the differences between agriculture and industry as a proportion of GDP, the saving ratio, labour productivity and the public sector as a proportion of GDP are significant. On the other hand, the intensity of trade flows contributes significantly to reducing the cyclical distance between the economies. However, it seems that the nominal convergence over the past decade has not been accompanied by any increase in cyclical coincidence. This increase may occur in the future, when the greater trade integration entailed by Monetary Union is clearly perceived.

It is worth considering, in this context, the cyclical integration of the Spanish economy. Table 2 illustrates the position. Spain is more integrated with the euro area economies than the average degree of association of the group, and its distance from the enlargement economies (and the United States) is similar to that of the rest of the euro area countries. As for changes over time, like the other euro area countries, Spain has not undergone major changes with the establishment of Monetary Union, either as regards the degree of average synchrony with the rest of the euro area countries or as regards the distance from the United States.

1. See *Are European Business Cycles Close Enough to be just One?*, forthcoming Working Paper by Camacho, Pérez-Quirós and Sáiz.

1. AVERAGE CORRELATIONS OF INDUSTRIAL PRODUCTION BETWEEN GROUPS OF COUNTRIES. 1990-2003

	EURO AREA COUNTRIES	ENLARGEMENT COUNTRIES	UNITED STATES
Euro area countries	0.35	0.16	0.28
Enlargement countries	0.16	0.23	0.11

2. AVERAGE CORRELATIONS OF INDUSTRIAL PRODUCTION BETWEEN SPAIN AND GROUPS OF COUNTRIES

	EURO AREA COUNTRIES	ENLARGEMENT COUNTRIES	UNITED STATES
Sample 1990-2003	0.46	0.17	0.39
Sample 1965-1989	0.54	—	0.42

SOURCE: Banco de España

consumer and producer prices. Therefore it cannot be ruled out that the exchange rate may continue to help palliate inflationary pressures. Operating in the opposite direction are the increases in indirect taxes and in regulated prices in some euro area countries, such as, for example, those resulting from the reform of health care financing in Germany, which have already led to a pick-up in services prices in these first few months of the year.

2 Fiscal and structural policies in the euro area

2.1 FISCAL POLICY

In 2003 public finances in the euro area further deteriorated for the third year running. The budget deficit of the euro area as a whole increased by 0.4 pp to 2.7% of GDP (see first panel of Chart III.4). This was the result of a 0.6 pp rise in the weight of public expenditure in GDP to 49.1%, only partly offset by a slight increase in the share of public revenue in output, which stood at 46.4% of GDP. This increase in the area's budget deficit was mainly a consequence of sluggish activity since, in cyclically-adjusted terms, the primary balance barely changed according to European Commission estimates, indicating that the fiscal policy stance was neutral in the euro area as a whole. The combination of low economic growth and increased borrowing requirements meant that the public debt/GDP ratio rose by 1.2 pp to 70.4%, interrupting the downward trend seen between 1997 and 2002.

General government balances worsened in all Member States with respect to the previous year, except in Belgium, Spain and Ireland, which were also the only countries to enjoy a small surplus. In 2003 the highest deficits were recorded in Germany, France, the Netherlands and (on provisional data) Greece, which reached or exceeded the 3%-of-GDP limit specified in the Treaty on European Union. The budget deficits of Germany and France rose notably to 4.1% and 3.9% of GDP, respectively. In the Netherlands, whose public finances are more sensitive to cyclical position than those of other Member States, the government had to take consolidation measures in the midst of a sharp economic slowdown, but was unable to prevent the deficit from exceeding 3% of GDP. Italy and Portugal managed to record deficits below this level only because of extraordinary revenue from specific operations such as, for example, tax amnesties, sales of non-financial assets and capital transfers relating to the shifting to general government of the pension obligations of fully or partially State-owned corporations. The total impact of these operations on the 2003 budget was around 2% of GDP in both these countries. Finally, of the seven Member States that in 2002 had departed from structural fiscal balance, only in Ireland, the Netherlands and Portugal did the cyclically-adjusted budget balance improve by an amount equal to or higher than 0.5% of GDP, in line with the recommendations of the 2003-2005 Broad Economic Policy Guidelines.

In the last few years, some countries have cut direct taxes and, in this way, helped to improve incentives for the efficient allocation of resources in the economy. These reforms have generally not entailed a significant deterioration in the underlying budget position because they have been financed by higher indirect taxes. In fact, in 2003 there was a simultaneous increase in the cyclically-adjusted components of revenue and expenditure in proportion to GDP (see third panel of Chart III.4). Nonetheless, evidence suggests that the tax cuts would have had a more favourable effect on the economy if there had been a parallel reduction in public spending.

Against the background of weak activity described above, the application of the fiscal discipline framework proved to be complex and, in certain cases, problematic and even disappointing. In particular, when in January and June 2003 the budget deficits of Germany and France for 2002 were found to have exceeded the limit of 3% of GDP, the respective excessive deficit procedures were initiated. As provided for by the Stability and Growth Pact, the ECOFIN Council required effective measures to be taken within a maximum of four months from those dates, for the purpose of correcting the situation by 2004. However, the autumn forecasts by the European Commission revealed that the measures adopted by the two countries have

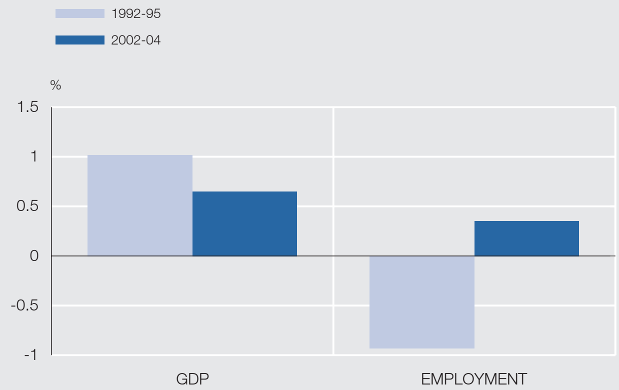
THE BEHAVIOUR OF EMPLOYMENT IN THE EURO AREA DURING THE RECENT CYCLICAL SLOWDOWN

During the prolonged economic downturn that has affected the euro area member countries in recent years, employment has behaved differently than in previous phases of weakness, showing significant reluctance to adjust to the slowdown in the rate of growth of the area. Whereas at the beginning of the 1990s employment began to be destroyed (on aggregate in the euro area countries) when GDP was still growing at rates of more than 2.5%, in the more recent period employment has not actually fallen, despite GDP growth rates of less than 1% since end-2001. As seen in the first chart, GDP growth in 2002 and 2003 was slower than in 1992-1994, but employment fell on average by almost 1% per annum in the latter period, while it continued to grow slightly in 2002 and 2003. Also, the euro area unemployment rate increased by 3 pp between 1992 and 1994, and by only 0.7 pp in the most recent period (between its low in 2001 and 2003).

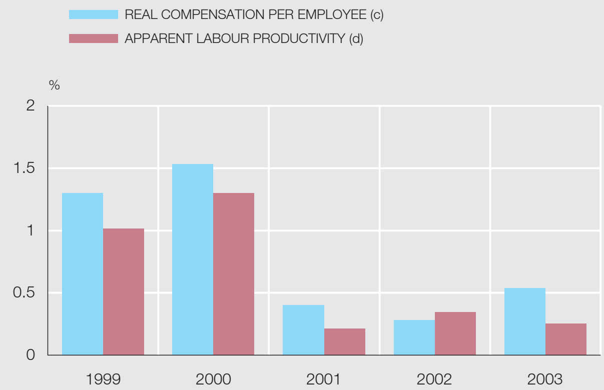
Given this more muted response by employment to the slowdown in activity (which has resulted in a significant deceleration in labour productivity), a downward adjustment to wages might have been expected, which would have moderated the negative impact of lower productivity growth on labour costs. As seen in the second chart, the fall in the rate of growth of labour productivity from 2001 was, in effect, accompanied by a similar-sized adjustment in the growth rate of real wages, although from 1999 the growth of the latter has tended to exceed that of productivity, leading to a deterioration in profit margins during this period. The limited impact of the economic slowdown on employment may therefore have been more a consequence of firms having reduced their margins than of a significant downward wage adjustment.

Meanwhile, it is likely that this employment behaviour stems, at least in part, from the rigidity still present in European labour markets, especially in terms of the level of employment protection. Arguably, employers have tried to introduce flexibility into employment through other mechanisms, which have benefited from the latest reforms carried out in certain euro area countries. One such channel may have been the replacement of full-time employment by part-time employment. The ratio of part-time to total employment in the euro area has,

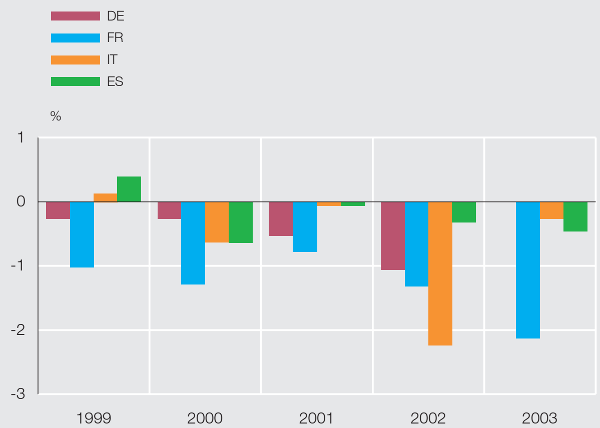
1. EMPLOYMENT AND GDP (a)



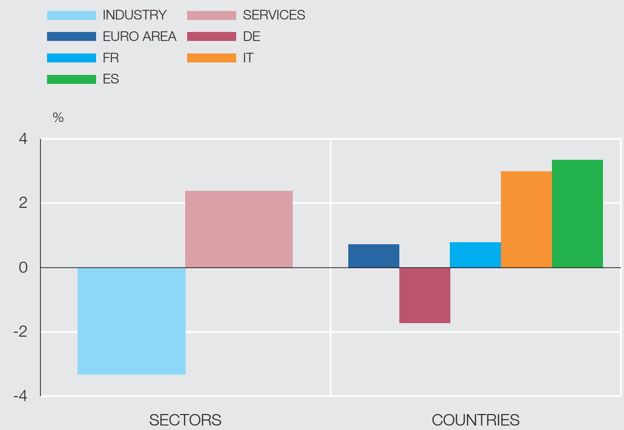
2. LABOUR COSTS (b)



3. HOURS WORKED (e)



4. EMPLOYMENT BY SECTOR AND COUNTRY (f)



SOURCES: Eurostat and author's calculations.

a. Average annual growth rates in each period.
b. Year-on-year rates of change.
c. In terms of the GVA deflator. The 2003 figure is for the first three quarters.
d. GDP per worker.
e. Per worker per week.
f. Rate of change in the period 2002 - 2003.

THE BEHAVIOUR OF EMPLOYMENT IN THE EURO AREA DURING THE RECENT CYCLICAL SLOWDOWN (CONT'D) BOX III.4

since 1998, been on a smoothly rising trend, which seems to have steepened since end-2001. Also, the total employment figures mask the different behaviour of permanent employment (which has maintained growth rates close to 1%) and of temporary employment, through which it has been possible to make part of the adjustment, given the falls recorded since 2001. Finally, some firms seem to have chosen to maintain their workforces while reducing the average number of hours worked per person employed (see third chart).

However, the trend in euro area employment by sector shows that the aforementioned European labour market rigidity has not prevented a significant fall in the number of employees in the industrial sector, which has been more affected by the economic slowdown. By contrast, the services sector has withstood the period of low growth better and has continued to create jobs in recent years, albeit at a declining rate. The resilience of employment in the face of the slowdown in the euro area is also the result of very uneven behaviour across countries, the case of Germany being notable. There, the stagnation of activity has been accompanied by significant job destruction.

Indicators of business sentiment regarding employment have been relatively encouraging in recent months. However, given the narrowing of margins during the economic slowdown (as a consequence of the limited adjustment in the number of persons employed) and the delay with which employment usually reacts to changes in activity, the generation of new jobs in the incipient recovery may prove to be particularly slow.

been insufficient to make for the elimination of their excessive deficit in 2004. The Commission thus recommended to the Council that it decide, pursuant to Articles 104.8 and 104.9 of the Treaty, that the action taken was indeed insufficient and that it require further adjustment measures, although it considered that the correction could be delayed until 2005. Germany and France insisted on a flexible interpretation of the Stability and Growth Pact recognising that the deterioration in public finances stemmed from an unforeseen unfavourable cyclical position and that additional corrective measures could damage their weak economic growth. Finally, the ECOFIN Council meeting of 25 November decided to reject the Commission's recommendations and to suspend the procedure then under way. Also, the Council approved a set of conclusions whereby the date for correcting the excessive deficit in these countries was postponed to 2005, and a fiscal adjustment was required of them that, in terms of the cyclically-adjusted balance, was more severe than 0.5% of GDP. Although the content of these conclusions drawn by the Council did not differ substantially from the proposal formulated by the Commission under Article 104.9, the method used by the Council differed from that provided for by the Treaty, giving rise to uncertainty over its legal implications. To clarify the nature of that ECOFIN resolution, in January 2004 the Commission announced an appeal to the European Union's Court of Justice.

These institutional developments, along with deficient fiscal policy management in some countries during the expansionary phase (which made it necessary to take corrective measures during the cyclical downturn), have sparked intense debate on the euro area's current framework of fiscal discipline. The European Commission considers that there are ways of perfecting the mechanisms in place and has announced that proposals will be submitted in this connection. In any event, regardless of whatever reforms may be decided on, to maintain the credibility of the institutional framework of budgetary discipline, it is particularly important that the countries meet their commitments, especially when they have excessive deficits, and that the multilateral surveillance procedures in place are observed.

The updated stability programmes unveiled between late 2003 and early 2004 point to a slight change of trend in the public finances of the area as a whole. These documents disclose that the euro area deficit will decrease slightly in 2004 (to 2.4% of GDP) and more sharply in 2005 (to 1.7% of GDP), with a moderately restrictive fiscal policy stance. However, the structural position of some Member States in 2006 will still not be close to a balanced budget. Moreover,

EURO AREA: HARMONISED INDICES OF CONSUMER PRICES AND WAGES

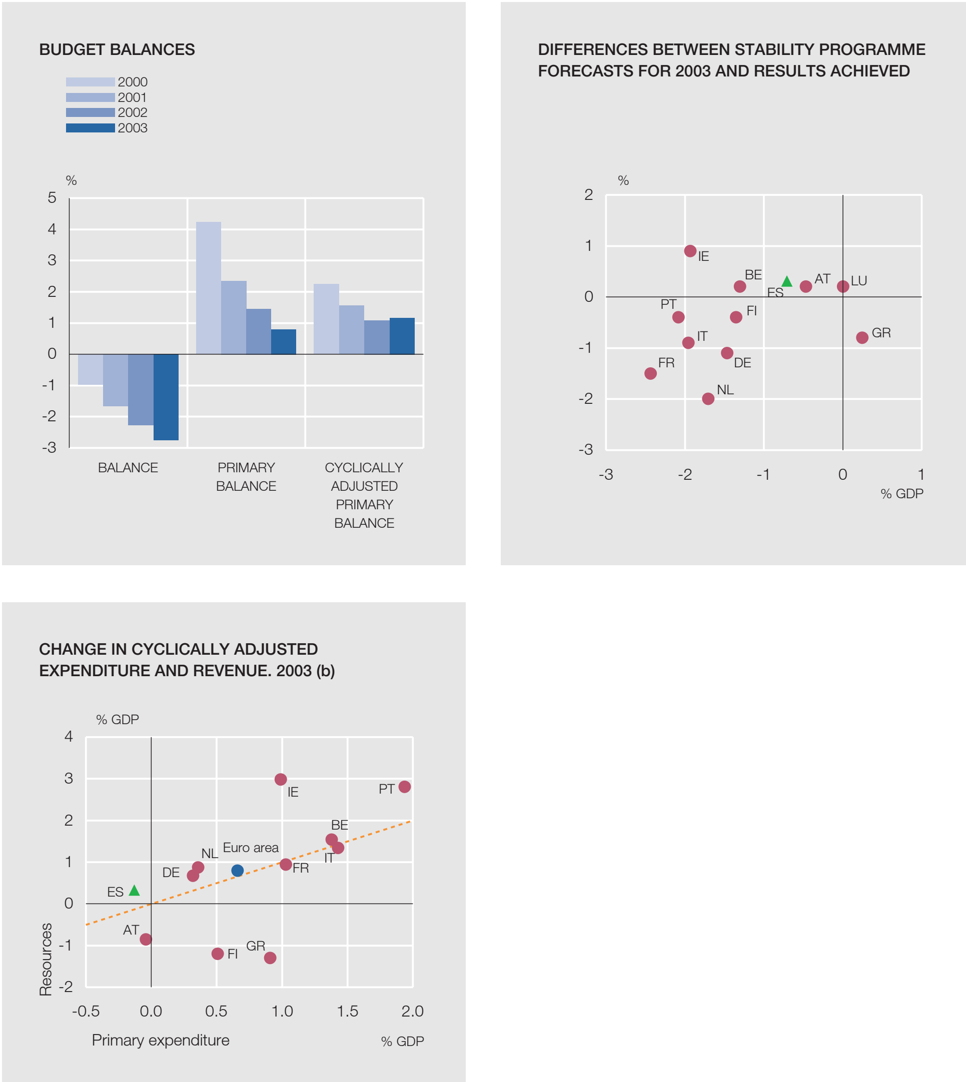
CHART III.3

SOURCES: ECB, Eurostat and national statistics.

a. Annual percentage changes.
b. Difference between the changes in GDP and employment.
c. Difference between the changes in compensation per employee and the GDP deflator.

there is a not insignificant risk in certain cases that an excessive deficit will continue or emerge for the first time. Indeed, in April 2004 the European Commission decided to apply the excessive deficit procedure against the Netherlands and the United Kingdom after their budget imbalances exceeded 3% of GDP in 2003. In addition, the Commission proposed that Italy be issued an early warning, which signals the possibility that the budget balance may deteriorate by more than the admissible limits and recommends the urgent adoption of corrective measures. Finally, the improvement in public balances is based, in certain programmes, on a hypothetical substantial pick-up in economic activity that might not materialise and on the implementation of fiscal consolidation measures that are insufficiently defined. In this respect, it is important to note that, although in 2003 pension and health system reforms were undertaken in some countries, population ageing will exert significant pressure on public expenditure. For this reason, it is essential to move with greater resolve to reduce debt ratios and reform the public pension systems.

EURO AREA: FISCAL POLICY (a) CHART III.4



SOURCES: European Commission (spring forecasts) and Stability Programmes.

a. Proceeds from the sale of third generation (UMTS) mobile telephone licences are not considered.
b. The countries above/below the line have seen an improvement/deterioration in their primary cyclically-adjusted budget balance.

2.2 STRUCTURAL POLICIES

The difficulties encountered by the euro area economy in the expansion of activity in the last three years, despite favourable financial conditions, highlight the need to persevere in the introduction of reforms to raise its potential growth. This need was recognised and formally stated by the European summits in Lisbon and Barcelona, which set specific targets for the years 2005 and 2010 that allow the progress made to be measured (see Box I.1).

Raising the area's potential growth and its GDP per inhabitant requires an increase in both labour input and labour productivity. Regarding the increase in labour utilisation, the total and female employment rates increased between 1999 and 2002 by 1.8 pp and 2.7 pp, respectively, to stand at 64.3% and 55.6% (see Table III.2). However, particularly in the first case, it seems unlikely that the intermediate targets for 2005 (67% and 57%, respectively) can be achieved, although in 2003 some headway was made in this connection. The measures adopted tended to focus mainly on tax reform, without addressing change in the systems of social benefits, which are probably the main disincentive to active job-

STRUCTURAL INDICATORS FOR THE EUROPEAN UNION

TABLE III.2

	1999	2000	2001	2002	2003
LABOUR MARKET					
Employment rate (15-64)	62.5	63.4	64.1	64.3	
Female	*52.9*	*54.1*	*55.0*	*55.6*	
Male	*72.0*	*72.8*	*73.1*	*72.8*	
Employment rate (55-64)	37.1	37.8	38.8	40.1	
Female	*27.1*	*28.0*	*29.1*	*30.5*	
Male	*47.5*	*48.0*	*48.9*	*50.1*	
Unemployment rate	8.7	7.8	7.4	7.7	8.0
Female	*10.2*	*9.2*	*8.6*	*8.7*	*8.9*
Male	*7.5*	*6.7*	*6.5*	*6.9*	*7.3*
Long-term uneployment rate	4.0	3.5	3.1	3.0	
Direct taxes and social contributions on low-wage earners	39.1	38.6	37.7	37.8	
KNOWLEDGE SOCIETY					
R&D (% GDP)	1.9	2.0	2.0	2.0	
Percentaje of homes with Internet access		18.3	36.1	38.9	45.1
Percentaje of enterprises with Internet access			70.3	79.7	84.2
Patent applications per million inhabitants	210.4	232.7	241.2		
Expenditure on information and communication technology, as % GDP		6.5	6.4	6.1	6.2
On information technology		*3.3*	*3.2*	*3.0*	*3.0*
On communication technology		*3.2*	*3.2*	*3.1*	*3.2*
Venture capital investment (% GDP)	0.1	0.2	0.1	0.1	
Public expenditue on education (a)	5.0	4.9	5.2		
Continuous training (% population 25-64)	8.2	8.5	8.4	8.5	9.7
ECONOMIC INTEGRATION AND COMPETITION					
Sectoral prices					
Price of telecommunications (EUR/10 mins)					
Local call	0.40	0.39	0.40	0.39	0.39
National call	1.67	1.32	1.13	1.02	1.00
Call to USA	3.48	3.09	2.63	2.22	2.13
Electricity prices (euro/kWh)					
Industry users	0.064	0.063	0.064	0.062	0.065
Households	0.105	0.103	0.103	0.103	0.103
Gas prices (euro/GJ)					
Industry users	3.49	4.22	6.12	5.75	5.56
Households	6.81	7.24	8.49	8.42	8.37
Foreign trade, as % GDP (b)					
Intra-EU trade	16.2	17.8	17.5	17.0	16.5
Extra-EU trade	9.6	11.5	11.4	10.8	10.6

SOURCE: European Commission.

a. Average level in the twelve countries for which information is available for 2001.
b. Average of total exports and imports.

seeking by the unemployed. An important exception in this respect is the reform approved last year by Germany, which has recently come into force and which places unemployment benefits for the long-term unemployed on an equal footing to welfare aid. The long-term unemployed in Germany have to accept jobs paying wages below the level set in the relevant collective agreements. Finally, the new regulation makes it obligatory, for the purpose of entitlement to receive benefits, to accept jobs involving a lower level of occupational skills than those of the job-seeker, unless the wage is below that set in the collective agreement or, in the absence of the latter, below the regional average wage. Some of these aspects were reformed in 2002 in the Spanish system of social benefits.

The contribution of labour productivity to the expansion of euro area output has an even less impressive record in recent years, since its growth rate has tended to decelerate significantly since the beginning of the 1990s. Bolstering the growth rates of labour productivity requires measures to foster investment (particularly in research and development (R&D) and in human capital) and to raise total factor productivity, the growth of which depends on a more efficient allocation of the available resources and on technological progress, particularly by spreading the use of communications and information technology.

There is thus evidence that, compared with the United States, new technologies are being adopted too slowly in certain areas of the euro area economy, including particularly wholesale and retail trade and financial services. Furthermore, the weight in the area's GDP of private investment decreased during the recent phase of low growth, while public investment has remained unchanged at 2.5% of GDP since 1998. Given this behaviour, in December 2003 the European Council approved the European Initiative for Growth, the aim of which is to boost investment in infrastructure, R&D and human capital (the priority areas identified in the Lisbon strategy) in the EU as a whole. As regards infrastructure, the initiative sets great stock by trans-European transport, energy and telecommunications networks. In particular, the so-called Quick Start Programme was established to identify priority projects which, given their degree of maturity, can be commenced within a short period of time. The projects focus mainly on the cross-border transport links needed to ensure that the networks of Member States are interconnected. This eliminates problems of local congestion and contributes to the creation of major transport routes conducive to European integration. As to investment in R&D, the initiative aims to contribute to meeting the target of the Lisbon agenda, which is to increase spending in this area from the current 2% of GDP to 3% in 2010, with two-thirds of this investment coming from private initiative. Among other policies, it is intended to promote the professional careers of European researchers and the recruitment of highly qualified researchers from third countries. Finally, in the field of education, the main challenge is not so much to increase the public resources earmarked for this purpose as to allocate them more efficiently, identifying the areas that will yield the best returns.

The regulatory environment is crucial for creating the most favourable conditions for economic growth. In this respect, the progress towards completing a true integrated internal market in the EU is, at this point in time, unsatisfactory. The pace of integration of the goods markets seems to have decelerated, as evidenced, for example, by the low level of cross-border investment. This loss of momentum can be seen particularly in the persistence of obstacles to the free movement of goods. The completion of an internal market in services has been hindered by constraints on their cross-border provision and on the freedom of establishment in other countries, while the absence of a legal framework regulating services limits competitiveness in a group of activities that accounts for more than two-thirds of EU output. The slow consolidation of the single market is due also to the lack of sufficient political will to push through legislative instruments such as those relating to the recognition of academic qualifications, community patents and the definition of a common consolidated basis for corporate income tax, and it is reflected in the diminished rate last year at which directives relating to the single market were being transposed.

There is also room for increasing the effectiveness of competition policies. In the network industries, market openness is far from being total, as evidenced by the high market shares of the dominant firms in telecommunications, gas and electricity. Of note, however, is the decrease in the average level of state aid and the political consensus for the regulation of mergers, which has yet to be applied in the Member States.

One of the areas requiring a more determined effort is financial services, where a satisfactory degree of integration has yet to be reached in both banking and capital markets. Indeed, both cross-border services and transnational mergers and acquisitions are still limited in scope. However, work continued in 2003 on implementing the Financial Services Action Plan aimed at achieving by 2005 the full integration of wholesale financial markets in the EU, the opening up of retail financial markets and the application of prudential regulations and efficient supervision rules. To date, the headway made from the legislative standpoint has been considerable, since most of the initially planned measures have been approved. Now the most important task, apart from completing the unfinished projects, is to ensure that the regulation agreed upon is applied rigorously. To this end, the monitoring of diverse indicators may be a very useful measure of the effective integration of the European financial markets. In 2003 the Committee of European Banking Supervisors (level 3) was set up to ensure the convergence of supervisory practices in the EU and advise the regulatory bodies. The formal establishment of the European Banking Committee (level 2), which will be entrusted with preparing the key legislation, is imminent now that the Council and the European Parliament have agreed on a Directive completing the new committee structure in the area of financial services.

In 2003 new legislative initiatives were approved in the field of corporate governance, with a view to strengthening the internal and external control of economic and financial management of private firms. The recent Parmalat crisis, along with those of other firms in the United States in recent years, has clearly shown the need for firm initiatives here. In this respect, it is important to promote the application of international accounting standards and to monitor the operations routed by firms through tax havens, where financial and tax controls are much laxer. Furthermore, the European Commission has launched various proposals to strengthen the role and the responsibility of audit firms and rating agencies.

In line with the move to strengthen reform initiatives, in March 2004 the European Council underscored the suitability of the current moment of economic recovery for undertaking the required reforms, and the need to closely monitor their execution by multilateral assessment of the countries' progress in meeting the goals and exchanging information on best practices.

3 The common monetary policy and monetary and financial conditions in the euro area

3.1 MONETARY POLICY DECISIONS

During 2003 the downward stickiness of inflation rates, along with weak activity (which only began to gain momentum from the summer months), conditioned the actions of the area's monetary authorities. In this complex environment, made more so by fluctuations in the euro exchange rate, the ECB was able to square a monetary policy stance geared to achieving its priority goal of price stability with monetary conditions conducive to the recovery of economic activity.

The successive indicators published at the beginning of 2003 revealed an unfavourable trend in economic activity, in comparison with the prevailing expectations in the final part of the preceding year. This was mainly the result of geopolitical tension, which triggered a substantial decline in stock market prices and a notable worsening of agents' confidence in the euro area. Thus, although the most likely scenario continued to be a return to higher growth rates during the year, a widespread climate of uncertainty was taking root, casting a shadow over the economic prospects for the first half of the year.

At the same time, although oil market pressures hindered any decline in inflation rates in the short term, the medium-term price outlook was favoured by the impact of flat activity on the price and wage formation mechanisms and by the prospect that the euro appreciation would progressively feed through to import prices and, ultimately, to consumer goods. This assess-

EURO AREA INTEREST RATES

SOURCES: ECB and Banco de España.

a. Estimated using Euribor data.

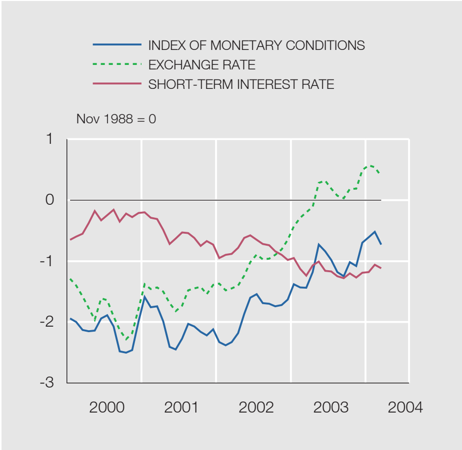
ment of the inflationary trends in the area led the ECB Governing Council at its meeting on 6 March 2003 to decide to cut the minimum interest rate on its main refinancing operations by 25 basis points to 2.5% (see Chart III.5). This easing of the monetary policy stance was intended to contribute to sustaining agents' confidence in a setting of downside risks for growth.

The outbreak of the Iraq war increased uncertainty because of the difficulty in assessing the extent to which the war would affect the world economy and the behaviour of euro area economic activity and prices. Against this background, the Governing Council announced that, if necessary, it would provide sufficient liquidity to ensure that the financial markets worked properly. However, the abatement of geopolitical tensions from April onwards also reduced the uncertainty about the world economy, and in the euro area this led to a recovery in the stock markets and in agents' confidence. Yet the economic activity figures released in spring confirmed that growth remained weak. Also, in those months the fall in oil prices helped to improve the price outlook. In these circumstances, on 5 June the ECB Governing Council decided to cut its official interest rates by 50 bp, taking the minimum bid rate on the main refinancing operations to 2%.

In the second half of the year, the ECB held its monetary policy stance unchanged, given that the medium-term inflationary outlook was compatible with the definition of price stability. Nonetheless, during the whole of the second half the growth rate of the HICP held somewhat above 2%, although this was mainly due to transitory factors. Indeed, expectations firmed regarding a decrease in inflationary pressure associated with the impact of the euro's appreciation on import prices and, in internal costs, with the anticipated slowdown in the growth of unit labour costs as a result of a certain deceleration in wage growth and in productivity gains. Furthermore, monetary policy decision-making took into account that the prevailing (historically very low) interest rates provided adequate support to the gradual recovery of output, as proven by the expansion of the credit aggregates. Because of the moderate economic growth, the sharp expansion of liquidity was not considered to jeopardise the prospects of favourable price behaviour in the medium term.

INDEX OF MONETARY CONDITIONS IN THE EURO AREA: CONTRIBUTIONS (a)

CHART III.6

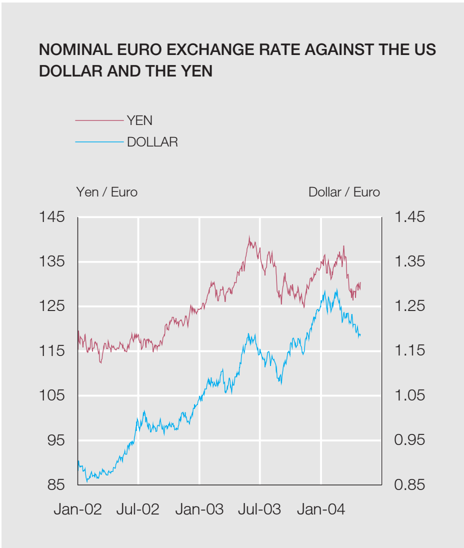


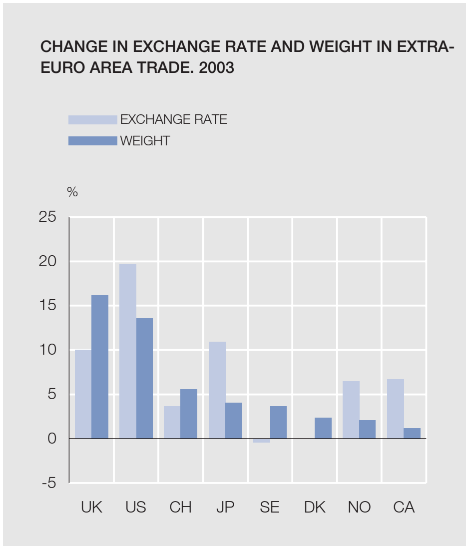
SOURCE: Banco de España.

a. Rises in the index denote contraction, and falls, expansion. The index of monetary conditions is equal to the sum of the contributions.

CHANGE IN EURO EXCHANGE RATE AND EURO AREA FOREIGN TRADE BY COUNTRY

CHART III.7





SOURCES: ECB, European Commission and Banco de España.

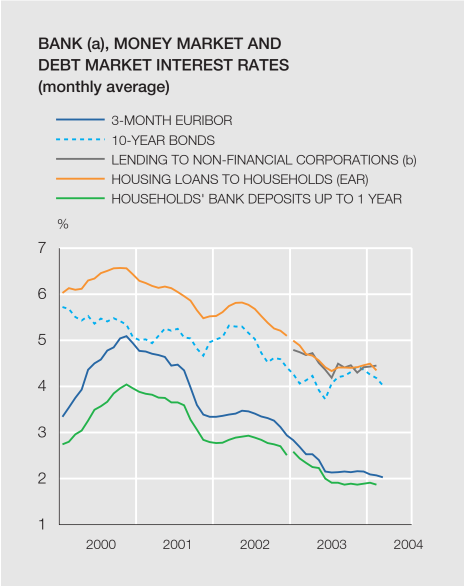
3.2 FINANCIAL DEVELOPMENTS IN THE EURO AREA

Financial conditions in the euro area in 2003 went through two distinct periods, the dividing line between which can be situated at the beginning of the Iraq war. In the first few months of the year, weak economic activity and the high prevailing level of uncertainty led to falling stock markets and rising interest rate spreads on corporate bonds, which were accompanied by a notable jump in volatility. However, the easing of geopolitical tension at the beginning of April brought an improvement in the economic outlook and marked a turning point in the performance of financial markets.

This improvement in financial conditions was partially offset by the notable appreciation of the euro, which, in nominal effective terms, amounted to 10% in the year as a whole (see Chart III.6). The particularly strong appreciation of the euro against the dollar (21%) may have been related to the heightening of the US economy's fiscal and trade imbalances, although the euro

EURO AREA INTEREST RATES

CHART III.8



SOURCES: ECB and Banco de España.

a. Data drawn from new statistics on interest rates compiled by the ECB for new operations.
b. Interest rates for loan terms of over five years.

also appreciated against other currencies, such as sterling and the yen (see Chart III.7). However, in the first few months of 2004, the euro depreciated against the dollar, partly correcting the previous year's appreciation.

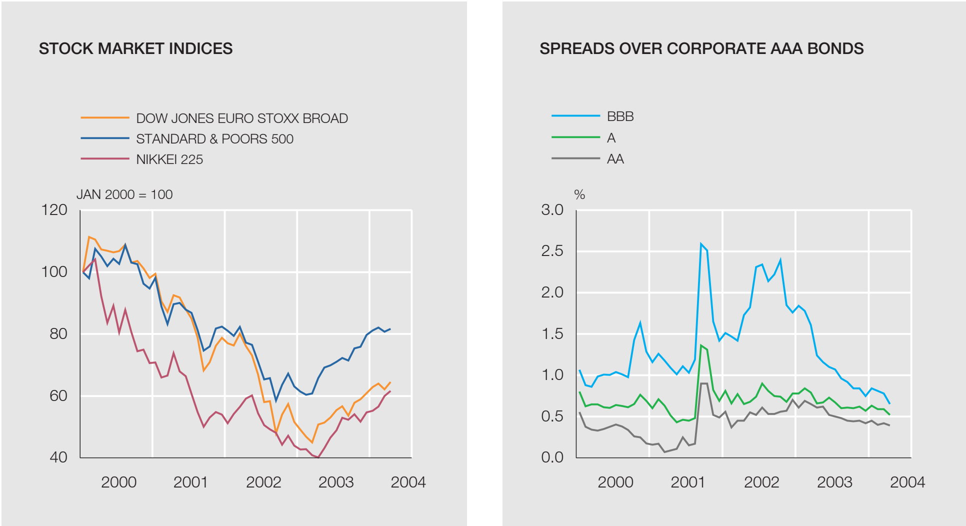
In line with the persistent absence of signs of a recovery in activity, the first half of the year saw money market interest rates gradually decline by similar amounts across the entire maturity spectrum. Hence, during this period the yield curve retained the slightly negative slope with which it had commenced the year. The subsequent progressive improvement in the cyclical outlook helped to bring about, in the second half of the year, a rise in medium- and long-term rates, given the market consensus that rises in official rates were increasingly likely within relatively short time horizons (see Chart III.5). These expectations, however, tended to dissipate from December as the euro strengthened.

This behaviour, which coincided with that seen in the United States, was linked to expectations of low growth and inflation which, in an uncertain economic and political environment, favoured agents' preference for relatively secure assets. From summer, 10-year bond yields in the euro area countries started to rise as a result of the improvement in the economic outlook, reaching 4.5% in November (see Chart III.8). Since then, there have been various fluctuations, although by May 2004 ten-year yields had returned to similar levels.

With international public debt markets in virtual lockstep, long-term European interest rates were indirectly affected by the vicissitudes of the US economy. These particularly included the perception of a certain risk of US deflation in the first half of the year; the US Federal Reserve's declared intention to intervene in the debt markets if the conventional room for manoeuvre of monetary policy became exhausted; and the strong demand for US public debt securities by the authorities of certain Asian countries whose exchange rate regimes are tightly tied to the dollar and whose currencies have been subject to persistent upward pressure.

STOCK MARKET INDICES AND CORPORATE BOND RATES (a)

CHART III.9



SOURCES: ECB and Banco de España.

a. Euro-denominated bonds issued by non-financial corporations.

The equity markets are perhaps those that most clearly reflected the change in the financial environment in 2003. Thus the fall in market prices initiated in early 2000 lasted until mid-March (see Chart III.9). These falls, which ran in parallel to the decline in yields on debt markets, took European stock market indices upwards in a climate of high volatility, in some cases to levels unknown since 1996. The outbreak of the Iraq war set in train a rapid rally in market prices which saw the Euro Stoxx index rise significantly, although at year-end it was still 40% below its level at the beginning of 2000. The performance of the European stock markets in 2003 was similar to that of the other world markets, indicating that this behaviour was fundamentally determined by factors of a global nature.

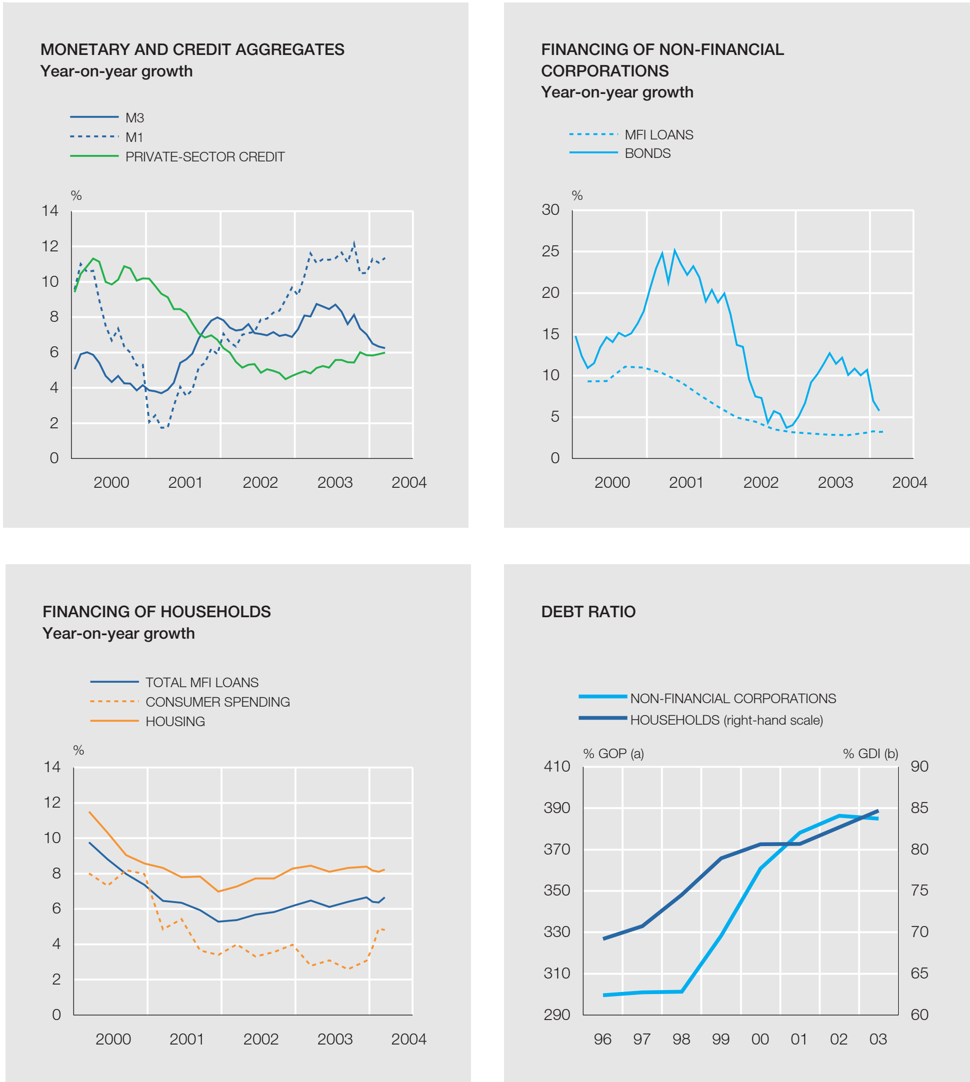
The improvement in the global economic climate in the second half of the year was also reflected in the corporate bond markets, where the spreads between the yields on corporate and public debt narrowed very significantly, especially in the higher risk segment. Also, the lower uncertainty helped to reactivate corporate debt security issues, which grew by 11% on average compared with the previous year, against an increase of 7% in 2002.

The interest rates applied by credit institutions on new business fell in summer 2003 to their lowest levels for the last few years (see Chart III.8). This, along with the persisting extreme caution in portfolio composition decisions, explains why the private sector again showed a high preference for liquid assets in 2003, as evidenced by the behaviour of the M1 and M3 monetary aggregates (see Chart III.10). In particular, M3 posted very high rates of expansion practically throughout the year, although its growth rate began to moderate somewhat from summer, when a gradual shift was initiated from repos and marketable instruments towards alternative longer-term financial assets not included in the aggregate.

The financing extended by MFIs to the resident private sector showed a profile of progressive recovery throughout the year, reaching growth rates close to 6% in Q4. This was consistent with the increasingly buoyant economic activity and with the gradual trend towards stabilisation of the credit terms available to borrowers, as revealed by the Bank Lending Survey, which

MONETARY AND CREDIT AGGREGATES

CHART III.10



SOURCES: ECB and Banco de España.

a. Gross operating profit.
b. Gross disposable income.

provides quarterly information to the Eurosystem on the terms applied in new loans by a representative sample of euro area banks.

The sectoral breakdown of credit shows that financing to households and, more particularly, bank loans for house purchases, were the most dynamic component. Low mortgage rates contributed, along with other factors, to enabling broad segments of the population to gain access to the housing market, prompting sharp growth in house prices in certain countries. The increase in the price of collateral has also favoured the extension of loans by institutions. Consequently, household indebtedness rose further to 85% of gross disposable income. The financing extended to non-financial corporations grew at a relatively low pace (slightly below 3.5%), which helped their debt ratio to stabilise at the previous year's level.

Credit behaviour across the euro area countries was in most cases consistent with this pattern of moderate recovery in the region as a whole, although large differences persisted in growth rates. The greatest buoyancy was again concentrated in those Member States in which investment in real estate assets showed most vigour. Credit growth moderated significantly in Portugal, where agents had to take action in a recessionary setting to adjust downwards their earlier high levels of indebtedness. Credit remained notably sluggish in Germany as a result of determinants such as demand (given weak activity) and, possibly, supply. As a result, the rate of credit expansion in Germany (1.4%) was the lowest in the entire euro area.

IV THE SPANISH ECONOMY

1 *Economic policies*

1.1 MONETARY AND FINANCIAL CONDITIONS

Financing conditions in Spain in 2003 were substantially generous, more so than in the euro area and, indeed, than in 2002. Against this background, companies and, in particular, households resorted to increasing their debt to sustain their spending and investment decisions. As highlighted in the previous chapter, money market interest rates in the euro area continued on the declining course initiated in 2002, associated with the expectations of cuts in the ECB intervention rate, which were ultimately made in March and June for a total of 75 bp. Bank interest rates on loans and deposits followed the same path, though the cuts were not uniform and were sharper in the case of lending to companies and housing loans, where a total of over 80 bp was shaved off. In the opening months of 2004, bank financing costs held at around the levels attained at end-2003.

Spanish long-term public debt yields moved on a declining trajectory to mid-2003, which placed the interest rates on these instruments at a historical low. There was a subsequent move in the opposite direction as the economic outlook in the euro area and in other regions improved. Ten-year yields thus ended the year at 4.3%, 9 bp below the end-2002 level. The pattern was similar in the other euro area bond markets, and the differential with the German *bund* remained at practically zero. The impact of the decline in public debt interest rates on the cost for non-financial corporations of bond financing was amplified owing to the narrowing of corporate credit spreads.

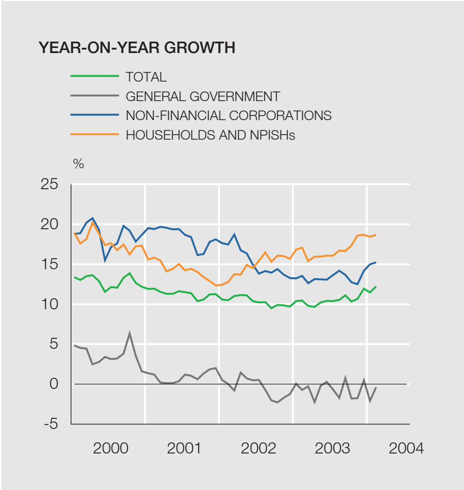
The influence of interest rate developments on the habitual indicators of monetary and financial conditions in 2003 was strengthened by the pick-up in share prices on national and international bourses, against a backdrop of brighter global macroeconomic prospects and improved earnings at listed companies. The main indices thus closed the year with rises, after three years of falls. The gain posted by the Madrid Stock Exchange General Index (27.4%) was similar to that recorded by the S&P 500 for the US market and higher than that of the euro area's broad Euro Stoxx index. These developments were accompanied, moreover, by lower price volatility, associated with the lessening of uncertainty. The rising course of stock market prices continued until early March 2004, when the terrorist bombings of 11 March in Madrid caused prices to fall and volatility to increase, although this effect abated in the following days. The reduction in the inflation rate and the appreciation of the euro during 2003 served to tighten monetary and financial conditions.

Household wealth remained on the rising trend of recent years in 2003, buoyed by the pick-up in stock market prices and the continuing rise in house prices which, drawing on data from the Ministerio del Fomento, grew by 17% in 2003, 0.5 pp up on the previous year.

In these circumstances, the non-financial private sector resorted more heavily to borrowed funds. Nonetheless, the growth of such funds behaved unevenly in terms of sectors and purpose (see Chart IV.1). The rate of increase of debt taken on by households increased by approximately 3 pp to 19%, as a result of the acceleration in lending for house purchases – the year-on-year rate of which rose to 21% at year-end – and of the easing in the rate of lending for other purposes. The rate of financing raised by non-financial corporations continued to grow at around 14%, similar to the previous year. The increase in companies' liabilities was, moreover, highly concentrated in specific activities, such as real-estate. Conversely, larger corporations reduced their debt. The expansionary course of financing to the non-financial private sector prompted a fresh increase in household and corporate debt ratios, although the

FINANCING OF RESIDENT NON-FINANCIAL SECTORS

CHART IV.1



SOURCE: Banco de España.

interest burden on households and firms held at moderate levels owing to the declining trend of interest rates.

In short, the balance sheet position of the non-financial private sector did not detract from the buoyancy of investment and consumption in 2003. Nor will it do so in the immediate future, although the influence of variables such as interest rates or financial-asset and housing prices will foreseeably have tended to increase, fuelled – in the case of interest rates – by their low level and by the greater relative weight of floating-rate loans.

1.2 DOMESTIC MACROECONOMIC POLICIES

Fiscal policy design in 2003 was affected by the entry into force of the legislation on budgetary stability[1] and by the commitments stemming from the Stability and Growth Pact. Under these premises, fiscal policy was geared to achieving a balanced budget, with its starting point an estimated overall general government deficit of 0.2% of GDP in 2002 and a macroeconomic scenario of recovery, with forecast GDP growth of 3% in 2003. The improvement in public finances was expected to be achieved through the elimination of the territorial government deficit (0.4% of GDP in 2002) and a minor cut in central government borrowing needs; by contrast, a modest deterioration was expected in the social security surplus. The fiscal projections of the Stability Programme for the period 2002-2006, which was unveiled in December 2002, extended this fiscal consolidation strategy into the medium term, anticipating the attainment of a budgetary surplus at the end of the projection horizon and sustained decreases in the public debt/GDP ratio to 46.9% in 2006.

As indicated, the budget for 2003 was subject to the guidelines laid down in the budgetary stability legislation. In addition to targeting a balanced budget for the overall general government sector and each of its related agents[2], the legislation entailed setting a spending ceiling for the State and, hereunder, a reserve fund, equivalent to 2% of the ceiling, so as to meet unforeseen non-discretionary spending requirements. The amount of this fund (€2.29 billion) acted as a constraint on spending in 2003, as reflected by the comparison of the amount with that of the amendments to budgetary appropriations in previous years, and it added an element of discipline into the budget outturn.

1. Law 18/2001 of 12 December 2001, and the General Law on Budgetary Stability and Organic Law 5/2001 of 13 December 2001, complementing the General Law on Budgetary Stability. **2.** Central government (central administration and social security), regional (autonomous) governments and local governments.

The 2003 budget included in its revenue projections the effects, first, of the reform of personal income tax[3], which came into force last year, with an estimated cost of 0.4% of GDP in 2003 and of a further 0.1% in 2004; and further, of the new local government tax arrangements which, in their initial roll-out, entailed exemption from the local tax on business activity for all individuals and for small and medium-sized companies with a turnover of less than €1 million, with an estimated cost of around 0.1% of GDP. The freeze on excise duties also reduced estimated tax takings in the 2003 budget. On the expenditure side, the most significant – and expansionary – measure came about further to the signing of the Government-Trade Union agreement. The result of this was an easing of the restrictions in force since 1996 relating to the replacement rate of general government personnel. Also, a new remuneration item tied to productivity was introduced, along with an improvement in supplementary payments. Finally, the 2003 budget provided for a 7.8% increase in public investment, above the envisaged growth of nominal GDP. Further, a sizable increase (21%) in infrastructure investment through State-owned public enterprises was foreseen, meaning that the forecast growth of State public-sector investment as a whole was 12.9%.

Bearing in mind the effect of these measures and the forecast of a pick-up in GDP growth incorporated into the budget, the balanced budget target set for 2003 involved initially giving fiscal policy a moderately expansionary orientation – reflected in the habitual fiscal impulse indicators – rather than the slightly restrictive stance of previous years. Nonetheless, compliance with the commitments under the Stability and Growth Pact, which require fiscal positions close to a balanced budget or with a surplus in the medium term, was ensured. Certain downside risks were detected in respect of these forecasts, stemming from the possibility that actual growth might be less than foreseen and that the impact of the personal income tax reform on revenue might be greater than estimated. There were also certain doubts about the practical implementation of the Law on Budgetary Stability, in particular about the mechanisms enabling regional government deficits to be reduced. All these factors meant that there was a possibility that the general government accounts would post a modest deficit.

As detailed in section IV.7 of this chapter, the result in terms of public finances in 2003 was better than foreseen in the Budget, with an overall general government surplus of 0.3% of GDP being recorded. The risks linked to a scenario of lower growth or of a greater impact of the personal income tax reform on revenue did not materialise, although there was something of an overrun on regional and local government accounts, which posted a deficit of 0.3% of GDP. In terms of the habitual fiscal impulse indicators, said impulse ultimately remained slightly restrictive. Finally, the debt ratio stood at 50.8% of GDP.

Certain steps were taken during 2003 in the area of pension systems, aimed mainly at promoting private capitalisation systems through the establishment of new tax benefits or the extension of those already in place. Mention should be made here of the measures incorporated into the new personal income tax regulations – the raising of the ceiling on individual contributions and of tax deductions, and the creation of guaranteed pension schemes[4] – and the setting up of a pension fund for civil servants[5]. During the year new, higher-than-initially-budgeted provisions were made to the social security reserve fund, taking its amount at the end of the year to above the target of 1% of GDP stipulated for 2004. Finally, the commitments arising from the renewal of the Toledo Pact, in October 2003, did no more than update the recommenda-

3. Law 46/2002 of 18 December 2002 on the partial reform of personal income tax. **4.** A new, voluntary social insurance instrument that is exempt from the tax on insurance premia. **5.** Provision for this pension fund was made for the first time in the 2004 budget. Successive budgetary legislation will determine the amount of total gross wages to be earmarked for the Fund.

tions already in force and note the need to introduce measures to help ease the social security system's financial sustainability problems in the medium term. The introduction of specific reforms on the parameters of the pensions system was not addressed.

Following the approval in late 2002 of the measures to reform the unemployment benefits system, under Law 45/2002, employment policies in 2003 were aimed at maintaining the incentives for stable employment already in place, through discounts on employers' social security contributions linked to contracts promoting permanent employment or converting temporary jobs into permanent ones. In addition, there were new measures to promote participation by women of an age at which they risk abandoning the labour market to look after their children. These took the form of a special personal income tax deduction for the women concerned and the increase in discounts on employers' social security contributions for contracts entered into after maternity. The policy to promote labour market participation was extended to other groups – essentially young people and the over-55s – by means of the reform of the social insurance systems for the self-employed[6]. Lastly, at the close of the year the Law on Employment[7] was approved. This legislation seeks to improve employment policy co-ordination between the central and regional governments, and to increase efficiency in the working of employment services and in the application of active policies.

The housing market was also the subject of government measures in 2003. These were aimed, first, at promoting the house rental market and, further, at reducing the costs of mortgage transactions and stabilising the effort required by households in house purchases. To attain the first goal, the new personal income tax introduced tax benefits for landlords renting out housing; moreover, among the set of economic reform measures in Royal Decree-Law 2/2003, enacted in April, a reduction in corporate income tax was proposed in the case of companies created to operate rented housing, under certain conditions. This same Royal Decree-Law amended certain aspects of the law on the subrogation and modification of mortgage loans, with a view to reducing the expenses associated with possible changes in agreed conditions and, in particular, concerning the conversion to fixed-rate loans and the extension of loan-repayment periods.

Finally, the package of economic reform measures approved in April also affected the promotion of investment, scientific and technological policy, and the diffusion of the new information and communications technologies. It did this by means of the introduction of an accelerated depreciation coefficient under corporate income tax, for investment, and of new deductions under this same tax for spending on R+D+i and on new technologies.

2 Demand

As the foregoing analysis reveals, the economic policy stance in 2003 remained favourable to growth and, against this background, the rate of increase of domestic spending in the Spanish economy stepped up during the year, posting growth of 3.3% in real terms, against 2.6% in 2002. Contributing to this recovery were both private consumption and investment in capital goods, the growth of which turned positive following its heavy fall in 2002. Further, and despite the slackness of the European environment, foreign trade transactions also regained momentum. As a result, final demand grew by 3.5% in real terms, up from 2% in 2002. During the year, the growth of final demand was higher in year-on-year terms in the first six months, owing to the notable rise in investment in equipment and in exports, though it decelerated subsequently. This profile partly reflects the fact that, at the outset of 2002, these variables touched bottom, accelerating strongly in the second half of that year (see Chart IV.2).

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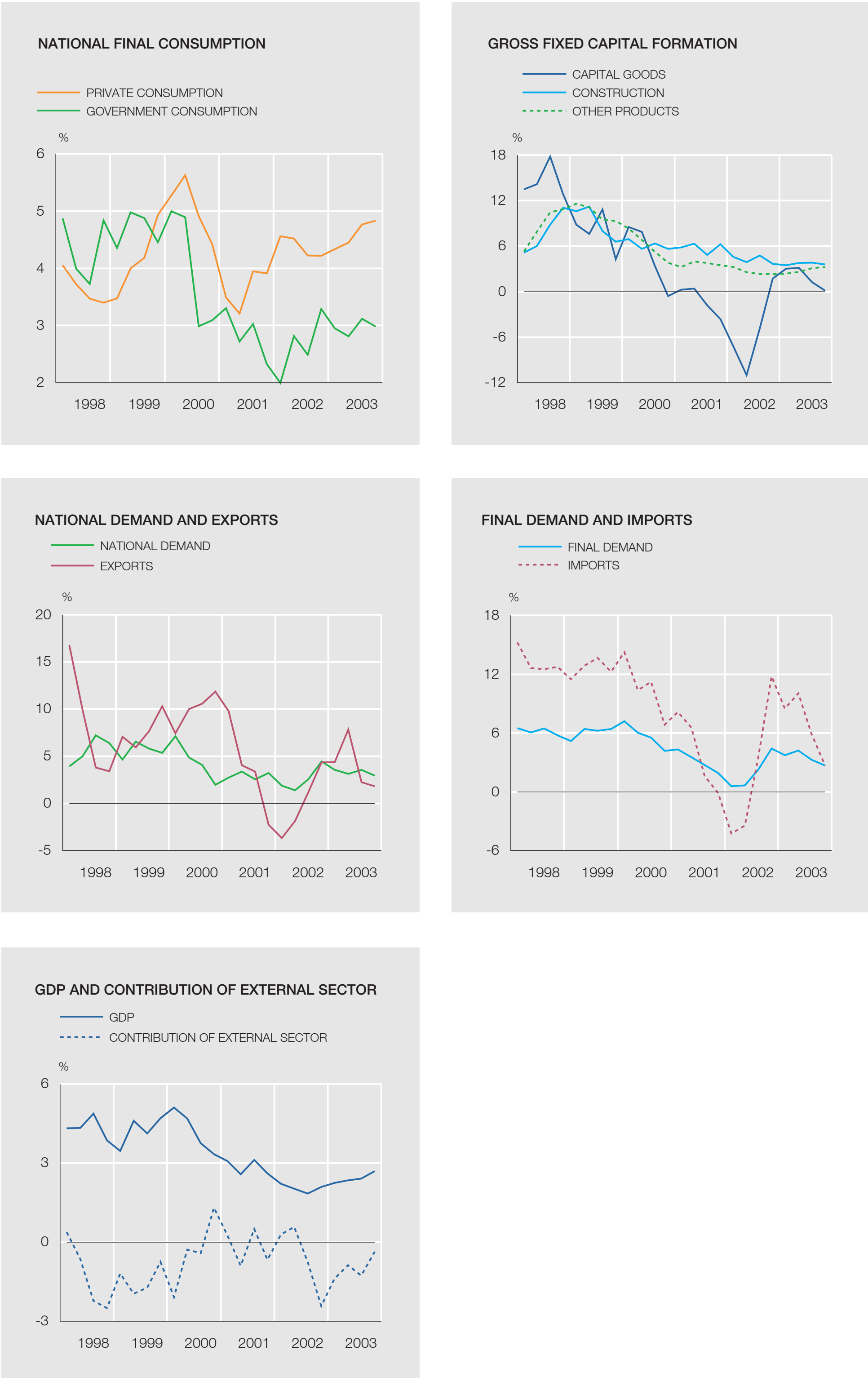
6. Royal Decree-Law 2/2003 of 25 April 2003 on economic reform measures. **7.** Law 56/2003 of 16 December 2003 on employment.

MAIN MACROECONOMIC AGGREGATES (a)

CHART IV.2



SOURCE: INE.

a. Year-on-year rates of change based on real seasonally adjusted series.

CONSUMPTION AND GROSS FIXED CAPITAL FORMATION BY INSTITUTIONAL SECTOR (a) TABLE IV.1

	% of GDP		RATE OF CHANGE					
	1995	2003	1998	1999	2000	2001	2002	2003
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.8	59.9	4.4	4.7	4.0	2.8	2.6	3.0
Durable consumption	*6.6*	*8.2*	*12.9*	*12.4*	*1.3*	*2.1*	*1.0*	*4.7*
Non-durable consumption	*53.2*	*51.7*	*3.2*	*3.5*	*4.4*	*3.0*	*2.9*	*2.7*
Residential domestic investment (b)	5.7	6.9	8.6	8.6	8.6	1.7	6.2	5.0
CORPORATIONS								
Private productive investment (c)	12.6	14.2	9.7	9.9	7.1	3.0	-2.5	1.5
Construction and other products	*6.3*	*7.0*	*3.0*	*11.2*	*10.9*	*8.4*	*1.5*	*1.5*
Equipment and other products	*6.3*	*7.3*	*15.2*	*9.0*	*4.2*	*-1.4*	*-6.1*	*1.6*
GENERAL GOVERNMENT								
Final consumption expenditure	18.1	18.6	3.7	4.2	5.1	3.6	4.4	4.6
Gross fixed capital formation	3.7	3.5	14.1	4.8	-5.8	7.9	7.3	5.4
Of which:								
Construction and other products	*2.9*	*2.5*	*18.4*	*5.0*	*-10.9*	*8.6*	*6.9*	*6.1*
MEMORANDUM ITEM								
Gross fixed capital formation	22.0	24.7	10.0	8.8	5.7	3.3	1.0	3.0
Equipment	*6.1*	*6.9*	*14.5*	*7.8*	*4.7*	*-1.2*	*-5.4*	*1.9*
Construction	*12.6*	*13.9*	*7.8*	*9.0*	*6.1*	*5.8*	*4.2*	*3.7*
Other products	*3.3*	*3.9*	*8.7*	*10.3*	*6.0*	*3.6*	*2.6*	*2.8*

SOURCES: INE and Banco de España.

a. Data in real terms.
b. Excludes investment by sole proprietors.
c. Includes investment by sole proprietors.

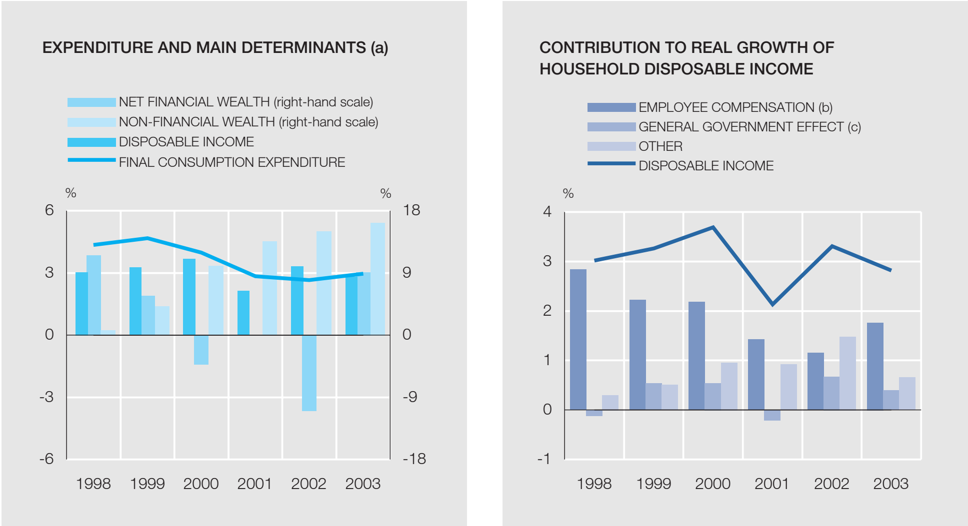
As indicated, household final consumption was one of the factors that contributed to the pick-up in demand in 2003, after having been one of the mainstays of spending in the years the downturn was under way. The momentum of consumer spending in 2003 placed its annual average growth rate at 3% in real terms, 0.4 pp up on the previous year (see Table IV.1). Among the different components of consumption, there was a notable acceleration in spending on durable goods, especially motor vehicles, and in spending on services, which remained buoyant throughout the year.

Household disposable income contributed to sustaining consumption growth in 2003. Although gross disposable income grew by 6%, almost 1 pp down on 2002, the lower growth of consumer prices meant that, in real terms, it slowed less. It posted a real increase of 2.8%, driven by the increase in wage income and based on a significant net contribution by general government (see Chart IV.3). In turn, wage income benefited from the continuing favourable behaviour of employment, the growth of which intensified, and from the rise in real wages, which reflected the acceleration in compensation per employee and the improved terms of trade. The net contribution of the public sector stood at around 0.5 pp in real terms. This contribution was somewhat down on 2002, despite the expansionary impact stemming from the personal income tax reform, owing to the lower growth of social benefits against the background of a brisker pace of economic activity and a moderating inflation rate, which lessens the impact of indexation on pensions.

The interest rate cuts in 2003 restricted the increase in the household interest burden, but also reduced their interest income; as a result, and as observed in the past four years, the net contribution of interest to the growth of disposable income remained negative. The decline in interest rates was practically equivalent to the reduction in the inflation rate, whereby real rates held relatively stable at a level conducive to buoyant consumption.

FINAL CONSUMPTION OF HOUSEHOLDS AND NPISHs

CHART IV.3



SOURCES: INE and Banco de España.

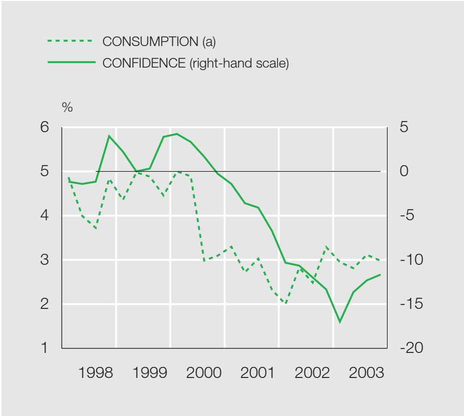
a. Real rates of change.
b. Net of social contributions.
c. Includes social benefits and taxes on income and wealth.

Household net wealth was on a more expansionary course in 2003 than in 2002. On one hand, the stock market rally in the second half of the year gave rise to growth in net financial wealth which marked a turnaround on the declining course sustained over the previous two years (see Chart IV.3). On the other, non-financial wealth continued to grow at an even faster pace, driven by the increase in house prices. Consequently, both components of wealth contributed – albeit to differing degrees – to supporting consumer spending, which would in principle have been propitious to a reduction in the saving ratio; yet this did not come about. It should be borne in mind that the improvement on stock markets was relatively belated and that there were certain factors of uncertainty which persisted for months. Thus, although consumer confidence clearly improved from 2003 Q2, once the end of the armed conflict in Iraq had been announced (see Chart IV.4), the recovery led scarcely to a return to the levels recorded in early 2002, at which point the uncertainty over the future course of the world economy and the risks arising from the geopolitical situation were still high.

It is estimated that residential domestic investment posted growth of close to 5% in 2003, following the recovery the previous year (see Chart IV.5). Contributing to this buoyancy were the various determinants of housing demand. As indicated, the growth of household disposable income has remained high over the past two years, while the user cost of housing has declined significantly. Among the elements making up user cost, the factor most prompting this decline has been the expectation that the value of real assets would rise, driven by the prolonged and notable growth of their price. The low user cost has made housing services cheaper for owner-occupiers and for potential buyers. By contrast, rentals have responded to higher prices in the housing market with significant rises. Testifying to this is the rental component of the CPI, which has been increasing at a rate of over 4% in recent years, bearing on the cost of housing for households that rent. House affordability for potential buyers, which is approximated either by the ratio of the market price of these assets to the average wage (as an important part of the ability to pay) or by the proportion of wages that must be earmarked for paying a mortgage loan instalment, worsened in 2003 (see Chart IV.5).

FINAL HOUSEHOLD CONSUMPTION AND CONFIDENCE INDICATOR

CHART IV.4



SOURCES: INE and European Commission.

a. Year-on-year growth rate of the real seasonally adjusted series of final consumption expenditure of households and NPISHs.

The demand for real-estate assets as a means of placing wealth remained significant in 2003 in a setting of rising household net worth, in view of the highly attractive returns provided by investment in these real assets compared with other alternative investments (see Chart IV.5). Insofar as the recovery in the equity markets initiated in 2003 firms, the relative return on real-estate assets should foreseeably decline, with the associated demand pressure falling accordingly. Finally, it should be remembered that a significant portion of residential investment is by non-residents, and this segment continued to grow notably in 2003.

The strong growth of residential demand has continued to drive the price of housing upwards. Indeed, despite the significant increase once again in the stock of housing under construction last year, house prices grew on average by 17% in 2003. The highest growth was in the biggest towns and cities (500,000 inhabitants and over), while in coastal municipalities with fewer than 50,000 inhabitants the price of housing continued to rise at a higher rate than in inland municipalities of a similar size.

As regards general government demand, final consumption spending in 2003 grew by 4.6% in real terms, slightly up on the previous year's figure of 4.4% (see Table IV.1). In nominal terms, however, a slight slowdown was observed owing to the lower growth of its deflator. Among the government consumption components, employee compensation grew by 6.7%, 0.2 pp up on 2002. This was due to the acceleration in compensation per employee, and to a slight increase in the pace of public-sector job creation. Public investment, for its part, grew by 5.4% in real terms, entailing a slowdown of about 2 pp on 2002. It should be borne in mind that these figures do not include investment in infrastructure routed through State public enterprises of the Ministerio de Fomento group, which is recorded as private-sector investment.

It is estimated that gross fixed capital formation, after declining in 2002, increased by 1.6% over the course of 2003. The pick-up in productive investment essentially reflected the trend of investment in capital goods which, following two years' successive declines, especially sharply so in 2002, grew by 1.6% last year (see Table IV.1). The growth of business investment in construction was on a similar scale to that in equipment, at around 1.6%, involving in this case a slight loss in additional momentum, following the estimated notable slowdown in 2002. The behaviour of productive investment during the year can be approximated by that of total investment in equipment. The latter was not uniform, since it slackened during the second half

RESIDENTIAL INVESTMENT

CHART IV.5

SOURCES: Instituto Nacional de Estadística, Ministerio de Fomento and Banco de España.

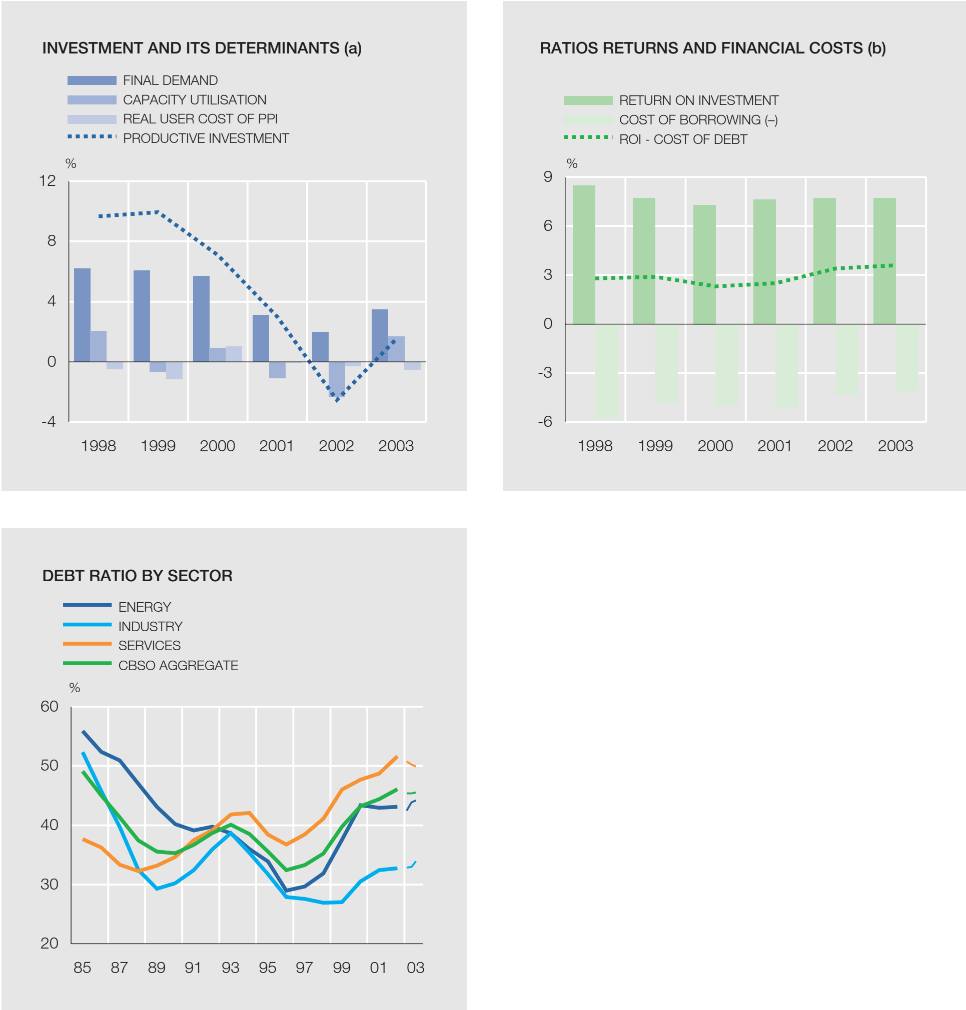
a. Real change.
b. Real rates of change.
c. Annual payment (capital and interests) on a standard loan as a proportion of the average annual wage, as measured by the wage cost of the Quarterly Labour Cost Survey (ETCL).
d. Wage approximated by the ETCL wage cost.

of the year, a feature that was amplified in terms of the year-on-year growth profile owing to the rise observed in the second half of 2002 (see Chart IV.2).

Private productive investment in 2003 should be analysed set against the weakness that has characterised companies' investment spending since 2001 (and which, as indicated, has been reflected most in investment in equipment); from this standpoint, last year's recovery has as yet proven limited. Taking the habitual determinants, the recovery in investment in 2003 partly reflects the greater buoyancy of final demand, which increased by 3.5% over 2003 as a whole, outgrowing the 2002 rate by 1.5 pp (see Chart IV.6). During 2003 the rise in final demand was concentrated in the first half of the year, easing off slightly in the second half. The user cost of capital in real terms fell in 2003 for the second year running as a result of the cut in nominal interest rates and the slight acceleration in the private productive investment deflator. Both factors – robust demand and financial conditions – would have warranted a sharper rebound of investment spending in 2003.

PRIVATE PRODUCTIVE INVESTMENT

CHART IV.6



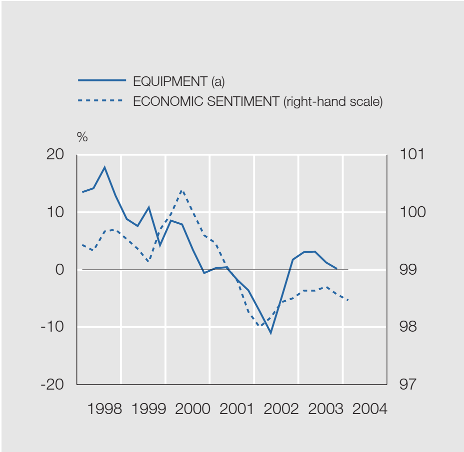
SOURCES: INE, European Commission and Banco de España.

a. Real rates of change and differences for the degree of capacity utilisation and for the real user cost of PPI.
b. CBA data to 2002 and CBQ data for 2003.

The pick-up in final demand was reflected in an increase in capacity utilisation in industry, which stood at 78.9% in annual average terms in 2003, slightly up on its historical average (78.2%). Further, the proportion of industrial corporations assessing their plant capacity as excessive fell considerably in relation to the previous year. However, in the second half of the year this proportion was on a rising trend, in line with the loss of momentum of investment in equipment. This trend was partially corrected in the first half of 2004. The Eurostat synthetic indicator of economic sentiment held virtually stable throughout the year, showing a slight deterioration in Q4 (see Chart IV.7). This profile is also consistent with the tendency of listed companies' medium-term earnings growth expectations to fall, which became more accentuated in late 2003. In sum, despite the acceleration in final demand last year, the improvement in demand expectations has conceivably been more limited.

As to the financial determinants of investment, the situation of companies in 2003 was fairly sound. Nonetheless, in some relevant industries a restructuring process was necessary. This has run over the past two years and was essentially the consequence of the increase in the interest burden and the subsequent squeeze on gross income generated, further to the interest-rate rises that took place in 2000 and 2001 against the background of substantial resort

INVESTMENT IN CAPITAL GOODS AND ECONOMIC SENTIMENT INDICATOR CHART IV.7



SOURCES: INE and European Commission.

a. Year-on-year growth rate of the real seasonally adjusted series of gross fixed capital formation in capital goods.

to financing. Drawing on information from the quarterly survey of the Banco de España Central Balance Sheet Data Office, financial charges, after notable growth in 2001, moved on a falling profile over the following two years as a result of the favourable course of interest rates. These cuts were accompanied by less recourse to interest-bearing debt, meaning that the ratio which measures the cost of borrowed funds stands at a historical low of 4.1%, and the growth rate of companies' debt ratios has tended to be checked. This result appears to confirm the fact that companies earmarked a portion of the resources generated in 2002 and 2003 to undertake financial restructuring, prior to setting new investment projects in motion (see Chart IV.6).

The ordinary return on net assets stood at around 7.7% last year, as a result of the increase in financial revenue – reflecting the inflow of dividends from subsidiaries abroad – and the moderate growth of depreciation and operating provisions. However, interest-rate levels might be close to their floor, meaning that the maintenance of high returns will depend more in the future on the capacity to generate a gross operating profit.

In the light of the sustained growth in recent years of investment in construction as a whole (including that of households, firms and general government) and the significance of this for the continuing high rates of increase of GDP, Box IV.1 assesses the behaviour of investment in construction from a time perspective. With specific regard to the private productive investment in construction component (which, as earlier indicated, has continued contributing to the growth of business investment despite the considerable decline in its rate of increase in the past two years), the box highlights the importance for this component of investment by companies undertaking public works on account of general government. These companies made a contribution to the increase in private productive construction of over 3 pp in 2001 and 2002, which underscores the sluggishness of spending on investment by other companies, particularly in 2002. It is estimated that the invigorating role played by public enterprises' investment activity will have extended into 2003, in view of the high volume of civil engineering works procured by them since 2001.

Turning to external demand, real exports of goods and services on QNA estimates were substantially buoyant in 2003, increasing by 4% compared with zero growth in 2002. There were significant differences between goods exports, which grew by 5.7% in real terms, and services

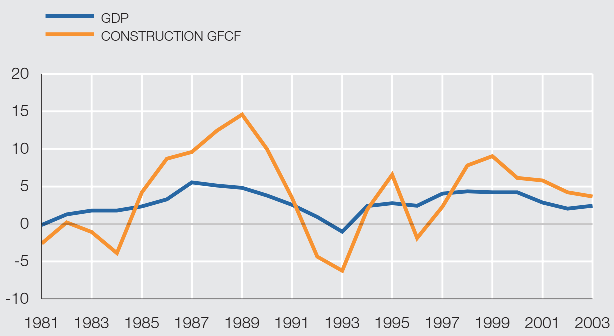
One of the spending components behind the Spanish economy's resilience to cyclical slowdown up to 2002, which continued to support growth in 2003, was investment in construction. This box assesses the recent behaviour of construction from a broader perspective. The first chart confirms that, since 1997, spending on construction has grown, in real terms, at a higher rate than GDP; the average rate of growth of investment in construction between 1998 and 2003 was 6.1%, almost three percentage points higher than that of output. The chart also shows that there was another long period of high construction growth between 1985 and 1991, although on that occasion the cyclical profile was more pronounced. In addition, other shorter, albeit more intense, cycles in this component of investment are seen, such as that recorded between 1995 and 1997. Overall, during the period 1982-2003, investment in construction was 3.8 times more variable than GDP.

The next chart enables the cyclical peaks and troughs recorded in the last two decades to be compared. Three complete cycles of investment in construction are identified during these years, centred on troughs in 1988 Q1 (not shown in the chart), 1993 Q3, 1997 Q4 and 2003 Q1. The most notable feature of this latter cycle is the smooth and prolonged slowdown, from the peak in 1999 Q2, which contrasts with the much sharper profile observed in the two previous cycles. In fact, the intensity of the cycle (the difference between peak and trough) between the peaks, and the troughs identified in 1988 and 1993, was five times that estimated between 1998 and 2003. Likewise, the recovery from the cyclical trough identified in early 2003 is very tentative (although this is one of the aspects, including the precise timing of the trough, potentially subject to greatest revision as new data are received). In sum, construction has, during the latest cycle, displayed a much more stable path than on previous occasions, so that it has contributed to the lower cyclical variability of GDP.

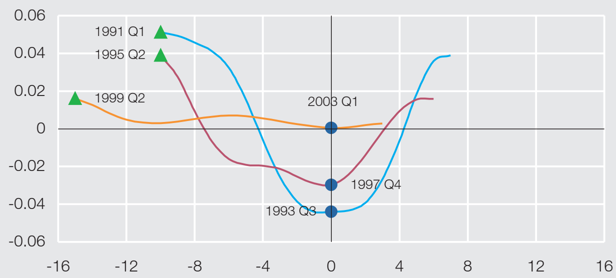
The composition of construction provides some keys to the behaviour of this aggregate in recent years. The third chart shows the contributions of residential and non-residential investment to spending growth. Non-residential investment (currently representing 52% of construction and 7.2% of GDP) is seen to be relatively expansionary and variable throughout the period. Residential investment, meanwhile, has followed a more stable path, although its weight in GDP has also risen, to reach 6.7% in 2003, almost one percentage point more than in 1997. Comparing the two longest periods in which construction has grown faster than GDP (1985-1991 and 1997-2003), it can be seen that the contribution of residential investment to the growth of this aggregate was similar (2.7 pp), while non-residential investment made a much more expansionary contribution in the 1980s than in the second half of the 1990s. The continued stimulus provided to housing investment by the reductions in mortgage interest rates in this latter period helps to explain its resilience, in contrast to its greater variability in the 1980s.

As for non-residential investment, it should be recalled that the intensity of public investment was much lower in the second half of the

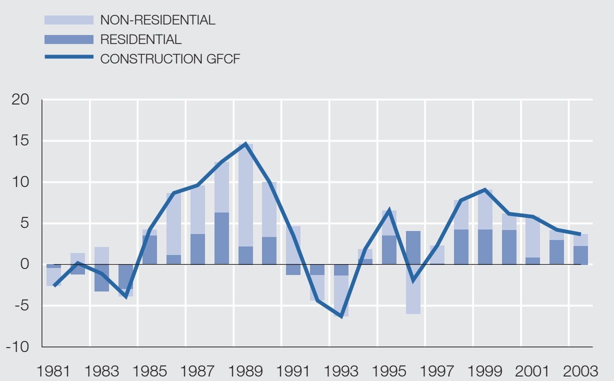
1. ANNUAL GROWTH RATES



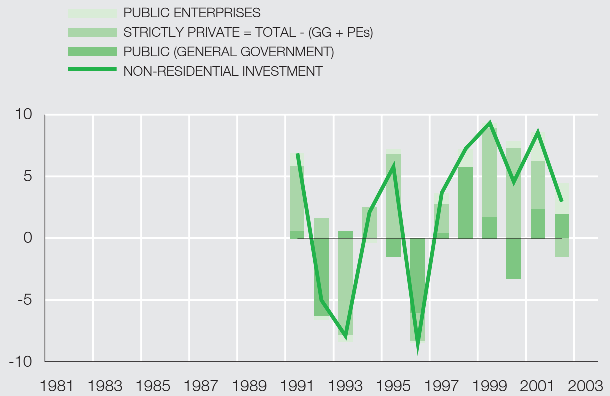
2. CONSTRUCTION CYCLES CENTRED ON THEIR LOW POINT



3. CONTRIBUTION TO GROWTH OF INVESTMENT IN CONSTRUCTION



4. CONTRIBUTION TO GROWTH OF NON-RESIDENTIAL INVESTMENT



SOURCES: Instituto Nacional de Estadística and Banco de España.

1990s than ten years previously. The last chart shows non-residential investment in construction, and its public and private components, since 1991. Within the private component, investment by firms that execute public works[1], but which are classified as non-financial corporations, is identified separately in accordance with National Accounts criteria. It is seen that the budget adjustment of 1996 and 1997 had a significant effect on general government investment in construction, especially in 1996, giving rise to the cyclical trough identified in those years for investment in construction. Between 1998 and 2001, construction carried out by private sector firms became more important, but contracted in 2002, in line with the overall behaviour of business investment. For its part, construction carried out by firms linked to the public sector made a significant contribution in 2001 and 2002, picking up the baton from private investment in that period.

In short, notable among the factors that have sustained the growth of construction over the latest cycle and made its variability unusually low are, first, the stable growth in residential investment from 1998 (driven, among other factors, by the fall in the cost of mortgage financing) and, second, the smaller extent of the upturn in other investment in construction. The positive contribution of public works is also notable, both those executed directly by general government and those performed through non-financial corporations.

1. The boom in this type of investment from 1997 is a consequence of the creation of new corporate public entities, the most notable case being the setting up of the rail infrastructure operator, GIF (G*estor de Infraestructuras Ferroviarias*). The weight of the investment channelled through these firms rose from 4% of total non-residential investment in 1997 to 9.5% in 2002.

exports, which were flat against the background of slackness in the tourism sector. The rise in goods exports was higher than the increase in world demand, despite the deterioration in competitiveness arising from the appreciation of the euro. It is estimated that this translated into a recovery in the Spanish share in world trade, measured in real terms, after the fall-off in 2002.

Among the determinants of goods exports, external demand picked up somewhat in relation to its notable slackness in 2001 and 2002 (see Chart IV.8). The expansion embarked upon in the second half of 2002 was interrupted in the opening months of 2003 by the uncertainty associated with the Iraq war and with the outbreak of SARS in certain Asian countries. But in the second half of the year, as these factors of uncertainty progressively abated, world demand resumed a path of recovery, underpinned by the dynamism of the United States and of the main Asian economies. The most buoyant markets were in Asia, where China is increasingly important, central and eastern Europe, and the United States. Demand in the euro area countries, Spain's principal trading partners, posted a very modest increase.

It was indicated earlier that the price competitiveness of Spanish products deteriorated notably in 2003. The appreciation of the euro influenced the significant rise in the relative price and cost indices vis-à-vis the non-euro area countries, while the competitiveness indicators in relation to the euro area countries worsened slightly. This deterioration in the competitive position of the Spanish economy came about despite the containment of export prices, which entailed a notable contraction in Spanish exporting companies' margins.

The meagre increase in external demand and the adverse trend of price competitiveness did not prevent exports from performing with considerable vigour. As the disaggregated Customs data show, sales to euro area countries in real terms expanded considerably, especially in the first half of the year. In the second half, the year-on-year rate slowed, largely reflecting the recovery in exports in the second half of 2002. For the year on average, growth was far higher than the moderate increase in imports from the euro area countries. Exports outside the euro area sustained high growth rates in real terms, in line with the greater buoyancy of demand in these economies and in the light of the sizable reduction in export prices in euro, which partly offset the adverse effect on competitiveness of the changes in the exchange rate.

EXTERNAL DEMAND AND ITS MAIN DETERMINANTS (a) CHART IV.8

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

a. Year-on-year real rates of change.
b. Inverse of the ratio of the Spanish exports deflator to the export prices of the rest of the world corrected by the exchange rate.
c. Positive values denote a loss of competitiveness of exports, imports and the Spanish tourist sector, respectively, and negative values a gain.
d. Average GDP of the countries of origin of Spanish tourism, weighted by the number of visitors.
e. Ratio of producer price index to Spanish imports deflator.
f. Inverse of consumer price based real effective exchange rate vis-à-vis the OECD.

In terms of products, and confining the analysis to manufacturing exports, sales of goods from high- and medium-high technology-intensive industries were the most buoyant in real terms. In the medium-high technology branches, those with most weight in the Spanish exporting structure, sales of motor vehicles, machinery and mechanical equipment, and chemicals were notable. The medium/low-technology-intensive branches contributed much less to the increase in exports. Finally, exports from the low-technology-intensive branches grew at moderate rates in real terms; only the food, beverages and tobacco branch retained its vigour. The slackness of sales of less-technology-intensive products partly reflects their greater sensitivity to developments in price competitiveness.

Services exports registered zero growth in 2003 after backsliding in 2002. This performance was largely the result of the slackness of tourism, in the face of sluggish world demand and the deterioration in their competitiveness. Exports of other services were also very slack.

According to World Trade Organisation data, worldwide tourist activity, measured by tourist inflows, shrank by 1.2% in 2003, after picking up moderately in 2002. Tourism was affected by the uncertainty arising from the Iraq conflict and from SARS in certain Asian regions. Across the different areas, the greater number of tourists visiting central and eastern Europe contrasted with the forceful contraction in the south-east Asian markets, while in European Mediterranean countries tourist numbers were flat in relation to the previous year. Against this backdrop, tourism exports posted zero growth in Spain in real terms, after sliding considerably in 2002. The number of tourists entering Spain across borders was virtually unchanged according to the Frontur statistic, with growth of 0.1%, a figure in line with overnight stays in hotels, which grew by 0.7%. In terms of countries of origin, there was a reduction in tourist inflows virtually across the board, with numbers from Germany, France and Italy falling off in particular, against the background of weakness in the European economies. However, this decline was offset by the strong increase in British tourists (9.7%), the United Kingdom remaining our main market.

The Instituto de Estudios Turísticos published the Egatur survey on tourist expenditure for the first time in 2003. The survey data show the meagre increase in the number of visitors and the slight reduction in the duration of their stay. This latter factor largely explains the fall in average spending per person despite the increase in daily spending per tourist. Significantly, however, the daily spending of tourists from non-euro area countries – especially from the United Kingdom, the United States and Latin America – fell, being offset by the increase in daily spending by euro area tourists.

Also contributing to the stagnation of the tourist sector in 2003 was the trend of relative prices vis-à-vis our main customers and competitors. The CPI component of tourism and hotels and restaurants continued to post clearly above-average growth. In this respect, while hotel prices remained moderate, the prices of other tourism-related services again rose notably.

As discussed in the foregoing paragraphs, both national demand and exports quickened in 2003. As a result, the growth in real terms of final demand was 3.5%, 1.5 pp up on 2002. Its robustness contributed to the buoyancy of imports of goods and services, which grew by 6.7% in real terms in 2003, compared with 1.8% the previous year.

On QNA figures, goods imports grew by 7.8% over the year as a whole. That said, they tended to slow in the closing months in year-on-year terms, largely reflecting the recovery in imports in late 2002. Contributing to the vigour of goods imports in 2003 was, along with the increase in final demand, their cheaper relative prices, the result in turn of the strong appreciation of the euro. The course of import prices was conducive to the penetration of imported products in the Spanish market, meaning that the ratio of imports per unit of final demand increased in relation to the previous year. Imports of services performed more moderately than those of goods, with real growth of 1.2% set against the flatness of the previous year.

On disaggregated Customs data, real imports of goods from the EU rose by 6% in 2003, while purchases from the rest of the world climbed by 9.3%. In terms of products, the performance of imports was in step with that of the demand components. Purchases of capital goods surged by 16.7% for the year on average, with the thrust of the components of machinery and, in particular, of construction and data processing equipment to the fore. Consumer goods imports also grew notably, with their components recovering across the board. Conversely, foreign purchases of intermediate goods moderated considerably, in line with the trend of industrial activity. In terms of technological intensity, the growth of real imports of goods relating to the low and medium-low technology sectors was higher, owing to the gain in price competitiveness of these products imported into the domestic market. Nonetheless, there were also sizable increases in imports of goods with a higher technological content, such as office machinery and computers.

In sum, imports once again outgrew exports in 2003, entailing a widening of the negative contribution of the external sector to GDP growth to -1 pp, compared with 0.3 pp the previous year. The performance of the external sector thus curbed the recovery in GDP, which grew by 2.4% over the year as a whole compared with 2% in 2002.

3 Activity

Despite the acceleration in GDP in 2003, the value added of the market economy once again underwent a slight loss of momentum last year, growing by 1.8% compared with an estimate of 1.9% for 2002. Indeed, from the standpoint of productive activity, the higher growth rate of GDP was the outcome of the more expansionary trend of non-market services and of the notable increase in indirect taxes on products. The growth rate of market value added was 1 pp lower than its growth potential, which meant that the gap between actual and potential activity – the so-called output gap – virtually closed in 2003, as can be seen in the top left-hand panel of Chart IV.9.

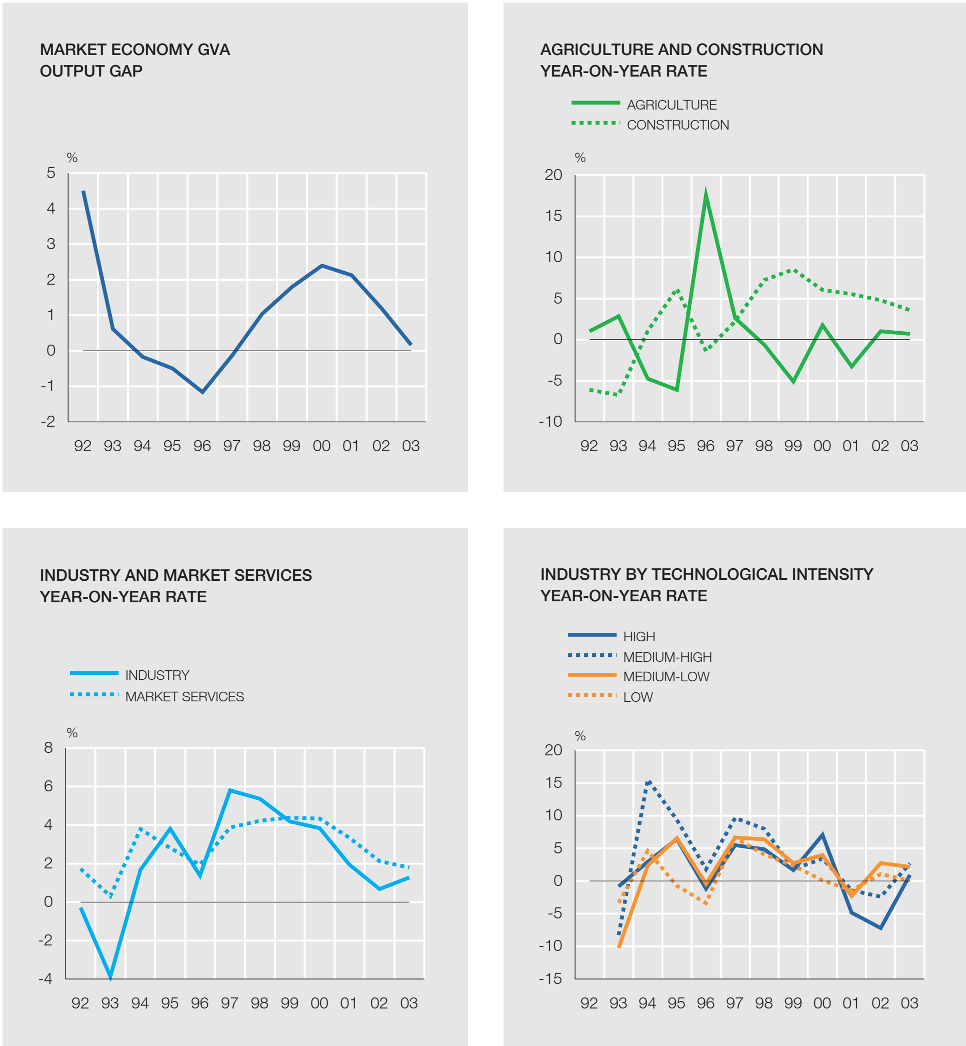
The potential growth capacity of the Spanish economy scarcely changed in 2003, although the contraction in investment in capital goods in 2002, for the second year running, bore slightly adversely on the contribution of capital to potential GDP growth. Conversely, the growth of total factor productivity – a variable which approximates, among other things, the incorporation of technological progress – held stable, albeit significantly below the estimate for it in other developed economies. In the case of the labour factor, the contribution to potential growth also held stable and, in this instance, far above what was observed in other developed countries. The high contribution of the labour factor to potential growth in Spain is related to the increase in the participation rate of the population of working age (which reflects, in turn, immigration and the higher participation by women in the labour market) and to the decline witnessed in the rate of structural unemployment. Both factors are discussed in greater detail in a subsequent section.

The slight slowdown in market-economy activity in 2003 spread to the different branches of activity, with the sole exception of the industry and energy branch. The moderation was more marked in the case of construction which, however, remained the branch with the highest rate of expansion. As can be seen in the top right-hand panel of Chart IV.9, the loss of momentum in activity in the agricultural and fisheries branches was for only 0.3 pp, whereby in 2003 it maintained a positive albeit low rate of increase (0.7%), the outcome of low growth in livestock production and a highly contained impulse in agricultural output. Crops did not fare favourably in 2003 owing mainly to the lack of rain in the spring. As a result, the scant growth of the agricultural sector was based on specific produce such as citric fruits, and the grape and olive harvests.

Overall, the year 2003 was a favourable one for the industry and energy branch, which grew by 1.3%, 0.7 pp above the previous year's figure (see bottom left-hand panel of Chart IV.9). The rate of increase in both the energy and industrial goods branches rose, as a result – in the first instance – of higher economic growth and of other more specific factors, including most notably the summer heat wave. The momentum of industrial activity was a consequence of revitalised exports, especially those to the euro area, even though activity in these countries was sluggish. Domestic demand also contributed to sustaining industry, on the side of both consumption and of investment in capital goods. Unlike the previous year, when it was the medium-low technological intensity products which upheld industrial activity, in 2003 the re-

GVA BY SECTOR
OUTPUT GAP AND YEAR-ON-YEAR RATES OF CHANGE

CHART IV.9



SOURCES: INE and Banco de España.

covery was led by the high and, above all, medium-high technology branches (see bottom right-hand panel of Chart IV.9). Significantly, as has been the case since 2000, the more labour-intensive sectors – which mostly coincide with those with fewer technological demands – saw their activity contract.

The thrust of construction activity in 2003 was less than the previous year, since its rate of increase fell by almost 1 pp (see top right-hand panel of Chart IV.9). However, its growth rate of 3.6% remained the highest for the Spanish economy for the sixth year running. The loss of steam in construction was rooted both in a lesser public investment drive in civil engineering works and in the somewhat more marked slowdown in building activity. Under this latter heading, however, residential building maintained significant momentum, while construction of buildings intended for other uses was affected by the diminished pace of market-services productive activity, which is the sector that has most invested in construction in the past.

The moderate growth of the industrial sector and the less robust tone of construction were the determinants of the slowdown in markets-services activity, which increased at a rate of 1.8% in 2003, 0.3 pp down on 2002 (see middle panel of Chart IV.9). Indeed, the lack of resolute momentum in industrial activity and the emerging signs of saturation in the property market were influential in the loss of steam in real-estate, rental and business activities, which weighed down overall market services. Nonetheless, in view of its technological content, mention should be made of the recovery in the IT and R&D sector during 2003, which marked a turnaround on its recent course. For 2003 as a whole, a favourable note was struck by the distributive trade, hotels and restaurants, and transport branches. In the case of the distributive trade, momentum was provided by the greater vigour of private consumption, while for hotels and restaurants and transport the catalyst was the pick-up in tourism, which underwent its worst spell in 2002.

4 The labour market

In 2003 employment[8] exhibited a progressive recovery after the slowdown in the previous year, in step with the greater buoyancy of economic activity. In QNA terms, the rate of net job creation was 1.8% for the economy as a whole, and 1.9% for the market economy, 0.3 pp down on the previous year in both cases (see top left-hand panel of Chart IV.10). The performance of employment means that the very modest rate of change of apparent labour productivity (0.6%) is unchanged, in line with the past trend of this variable. In the case of the market economy, apparent labour productivity even fell, by 0.2%. The behaviour of productivity was accompanied by a decline in labour costs, in real terms, the result of the high growth of the value-added deflator, since wages, in nominal terms, accelerated in 2003. From the standpoint of employees, real wages increased slightly owing to the lower growth of consumer prices.

The recovery in employment was not extensive, however, to all branches of activity in 2003. While services and construction showed greater dynamism in job creation, employment continued to be destroyed in agriculture, albeit at a lesser rate than in previous years. In industry, meanwhile, the ongoing decline in employment initiated the previous year intensified. The pick-up in industrial activity in 2003 was therefore not accompanied by similar behaviour in employment, which fell by 1.1%, exhibiting moreover a markedly declining quarterly profile after the incipient recovery observed in late 2002 and early 2003. In construction, following the slowdown in the second half of last year, the growth rate of numbers employed increased by 0.9 pp to 3.8%, attaining growth of over 4% as from Q2. The performance of employment, which contrasts with the loss of momentum of activity, led to a reduction in apparent labour productivity, which might be related to the stage of completion of much of the work in the construction industry, which is more labour-intensive. Finally, employment in the services sector quickened by 0.4 pp, posting average growth of 2.8%. In market services the increase in numbers employed was 3.4%, compared with 1.4% in non-market services. The pick-up in employment in market services was accompanied by declines in apparent labour productivity, in line with the reduction seen in labour costs in real terms.

On National Accounts data, the recovery in employment in 2003 only affected dependent employment, which increased by 2.4%, while self-employment diminished by 0.9%, a similar rate to that in 2002. These figures broadly match those of the EPA (Spanish Labour Force Survey). This survey further showed that immigrant workers participated to a significant extent in this increase in employment. Their numbers rose by 25.2% in 2003, raising their relative weight by 1 pp to 5.7% of total employment.

In terms of contracts, higher job creation in the dependent employment segment was extensive both to dependent employees with permanent contracts, the high rate of growth for which (4.1%, 0.3 pp up on the previous year) was maintained, and to dependent employees with temporary contracts, which accelerated notably to growth of 2%, against 0.6% the previous

8. Measured by the number of equivalent full-time jobs.

EMPLOYMENT AND UNEMPLOYMENT

CHART IV.10

SOURCES: INE and Banco de España.

a. Seasonally adjusted QNA series. Full-time equivalent employment.
b. EPA (Spanish Labour Force Survey).
c. EPA. Unemployment series spliced by the Banco de España.
d. Compensation per employee in the market economy.

year. This latter segment moved, moreover, on a markedly rising quarterly path (see the top right-hand panel of Chart IV.10). It may firstly be deduced that the system of rebates on employers' social security contributions and the lower firing costs associated with the new permanent contracts, which already upheld the growth of permanent employment during the period of lower economic activity in 2001 and 2002, have continued to exert a favourable influence on employment growth during the 2003 recovery. Secondly, as was to be expected, the creation of permanent employment in the upturn has combined with a marked rise in temporary hires, which might be due in part to the persistence of some uncertainty. As a result, temporary employment as a proportion of total employment declined only slightly in 2003 to 30.6% in annual average terms (0.4 pp down on 2002). It remains, however, at a very high level, which highlights the need to introduce further measures that contribute to reducing labour market duality. The INEM statistics on contracts testify to this diagnosis, showing growth in the total number of registered contracts of 3.4% (against 0.9% the previous year), based exclusively on the recovery in temporary contracts (3.9%), since permanent contracts fell by 1%. Higher job creation in 2003 was the case both for full-time and part-time dependent employees, with the proportion of part-time employees increasing slightly to 8.3% of total employees.

With regard to labour supply, the numbers joining the labour market in 2003 retained the dynamism of previous years, albeit at a somewhat lower rate. Specifically, the labour force increased by 2.6%, compared with 3% in 2002. The number of working Spanish nationals grew by 1.5%, 0.4 pp down on 2002, while the immigrant labour force increased by 25.9%, 3 pp up on the growth in 2002, accounting at present for 5.8% of the total labour force. The buoyancy of the labour force was the outcome of the rise in the participation rate, which increased to 55% (1 pp up on 2002); in terms of the proportion calculated for the under-65s there was a bigger increase (of 1.4 pp) to 68.5%. The increase in labour market participation was mainly concentrated among women, for whom the participation rate rose from 41.8% in 2002 to 43.3% last year. This was the result of the greater tendency seen in recent years for women to join the labour market. The trend has been reinforced by means of incentives created by the rebates system for the permanent hiring of women, along with other measures adopted to help reconcile working and family life. The male participation rate increased by a notably smaller amount (0.5 pp) to 67.4%.

Despite higher job creation in 2003, the dynamism of the labour force meant that the number of unemployed increased slightly, although this increase (2.1%) was notably less than that in 2002 (11.4%), as can be seen in the bottom left-hand panel of Chart IV.10. The increase in the number of unemployed was in fact virtually zero in the second half of the year, and over the year as a whole the unemployment rate was 0.1 pp down on 2002 to 11.3%. Registered unemployment according to INEM records was similar, with growth of 2.2% for the year as a whole, 3.8 pp down on 2002. By gender, the female cohort performed best, the associated unemployment rate dipping by 0.4 pp to 15.9%, while the unemployment rate for men was up 0.2 pp to 8.2%. This narrowed slightly the sizable gap between both groups. In terms of age, the unemployment rate held stable among youths (18%), while there were mild movements in the opposite direction in the other age groups. The rate of joblessness for individuals in the 30-44 age bracket edged up 0.1 pp to 9.9%, while it fell by the same proportion among the over-45s to 7.2%. As a result, the marked differences in unemployment across the different age groups remained practically unchanged.

Finally, the weight of long-term unemployment in total unemployment fell once again in 2003, thereby continuing the trend decline seen in recent years, albeit at a considerably more moderate rate. Specifically, long-term unemployment fell by 0.4 pp to 37.1% over the course of 2003. This would suggest the advisability of furthering the labour market structural reforms carried out in recent years (Box IV.2 makes an initial assessment of the effects on the labour market of the reform of unemployment benefits finally approved in late 2002). The available estimates of the NAIRU[9] for the Spanish economy – an approximation to the structural rate of unemployment – show that the series of labour reforms introduced since the nineties entailed a considerable reduction in this rate, but that the process would have come to a halt in the recent period (although the new income tax cuts introduced in 2003 should contribute to a further reduction in the NAIRU). The depiction of the Phillips curve in the bottom right-hand panel of Chart IV.10 supports this diagnosis since it indicates that the increase in unemployment in 2002 and 2003 has not given rise to lower wage pressures, while in the second half of the nineties the reductions seen in unemployment were not accompanied by greater wage pressures.

9. The non-accelerating-inflation rate of unemployment is the unemployment rate level at which it is estimated that there are no pressures on the supply side of the economy that might induce an increase in inflation.

THE 2002 REFORM OF THE UNEMPLOYMENT BENEFIT SYSTEM

BOX IV.2

The final terms of the reform of unemployment benefits, initiated in May 2002, were established by Law 45/2002, passed in December 2002. The main aim of this reform was to provide incentives for the unemployed to gain access to employment, improving the relationship between unemployment protection and job search. Accordingly, the reform included a number of measures to increase the intensity of job search by unemployed persons, the rules on the payment of wages after dismissal were amended[1] and minor changes were made to the unemployment protection of specific groups[2]. Although it is perhaps still too soon to assess the impact of this reform, the effects on the functioning of the labour market that have been detected are summarised below.

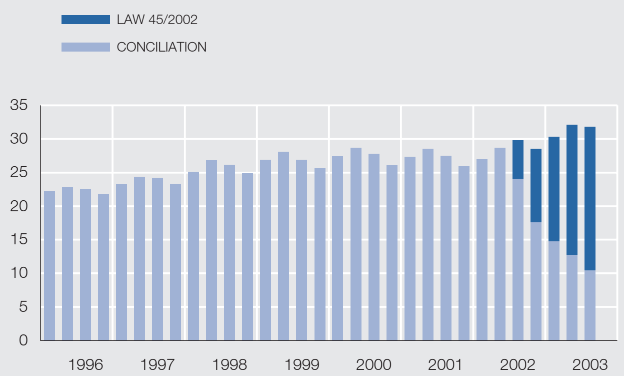
The changes to the rules on wages payable after dismissal have led to a significant reduction in the average firing costs faced by firms. The data available indicate that firms are making intensive use of the possibility of declaring dismissals unfair within 48 hours of their notification, to avoid paying the wages of the worker until at least the date of the conciliation hearing. Specifically, INEM (national employment office) information on eligibility for unemployment benefit indicates that around two thirds of terminations of contract whose fairness was previously determined at conciliation hearings are now immediately declared unfair by the firms themselves (see first chart). This pre-emption involves a saving for firms of around one month's wages, corresponding to the estimated average period between a dismissal and the conciliation hearing. This reduction in the cost of terminating contracts comes at the price of immediately assuming the unfairness of the termination and thus paying the maximum compensation provided for by law, which is equal to 45 days' wages per year worked, subject to a maximum 42 months' wages[3]; firms seem to prefer this option, given the low probability that a dismissal will eventually be found fair.

However, the effects on the functioning of the labour market of the other measures included in this reform are, at least so far, less perceptible. First, the various measures adopted to increase the incentives for unemployment benefit recipients to accept job offers, including the obligation to sign an activity commitment and the changes in the definition of an appropriate job offer and in the sanctioning system, do not seem to have resulted in any increase in the intensity of job search by the unemployed. At least no significant change is detected in the trend of the outflow from unemployment to employment

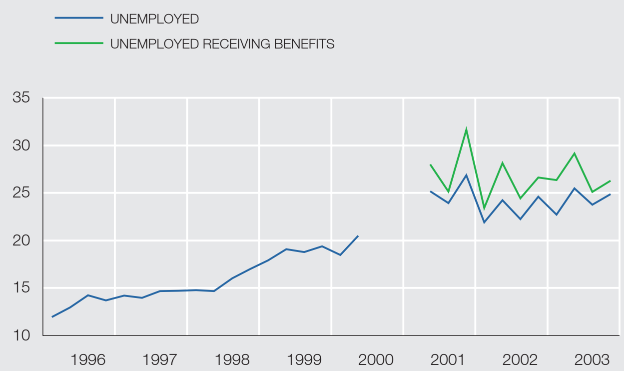
1. These rules relate to the wages firms are required to pay to workers for the period between the notification of dismissal and the decision in a conciliation hearing or by an employment tribunal declaring the dismissal void or unfair. **2.** The Decree-Law passed in May also provided for the progressive disappearance of the agricultural unemployment benefit scheme in Andalucía and Extremadura, and its replacement by a contributory system for all the regions. However, Royal Decree 426/2003, passed in April, established a system of support for workers excluded by the aforesaid reform with similar characteristics.

3. In the case of a permanent employment-promoting contract, 33 days per year worked, subject to a maximum 24 months' wages.

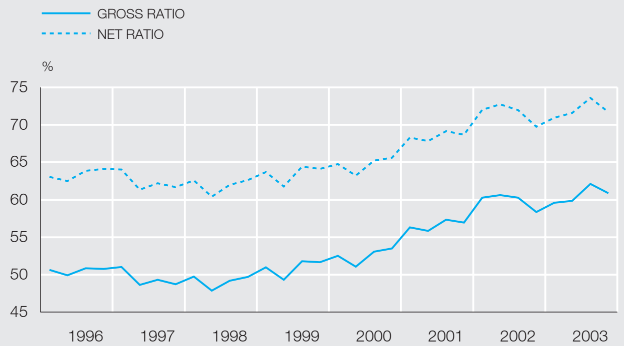
1. ENTRANTS TO UNEMPLOYMENT BY ROUTE



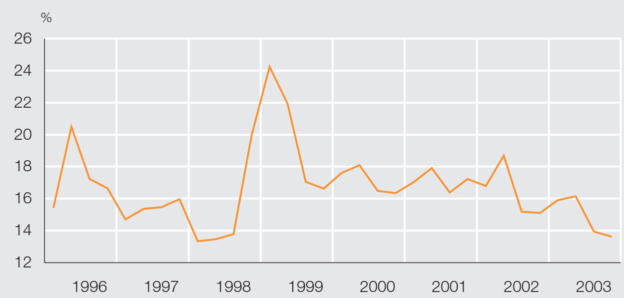
2. OUTFLOW FROM UNEMPLOYMENT TO EMPLOYMENT (% unemployed)



3. REPLACEMENT RATIO



4. PLACEMENTS BY THE INEM



SOURCES: Ministerio de Trabajo y Asuntos Sociales and Banco de España.

of unemployed persons receiving unemployment benefit and, therefore, potentially affected by these changes[4] (see second chart). Also, INEM actions in this area have not been significantly modified, since no reduction is observed in the replacement ratio as a result of increased sanctioning of unemployed persons whose job searching is less active[5] (see third chart).

Second, the activity of the INEM in its role as intermediary between the supply and demand for labour does not seem to have been improved as much as necessary either. The data on the percentage of placements made by the INEM even show a slight decline in recent quarters (see fourth chart), indicating the need for the INEM to become a really effective intermediary in the labour market, to which firms and workers turn not just for administrative reasons. In this connection, the passing of the Employment Law is a step in the right direction, insofar as it defines the general framework of employment policy, establishing as basic priorities the labour-market re-insertion of unemployed persons, with greater attention to groups with special difficulties, and it determines the distribution of competences in this area between central government and the regions. Also, in the INEM's budget for last year, there was a significant increase in those items relating to personnel and real investment. These increases should be maintained and used to improve the INEM's intermediation function. Without a greater effort in this area it is unlikely that the objectives of the set of measures adopted in this reform, which aim to reduce the distance between the unemployed and the labour market, can be achieved.

4. As this information is only available from 2001 the total outflow of unemployed persons is also given to show its past behaviour. **5.** Given the progressive nature of the sanctions introduced by this reform, it is possible that more time may be needed for the effects on the replacement ratio to become apparent.

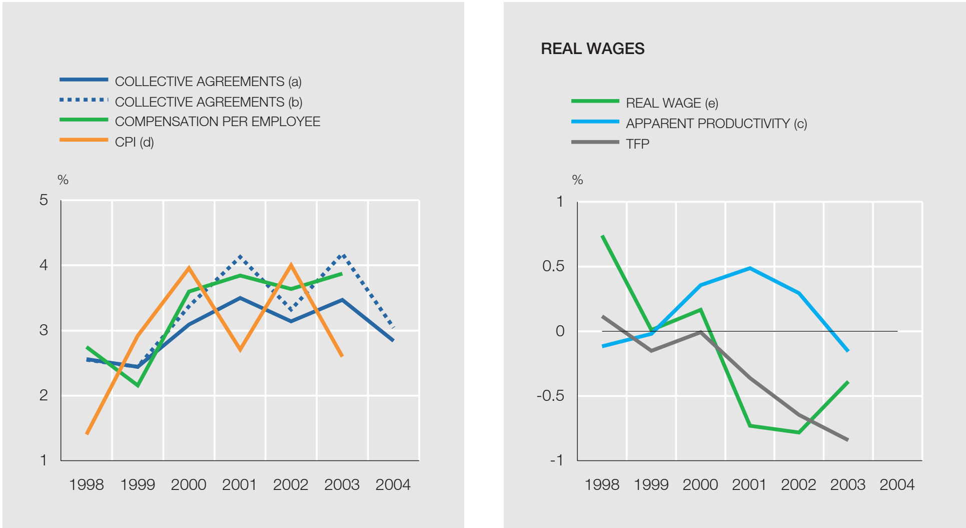
Turning to wage developments, there was an increase in 2003 in wage settlements under collective bargaining agreements. This contrasted with the progressive decline in the inflation rate during the year, as can be seen in the left-hand panel of Chart IV.11. Average wage settlements under collective agreements were 3.5%, compared with 3.1% in 2002, standing above the margins laid down in the renewed Interconfederal Agreement for Collective Bargaining (AINC by its Spanish abbreviation). Further, despite the reduction in inflation during the year, there were no significant differences between the agreed increase under revised pluriannual agreements and under newly signed agreements.

The behaviour of wages highlights the substantial nominal inertia characterising collective bargaining arrangements in Spain, which tends to pass through price developments to wages with a delay. This inertia is greater if regard is had to the effect of wage indexation clauses. In 2003, the clauses arising from the deviation of inflation from its official target in 2002 were activated, and this meant an additional wage increase of 0.7 pp. The better relative performance of prices in 2003, which gave rise to a deviation of inflation from its official target at year-end of 0.6 pp, will lead to a considerably lower attendant upward wage revision in 2004 of around 0.2 pp. The renewal of the AINC for this year, agreed upon by the social agents, involves the continuity of the wage-setting procedure. And this, along with the expected reduction in inflation, provides significant support for the resumption of a path of greater wage restraint. However, although the current bargaining arrangements may offer certain advantages at times of a decline in actual inflation, they lack the flexibility needed to provide the Spanish economy with an efficient adjustment mechanism in the face of different economic shocks. It is thus necessary to reform the collective bargaining system so as to allow wage increases to be tied more closely to the specific conditions of companies and employees.

Given the behaviour of wages, and on QNA figures, the growth rate of compensation per employee increased slightly in 2003 to 4.2% across the whole economy and to 3.9% in the market economy. However, compensation per employee in real terms, calculated with the value-added deflator, fell again in the market economy (see the right-hand panel of Chart IV.11). The slide in compensation in real terms, due to the notable growth of the deflator, is undoubtedly one of the factors behind the favourable behaviour of employment over the past business cycle.

WAGE DETERMINANTS

CHART IV.11



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales.

a. Ignoring indexation clauses. The data for 2004 are to March.
b. Including the effect of the previous year's indexation clause. The data for 2004 are to March.
c. Market economy.
d. Annual rate of change in December.
e. Compensation per employee deflated by the value added deflator.

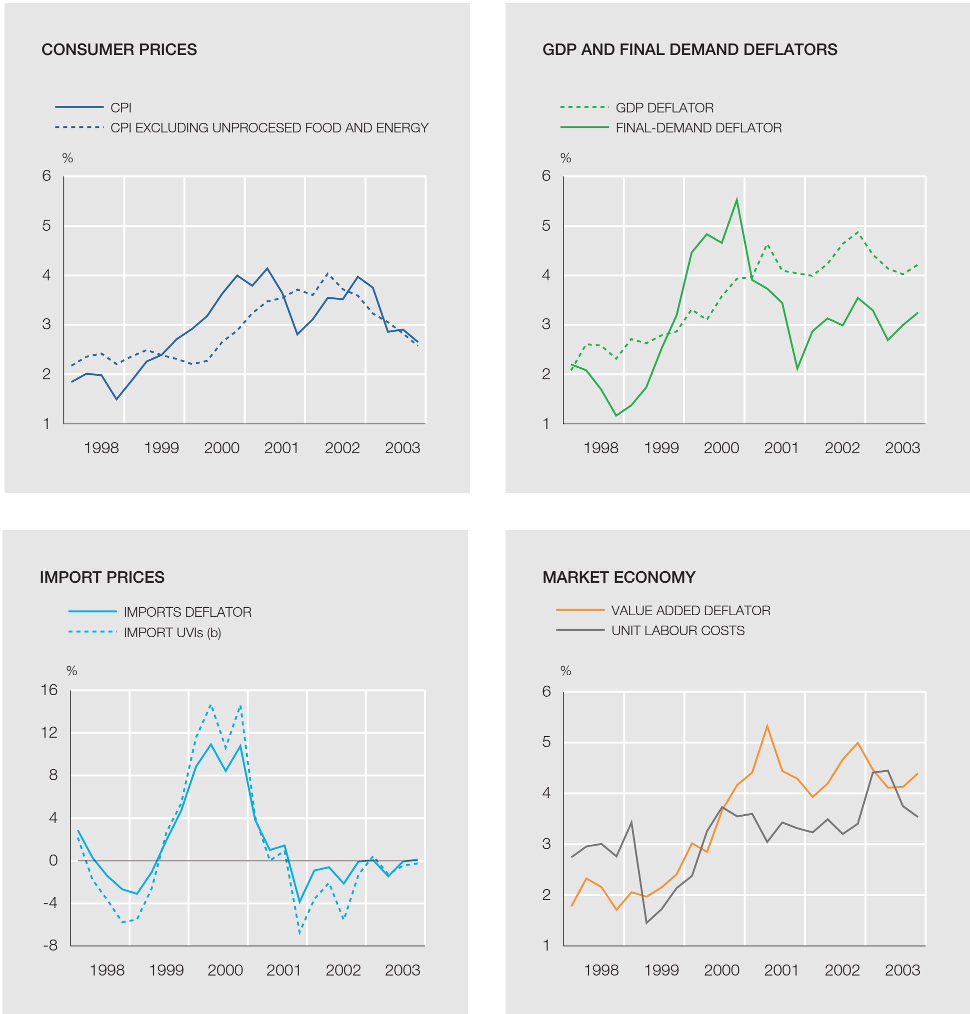
5 *Costs and prices*

As can be seen in the top left-hand panel of Chart IV.12, the growth rate of the consumer price index fell notably in 2003, and continued to do so in the opening months of 2004. On average last year, the CPI posted a rate of change of 3.0%, 0.5 pp down on 2002. Over the year as a whole the reduction in inflation was much more marked, falling from a rate of around 4% at end-2002 to 2.6% in December 2003. Contributing to this reduction, first, was the stripping out of certain temporary upward effects originating in 2002, including those arising from the changeover to the euro, from the increase in certain indirect taxes, and from rises in specific administered prices. Further, there was a fresh reduction in import prices, as a result of the marked appreciation of the euro against the dollar and, to a much lesser extent, of the moderate trend of our main trading partners' export prices.

In terms of components, the reduction in the growth rate of the CPI during the year was across the board. Energy prices in particular were assisted by the trajectory of the euro and the correction of oil prices on international markets, given that there is traditionally a high degree of pass-through. The CPI excluding unprocessed food and energy prices stood at a rate of 2.5% at the close of 2003, compared with a rate of somewhat over 3.5% at end-2002; to date in 2004, its rate has remained relatively unchanged on that at end-2003.

Within the CPI excluding unprocessed food and energy prices, services prices slowed most, posting a rate of 3.6% in December 2003. This reduction largely reflected the stripping out of the upward effects of the physical introduction of the euro, which were particularly sharp in certain services such as restaurants and bars, and which offset the behaviour in the opposite direction of the prices of other services, such as telephony, the rate of decline of which eased substantially, or air transport, which accelerated in the second half of the year. Non-energy industrial goods prices slowed sharply in the second half of the year, in a context of cheaper import prices and an easing of domestic output prices. The prices of clothing and footwear and, to a lesser extent, cars exhibited a particularly marked moderation, while the most sizable price cuts in video, sound, photographic, cinematographic and IT equipment steepened as the year unfolded. Finally, processed food prices, assisted also by the trend of import prices,

COMPOSITION OF FINAL DEMAND AND GDP DEFLATORS (a) CHART IV.12



SOURCES: INE and Banco de España.

a. Annual growth rates.
b. Goods import unit value indices.

were restrained; the end-2003 rate was 2.7%, 1 pp below the January 2003 figure, which partly reflects the stripping out of the index of the tobacco price increases in 2002.

Among the more volatile CPI components, the rates of change of energy prices eased substantially from 5.5% in January to -0.1% in December 2003. This result was due solely to changes in the prices of oil derivatives, as the price of electricity increased for the first time in recent years further to a new system of charges. The growth of unprocessed food prices held at 6.0% on average in 2003, a figure influenced by the 11.6% rise in fruit prices.

In early 2004 there was a turnaround in energy prices as a result of the rise in the price of oil. In 2004 Q1 this effect was partly countered by the appreciation of the euro. Moreover, the rises in oil prices at the outset of 2003 were conducive to a continuing decline in the year-on-year rates of both the energy component and the overall CPI, with the latter standing at 2.1% in March. Subsequently, the more severe rise in oil prices and the greater stability of the euro, compounded by the fresh pressures on certain food prices and the comparison with the notable easing of prices in spring 2003, led to a significant rise in the 12-month growth rate of the CPI to 2.7% in April 2004.

Unlike consumer prices, the growth of the final demand deflator held stable in 2003, posting a rate of increase of 3.1% for the year on average (see top right-hand panel of Chart IV.12). Developments in final prices reflected the differing trajectory of their components. The rate of increase of the private consumption deflator was 0.4 pp down on the previous year, in step with the CPI. In recent years this deflator has been growing at a rate below that of the GDP deflator owing to the moderation of import prices and to the high inflation in the construction industry, which affects GDP but not consumption. The gross fixed capital formation deflator increased by 5.3%, against 4.5% in 2002, while export prices held stable at a moderate rate of 1.0%. This growth masked a price performance that was different in respect of exports to the EU countries and those to the rest of the world; in the former instance they increased moderately, in line with the prices of these trading partners, while in the latter case they diminished notably, a development associated with the appreciation of the euro against the dollar. Under gross capital formation, the construction deflator quickened once more, in tow to house-price rises. Capital goods prices rose by 2.0%, despite the marked fall in import prices for this type of good.

The imports deflator fell once again, albeit to a lesser extent than the previous year, posting a decline of 0.3% on average in 2003 (see bottom left-hand panel of Chart IV.12). The notable appreciation of the euro against the dollar was propitious to the lower prices of goods from outside the EU, and the increase in the import prices of Community-market products remained very small. For the year on average, the sharpest decline was in capital goods prices.

The domestic component of inflation, approximated by the GDP deflator, slowed moderately, posting growth of 4.2% on average in 2003, 0.2 pp down on the preceding year. This modest slowdown was the result both of the slight loss of buoyancy of the non-market services deflator, driven by the trend of public-sector employee compensation, and of the behaviour of market-economy prices (which grew by 4.3%) and, in particular, those of the market services branch, where there was a reduction in unit margins. Net taxes per unit of output showed burgeoning growth (8.6% for the year on average) once again, despite the absence of changes in indirect taxes in 2003.

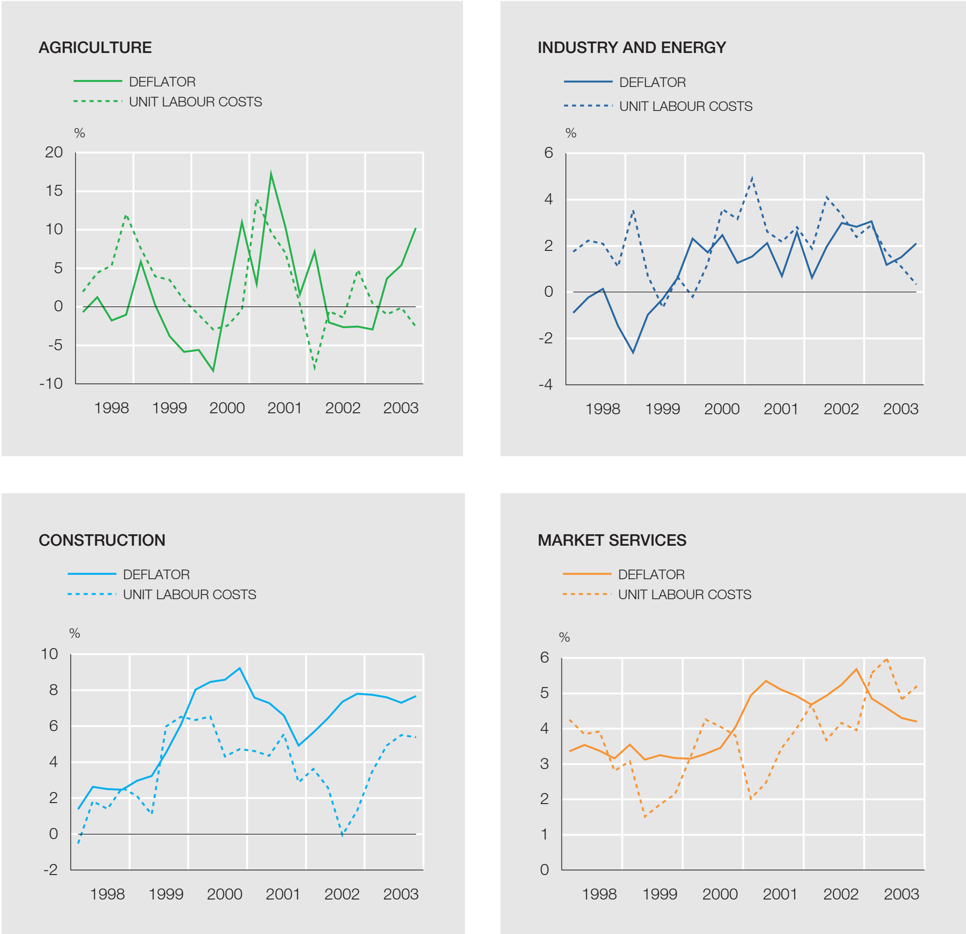
As can be seen in the bottom right-hand panel of Chart IV.12, the slowdown in the market economy value-added deflator was compatible with an acceleration in unit labour costs, driven by the marked decline in apparent productivity and, to a lesser extent, by the increase in compensation per employee. In 2003 Q1, the rate of increase of unit labour costs steepened, while in the following quarters it progressively eased. Overall, the course of the deflator and of costs led to a fresh widening of operating margins in 2003, albeit less so than in 2002, which may be related both to the lesser momentum of demand in the market economy, and to the appreciation of the euro. As is analysed in the following section, the widening of margins was fairly generalised across the different branches of activity, with the exception of market services.

5.1 COSTS AND PRICES: THE PRODUCTIVE BRANCHES

As indicated, the unit operating margin widened in 2003 more moderately than in the previous year. This was the case across the board in the different branches of activity, with the exception of market services, where a decline in the margin was seen, and in industry, where it held stable.

As can be seen in the top left-hand panel of Chart IV.13, under primary activities the value-added deflator quickened markedly, to a growth rate of 4.1% (-0.3% in 2002), probably as a result of specific supply-side factors. This, along with the continuing decline in unit labour costs, derived from the course of average compensation, led the unit margin to widen signifi-

PRICES AND COSTS BY SECTOR (a) CHART IV.13



SOURCES: INE and Banco de España.

a. Uncentred annual percentage changes based on seasonally adjusted QNA series.

cantly in 2003. Although apparent labour productivity continued to grow at a high rate, it slowed over the course of the year, which was but the reflection of the petering out of the strong reduction in employment in the sector in recent years.

In 2003 there was a clear difference in behaviour between the industry and energy branches. In industry, the value-added deflator grew by 1.3%, 0.4 pp down on 2002. Notwithstanding, margins held stable, discontinuing the declining trend observable since 1999. This was the consequence of the considerable slowdown in unit labour costs, in the face of the apparent labour productivity gains which arose from the heavy loss of jobs in industry in 2003. Alternatively, if a more appropriate measure of the operating margin is used, taking into account the user cost of capital (as indicated in Box IV.3), a more moderate increase in margins as from 2002 can be seen, following their strong correction in 2001. However, this increase was not widespread across all the industrial sub-branches: specifically, in the textile and plastics branches there were sizable declines.

In the energy branch, the value-added deflator quickened to a growth rate of 5.2% in 2003. Unit labour costs grew significantly as a result of the forceful acceleration in average compensation, while substantial productivity gains arose as a result of job destruction. Despite this, the unit operating margin widened, since the acceleration in unit labour costs was less than that of the GVA deflator.

MARGINS IN MANUFACTURING

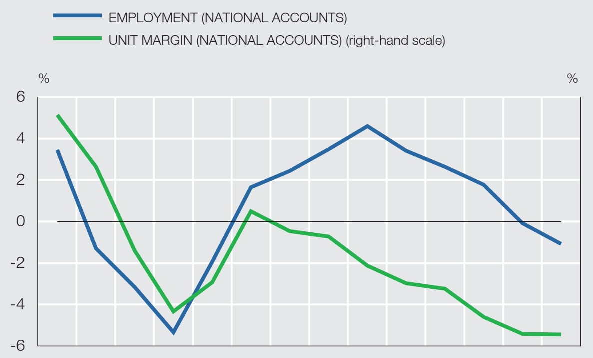
Profit margins, or mark-ups, are usually approximated by the unit operating margin (i.e. the share of the operating surplus in nominal value added). According to the National Accounts, the unit operating margin of Spanish industry fell continuously between 1995 and 2002 (see first chart), while employment grew at a significant rate during most of this period. This downward path of industrial margins tended to level off in 2003, as a consequence of the adjustment induced by employment, which fell by 1.1%.

However, the National Accounts unit margin is an incomplete measure of mark-ups, since it fails to deduct the user cost of capital. When margins are approximated taking into account this component of costs the results for the second half of the 1990s are very different: subject to a certain degree of fluctuation, industrial mark-ups tended to increase, reaching a peak in 2000. The smooth increase in mark-ups over these years (in contrast to the National Accounts approximation) is explained precisely by the moderation in the cost of capital, as a consequence of the significant reductions in interest rates during that period. However, the tendency for the user cost of capital to decline ended in 2001, when the real interest rate applicable to investment rose significantly on account of the increase in risk premia. The recovery of the margin since 2002 has been moderate. The mark-up estimated using data from the Banco de España Central Balance Sheet Data Office confirms this more complete approximation of the value of industrial margins (see second chart), although the fall in 2001 would have been smoother.

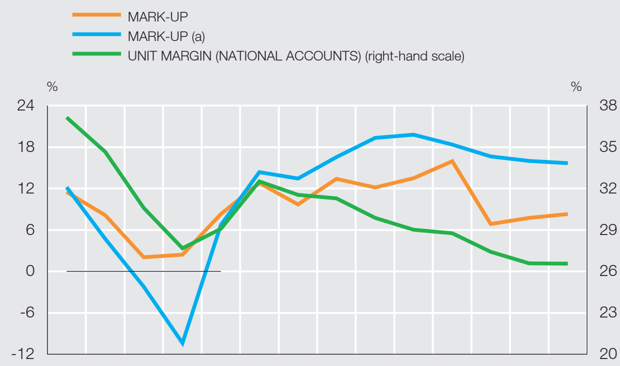
This behaviour of industrial mark-ups would explain the apparent contradiction between two phenomena which coexisted between 1995 and 2001: a sustained decline in the unit margin and highly buoyant employment. The increase in industrial employment over that period, at a rate of almost 3% per annum (see third chart) is consistent with the trend in margins, if the latter are adjusted to reflect the behaviour of the user cost of capital. When the decline in the cost of capital was interrupted in 2001 the mark-up contracted significantly, but this contraction tended to moderate in subsequent years owing to a sustained decline in industrial employment, which fell by 2.5% in the final quarter of 2003.

The disaggregated analysis contained in the table below shows that margins behaved fairly uniformly across the various industrial sectors. The fall in margins in the late 1980s and in the early 1990s and their recovery in the second half of the 1990s occurred in all industrial sectors, except for the food industry, where the decline was uninterrupted. However, the moderate recovery in margins in 2002 and 2003 was less widespread, only occurring in six of the ten industrial sectors. In four of them the growth was very significant, while in the other two it was less pronounced. In the other sectors, which are generally the most export-oriented (as seen in the final column of the table), and therefore those most exposed to foreign competition, margins tended to be squeezed. Worthy of note was the poor performance of the textile industry, seriously affected in recent years both by the delocation of industrial production and by the depreciation of the euro, and of transport equipment, both of which are subject to strong international competition.

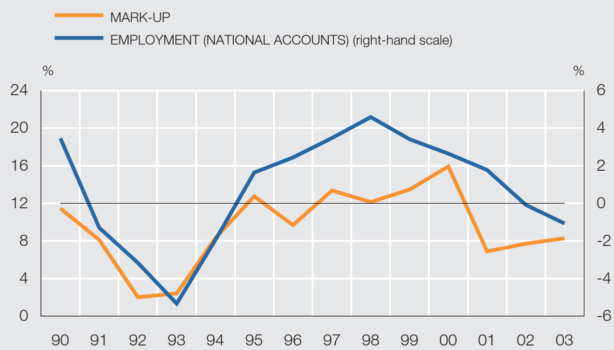
1. SPANISH NATIONAL ACCOUNTS: UNIT MARGIN AND EMPLOYMENT



2. ALTERNATIVE MEASURES OF THE MARGIN



3. MARK-UP AND EMPLOYMENT



4. CHANGES IN THE MARK-UP IN THE VARIOUS INDUSTRIES BY SUB-PERIOD

	00-95	01-00	03-01	X/P
Metals	3.1	-15.3	0.2	20.5
Non-metals	8.8	-12.0	0.6	18.4
Chemicals	6.5	-12.0	5.4	31.0
Machinery	2.0	-7.3	-1.5	43.6
Transport equipment	6.1	-10.2	-2.3	59.0
Food	0.3	-7.1	4.7	13.1
Textiles	-1.3	-13.2	-11.0	25.2
Other	3.9	0.2	6.0	15.6
Paper	2.9	-6.0	7.3	11.4
Plastics	4.6	-5.4	-4.7	29.2
TOTAL	3.2	-9.0	1.4	28.2

SOURCES: Instituto Nacional de Estadística and Banco de España.

a. Mark-up calculated on the basis of Banco de España Central Balance Sheet Data Office data as the ratio of ordinary net profit to nominal gross value added. The 2003 figure is a projection based on Central Balance Sheet Data Office quarterly data.

In construction, the value-added deflator continued to accelerate significantly to a rate of 7.6%, since the strength of demand held activity above its potential. This allowed the unit operating margin to increase appreciably for the fifth year running, albeit less markedly so than in 2002, despite the strong acceleration in unit labour costs. The latter were more buoyant owing to the strong growth of average compensation, likewise affected by demand pressure, and to the contraction of apparent labour productivity, associated with the stage at which most construction work is at.

In market services the deflator grew significantly, albeit more moderately than in previous years. This, along with a strong rise in unit labour costs, led to a decline in the operating margin for the first time since 2000. Unit labour costs increased as a result of a combination of higher growth in compensation per employee and apparent labour productivity losses.

6 Competitiveness

As discussed in Chapter I, the sustainability of the process of real convergence in which the Spanish economy has been immersed depends, against a background of growing globalisation and competition, on its capacity to promote and strengthen its competitive position, among other factors. Of influence here are conjunctural factors, such as the inflation differential vis-à-vis our main trading partners, and more structural factors, such as the ongoing change of the productive and trading structure.

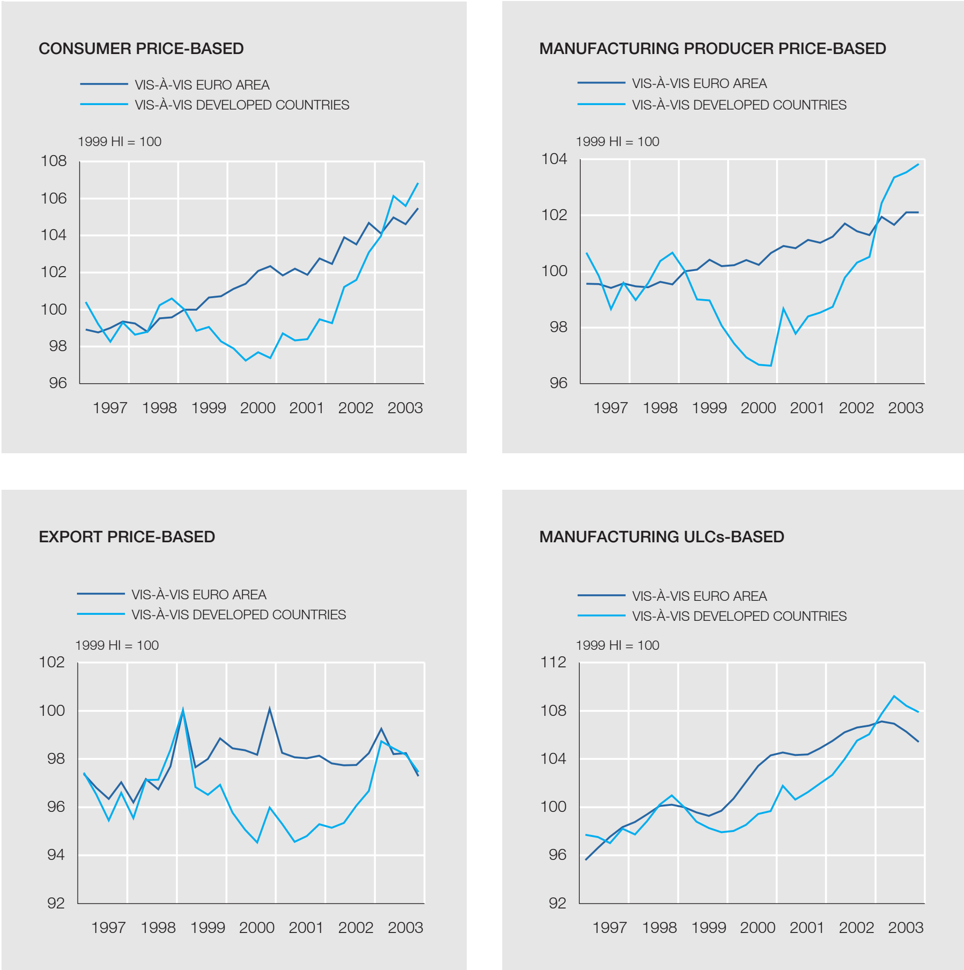
Regarding conjunctural factors, the competitiveness indicators vis-à-vis the euro area in 2003 generally showed losses in competitiveness, reflecting the inflation differential the Spanish economy maintains with the region (see Chart IV.14). Thus, although the upward trend of the index compiled with relative consumer prices eased in 2003, due basically to a slackening of the expansionary rate of the services component, competitiveness has continued to be eroded. And when this is added to the decline posted since the introduction of the euro, the resulting figure is 6%. The trend of the indices of manufacturing and export relative prices has, since 1999, been more contained; indeed, the relative index of export prices shows a slight advantage favourable to Spain to have built up. During 2003, the trends of the unit labour costs indices also diverged: while the index for manufacturing stabilised, translating into a 1.6% reduction in the cumulative inflation differential since 1999, the index for the economy as a whole saw its upward profile steepen. Instrumental in this result was the widening of the growth differential for compensation per employee, which was not countered by the modest relative improvement in apparent labour productivity.

The indicators of competitiveness vis-à-vis the developed countries not belonging to the euro area showed a notable and generalised loss in competitiveness in 2003 as a result of the appreciation of the euro. The appreciation of the nominal component – by over 10% – added to the more modest appreciation experienced in the two previous years, whereby the gains in competitiveness attained since the introduction of the euro were, overall, cancelled out. Adding to the behaviour of the exchange rate was the increase in the relative prices and costs indices – with the exception of the export price index – which, nevertheless, saw their upward trend slacken. As earlier signalled, the competitiveness indicator compiled with export prices behaved more moderately, whereas the producer price index trended like the nominal component.

It was mentioned how the gradual deterioration in the Spanish economy's competitiveness via prices and costs was not manifest in foreign trade results; indeed, foreign trade flows in 2003 outgrew their markets. This was also reflected in the behaviour of the indicator of the Spanish

COMPETITIVENESS INDICES FOR SPAIN (a)

CHART IV.14



SOURCE: Banco de España

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

economy's openness (65%), which continued to narrow the gap with the euro area (75%). Nonetheless, in 2003 the external deficit on the balance of goods and services widened notably, as can be seen in the National Accounts data, which place it at 3.5% of real GDP, 0.9 pp up on the previous year. In turn, according to Customs data, the goods trade deficit stood at 7.8% of real GDP.

The buoyancy of trade flows made for an upward impulse in both the share of exports of Spanish goods on international markets and in the penetration of imports on the domestic market. Specifically, export shares in nominal terms, and valuing the growth of markets in euro, increased to levels of 2.1% and 4.2% vis-à-vis the world and the euro area, respectively. In real terms, the share of exports in markets returned to 1999 levels, around which it has been hovering in recent years. The import penetration ratio, measured as the volume of imports of goods and services – or of goods – in terms of real GDP, increased in 2003 to 25.5% – or 21.3% – following its flatness, or slight fall-off, in the two preceding years.

As indicated in Section 2, the relatively favourable performance of Spanish exports in 2003 is due in part to the containment of export prices which, against the background of the strong appreciation of the euro, has led to a contraction of export margins. As Table IV.2 illustrates,

RATES OF CHANGE MANUFACTURING EXPORT MARGINS

TABLE IV.2

	AVERAGE 93-98	1999	2000	2001	2002	2003
	SPAIN					
1. Export margins (1.1/1.2=2x3)	**0.9**	**-2.7**	**2.3**	**-1.2**	**-1.7**	**-3.5**
1.1 Manufacturing export prices	2.9	-1.5	4.8	2.7	1.1	-2.2
1.2 Industrial unit labour costs	2.0	1.2	2.4	4.0	2.9	1.4
1.2.1 Compensation per employee	*3.6*	*2.0*	*3.6*	*4.1*	*3.7*	*3.8*
1.2.2 Productivity per person employed	*1.5*	*0.7*	*1.2*	*0.2*	*0.8*	*2.4*
2. Relative return on exports (a)	**0.2**	**-1.5**	**2.7**	**0.7**	**-0.6**	**-3.5**
3. Unit margin in manufacturing (b)	**0.6**	**-1.2**	**-0.4**	**-1.9**	**-1.1**	**0.0**
	SPAIN - EU COMPARISON					
4. Export margins relative to EU (4.1/4.2)	**-0.2**	**-0.8**	**-2.0**	**-1.0**	**-0.3**	**-1.0**
4.1 Relative export prices of manufactures	2.1	-0.8	1.0	0.6	1.1	-0.9
4.2 Relative industrial unit labour costs	2.3	0.1	3.0	1.6	1.4	0.1

SOURCES: Ministerio de Economía, OECD, European Commission and Eurostat.

a. Ratio of the manufacturing exports deflator to the industrial GVA deflator.
b. Inverse of employees' share in industrial GVA.

the unit margin in Spanish manufacturing industry tended to stabilise in 2003, after successive falls in prior years, as a result of the moderation of unit labour costs induced by the employment adjustment during the year. Nonetheless, the substantial deterioration in the relative return on exports, measured by the growth differential between export prices and the value-added deflator in industry, meant that the export margin also fell strongly in 2003. The contraction of export margins in Spain remained greater than the average for the Community countries.

Turning to considerations relative to the economy's capacity to increase its efficiency and welfare in the long run, competitiveness in recent years can be seen to have been influenced by the moderate growth of apparent labour productivity. This weakness no doubt reflects the intense job creation that has characterised the current expansionary cycle and which has allowed the unemployment rate to be reduced significantly. However, the fact that total factor productivity also shows very moderate growth denotes insufficient progress as regards improvements in human capital and the incorporation of technical progress into productive processes (see Table IV.3).

The Spanish economy has made headway both in improving human capital and in furthering innovation. However, the distance separating us from the EU remains considerable and highlights the efforts still needed to attain the targets set at the Lisbon Summit as regards increasing productivity. This relative weakness is highly significant in the area of innovation (approximated through spending on R&D), where the gap with the EU is still notable in most industries and, most especially, in those with greater technological requirements (see Box IV.4). That contributes to explaining the Spanish economy's lesser capacity to improve product quality and promote growing specialisation in its industrial structure in respect of those products which add greater value and for which the demand on international markets is growing at a higher rate.

Among the factors bearing more on the competitive position of the Spanish economy in the medium term, the enlargement of the EU is an event of singular importance. Along with the process of European integration, the enlargement of the EU will result in heightened competi-

REAL CONVERGENCE AND COMPETITIVENESS INDICATORS TABLE IV.3

	1995		2003		LATEST DATA
	SPAIN	SPAIN / EU	SPAIN	SPAIN / EU	
GDP PER CAPITA AND COMPONENTS					
GDP per capita (a)	14.0	79.0	21.2	87.4	2003
Pop. 16-64 / total pop.	68.1	102.2	68.3	103.0	2003
Employment rate (b)	50.8	80.8	59.7	88.6	2003
Labour productivity (c)	40.4	95.7	42.8	93.5	2003
TOTAL FACTOR PRODUCTIVITY AND CAPITAL STOCK					
TFP (d)	100.0	100.0	102.3	96.7	2003
Total capital stock/employment	119.7	90.5	129.9	90.7	2003
Technological capital / GDP	6.4	43.0	6.2	40.8	1999
Human capital / pop. 16-64	32.3	66.9	36.3	71.7	1999
OTHER SUPPLEMENTARY INDICATORS					
R&D expenditure / GDP	0.8	41.8	1.0	47.9	2001
ICT GVA (e)	3.7	77.7	4.0	70.1	2001
ICT expenditure per capita (f)	448.9	56.8	1,034.5	70.2	2003
Publ. expend. on education / GDP	4.7	90.1	4.4	87.9	2001
Pop. of working age with tertiary education / total pop.	29.5	53.2	41.6	64.4	2002

SOURCES: Eurostat, OECD, FUNCAS, Ministerio de Economía and Banco de España.

a. Current euro in PPP (000s).
b. Employment/population aged 16-64.
c. Euro PPPs (000s) per person employed.
d. 1995 = 100.
e. As % of whole-economy GVA.
f. Euro PPPs per inhabitant.

tion and will pose a new challenge to the competitive capacity of Spanish industry. The slow process of adjusting productive and trade structures to the European model, along with the relatively slower headway in incorporating new technologies, both in manufacturing and in services, might be limiting the Spanish economy's growth potential (see Chart IV.15). In this respect, the competitive behaviour of the tourism industry is well worth mentioning. Set against the notable growth of Spanish supply and the opening up of new tourist destinations, with similar characteristics to Spain's, the flow of visitors arriving at our borders is proving to have its basis in the containment of lodging prices. Average expenditure per tourist is diminishing notably, whereby the industry's competitive capacity will have to be geared in future not only to the inflow of tourists, but also to the ability to generate resources from these inflows.

7 General government activity

In 2003 the general government sector posted a surplus of 0.3% of GDP (see Table IV.4), improving on the initial forecast of a balanced budget against the background of an economic recovery that was less intense than foreseen at the start of the year. Nonetheless, the growth of nominal GDP – a variable with a decisive influence on public accounts in the short term – significantly exceeded the initial forecasts. The primary surplus increased slightly to 2.9% of GDP, while the public debt ratio stood at 50.8% of GDP, down substantially from 54.6% in 2002.

The State and its agencies recorded a deficit of 0.4% of GDP, somewhat below budget, and the Social Security system improved significantly on its expected surplus, increasing its lending capacity to 1.0% of GDP, which enabled fresh provisions to be made to the reserve fund, taking it to €12.02 billion (1.6% of GDP) at the end of 2003. Conversely, territorial government, for which a balanced budget had been foreseen, posted a deficit of 0.3% of GDP, similar to

Technological innovation is a complex process, the success of which depends on the financial resources employed, the existence of an adequate supply of human capital and an environment conducive to the diffusion and acquisition of knowledge. Research and development (R&D) is one of the most important activities involved in innovation and, also, the one that has the most direct impact on factor productivity[1]. The disaggregated information on R&D spending in Spain and in the EU as a whole (one of the few indicators available in this area) enables certain characteristics of the pronounced innovation gap between the Spanish economy and other European countries to be highlighted.

In particular, this box will attempt to analyse the extent to which this gap is explained by less intensive R&D expenditure by the various industries (spending effect), or whether the pattern of productive specialisation of the Spanish economy, owing to its different degree of technological content, favours these differences (structure effect).

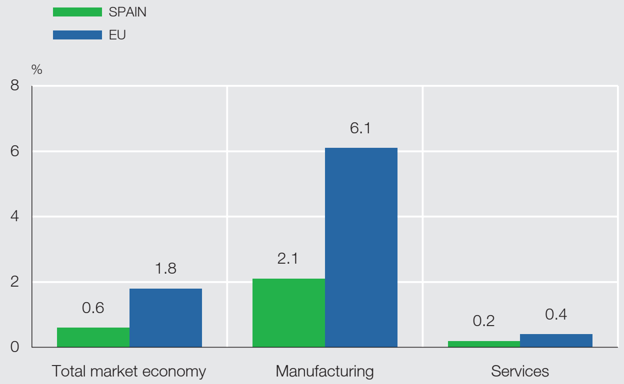
1. Innovation also includes expenditure on industrial design and engineering, on the marketing of new products and on the acquisition of tangible and intangible technologies. In fact, according to the INE's Technological Innovation Survey for 2002, internal R&D expenditure represented somewhat more than one third (34.8%) of total spending on innovation activities by Spanish firms, while the acquisition of machinery and equipment and other innovation activities represented 32.5% and 32.7%, respectively.

The answer is important, since these two factors have different implications for the convergence process required to bring R&D expenditure into line with European levels and to meet the objectives set at the Lisbon Summit for this variable.

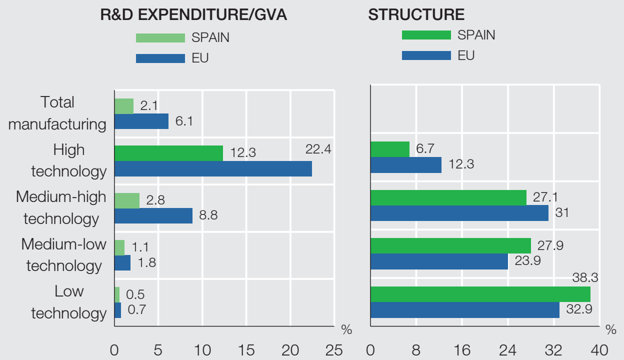
The first chart shows the levels of internal R&D spending in the two main sectors of the market economy, as a percentage of their value added, both for the Spanish economy and for the EU as a whole. The figures are for 1999, the latest year for which sectoral information is available, but they are not expected to have changed much since then. As can be seen, the Spanish economy's spending on R&D is below the EU average, both in the case of market services and in that of manufactures, although in the latter case the differences are more significant, explaining almost the entire gap at the aggregate level.

The various manufacturing sectors have been grouped in accordance with the OECD classification of industries by their technological intensity. The second chart shows for each the spending and structure effects mentioned above. As can be seen, the intensity of the Spanish economy's R&D spending is lower than that of the EU in all industrial sectors (even at a more disaggregated level than that shown in the chart). Also, the differences are larger in those industries with greater technological requirements, although it should be point-

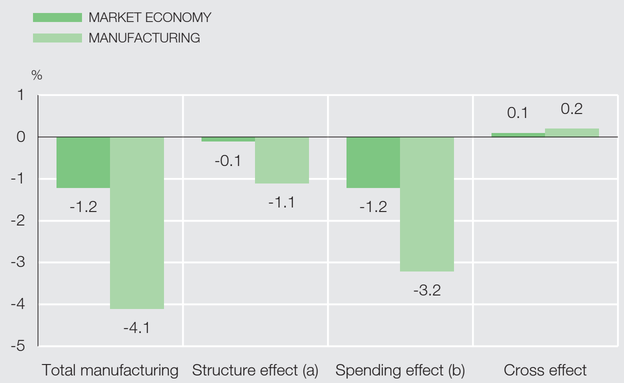
1. R&D EXPENDITUE AS A PROPORTION OF VALUE ADDED IN SPAIN AND THE EU



2. EXPENDITURE AS A PROPORTION OF VALUE ADDED AND STRUCTURE BY TECHNOLOGICAL INTENSITY IN 1999. SPAIN AND EU



3. SPAIN-EU R&D EXPENDITURE GAP: COMPONENTS



SOURCE: Banco de España.

a. Gap obtained on the basis of aggregate expenditure for Spain assuming average EU expenditure by branch.
b. Gap obtained on the basis of aggregate expenditure for Spain assuming the same structure of value added by branch as in the EU.

ed out that these activities have a comparatively low weight in the Spanish productive structure.

To assess the extent to which the differential observed at the aggregate level is explained by each of the factors analysed, it has been broken down by means of shift-share analysis. The first factor, which captures the differences in sectoral specialisation, shows what the differential would be if the intensity of R&D spending of the various sectors of the Spanish economy were equal to that of the EU as a whole. The second factor, which captures the discrepancies in spending, approximates what the differential would be if the productive structure of Spain were equal to that of the EU. A third, residual, factor would capture the interaction between the two preceding elements. The results suggest that the differential in aggregate R&D spending, both for the market economy as a whole and for manufacturing, stems essentially from the lower research intensity in the various industries. Thus, if the intensity of R&D were equal to that observed in the EU, the gap would be cut significantly. The fact that the Spanish economy has a productive specialisation oriented towards industries with a lower technological content also helps to explain the aggregate gap, but not to the same degree.

The conclusions that may be drawn from this analysis point to the need for a major research and development drive by Spanish industry as a whole and, especially, by those sectors that produce goods with greater technological requirements, where the gap with the EU is notable. These differences may explain, among other factors, the difficulties these sectors have increasing their presence in the Spanish productive structure and in international markets, since the smaller research effort is usually associated with specialisation in the lower quality segments of production within each industry.

that of the previous year both in the case of the regional (autonomous) governments (0.2% of GDP) and local governments (0.1% of GDP). It is worth recalling that the budgetary stability legislation[10] requires tiers of government running a deficit to submit economic and financial plans enabling such deficit to be corrected in the medium term.

In terms of components, the improvement in the general government financial balance came about due, above all, to lower interest payments which, with a decline of 5.2% on the previous year, saw their weight in GDP fall by 0.3 pp. Nonetheless, mention should also be made of the positive contribution of revenue to this result since, despite the tax changes – all with a contractionary effect on revenue – introduced in 2003 (the personal income tax reform, the partial elimination of the tax on business activity, the freeze on excise duties), the weight of revenue in terms of GDP increased by 0.1 pp to 40.3%, which runs counter to the decline of 0.3 pp envisaged in the Stability Programme 2002-2006. Primary current expenditure as a percentage of GDP held unchanged.

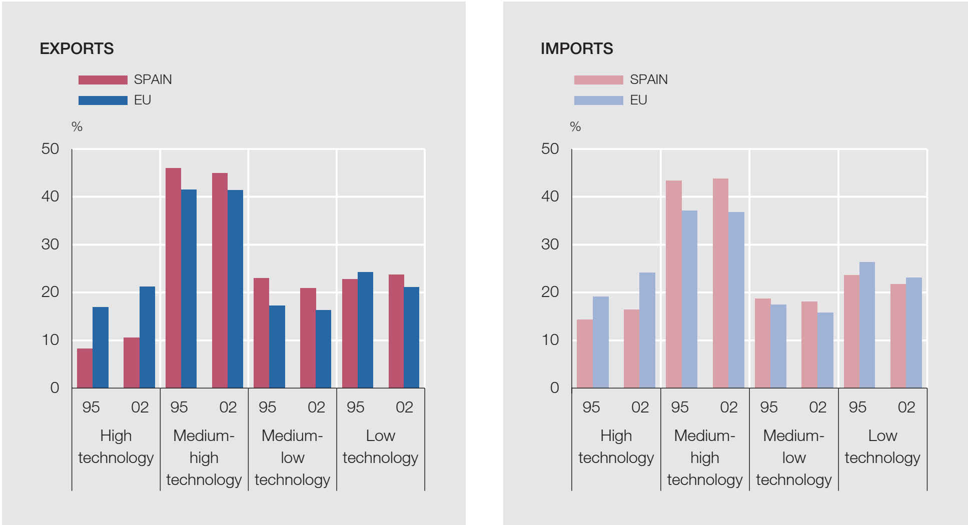
There was a moderate increase in the fiscal burden in 2003 which may be attributed practically in its entirety to the buoyancy of revenue from taxes on production and imports (0.3% of GDP), which offset the loss of weight of revenue from taxes on income and wealth. This strong increase in indirect tax was largely due to the relative resilience of consumption, although the marked buoyancy of construction companies' billings and of real estate development already detected in the second half of 2002 might have continued affecting VAT takings. A further factor was the strength of transfer tax and stamp duty, which grew by over 10% in 2003.

The growth of current taxes on income and wealth was much more moderate, slowing from a rate of change of 11.7% in 2002 to 3.6% in 2003, with its weight in terms of GDP diminishing by 0.3 pp. The most salient development in connection with these taxes was the entry into force of the personal income tax reform[11], with an estimated cost in terms of revenue of 0.5%. It was foreseen

10. General Law 18/2001 of 12 December 2001 on Budgetary Stability, and Organic Law 5/2001 of 13 December 2001, complementing the former. **11.** The main features of this reform were the reduction in the number of brackets to 5 (previously 6) and in the top and minimum rates (by 3 pp to 45% and 15%), the increase in personal and child allowances and the reduction relating to dependent employment. The tax rate on capital gains generated over more than 1 year was reduced in line with the change in the minimum rate, and withholdings on certain income were also brought into line with that rate (15%). Other relevant amendments are briefly indicated in section 2.

SPANISH TRADE SPECIALISATION: COMPARISON WITH EU (a)

CHART IV.15



SOURCES: Eurostat, Aduanas and Banco de España.

a. As percentages of total exports and imports, respectively.

that most of this figure would correspond to 2003 (up to 0.4% of GDP), owing to the lower withholdings on salaried income that year. Notwithstanding, it is estimated that personal income tax revenue would have grown in 2003 at somewhat below the rate of nominal GDP (above, therefore, the initial estimate), as a result above all of certain effects that would have dampened the initial impact of the reform, such as the delay in early 2003 in the application of the new (lower) withholding rates on salaried income, and the bringing forward of this type of revenue by certain public enterprises. In this respect, lower direct tax takings as a percentage of GDP were mostly due to the decline in revenue relating to corporate income tax, once adjusted for the effect induced in 2002 by the change in the taxation of unreported capital gains.

Revenue relating to social security contributions maintained its weight in GDP, with the high level attained the previous year (13.6%) thus firming. The buoyancy of employment, with the growth in social security registrations virtually unchanged on the previous year (3%), and the widening of tax bases help explain this result. Lastly, the trend of non-tax revenue was influenced by the fall in proceeds from Banco de España profits, which was largely offset by the strong increase in capital transfers, particularly those from EU funds.

Turning to the primary current expenditure components, the share of spending on final consumption in GDP increased slightly. Under government consumption, however, the associated components showed divergent trends. The compensation of employees in the service of general government quickened moderately on 2002, a development perhaps due – on the information available on non-market services – both to the increase in the number of employees and to that in compensation per employee, and is consistent with the expansionary measures adopted in 2003 discussed at the start of this chapter. Conversely, intermediate consumption (purchases of goods and services) and social transfers in kind (essentially related to health and State-subsidised private education spending) slowed notably in relation to the high growth posted in 2002 (due in part to the extraordinary expenses incurred that year in connection with the *Prestige* disaster), although their growth remained higher than that of nominal GDP.

Welfare benefits decelerated considerably in relation to 2002, though their share in GDP remained practically unchanged. That reflects on one hand the smaller extra payment to pen-

MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS TABLE IV.4

% of GDP

	2000	2001	2002	2003
1. Total revenue	**39.3**	**39.5**	**40.2**	**40.3**
Current revenue	38.8	38.9	39.5	39.5
Taxes on products and imports	*11.7*	*11.4*	*11.6*	*11.9*
Taxes on income and wealth	*10.5*	*10.4*	*10.9*	*10.6*
Social contributions	*13.3*	*13.5*	*13.6*	*13.6*
Other current revenue (a)	*3.3*	*3.5*	*3.4*	*3.3*
Capital revenue	0.6	0.6	0.7	0.8
2. Total expenditure (b)	**40.2**	**39.9**	**40.2**	**39.9**
Current expenditure	35.6	35.1	35.3	35.2
Final consumption	*17.6*	*17.5*	*17.8*	*17.9*
Social benefits other than transfers in kind	*12.3*	*12.2*	*12.3*	*12.3*
Interest (b)	*3.3*	*3.1*	*2.8*	*2.5*
Subsidies	*1.2*	*1.1*	*1.2*	*1.1*
Other transfers	*1.2*	*1.1*	*1.2*	*1.3*
Capital expenditure	4.6	4.8	4.9	4.8
Gross capital formation (c)	*3.1*	*3.3*	*3.5*	*3.5*
Other expenditure	*1.4*	*1.4*	*1.4*	*1.3*
3. Net lending(+) or net borrowing (-) (b) (3=1-2)	**-0.9**	**-0.4**	**0.0**	**0.3**
MEMORANDUM ITEM:				
Primary surplus	2.4	2.8	2.8	2.9
Gross debt (b)	61.2	57.5	54.6	50.8

SOURCES: INE, Ministerio de Hacienda and Banco de España.

a. Includes gross operating surplus.
b. According to the Excessive Deficit Procedure methodology.
c. Includes net acquisitions of non-produced non-financial assets.

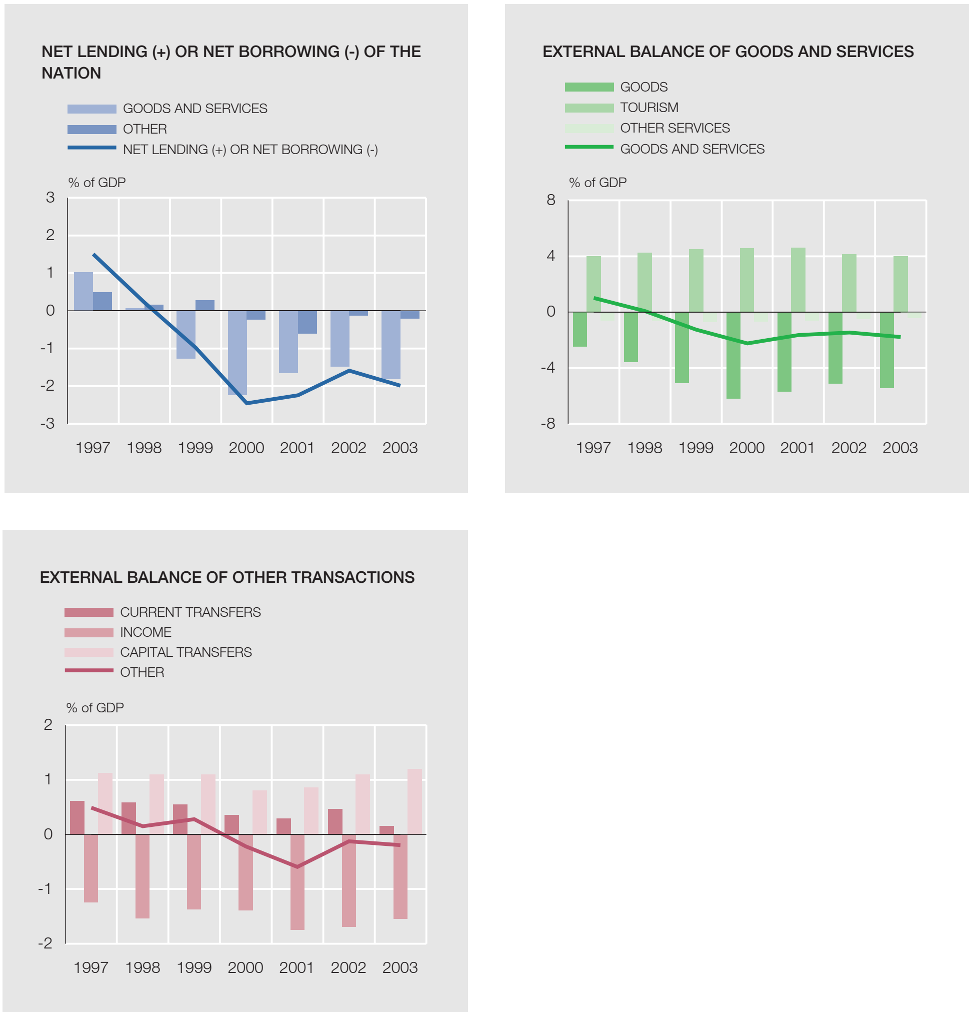
sioners for the deviation of the CPI from the initially envisaged official inflation target and, on the other, the strong deceleration in unemployment benefits, which increased at a rate of 6% compared with 15.5% the previous year, with growth in the number of beneficiaries of 3.2% in annual average terms. The course of this latter variable entailed a slowdown in the trajectory of ongoing increases in the net replacement ratio seen in previous years.

The earlier discussed decline in interest payments was due to the ongoing reduction in both the implicit interest rate on debt and the public debt/GDP ratio. Capital expenditure, for its part, slowed considerably in 2003, due above all to the decline in investment aid and capital transfers, while public investment showed a degree of vigour in 2003, with growth of 7.8%, although this was down on that in 2002 (11%). It should be recalled however, that a notable portion of the public investment drive is routed through the private sector, either via public enterprises or via private concessionaires, with companies receiving the funds needed by means of capital injections or loans.

In sum, the relative strength of taxes, despite the personal income tax reform, and the continuing reduction in interest payments meant an overall general government budget surplus of 0.3% of GDP was achieved. This marked an improvement on the outturn envisaged in the Budget for the year and in the related updated Stability Programme. Hence, against the background of a slight economic recovery, the habitual indicators used to assess the fiscal policy stance show that, in 2003, said stance was restrictive. They further pointed to compliance, for the second year running, with the condition whereby the general government balance in cycli-

REST OF THE WORLD ACCOUNT

CHART IV.16



SOURCE: INE.

cally adjusted terms had to be close to zero or in surplus, an operational criterion used in the assessment of compliance with the Stability and Growth Pact.

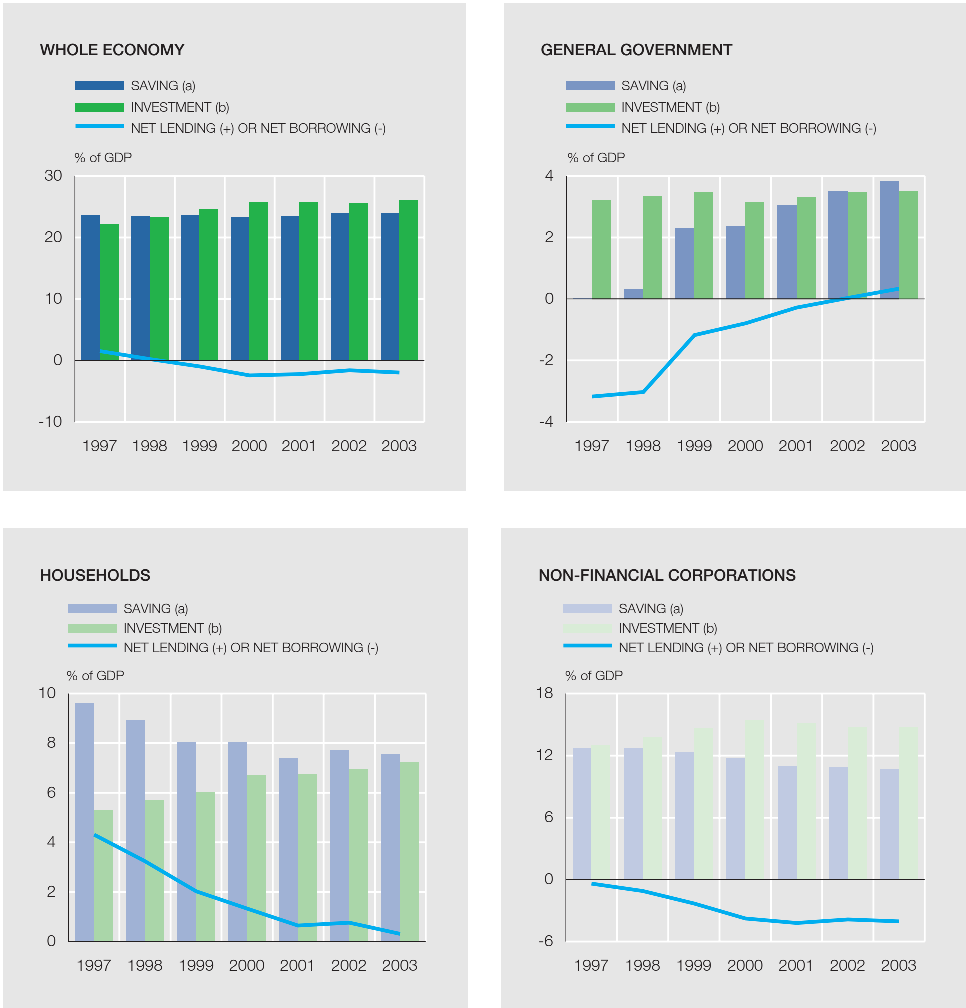
8 The economy's rest of the world account and capital account

On National Accounts figures, the Spanish economy's net financing requirements increased to 2% of GDP in 2003, 0.4 pp up on the previous year. This was the outcome of the notable increase in the current-account deficit, which stood at 3.2%, offset only in part by the higher positive balance on capital account, which stood at 1.2% of GDP (see Chart IV.16).

The increase in the current-account deficit firstly reflected the expansionary impulse behind the deficit on the goods account, the mildly improving path of which in the two preceding years came to a halt and stood at 5.4% of GDP. This was the combination of the lesser expansion of exports compared with imports and a negative change in the terms of trade. The contractionary tone of this balance eased slightly in Q4, when the deficit in real terms declined slightly, at the same time as the terms of trade for goods turned positive. As discussed in previous sections of this chapter, the wide difference between the vigour of domestic demand and the slackness of external demand accounts largely for how more buoyant import flows are than exports flows. Notwithstanding, the behaviour of exports was fairly favourable, despite the notable appreciation of the euro.

In 2003, the share of the balance of services in GDP stabilised at 3.6%, the result of a fresh deterioration in the tourism balance and an improvement in the deficit on other services. As

SAVING, INVESTMENT AND NET LENDING (+) OR NET BORROWING (-) CHART IV. 17



SOURCES: INE and Banco de España.

a. Gross national saving.
b. Gross capital formation.

regards the behaviour of the surplus on tourism, its share in GDP has diminished by 0.6 pp since 2001, standing at 4% in 2003. The sluggishness of revenue, where the instability of the external environment and the low levels of consumer confidence in the developed countries are influential, and the mild pick-up in expenditure (especially in the second half of the year), driven by the appreciation of the euro, explain in part this result.

The deficit on net property income narrowed slightly in 2003 to 1.5% of GDP. From the Balance of Payments standpoint this result, which encompasses a mild improvement in income received and a modest reduction in income paid, reflects a substantial increase in the surplus on the “other resident sectors” income balance, assisted by the pick-up in income relating to assets abroad which, nevertheless, would have been impacted by the depreciation of the dollar. The general government and MFI (monetary financial institutions) income balance reflected, however, a bigger increase in interest payments on their liabilities. The surplus on current transfers narrowed significantly in relation to the level observed in 2002 as a whole. This was due to the moderation of receipts, which were affected by the contraction in some of the funds from the EU, such as the European Social Fund, and by the notable increase in payments, especially those to the EU and emigrants’ remittances. Finally, the increase in the share in GDP of net capital transfers was due to the significant increase in certain structural funds received from the EU, such as the ERDF and the EAGGF-Guidance, which more than cancelled out the adverse behaviour of transfers from the Cohesion Fund. In any event, the timing of EU receipts and payments affects the comparability of data from one year to the next.

The increase in the Spanish economy's financing requirements was the outcome of the expansionary impulse of gross capital formation, the share of which in GDP climbed to 26%, while that of gross national saving held stable at 24%. Across the different sectors, the greater lending capacity of general government countered the reduction in that of households and the increase in the borrowing requirements of corporations which, in turn, reflected higher borrowing requirements of non-financial corporations (see Chart IV.17).

The general government sector extended its saving capacity, maintaining its investment – at 3.5% of GDP – at a similar level to 2002. Meanwhile, households and, to a greater extent, companies reduced their related levels of saving (to 7.6% and 12.6% of GDP, respectively), while boosting their levels of investment. Specifically, household investment in housing held on the expansionary path characterising it in recent years, and in 2003 it amounted to 7.3% of GDP. Spanish companies' private productive investment rose slightly to 15.2% of GDP, reflecting the upward momentum of financial institutions' investment, since non-financial corporations' investment held at similar levels to those of previous years. The following chapter analyses how this increase in the Spanish economy's deficit position has been financed.

V FINANCIAL DEVELOPMENTS IN SPAIN

Financial developments in Spain

In 2003 developments in financial flows, markets and intermediaries in Spain were shaped primarily by the decline in the euro area's official interest rates, which stood at historical lows. Also influencing developments was the improvement in the domestic and international economic environment despite the scant growth in the euro area. This improvement took the form of lower uncertainty and a more favourable macroeconomic outlook in many areas. Among these areas was Latin America, where some Spanish financial and non-financial corporations have significant interests.

Last year the financing conditions of the non-financial private sector became appreciably more generous due to a number of factors. First, lending rates to firms and households continued on the downward path of 2002. Second, on the domestic and international stock markets, prices recovered after falling for three years running, with an accompanying decrease in their volatility to levels below those in the early 2000s. Finally, the fall in corporate risk premia on credit derivatives markets, along with a slight decrease in long-term public-debt interest rates, resulted in a reduction of the cost of corporate financing with fixed-income securities.

In this setting, households and firms continued to base a significant part of their spending on heavy recourse to external financing which, in the case of households, accelerated significantly to growth rates of nearly 19% at the end of the year. The growth rate of financing received by firms rose slightly to around 14%. As in 2002, these rates were largely explained by the expansion of property-related credit, which helped to sustain the upward path of house prices, these rising on average by 17% in 2003. This figure is slightly higher than in the previous year and its magnitude suggests an overvaluation that has not yet started to be corrected.

The increasing recourse to external funds further pushed up the debt ratios of corporations and especially of households. However, the favourable financing conditions and, in the case of households, the lengthening of the average period taken to repay mortgage loans, allowed the associated debt-service burden to remain substantially unchanged at moderate levels. The higher volume of debt did not prevent the sector's net wealth from increasing, thanks to the stock market recovery and, in particular, to the considerable house price rises.

The strong credit growth, along with the surge in mutual fund share purchases in 2003, widened the gap between loans and deposits on the balance sheets of Spanish deposit institutions. This gap was financed by resort to the interbank markets, to debt issuance and to securitisation. Indeed, the issuance of securities by financial institutions was behind the notable expansion of the primary bond markets, which saw net issues by residents grow 70% with respect to 2002, despite the fall-off in general government operations and a further net redemption by non-financial corporations. Capital increases on the equity markets, however, held on their declining path of recent years, despite the upturn in stock market prices. Furthermore, the credit expansion, the greater economic buoyancy, the favourable course of financial markets, the improved economic conditions in Latin America, the cost containment efforts and the lower need for write-downs and provisions contributed to a significant recovery in the profits of Spanish credit institutions, while their solvency ratio remained at comfortable levels.

In sum, the financial position of the entities with a central role in channelling financial flows between the various sectors of the economy, and that of Spanish corporations and house-

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE V.1

% GDP	1998	1999	2000	2001	2002	2003
National economy	0.2	-1.0	-2.5	-2.2	-1.6	-2.0
Non-financial corporations and households and NPISHs	2.1	-0.3	-2.3	-3.4	-3.0	-3.7
Non-financial corporations	*-1.1*	*-2.3*	*-3.4*	*-4.5*	*-4.5*	*-4.6*
Households and NPISHs	*3.3*	*2.0*	*1.1*	*1.1*	*1.5*	*0.8*
Financial institutions	1.1	0.5	0.8	1.6	1.5	1.4
General government	-3.0	-1.2	-0.9	-0.4	-0.1	0.3

SOURCE: Banco de España.

holds, are compatible with continued strong consumption and with the recovery of private productive investment. Nevertheless, the level of debt leaves less scope for corporations and especially households to continue resorting heavily to external funds to finance their spending, which may therefore become more dependent on the behaviour of current income. Also, the higher debt, along with the changes in the composition of portfolios in recent years, means that the consumption and investment decisions of the non-financial private sector depend more than in the past on changes in the cost of debt and in financial and real asset prices. In the case of households, their spending may have been made more sensitive to interest rate changes by the increasing prevalence of floating rate mortgage loans and by the low inflation and interest rates (see Box V.1).

1 Financial flows in the Spanish economy

In 2003 the financing received by the non-financial private sector continued to expand at high rates and even showed a significant acceleration in the case of that flowing to households. The buoyancy of lending for property activities played a significant role in this expansion.

The net financial saving ("net financial transactions" in ESA 95 terminology) of the non-financial private sector decreased again as a result of the slight rise in corporate net borrowing requirements and, above all, of the decline in household net saving (see Table V.1 and Chart V.1). By contrast, general government increased its net lending position, while financial institutions did not change theirs significantly. As a result, the net debit balance of the Spanish economy increased to 2% of GDP, 0.4 pp more than in 2002.

1.1 FINANCIAL FLOWS OF HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

Following the moderate recovery in 2002, the net financial saving of households and of non-profit institutions serving households (NPISHs) declined in 2003 (see Table V.1) to stand at 0.8% of GDP, its lowest value in the last few years. Contributing to this fall were the low level of interest rates, the increase in the sector's real estate and financial wealth (associated with rising house and stock market prices) and agents' favourable expectations as to the growth of activity and employment.

Financial asset purchases by households increased to 10.5% of GDP, a rise of 1.7 pp with respect to 2002 (see Table V.2). The breakdown into components shows that the weight of cash and cash equivalents (cash and sight and savings deposits) increased for the third year running and was thus again the main item within the financial flows of assets. The downtrend since 2000 in the relative weight of time deposits continued, and in 2003 there was even a decline in the outstanding balance of these instruments. Also, in line with the expanded supply of fixed-income securities, investment in securities other than shares increased by nearly 0.5 pp to 0.43% of GDP, after the negative change in 2002. Meanwhile, the higher stock market

THE SENSITIVITY OF THE HOUSEHOLD DEBT-SERVICE BURDEN TO CHANGES IN INTEREST RATES

In recent years, floating-rate agreements have become widespread in Spain, especially in the case of mortgage loans. This means, at least in the short term, that the debt-service burden of households, defined as the ratio of the interest and principal payments associated with the loan to their income, is now more sensitive than in the past to interest rate changes. The impact of movements in this variable depends on several factors, such as the level of financing costs, the rate of inflation and repayment periods. To illustrate these effects, the adjoining charts show how the debt-service burden associated with a floating-rate fixed-instalment loan varies under different assumptions for the relevant variables. Specifically, the cost of financing is assumed to be constant (scenario I) and to increase permanently by two percentage points (pp) in year two (scenario II), in year five (scenario III) and in year ten (scenario IV). In the simulations, the debt is three times the borrower's income, which grows at a constant rate equal to the inflation rate. In the first chart, the initial nominal interest rate is 9%, the inflation rate is 7% and the term of the loan 15 years; in the second, the first two variables are reduced, respectively, to 4% and 2% and the duration is not changed, while in the third, the previous hypotheses are maintained, except for the term, which is 30 years.

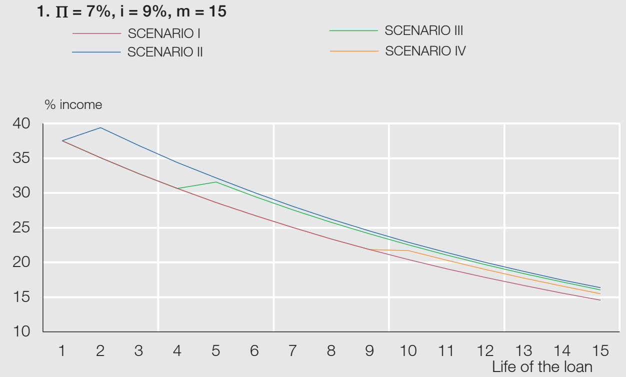
As may be seen in the charts, the lower the nominal interest rates and the longer the repayment periods the higher the sensitivity of the debt-service burden to changes in the cost of financing. For instance, if the movement occurs during the second year of the life of the loan, the debt-service burden rises by 1.9 pp for a 15-year loan and an initial interest rate of 9% (Chart 1), while the effect is 3.2 pp for the same maturity and an interest rate of 4% (Chart 2), and 4 pp for this same level of the cost of financing and a 30-year maturity (Chart 3). At the same time, the magnitude of the impact tends to decrease with the period in which the shock occurs, although it does so more slowly the lower the level of inflation and the longer the term. Specifically, if it occurs in the tenth year the effect is almost nil under the assumptions of Chart 1, while it is 1 pp in a context of lower inflation rates (Chart 2) and 2.6 pp when, in addition, the repayment period rises to 30 years (Chart 3).

Another element that affects the sensitivity of the debt-service burden to changes in interest rates is the level of indebtedness. In this respect, it should be noted that the debt of Spanish households has grown by 150% over the last six years and that, owing to this factor alone, the sensitivity is 2.5 times higher than in the mid-1990s. According to the available indicators, the sensitivity seems to be above the average level for European households. For example, the differential between the average interest rate on all outstanding loans to households at the end of 2003 and that on those extended that year was 62 basis points (bp) in Spain, which was below the euro area average of 119 bp. Given the limited weight of new loans relative to those already existing, this suggests that in Spain the costs of the latter adapt more quickly to changes in market conditions in the area. This same result is inferred from the proportion of the volume of loan transactions negotiated in 2003 with an initial rate fixation of less than one year, which was higher in Spain (75%) than in the euro area (51.2%).

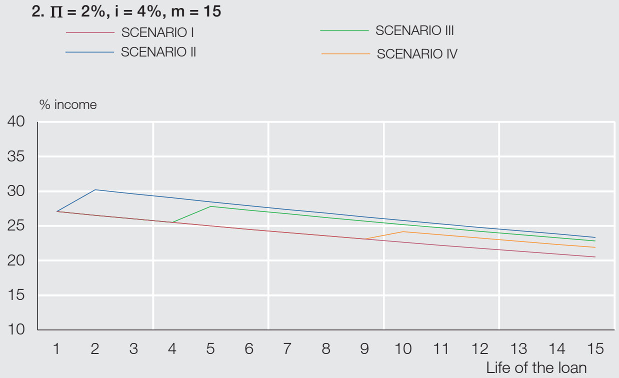
In short, the higher indebtedness of households, along with the lengthening of loan repayment periods and the current context of low interest and inflation rates, means that the sensitivity of the debt-service burden of Spanish households to changes in the cost of financing is higher now than it has been in the past. Also, the information available suggests that it is higher than the euro area average.

DEBT-SERVICE BURDEN ON A FLOATING-RATE LOAN (a)

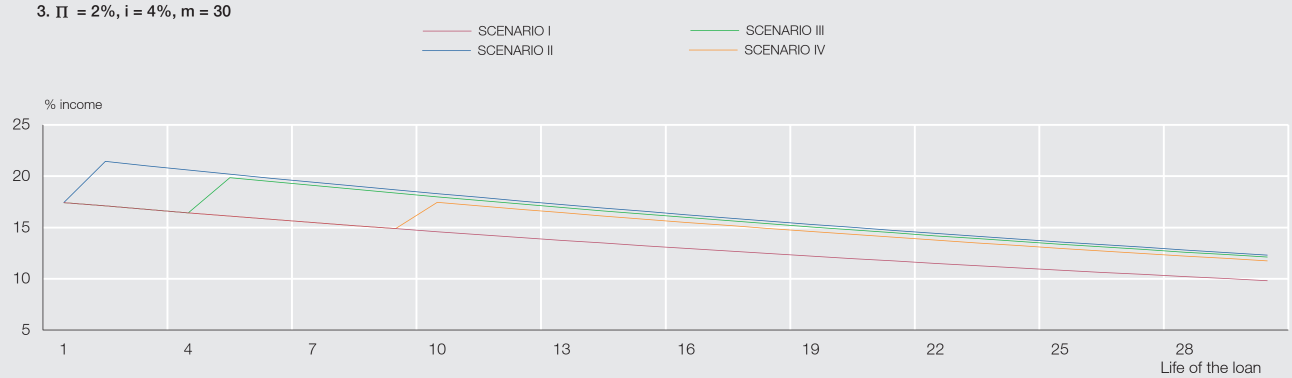
1. Π = 7%, i = 9%, m = 15



2. Π = 2%, i = 4%, m = 15



3. Π = 2%, i = 4%, m = 30



a. Π= inflation rate. i= initial interest rate. m= maturity. The loan is three times the income, which grows at the same rate as prices. The inflation rate is constant. Nominal interest rates remain constant in scenario I. In scenarios II, III and IV they increase by 2 pp in the second, fifth and tenth year of the loan, respectively, and they stay at that level until the loan maturity.

FINANCIAL TRANSACTIONS

CHART V.1

SOURCE: Banco de España.

prices and lower price volatility failed to spur the direct purchase of shares and other equity, which actually decreased slightly to stand at 0.6%. However, investment in mutual funds grew somewhat more than 2 pp relative to GDP, driven by higher subscriptions of securities funds (FIMs). Finally, contributions to pension funds rose moderately (0.2 pp), while those to life assurance schemes contracted by 0.8 pp.

The persistence of generous financial conditions, rising employment, greater economic buoyancy and increasing house prices – which allowed an upward revision of the value of mortgage loan collateral – helped the pace of household borrowing to quicken further in 2003 to 18.7%, up 3 pp on the rate in 2002. This came about mainly as a result of faster expansion of credit for house purchase, which at 21.3% was nearly 5 pp more than in the previous year.

The net financial saving of non-financial corporations decreased slightly in 2003 to stand at –4.6% of GDP (see Table V.1). The higher net financing requirement resulted from a recovery in gross capital formation which, although modest, outweighed that in gross saving. By contrast, the financing gap, which is a measure of the external funds required to cover permanent financial and real investment, shrank by 0.5 pp to stand at 8.5% of GDP (see Chart V.2).

FINANCIAL TRANSACTIONS OF NON-FINANCIAL CORPORATIONS AND HOUSEHOLDS AND NPISHs — TABLE V.2

% GDP

	2000	2001	2002	2003
HOUSEHOLDS AND NPISHs				
Financial transactions (assets)	**9.6**	**7.8**	**8.8**	**10.5**
Cash and cash equivalents	0.9	1.2	3.8	4.4
Other deposits and fixed-income securities (a)	6.1	3.4	1.5	0.0
Shares and other equity (b)	1.5	-0.2	0.8	0.6
Mutual funds	-3.3	0.8	0.2	2.3
FIAMM	*-1.2*	*1.3*	*0.7*	*0.6*
FIM	*-2.0*	*-0.5*	*-0.5*	*1.8*
Insurance technical reserves	3.5	2.7	2.6	2.1
Of which:				
Life	*2.1*	*1.5*	*1.5*	*0.7*
Retirement	*1.1*	*0.9*	*0.9*	*1.1*
Other	0.9	0.0	-0.1	1.0
Financial transactions (liabilities)	8.6	6.8	7.4	9.7
Credit from resident financial institutions (c)	7.0	5.4	7.2	9.4
House purchase credit (c)	*5.4*	*4.8*	*5.2*	*7.2*
Consumer and other credit (c)	*1.6*	*0.6*	*2.1*	*2.1*
Other	1.6	1.3	0.1	0.3
NON-FINANCIAL CORPORATIONS				
Financial transactions (assets)	**26.3**	**16.4**	**16.4**	**17.2**
Cash and cash equivalents	0.9	1.7	1.6	0.9
Other deposits and fixed-income securities (a)	0.7	0.4	1.5	1.1
Shares and other equity (b)	14.1	6.1	6.9	6.8
Of which:				
Vis-à-vis the rest of the world	*10.5*	*4.6*	*5.1*	*4.6*
Other	10.5	8.3	6.4	8.5
Financial transactions (liabilities)	29.7	21.0	20.9	21.8
Credit from resident financial institutions (c)	7.5	6.5	6.3	7.1
Foreign loans	3.5	4.0	3.0	2.8
Fixed-income securities (a)	-0.9	0.0	-0.4	-0.2
Shares and other equity	12.8	5.3	6.0	5.1
Other	6.8	5.2	5.9	6.9
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):				
Financing (d)	18.1	15.6	14.3	16.1
Households and NPISHs	17.3	12.4	15.7	18.7
Non-financial corporations	18.7	18.1	13.3	14.2

SOURCE: Banco de España.

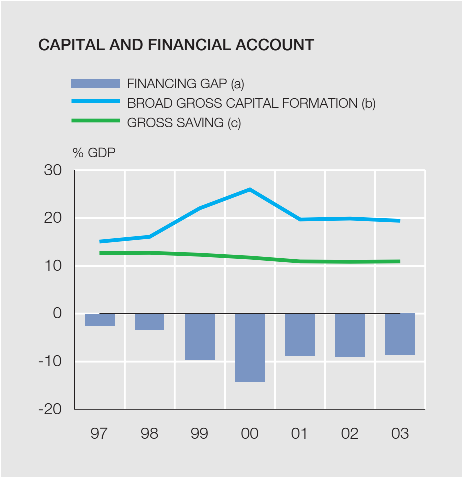
a. Not including unpaid accrued interest, which is included under "other".
b. Not including mutual funds.
c. Includes securitised loans.
d. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

The net acquisition of financial assets by corporations rose slightly to 17.2% of GDP (see Table V.2). This rise was not seen in external assets, however, whose flow in GDP terms decreased by more than 1 pp, basically as a result of the behaviour of deposits and investment in foreign shares.

Liabilities-side transactions also increased, standing at 21.8% of GDP (see Table V.2). This behaviour, however, was not across the board in all headings. Thus, despite rising stock market prices, the funds raised via the issuance of shares and other equity was, in GDP terms, lower than in 2002, standing at 6%. Interest-bearing external financing – securities

NON-FINANCIAL CORPORATIONS
(Cumulative four-quarter data)

CHART V.2



SOURCE: Banco de España.

a. Financial resources that cover the gap between real and permanent financial investment and gross saving.
b. Includes gross capital formation, stockbuilding and foreign equitities.
c. Includes capital transfers.

other than shares and loans – gathered pace after three years of deceleration, reaching a rate of 14.2% (see memorandum items in Table V.2). As in the previous year, there was a net redemption of fixed-income securities, albeit smaller this time, while the volume of funds raised via loans increased, although those from the rest of the world declined slightly. Analysis of credit behaviour by productive sector shows a practically zero expansion in that extended to industry, excluding construction, in line with the sluggish expenditure of this sector, and a slowdown in credit to construction, which, however, continued to grow at a high rate (14.7%). By contrast, credit to the services industry quickened, with the buoyancy of financing to the real estate services sub-sector (growth rate of 39.2%) being particularly notable.

1.2 GENERAL GOVERNMENT FINANCIAL FLOWS

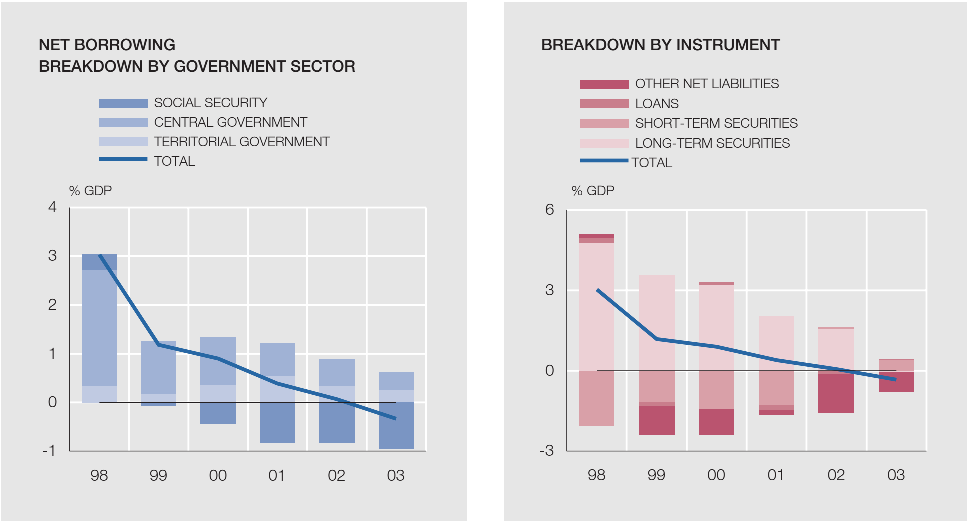
In 2003 general government posted a credit balance equal to 0.3% of GDP (see Chart V.3), as a result of another social security surplus, which offset the modest deficit of the central government and of the regional and local governments.

Despite the sector having shown a certain capacity to maintain a net lending position, the net issuance of marketable public sector securities was positive in 2003, although it returned to the downward path of recent years, interrupted in 2002. More specifically, there was a net redemption of long-term securities which, however, was smaller in amount than the net issuance of short-term securities. The net issuance by the State of Treasury bills and of 15- and 30-year bonds was positive, while there was again a negative net issue of 3- and 5-year bonds. The average life of central government debt thus rose slightly to six years. Net issues by regional and local governments amounted to 0.3% of GDP and, as in 2002, were predominantly long-term, while the outstanding short-term balances declined.

Credit institutions became the main providers of financing to general government in 2003, whereas the net flow from the rest of the world, which had been positive in the last few years, turned negative.

GENERAL GOVERNMENT FINANCIAL TRANSACTIONS

CHART V.3



SOURCE: Banco de España.

1.3 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY

In 2003 the net balance of the financial transactions of the Spanish economy stood at –2% of GDP, which represented an increase of 0.4 pp in the nation's borrowing requirement with respect to 2002 (see Table V.3).

Net purchases of foreign assets held at similar levels to those in the previous year (13.6% of GDP). The various instruments, however, behaved unevenly. Thus the flow towards cash and deposits decreased markedly (2.8 pp), while shares and other equity diminished more moderately (0.6 pp). By contrast, the purchases of securities other than shares increased by nearly 3 pp, due mainly to larger purchases of fixed-income securities by credit institutions such as mutual funds, which were fuelled by the significantly expanded supply of these securities on the international markets. Credit extended to the rest of world also increased, albeit by a smaller amount (0.4 pp).

The net liability transactions of the Spanish economy with the rest of the world stood at 15.6% of GDP, up 0.3 pp on 2002. This increase basically reflected changes in the foreign financing of Spanish financial institutions, which grew significantly in 2003. Thus the net acquisition of deposits and securities other than shares by non-residents amounted to 7.5% and 5.6% of GDP, respectively, the size of these figures being largely explained by the demand for financing from the resident credit sector (see Table V.3). Investment in shares and other equity fell off by more than 3 pp to stand at 0.9% of GDP.

2 *The Spanish financial markets*

The behaviour of the Spanish financial markets in 2003 was shaped, as mentioned above, by the greater domestic and international economic buoyancy, by the receding uncertainty and by the generous monetary conditions. Against this background, the main market developments were that fixed-income issues by financial institutions increased notably, that credit risk premia decreased and, above all, that stock market indices recovered from Q2 onwards after three consecutive years of falls and their volatility diminished.

2.1 THE PRIMARY MARKETS

Net issues by residents on primary markets for tradable securities grew very significantly (72% with respect to 2002), posting the highest levels for the last four years (see Table V.4). Their pattern of distribution by instrument and sector was the same as in prior years, although certain tendencies were more marked. There was a higher concentration in fixed income (98%), compared with equities (2%), as reflected in the scant public share offerings, the amount of

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE V.3

% GDP

	2000	2001	2002	2003
NET FINANCIAL TRANSACTIONS	-2.5	-2.2	-1.6	-2.0
FINANCIAL TRANSACTIONS (ASSETS)	25.1	12.2	13.7	13.6
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	2.8	-2.7	3.5	0.8
Securities other than shares	3.9	7.2	4.3	7.1
Of which:				
Credit institutions	*-0.3*	*2.0*	*0.5*	*3.7*
Institutional investors	*3.7*	*5.4*	*3.5*	*2.9*
Shares and other equity	15.6	5.2	5.3	4.8
Of which:				
Non-financial corporations	*10.5*	*4.6*	*5.1*	*4.6*
Institutional investors	*3.2*	*0.5*	*-0.1*	*1.1*
Loans	2.7	2.5	0.6	1.0
FINANCIAL TRANSACTIONS (LIABILITIES)	27.5	14.4	15.3	15.6
Deposits	6.7	2.8	4.4	7.5
Securities other than shares	7.1	3.1	4.5	5.6
Financial institutions	*1.1*	*1.5*	*3.3*	*6.7*
Other national sectors	*6.0*	*1.6*	*1.2*	*-1.1*
Shares and other equity	9.4	4.6	4.2	0.9
Of which:				
Non-financial corporations	*7.7*	*4.1*	*3.5*	*1.0*
Loans	4.1	4.3	3.5	3.2
Other, net (a)	0.2	-0.4	-1.1	-1.6

SOURCE: Banco de España.

a. Includes the asset-side caption reflecting insurance technical reserves.

which barely exceeded €400 million. In 2004 to date, activity on these markets has generally followed a similar pattern.

As in 2002, the most active issuers of fixed income were financial institutions, mainly as a result of the high borrowing requirement of credit institutions because their loans were growing much faster than deposits. The net volume of funds issued by this sector in 2003 exceeded €74.30 billion, which was 127% more than in the previous year. 57% of them related to transactions carried out directly by credit institutions, and the remainder arose mostly from securitisation vehicles set up basically by the major banking groups, which continued to grow rapidly. In particular, mortgage issues continued to show great vigour, although other issues declined, despite the fact that in 2003 it became possible for the first time to use for this purpose assets and loans extended to general government. At end-2003 asset-backed securities accounted for 38% of the outstanding balance of private-sector fixed-income securities and it is estimated that the volume issued in Spain last year represented 17% of the European total.

Net debt issuance by the foreign subsidiaries of credit institutions showed, by contrast, a decline. This was partly because their preference share operations were shifted to resident subsidiaries set up under the applicable regulations enacted last year (see legislation annex in this report). Meanwhile, the funds raised by banks in the share markets continued on their declining path initiated four years earlier, amounting to scarcely €250 million.

In the case of non-financial corporations, net issuance on domestic fixed-income securities

ISSUANCE AND PUBLIC OFFERINGS OF MARKETABLE SECURITIES

TABLE V.4

€ m

	2000	2001	2002	2003
Net issuance by residents (a)	**48,503.3**	**33,221.6**	**44,775.1**	**77,182.5**
Fixed income	15,084.9	28,419.7	41,017.6	75,407.3
Central government	*11,669.8*	*4,334.1*	*7,586.2*	*327.7*
Territorial government	*1,354.1*	*756.7*	*3,221.1*	*1,543.4*
Monetary financial institutions	*-1,881.7*	*13,008.3*	*13,656.6*	*42,426.2*
Other financial intermediaries	*6,339.7*	*9,899.9*	*19,098.3*	*31,946.3*
Non-financial corporations (b)	*-2,397.0*	*420.8*	*-2,544.7*	*-836.4*
Equities	33,418.5	4,801.9	3,757.5	1,775.2
Monetary financial institutions	*10,331.7*	*2,191.4*	*1,725.0*	*248.2*
Other financial intermediaries	*735.2*	*323.4*	*140.8*	*62.4*
Non-financial corporations	*22,351.6*	*2,287.2*	*1,891.7*	*1,464.5*
Public offerings	**2,695.3**	**3,085.8**	**1,009.4**	**417.4**
Privatisations	0.0	696.4	0.0	0.0
Other	2,695.3	2,389.4	1,009.4	417.4
MEMORANDUM ITEM:				
Net issuance by foreign subsidiaries	**32,190.9**	**23,320.5**	**14,383.2**	**12,473.2**
Financial institutions	21,040.5	11,832.7	12,684.0	8,325.1
Non-financial corporations	11,150.3	11,487.8	1,699.2	4,148.1

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.

markets continued to be negative, although less so than in 2002. This redemption was, however, offset by the greater momentum of the issues by foreign subsidiaries, which amounted to €4 billion. The lower uncertainty and the improved domestic and international economic outlook, reflected in a significant fall in risk premia, undoubtedly contributed to this. In any event, it should be noted that most securities issues launched abroad are not traded on Spanish secondary markets. These therefore have not benefited from the increased activity in this segment (see Table V.2), which in any case is smaller than the financial institutions segment. Meanwhile, share issuance by corporations held at moderate levels, somewhat below those in 2002. The most active issuers were construction companies, real estate firms and motorway concession holders. Unlike in other years, the increased volume of tender offers was not reflected in this component of financing because most merger and acquisition processes were carried out through exchanges of shares or delivery of treasury stock.

Net issuance of marketable securities by general government decreased to €1.9 billion against a background of lower borrowing needs in the sector. The decline was, nevertheless, notably sharper in the case of the central government than in that of regional and local government. It should also be mentioned that in 2003 the Treasury introduced certain new features into its issuance policy. In particular, it reduced the number of State issues and of tenders, and it increased the average amount issued per tender, which raises the liquidity of the securities.

2.2 SECONDARY MARKET ACTIVITY

The total trading volume grew in most segments of the secondary markets, except for derivatives. The highest rise was in AIAF fixed-income market, where trading surged by more than 43% in line with the notably expanded supply of these securities, particularly mortgage-backed securities (see Table V.5). This buoyancy persisted in the early months of 2004. In the fixed-income stock market, where the securities traded are mainly those issued by regional

THE BOND FINANCING OF SPANISH NON-FINANCIAL CORPORATIONS

BOX V.2

In recent years, large Spanish non-financial corporations have expanded and internationalised their business, leading to a significant increase in their investment abroad. To cover the large financing requirements arising as a result, firms have opted to use borrowed funds to a greater extent than own funds. Thus, between 1997 and 2002, the weight of debt in firms' liabilities rose from 36% to 45%. In turn, within interest-bearing borrowed funds, the relative importance of bond issues increased from 17% to 30% over the same period (see Chart 1), prompted by the boom in the European bond market following the introduction of the euro. This means that the composition by instrument of the liabilities of the largest companies is now more diversified.

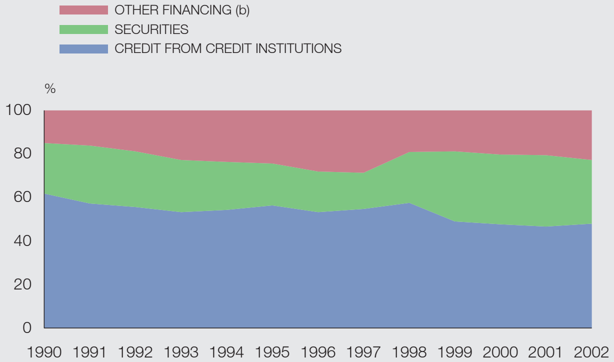
Most of the bond financing of large Spanish corporations in recent years has been carried out through special-purpose-vehicle subsidiaries located in countries with more favourable administrative, regulatory and tax regimes than in Spain. The funds obtained by these subsidiaries are channelled to the group's parent company, situated in Spain, which may subsequently distribute the resources among the various companies making up the group. Chart 2 shows that, in 2003, as a result of these operations, the stock of bonds issued by subsidiaries was more than four times that corresponding to national companies. This reflects the fact that, in the period 1996-2003, net issuance by the latter was negative, in the amount of €6.6 billion, while foreign subsidiaries made a positive net placement of more than €43 billion.

Most of the issues made abroad by these special-purpose vehicles are not traded on national secondary markets, so that the latter have not, as yet, benefited from the boom in these operations. This suggests that there is an opportunity here for national markets to develop, if these operations can be channelled towards Spain. Certain measures have recently been taken that might enable progress to be made in this direction[1]. These and other similar initiatives may have a favourable impact on the development of the national financial industry.

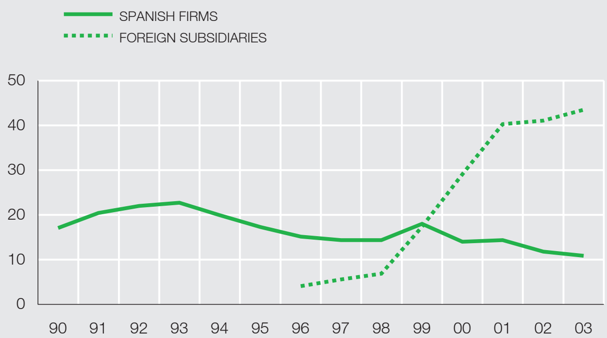
1. Law 19/2003 on capital movements, external transactions and the prevention of money laundering regulates preference-share operations in Spain and amends certain aspects of those relating to other debt instruments. In addition, Law 62/2003 on fiscal, administrative and social measures exempts firms located abroad from the taxes that would otherwise be payable upon moving their registered office to Spain, when the sole object of the company is the issuance of preference shares and/other financial instruments. For more details, see the article "Financial Regulation: 2003 Q4" in the January 2004 edition of the Banco de España's *Economic bulletin*.

LIABILITIES OF NON-FINANCIAL CORPORATIONS

1. INTEREST-BEARING LIABILITIES OF LARGE FIRMS INSTRUMENT STRUCTURE (a)



2. OUTSTANDING AMOUNTS OF BOND ISSUES OF NON-FINANCIAL CORPORATIONS



SOURCE: Banco de España.

a. From 1998, the individual data for the firms belonging to the Telefónica, Repsol YPF, Unión Fenosa, Iberdrola, Endesa and Altadis groups have been replaced by the consolidated group data presented in their annual reports.
b. Basically debts with group companies.

and local governments, the growth in turnover was more moderate (6%), in line with the lower issuance of these instruments.

Public-debt book-entry market activity grew by more than 13%, basically as a result of expansion of repo and of sell and buy-back transactions, which account for nearly 90% of the total. By contrast, the spot segments recorded a decline of 3%. Among the instruments, trading in Treasury bills advanced notably to a daily average of around €200 million, against €60 million in 2002. Treasury bill trading may have benefited from the inclusion of

TURNOVER ON SECONDARY AND DERIVATIVES MARKETS TABLE V.5

€ m

	2000	2001	2002	2003
Public-debt book-entry market (a)	**13,788,917**	**16,237,439**	**18,805,433**	**21,290,331**
Spot (b)	1,585,460	2,041,091	2,310,943	2,246,882
Repo and sell and buy-back	12,186,364	14,173,002	16,475,994	18,979,902
Forward (b)	17,093	23,346	18,496	63,547
AIAF fixed-income market (b)	**99,826**	**141,510**	**264,974**	**380,197**
Commercial paper	46,425	97,801	204,883	261,526
Ordinary and asset-backed bonds and mortgage certificates	52,189	41,488	56,289	115,269
Matador bonds	1,212	2,220	3,802	3,403
Stock exchange: fixed-income (b)	**39,692**	**56,049**	**69,820**	**74,346**
State debt	73	50	40	55
Territorial government debt	38,723	55,105	69,171	73,260
Other	896	894	609	1,031
Stock exchange: equities	**492,980**	**445,380**	**445,071**	**499,745**
MEFF derivatives markets (c)	**683,569**	**499,951**	**356,413**	**292,539**
Fixed-income	109,785	29,050	5,473	138
Short-term	*335*	*0*	*0*	*0*
Medium- and long-term	*109,450*	*29,050*	*5,473*	*138*
Equities	573,783	470,901	350,939	292,401
Ibex 35	*541,579*	*435,384*	*320,051*	*268,879*
Stock options	*32,205*	*35,517*	*20,668*	*12,714*
Stock futures	*0*	*—*	*10,220*	*10,808*

SOURCES: AIAF, Spanish stock exchanges, CNMV, Federation of European Stock Exchanges and Banco de España.

a. Only includes transactions involving 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.

these securities in two Spanish electronic trading platforms (Senaf and MTS España), from the formation in April 2003 of a group of 11 market-makers committed to maintaining a sufficient level of liquidity on these platforms and from the concentration of issue volume in a smaller number of issues. In addition, these changes may have helped non-resident holdings of Treasury bills purchased outright to rise from 3.8% of the total in 2002 to 10.3% in 2003.

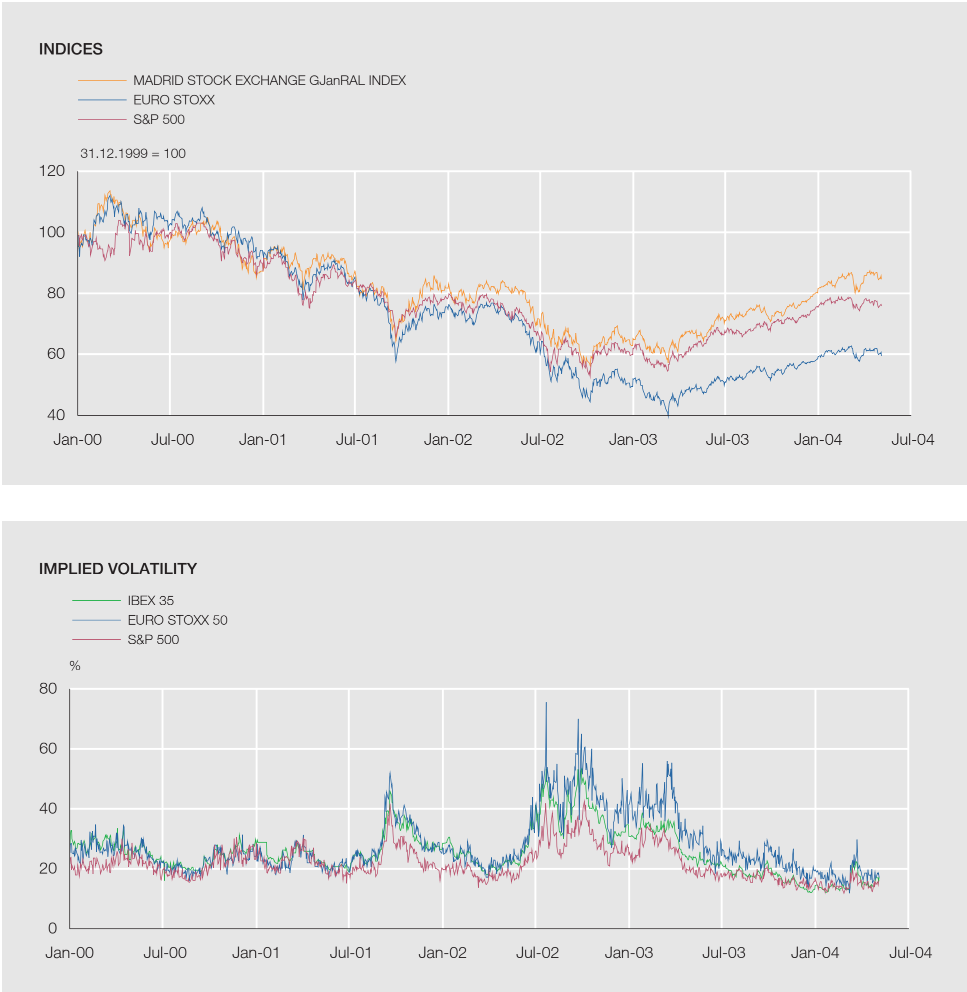
Stock market share trading rose particularly sharply in construction and real estate (up 86%), banking (14%) and electricity (13%). The most vigorous type of transaction was tender offers, associated with the increase in mergers and acquisitions. The volume of these transactions, at nearly double the previous year's level, was the highest for the last six years.

Activity on the Spanish derivatives markets held on its declining path of recent years. Turnover decreased by 28% with respect to 2002 and was only 30% of that in 1999.

Finally, in the institutional segment, the process of merging the Spanish financial markets continued. Thus in April 2003 Iberclear was set up as a central securities depository in Spain, comprising an accounting register and a securities clearing and settlement service for four markets: the stock exchanges, the public-debt book-entry market, AIAF and Latibex. Also, in September Meffclear was set up as a central counterparty for clearing transactions involving public debt.

STOCK EXCHANGE INDICES

CHART V.4



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

2.3 SECONDARY MARKET PRICES

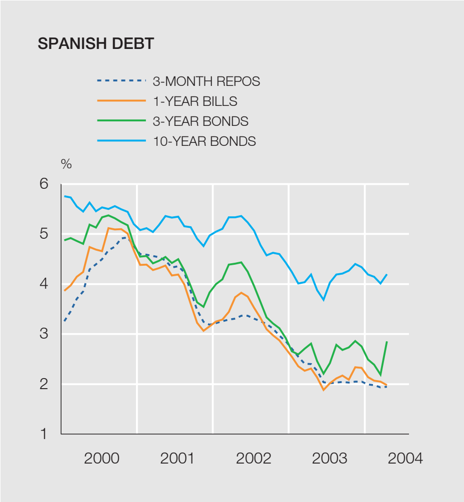
Stock market prices continued to fall in 2003 Q1, as in prior years, in a setting of high uncertainty associated with the consequences of the Iraq conflict and with doubts over the recovery of the world economy. However, from Q2 market prices benefited from the lesser geopolitical tension and the upward revision of international economic growth and corporate earnings projections. The share prices of the Spanish corporations with most exposure to Latin America also benefited from the improved outlook of that area. As a result, the Spanish indices, like those of most of the main international markets, were higher at end-2003 after falling for three years running. This performance was accompanied by a decline in year-end implied volatilities, which were close to their historical average for the last five years (see Chart V.4).

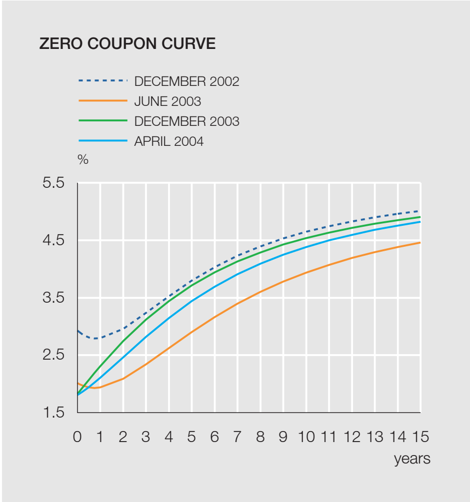
The rise in the IBEX 35 (28.2%) in the year as a whole was somewhat higher than that in the Overall Madrid Stock Exchange Index (IGBM), which was up by 27.4%, reflecting a better performance by the more highly capitalised securities. Comparison with other international markets showed that the domestic indices posted gains similar to those of the S&P 500 in the United States, which rose by 26.4%, and higher than those of the Euro Stoxx broad index in the euro area, which grew by 18.1%.

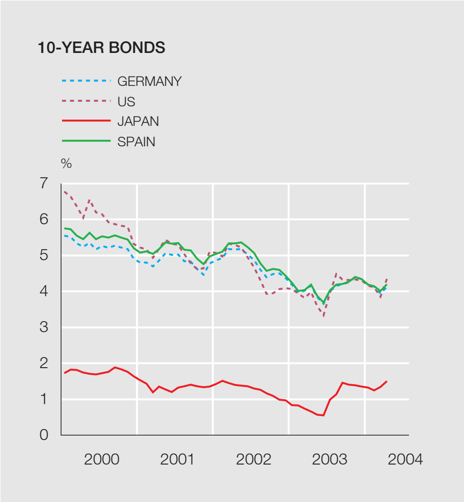
The market price recovery was seen in most sectors, albeit with certain notable exceptions. The largest rises were in telecommunications (up by 44.5%) and in financial services (31.5%), while indices in the consumer goods branch fell off, albeit moderately (–4%).

GOVERNMENT DEBT YIELDS (a)

CHART V.5







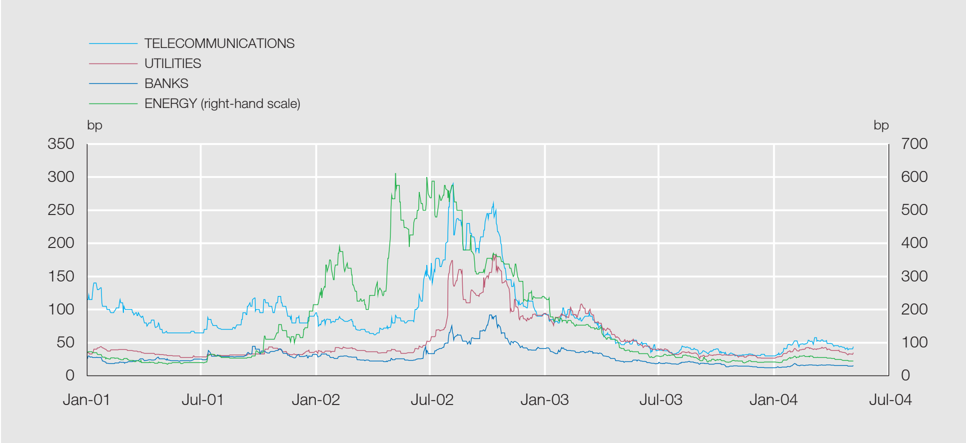
SOURCE: Banco de España.

a. Monthly averages.

Medium- and long-term yields on the Spanish public-debt book-entry market, like the other European and the US markets, declined until midway through the year, amidst high uncertainty over international macroeconomic developments (see Chart V.5). As a result, in mid-June Spanish 10-year bonds stood at 3.5%, a historical low. The second half of 2003 saw a rebound in market interest rates, linked to improving international economic prospects and receding uncertainty, as a result of which the benchmark 10-year bond ended at 4.30%, slightly below its end-2002 level. The spread relative to German 10-year bonds narrowed slightly during the year to stand close to zero. In this respect, the agency Fitch awarded its top rating to Spanish long-term public debt and in July Standard & Poor's changed its rating for this security from "stable" to "positive". Short-term yields showed a declining profile in the first half, reflecting expectations that the ECB would trim its official rates, which indeed it did. The final months of the year proved to be more stable.

Finally, the credit risk premia of the Spanish corporations traded on the derivatives markets held on a markedly declining path throughout 2003 (see Chart V.6), reflecting an improved corporate earnings outlook in a more favourable macroeconomic environment. This, along with the slight reduction in long-term government debt yields, led to a decrease in bond issuance costs paid by corporations.

5-YEAR CREDIT RISK HEDGE PREMIUM (a) CHART V.6



SOURCE: Credit Trade.

a. Average asset-weighted premia. On 22.6.03 a change came into effect in the contractual terms of European firms. The new contract carries lower associated premia (around 10%).

In 2004 to date the prices of floating-rate assets have continued their upward trend, accompanied by a decline in implied volatility, although this trend was temporarily broken in mid-March following the Madrid terrorist attacks on 11 March. Government debt yields fell in Q1, although they rose again in April.

3 Spanish financial intermediaries

The improved macroeconomic setting last year and the generous financial conditions stimulated demand for financial intermediation services in Spain. Additionally, a notable increase was seen in transactions between financial institutions themselves: higher interbank flows, growth in mutual funds that in turn invest in other funds and issuance by deposit institutions of mortgage securities intended to serve as the assets of securitisation vehicles. Consequently, the total volume of asset and liability flows of Spanish financial institutions rose from 44% of GDP in 2002 to 73% in 2003, well above the historical average. Of this increase, 15 pp correspond to transactions within the sector and the remaining 13 pp (from 39% to 52%) to transactions with other resident and non-resident agents.

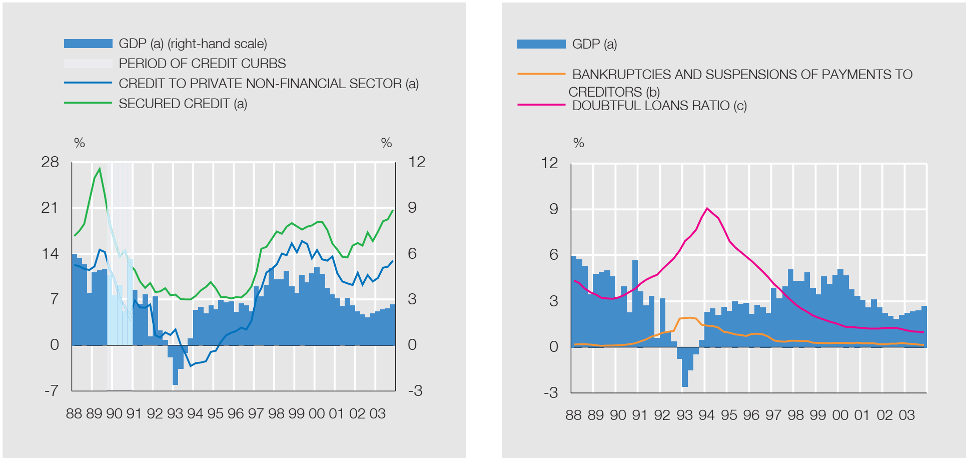
3.1 DEPOSIT INSTITUTIONS

In 2003 the results of Spanish deposit institutions recovered significantly against a backdrop of strong lending growth in Spain, limited defaults and lower write-downs than in the previous two years.

After remaining practically stagnant in 2002, the total assets of consolidated groups of deposit institutions grew by 10% last year (December on December). This growth is a result not only of the less negative impact on activity abroad exerted by movements in the Latin-American currencies and in the dollar-euro exchange rate, but also of a pick-up in domestic business, which increased by more than 10%. Activity abroad thus continued to lose weight, slipping to 14% of the total assets of consolidated groups in December 2003, against 17% in the same month of the previous year. Nevertheless, although some vulnerable points persist, the business outlook in Latin America is now better than two years ago, and this has led the major Spanish institutions to maintain and even increase their investment in the area. Indeed, the volume of assets abroad represented one-third of the total of the two major banking groups.

According to the information provided by individual financial statements, the growth of activity is basically due to an increase in loans to the non-financial resident private sector, which now represents more than 50% of the total (see Table V.6). Considering both those held on the bal-

CREDIT, DOUBTFUL LOANS AND BUSINESS CYCLE CHART V.7



SOURCE: Banco de España

a. Real year-on-year rates.
b. Liabilities affected by bankruptcy or suspension of payments to creditors as a percentage of total debt of Spanish non-financial corporations.
c. Doubtful assets/credit.

ance sheet and those assigned to securitisation vehicles, the pace of growth of this instrument rose further to 15.9%, after six years of expansion at very high rates (see Chart V.7). Other notable features are growth in secured loans of around 24% in 2003 (three-quarters of total growth) and the increase in floating-rate loans, which tripled that in fixed-rate loans.

As in previous years, mortgage lending was driven by the very high demand by households and by construction and real estate services firms, stimulated in turn by the low rates of interest, the buoyancy of employment and income and the upward trend in house prices. On the supply side, however, the results of the Bank Lending Survey show that Spanish institutions seem to have tightened somewhat their conditions for extending funds to households for house purchases. This tightening was most apparent in the required loan-to-value ratio, in other collateral required and in the margins applied to loans considered to be riskier. However, the interest rates charged by lenders continued to decrease, driven by the lower returns in the money markets (see Chart V.8). Thus, between January 2003 and January 2004, the average rates of new loans to households for house purchases decreased by around 80 bp, compared with the 75 bp decrease in the three-month interbank interest rate.

The terms and conditions on other types of loans (to corporations and households for consumption and other purposes) with a clearly lower growth rate also tightened, although less so as the year progressed. The average interest rates on new business decreased between 50 bp and 70 bp although, as in the case of housing loans, the falls were concentrated in the first half of the year (see Chart V.8).

The low interest rates and greater economic buoyancy were conducive to very favourable behaviour of loan default rates in 2003 (see Chart V.7). Thus, in the case of the resident private sector, doubtful assets declined by 0.7%, against an increase of 14% in the previous year, and, in terms of total credit, stood at 0.8%. Additionally, given the recovery of the international situation, the behaviour of total doubtful assets was even more favourable, with a decrease of 7% (increase of 29% in 2002). Despite this, institutions continued provisioning considerable amounts and, as a result, the coverage ratio increased to 257% at individual level and to 207% at consolidated level.

STRUCTURE OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT DEPOSIT INSTITUTIONS (a)

TABLE V.6

€ m

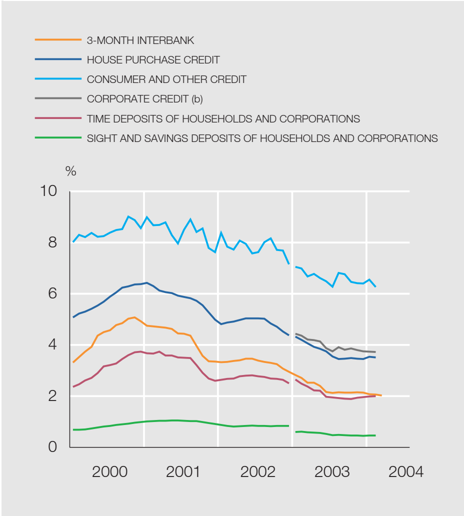
	TOTAL		BANKS		SAVINGS BANKS	
	2002	2003	2002	2003	2002	2003
ASSETS						
Cash and central banks (b)	1.5	1.3	1.3	1.2	1.7	1.5
Interbank market assets (c)	14.9	14.5	18.2	18.7	10.7	9.3
Lending	55.6	56.9	49.9	49.7	62.4	65.7
General government	*2.5*	*2.3*	*2.6*	*2.4*	*2.5*	*2.2*
Other resident sectors	*49.9*	*52.0*	*42.9*	*43.7*	*58.5*	*62.1*
Non-residents	*3.1*	*2.6*	*4.5*	*3.5*	*1.5*	*1.4*
Securities portfolio	20.9	20.6	22.8	23.2	19.2	18.0
Of which:						
Government debt	*7.9*	*7.7*	*7.4*	*7.4*	*9.0*	*8.5*
Equities	*6.6*	*6.2*	*8.1*	*7.5*	*5.0*	*4.8*
Other assets (d)	7.1	6.7	7.8	7.3	5.9	5.5
LIABILITIES						
Banco de España	1.2	1.5	1.6	2.2	0.8	0.6
Interbank market liabilities (e)	18.2	17.8	24.3	24.2	10.6	9.7
Customer funds	61.5	61.7	52.3	51.7	73.1	74.3
Asset repo sales to customers	*7.2*	*6.8*	*7.1*	*6.8*	*7.7*	*7.3*
Creditors: general government	*3.2*	*3.1*	*3.6*	*3.4*	*2.7*	*2.7*
Creditors: other resident sectors	*39.1*	*38.6*	*26.6*	*25.5*	*53.8*	*54.2*
Creditors: non-residents	*8.7*	*8.3*	*11.8*	*10.9*	*4.8*	*5.1*
Debt securities	*3.4*	*4.9*	*3.2*	*5.1*	*4.0*	*5.0*
Own funds, special reserves and subordinated financing	13.2	12.8	14.6	13.7	11.4	11.4
Of which:						
Subordinated financing	*3.6*	*3.3*	*4.1*	*3.7*	*3.1*	*3.2*
Other liabilities (f)	5.9	6.3	7.3	8.2	4.2	4.0
PROFIT AND LOSS ACCOUNT						
(+) Interest income	4.65	4.03	4.64	3.97	4.63	4.07
Of which:						
Dividends	*0.45*	*0.38*	*0.65*	*0.51*	*0.20*	*0.23*
(-) Interest expenses	2.39	1.90	2.57	2.06	2.17	1.71
Net interest income	2.26	2.13	2.06	1.91	2.46	2.36
(+) Commissions	0.65	0.63	0.70	0.67	0.58	0.58
(+) Profits on financial operations	0.04	-0.03	0.05	-0.10	0.04	0.07
Gross income	2.95	2.74	2.81	2.49	3.07	3.01
(-) Operating expenses	1.73	1.61	1.54	1.41	1.94	1.84
Net income	1.22	1.13	1.26	1.08	1.14	1.17
(-) Write-downs and provisions	0.56	0.40	0.62	0.40	0.46	0.39
(+) Other income	0.13	0.14	0.16	0.19	0.08	0.07
(-) Taxes	0.08	0.17	0.12	0.18	0.00	0.15
After-tax profit	0.72	0.70	0.68	0.69	0.76	0.70
MEMORANDUM ITEM						
After-tax profit (€ m)	8,927	9,575	4,841	5,370	3,676	3,767
As a % of own funds	11.6	11.6	10.9	11.6	12.9	12.1
Average total assets (€ m)	1,247,093	1,372,909	714,279	782,913	485,141	537,127
Year-on-year growth rate (%)	7.7	10.1	4.2	9.6	12.6	10.7

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 Banco de España repos) and ECB.
c. Credit and savings institutions (forward accounts, repos and securities lending) and repo puchases from the Banco de España.
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.

BANK (a) AND MONEY MARKET INTEREST RATES

CHART V.8



SOURCES: ECB and Banco de España.

a. There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.
B. Calculated as a weighted average of the interest rates on various transactions grouped according to volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

The downward trend in interest rates put additional pressure on liabilities-side margins. Thus, although the average remuneration of time deposits and of repos with the private sector fell in line with short-term market rates, that of sight and savings deposits decreased by much less (between 7 bp and 25 bp), since it started from a much lower level. This explains the narrowing of the spread between average loan and deposit interest rates, in a continuing process under way since the early 1990s that has obliged the institutions to make major efforts to contain operating costs (see Box V.3).

The narrowing of the spread between market rates and those on bank instruments boosted the growth of resident deposits in 2003, particularly sight and savings deposits. It was, however, insufficient to finance the credit expansion that took place, so institutions made relatively intense use of alternative, normally more costly, sources. For this reason, in 2003 the volume of new securitised assets was higher than in the previous year. Also, the net issuance of debt securities tripled, mostly due to the major commercial banks, since these were the ones at which the growth of loans extended (i.e. without deducting securitised loans) differed most from that of resident deposits. At year-end, these two sources together accounted for 16% of the total funds loaned by all deposit institutions, against 11% in 2002[1]. Also, commercial banks resorted more to the interbank markets (increase of €56.8 billion in the year) which, although it was mostly in the form of repos with the Banco de España or other credit institutions, led to a certain deterioration in the net uncollateralised debit position in the second half of the year, extensible to deposit institutions as a whole: 4.4% of total assets in 2003 Q4, against 3.8% on average in 2002.

Turning to results, 2003 saw a further contraction in operating margins, particularly the net interest margin. At consolidated level, however, this was almost totally offset by the improved

1. The weight of financing in markets would be even higher if the issuance of securities abroad by group subsidiaries were included.

One of the most important tasks of a banking system is to act as an intermediary, channelling resources from agents with surplus funds to those that require financing for investment or consumption. This intermediation function has a cost for savers and borrowers, reflected in the spread between the return required from the latter and the remuneration offered to the former.

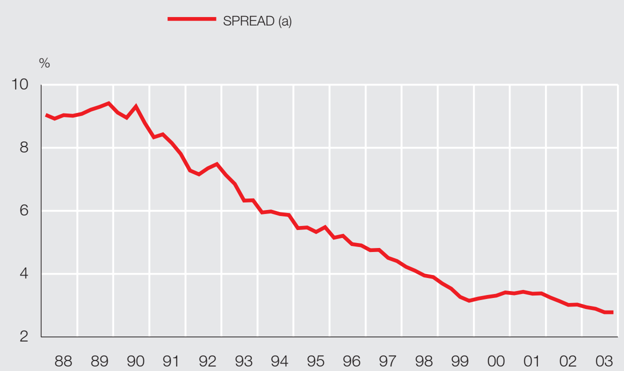
In the case of the Spanish economy, the spread between the average return on total local-currency lending by deposit institutions and the average cost of creditors and debt securities[1] has narrowed significantly over the last fifteen years (see left-hand panel of the chart below). This has not prevented Spanish banks from earning high returns at the end of the period considered, which is indicative of the fact that the narrowing of the spread reflects a real decline in the cost of intermediation. Undoubtedly, behind this phenomenon lie the opening up of markets and the increase in competition between institutions, both at the national and international level, which has pushed the latter to reduce costs and to improve their efficiency by incorporating new technologies and sources of business. Initially, the reduction in mandatory investment ratios was conducive to narrower spreads. Subsequently, the decline in average costs and, especially from 1998, the strong growth in the volume of business have enabled the trend to be sustained.

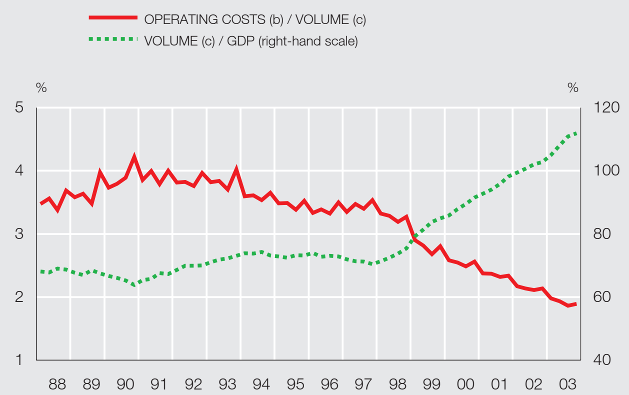
In these circumstances, the question arises whether there is any room for further reductions, when the spread on transactions between the Spanish banking system and the non-financial private sector is already below the euro-area average. In this respect, it is interesting to observe how, during a large part of the period considered, the narrowing of the spread went hand-in-hand with falling market interest rates, which have stimulated the demand for bank credit, while squeezing the liabilities margin, given that the remuneration of liabilities has a floor. Thus, of the approximately six percentage points by which the spread between average interest rates on lending and deposits fell between 1988 and 2003, around one and a half points are attributable to the assets margin (interest rate on lending less the market rate) and four and a half to the liabilities margin (market rate less the rate paid to creditors and holders of debt securities).

Given that it is difficult to expect further significant reductions in market interest rates, it is likely that in future there will be a reduction in the pressure on the liabilities margin, or even that it will rise somewhat. Indeed, there is a category of deposits, mainly used for transactions, the demand for which is relatively insensitive to changes in remuneration. Moreover, in a scenario marked by the petering out of the decline in interest rates and, consequently, also by lower growth in the demand for credit, it will be more difficult to achieve average-cost reductions of the order of those made over the last five or six years. However, any widening of margins will be limited by the higher current level of competition between the institutions (including, especially, those that operate mainly via Internet or telephone banking, which have been displaying a very aggressive fund-raising policy) and by the expansion of alternative investment options, e.g. through collective investment. In any case, banks can be expected to continue to extend and deepen the ongoing process of efficiency improvements.

1. Excluding interbank loans and deposits, which do not form part of the ultimate intermediation activity of banks.

DEPOSIT INSTITUTIONS : TOTAL SPREAD (a)





SOURCE: Banco de España

a. Average return on total credit in euro less average cost of creditors' funds and debt securities in euro.
b. Under the simplifying assumption that 70% of total costs correspond to standard business, a proportion equivalent to the average ratio between the revenues from the lending / deposit business and the total ordinary margin. If this proportion is higher in the early years, the fall in average operating costs will be underestimated.
c. The larger of: total credit in euro and creditors and debt securities in euro.

result on financial transactions (due to the good performance of the equities trading portfolio) and by the decrease in non-interest expenses. Consequently, the consolidated net operating margin edged down from 1.45% to 1.43% of total assets, with commercial and savings banks behaving similarly. Meanwhile, write-downs and provisions decreased, with particularly sharp declines in securities write-downs, other net provisioning and extraordinary losses. Thus, after falling 8% in the previous year, the net profit attributed to the group increased by 17%, with both ROA and ROE rising and the solvency ratio, as measured under Spanish regulations (stricter than the Basel rules), holding unchanged at 11%. The individual financial statements, although also showing an improvement on the previous year, disclosed a smaller rise in net profit, which resulted in a slight contraction in the ROA of savings banks and co-operatives (see Table V.6).

Overall, although certain risks persist regarding the volatility of business in Latin America, and the rapid build-up of credit in the domestic environment, the current financial situation of Spanish institutions is characterised by a high level of capitalisation and by a volume of provisions that is sufficient to withstand substantial rises in bad debts. This does not mean, however, that they do not have to strengthen their control mechanisms and avoid risk concentration which, in certain less favourable macroeconomic scenarios, could cause some difficulty.

3.2 INSTITUTIONAL INVESTORS

In 2003 both FIMs and pension funds resumed positive returns, while money-market funds continued to show minimal yields (see Chart V.9), which were negative in real terms. In a setting characterised by greater channelling of funds towards institutional investors (see Table V.7), there were also other regulatory and fiscal changes (such as, for example, the abolition of taxes on capital gains arising on transfers between mutual funds), which stimulated greater mobility of invested funds, increased competition between management companies and the emergence or extension of new fund types, including most notably alternative management approaches and funds of funds, which burgeoned. In fact, approximately one-quarter of the growth in net assets of FIMs consisted of shares or units held by other funds, meaning that the volume of new subscriptions by final investors was actually lower than stated in Table V.7. These developments point to the increasing professionalism and competitiveness of the Spanish mutual fund industry.

Despite the overall increase in business with institutional investors, there was a fall-off in demand for life assurance and pension funds, related to the finalisation of the process of compulsory externalisation of corporations' pension commitments[2]. Thus life assurance premiums declined by around 33% last year, although pension fund assets again grew by more than 10%, as a result of asset revaluation rather than from net contributions.

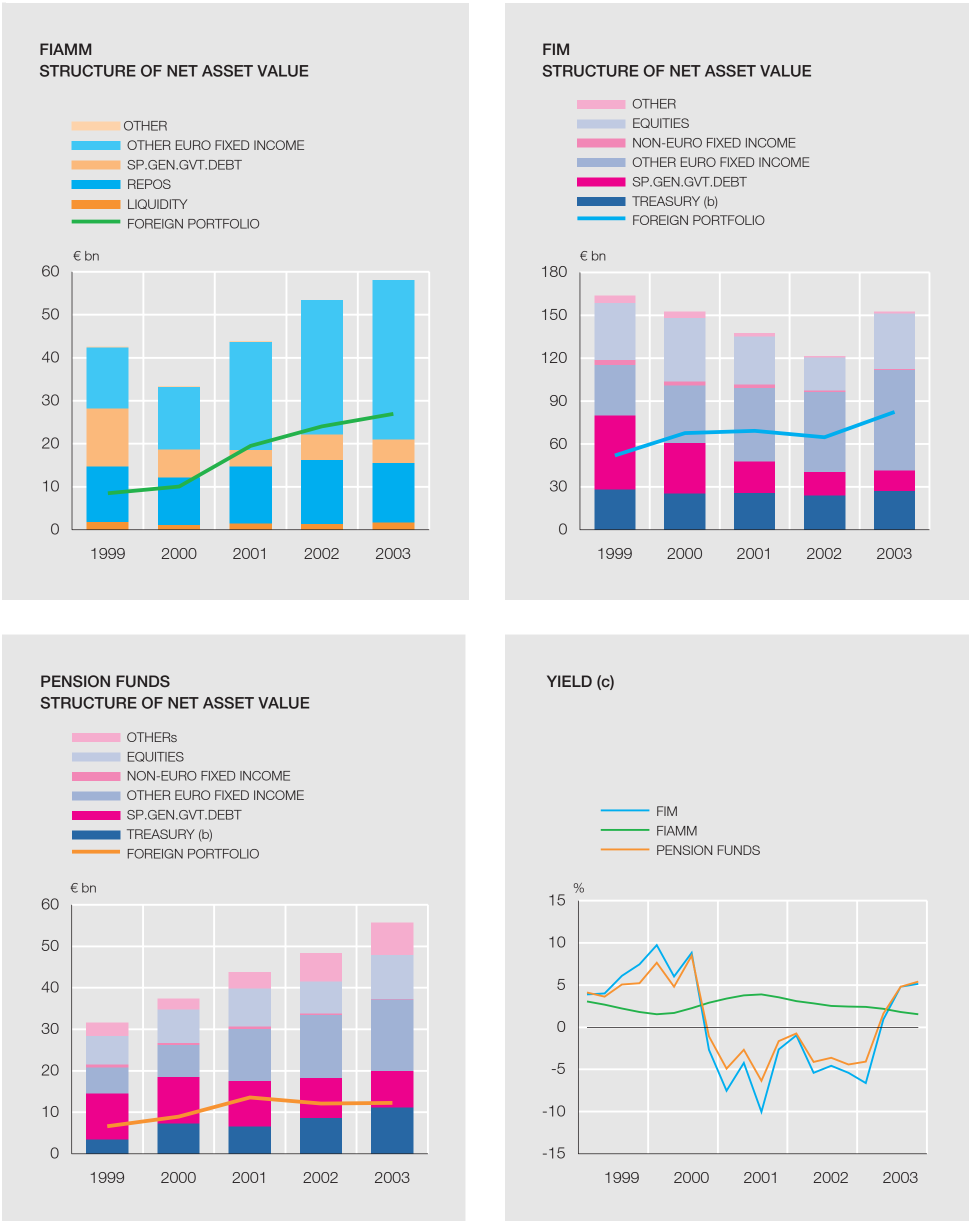
By contrast, mutual funds (particularly FIMs) saw high net subscriptions, after three years of sluggishness. Overall, the highest volumes of net subscriptions were in short-term fixed-income funds (47% of the total), guaranteed equity funds (54%) and global funds (18%)[3]. During the course of the year, however, flows to the riskier funds gained in importance.

The shifts mentioned above, managers' investment strategies and price movements in financial markets resulted in an increase in the weight of equities (see Chart V.9) both in the FIM portfolio as a whole (from 19% to 25% of total net assets) and in the pension fund portfolio (from 16% to 19%), although in the first case (the only one for which this information is avail-

2. Although a residual part, relating to retirement bonus commitments, has yet to be completed. **3.** Note that the sum of some components may be higher than 100 because of negative net subscriptions in other types of funds.

INSTITUTIONAL INVESTORS

CHART V.9



SOURCES: CNMV. Banco de España and INVERCO.

a. Includes repos.
b. Includes repos and money market assets.
c. Cumulative return over last 12 months.

able), it is due solely to the growth of shares or units in other mutual funds. Conversely, Spanish public debt continued to lose relative importance in the portfolios of institutional investors, while the percentage of external assets continued to be relatively high (54% in FIMs, 46% in money-market funds and 21% in pension funds).

4 The net worth position of the private non-financial sector

Financing and investment decisions, along with movements in financial asset and house prices, modified the net worth position of the private non-financial sector. Thus, the greater recourse to external funds brought new rises in the debt ratios of households and, to a lesser extent, of corporations. However, the declining path of interest rates, and the longer average repayment period of mortgage loans in the case of households meant that the associated debt burden did not change significantly, continuing at moderate levels. Meanwhile, the rally in stock market

FUNDS RAISED BY OTHER FINANCIAL INTERMEDIARIES TABLE V.7

€ m

	2000	2001	2002	2003	2003 BALANCES (a)
Total (b)	**3,449**	**16,198**	**18,620**	**41,018**	**368,584**
Pension funds					
Net contributions (c)	*6,454*	*6,738*	*6,422*	*4,823*	*55,765*
Life assurance					
Premiums net of claims (d)	*11,212*	*9,435*	*10,831*	*7,190*	*102,192*
Mutual funds					
Net share purchases	*-14,217*	*25*	*1,368*	*29,005*	*210,627*
FIAMM	*-10,172*	*9,556*	*8,329*	*4,147*	*58,054*
FIM	*-4,046*	*-9,531*	*-6,962*	*24,858*	*152,573*
MEMORANDUM ITEM:					
Deposit money institutions: change in accounts payable					
Other resident sectors	*52,424*	*55,174*	*43,830*	*47,773*	*652,106*

SOURCES: CNMV, INVERCO, Dirección General de Seguros, ICEA and Banco de España.

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 2003 figure is provisional (based on ICEA assuming the same ratio of premiums to claims as in the previous year).

prices meant that, despite their higher liabilities, the net financial wealth of both these sectors recovered. These events, together with the rise in property wealth associated with growing house prices, meant that the total net wealth of households continued on its rising path.

4.1 HOUSEHOLDS

The composition of the household financial portfolio shifted slightly towards riskier assets. Thus at end-2003, cash, deposits and shares in money-market funds and fixed-income FIMs represented 47.1% of total financial assets, down 2.7 pp on 2002. This decline basically resulted from a decrease in time deposits held by this sector, since their share decreased by 2.2 pp. By contrast, the relative importance of shares and other equity and of other FIMs increased by 3.1 pp to 31%, reflecting basically the recovery of stock market prices since last summer. For the first time since 1998, the weight of investment in insurance technical reserves decreased slightly (0.6 pp), standing at 15.3%.

As regards liabilities, the acceleration in household debt meant that the debt to gross disposable income (GDI) ratio rose by nearly 10 pp to slightly above 90% at end-2003 (see Chart V.10). With this new increase, household indebtedness has practically doubled that in the mid-1990s and stands somewhat above the euro area average, although it is still lower than in the United States and the United Kingdom. The increase is not so sharp if the ratio is defined in terms of the sector’s financial assets rather than GDI.

Despite this fresh increase in household indebtedness, the decrease in the cost of debt allowed the sector’s interest burden to decline slightly to 4.2% of its GDI, down 12 bp on the level at end-2002 (see Chart V.10). The total debt burden, which includes repayment of principle, also decreased a little (3 bp) to stand at 13%. Further, saving not earmarked for debt service, which has contracted by more than 6 pp since the mid-1990s, recovered slightly (11 bp), although it remained at very low levels (1.8% of GDI).

Meanwhile, household net wealth rose again last year. On this occasion, household net financial wealth also picked up, after falling for three years, to stand at a level practically equal

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs CHART V.10

SOURCE: Banco de España.

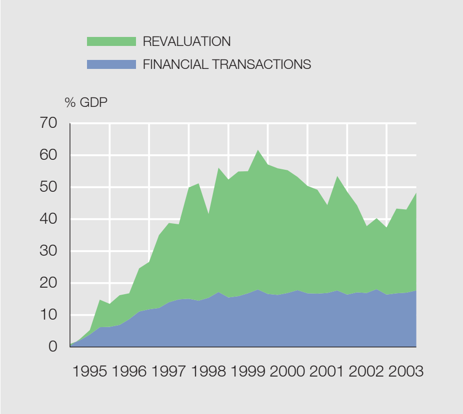
a. Includes bank credit and securitisation.
b. Assets 1 = total financial assets - "other".
c. Assets 2 = Assets 1 - shares - shares in FIM.
d. Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.
e. Estimated interest payments plus debt repayments.
f. Balance of households' use of disposable income account.
g. Gross saving less estimated debt repayments.

to that of GDP, despite the higher household liabilities, basically thanks to the higher share values (see Chart V.11). In any event, real estate wealth continued to be the main cause of growth in total wealth because of the notable fresh rise in house prices, which was particularly sharp in municipalities of more than 500,000 inhabitants and in those along the coast. This price rise was 17% on average, somewhat higher than in 2002, so the resulting cumulative house price rise from 1997 to 2003 amounted to 84.2% in real terms (see Chart V.12). The available estimates suggest that the current levels continue to exceed those that would be expected on the basis of their underlying determinants. There is thus a certain overpricing which, if the market behaves as it did after previous price surges, may gradually be corrected.

In fact, the rise in the value of households' assets, along with the containment of their debt burden at moderate levels and their low default rates, indicate that their financial position does not in itself limit their consumption and residential investment decisions. However, the high level of indebtedness makes it difficult to maintain a pattern of spending that, as in recent years, is increasingly financed by recourse to future income. In addition, as mentioned in

CUMULATIVE CHANGE IN NET FINANCIAL WEALTH OF HOUSEHOLDS AND NPISHs

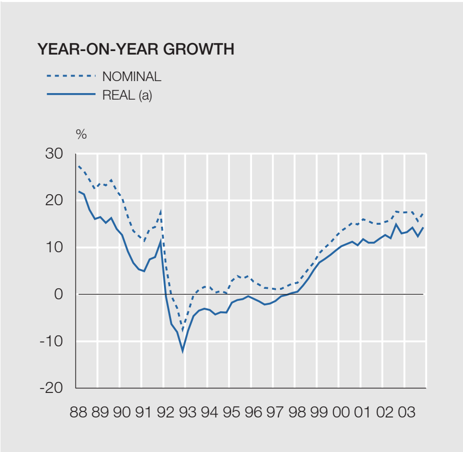
CHART V.11



SOURCE: Banco de España

CHANGE IN HOUSE PRICES

CHART V.12



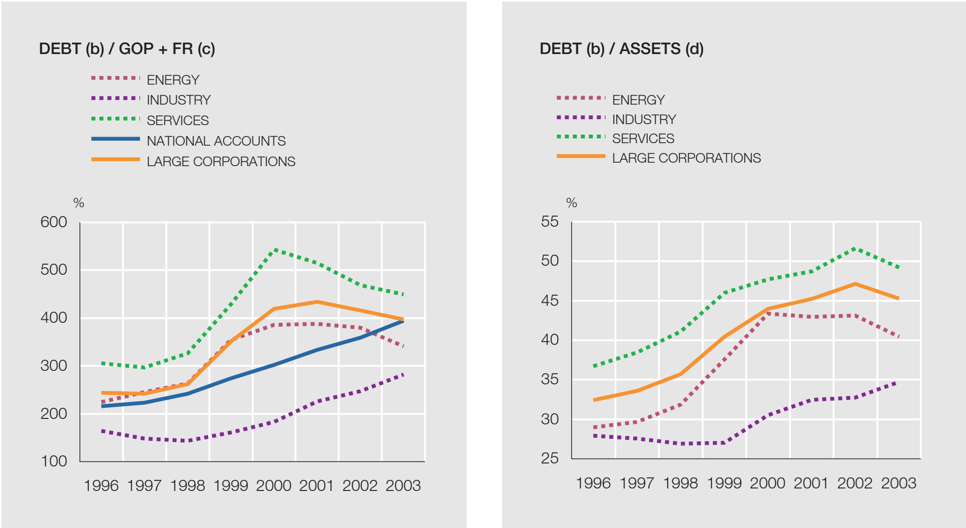
Chapter I of this report, it is reasonable to believe that the sector's net worth situation position and, therefore, its spending decisions are now more sensitive than in the past to fluctuations in financial asset and house prices and in interest rates. Given the low current level of saving not earmarked for debt service and the information provided by the ongoing household spending survey, the margin remaining before households' spending decisions are affected by unfavourable changes in these variables is relatively small in certain segments of the sector.

4.2 NON-FINANCIAL CORPORATIONS

The composition of the financial assets portfolio of non-financial corporations shifted towards the higher-risk end of the spectrum. Thus the shares and other equity portfolio grew by 1.3 pp to stand at 42.9%. The proportion of fixed-income securities (direct or via FIMs), although still small relative to total assets, rose by 0.4 pp to 2.5%.

The debt ratios of corporations again rose as a result of increased resort to external financing. Their levels of debt relative to operating results (gross operating profit plus financial revenue) stood slightly below 400% (see Chart V.13), which was 35 pp higher than in 2002. A significant part of this rise resulted from the high growth of financing extended to real estate services firms. By contrast, on CBSO data, the larger corporations have continued with their restructuring plans, while the more indebted branches (energy and services) have reduced their relative levels of debt.

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a) CHART V.13



SOURCE: Banco de España.

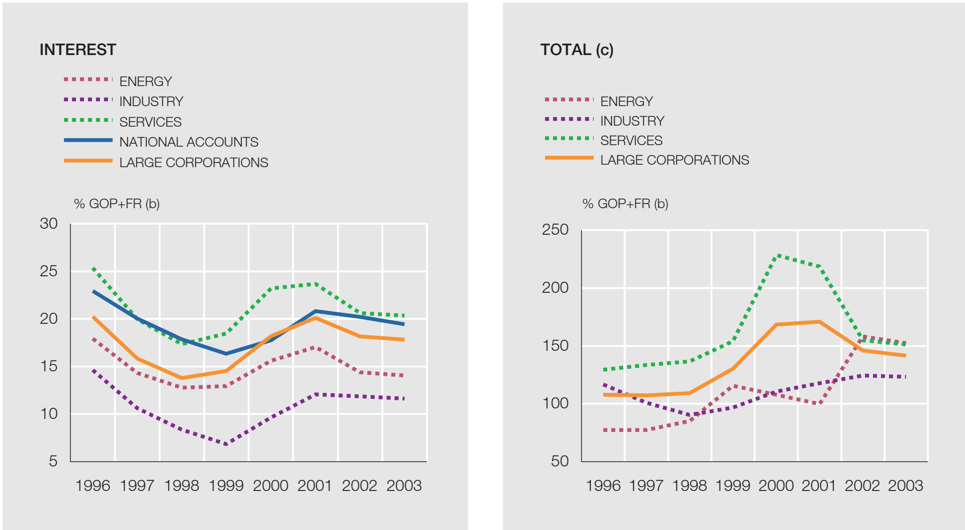
a. All the series, except "National Accounts", are calculated with CBSO information. Up to 2002, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

There were few changes in the composition by instrument of corporate debt. Lending by resident institutions, although slightly down in weight, continued to be the main source of financing, with a share of 64.5% of interest-bearing external funding. The weight of fixed-income securities also decreased (0.5 pp), as a result of the net redemption of short- and long-term securities. By contrast, the share of foreign loans, following the trend of previous years, increased by 1.1 pp to 28.8%.

The upward trend in financing extended to the sector was accompanied by reductions in the cost of debt. This allowed interest payments, measured as a proportion of operating results, to decrease slightly to 19.3% (see Chart V.14). According to the CBSO, the fall was particularly significant for energy sector firms, as a result of their lower debt levels and favourable earnings performance. If short-term debt is added to interest, it can be seen that there is a fall-off in the debt burden, absent in the industrial sector.

The net worth of corporations rose by 2.6 pp relative to GDP, basically due to stock market price rises (see Chart V.15). Moreover, profitability trended positively and, on CBSO data, ordinary net profit, which excludes extraordinary items, grew by 15.9%, and as a result ordinary profitability stood at 12.1%. This improvement was not, however, seen in the industrial branch, the sluggishness of which was reflected in practically zero growth. Net profit, which includes extraordinary revenue and expenses, turned positive again after the negative levels resulting from the substantial loss provisioning by certain companies in 2002. Bankruptcies, suspensions of payments and default rates in the sector remained low and even showed a certain improvement in 2003. However, none of the credit ratings of securities-issuing non-financial corporations were upgraded; rather, some were downgraded, although fewer than in the previous year.

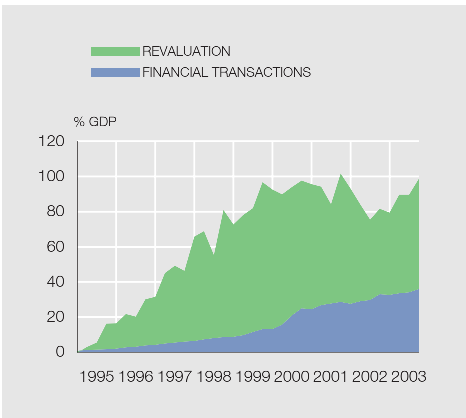
DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a) CHART V.14



SOURCE: Banco de España.

a. All the series, except "National Accounts", are calculated with CBSO information. Up to 2002, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).
b. Gross operating profit plus financial revenue.
c. Includes interest plus interest-bearing short-term debt.

CUMULATIVE CHAGE IN THE NET FINANCIAL WEALTH OF NON-FINANCIAL CORPORATIONS (a) CHART V.15



SOURCES: Banco de España.

a. Net worth is proxied by the valuation at market prices of the shares and other equity issued by non-financial corporations.

As a result of the positive earnings trend, the containment of the debt burden at moderate levels and the restructuring by certain large corporations, the financial situation of the sector is, in principle, conducive to the buoyancy of employment and the recovery of investment. Indeed, as mentioned in Box V.4, the synthetic indicators constructed from disaggregated CBSO data, which summarise the impact of corporations' financial positions on investment and employment, show levels of financial pressure that are below the historical average and that, in 2003, represent an improvement after three years marked by a certain deterioration.

RECENT TRENDS IN THE FINANCIAL SITUATION OF FIRMS AND THEIR IMPACT ON INVESTMENT AND EMPLOYMENT

BOX V.4

An analysis of the financial position of firms is an important element in any assessment of the outlook for use by the corporate sector of factors of production, such as labour and physical capital. For example, excessive indebtedness or a high debt-service burden can have an adverse effect on investment spending or may lead to the postponement of hiring decisions, thereby contributing to deepen recessions and to delay or dampen upturns.

It should also be noted that for a correct assessment of the financial position a disaggregated analysis is required, since there is no reason why the fragility of some firms should be set off against the solidity of others. Given that the impact the financial position has on investment and employment decisions varies according to the initial degree of financial pressure, the analysis of aggregate sector indicators may mask risk factors that only show up in studies conducted at a disaggregated level.

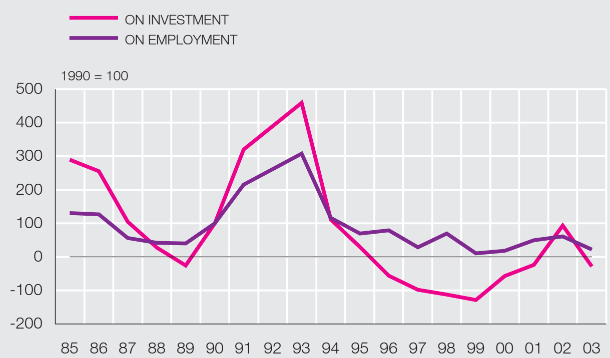
Using individual information on the firms reporting to the Central Balance Sheet Data Office, two synthetic indicators have been constructed to reflect the impact of the financial situation of firms on their subsequent investment and hiring decisions. The variables that make up these indicators are the profitability, the debt-service burden and (in the case of investment only) the indebtedness of each company. The weights of the variables in each indicator are equal to their estimated coefficients in the equations explaining, at the disaggregated level, the behaviour of the two macro variables in question. Where necessary, the sign of the variable is changed, so that a rise in the indicator denotes an increase in financial pressure and, therefore, a reduction in companies' spending (on investment and employment)[1].

Chart 1 shows the weighted average of the distribution of these two indicators. As can be seen, both show a certain deterioration in the financial position between 2000 and 2002. This was more pronounced in the case of the investment indicator, which may help to explain the slowdown in investment between 2001 and 2003. The information available for 2003 points to an improvement in both indicators. The analysis of the contribution of each component to the change in the indicators (presented in Charts 2 and 3) shows that all of them have contributed to this improvement, with the positive trend in profitability and, in the case of the investment indicator, the reduction in the debt ratio being especially important.

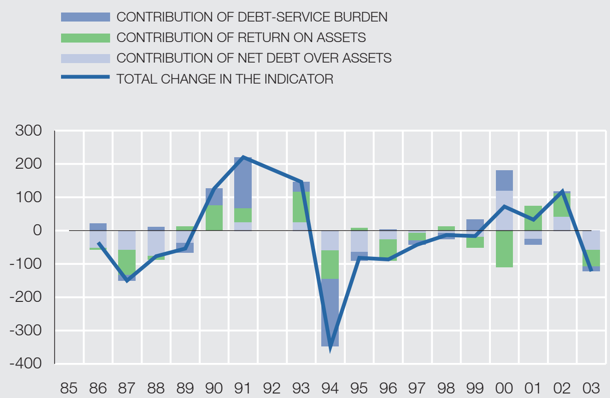
Overall, therefore, the latest trends in these indicators show an improvement in the financial position of firms. This, together with the fact that both indicators are close to, or even below, their historical average levels, means that the financial situation of the corporate sector is not, in itself, limiting the possibilities for more vigorous employment growth and a recovery in productive investment. However, the level of indebtedness of some firms has raised the sensitivity of their investment and hiring decisions to possible changes in variables which, like market interest rates and corporate risk premia, determine their financing costs.

1. For more details on the construction of these indicators, see Banco de España Working Paper No 0319 by I. Hernando and C. Martínez Carrascal, entitled *The Impact of Financial Variables on Firms' Real Decisions: Evidence from Spanish Firm-level Data.*

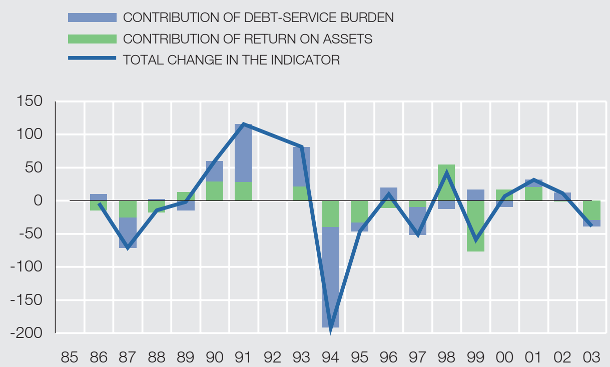
1. SYNTHETIC INDICATORS OF THE FINANCIAL PRESSURE ON FIRMS (a)



2. CHANGE IN THE SYNTHETIC INDICATOR OF FINANCIAL PRESSURE ON INVESTMENT AND THE CONTRIBUTION OF ITS COMPONENTS



3. CHANGE IN THE SYNTHETIC INDICATOR OF FINANCIAL PRESSURE ON EMPLOYMENT AND THE CONTRIBUTION OF ITS COMPONENTS

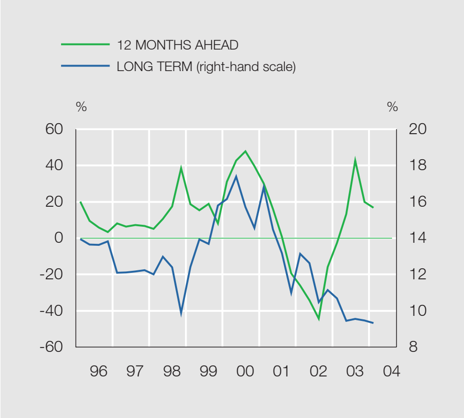


SOURCE: Banco de España.

a. Standardised weighted aggregate mean. A value of more than 100 indicates a less favourable financial position than the benchmark.

EARNINGS GROWTH EXPECTATIONS OF LISTED NON-FINANCIAL CORPORATIONS

CHART V.16



SOURCES: I/B/E/S and Banco de España

However, the debt levels reached by certain corporations might hinder them from accessing external sources of financing for their investment projects. In addition, some of the corporations that took balance-sheet restructuring measures in 2003 may attune their spending decisions to the progress being made by them in this process. Similarly, the high debt levels imply greater exposure to rising interest rates or to unfavourable changes in other variables influencing their debt-service capability. Specifically, an increase in the cost of debt might affect the investment or hiring decisions of certain corporations more strongly than in the past, particularly since long-term profit expectations, at least in the case of listed corporations, still show no clear signs of improvement (see Chart V.16).

Banco de España management report for 2003

1 Introduction

Included for the first time this year in the Banco de España *Annual Report* is a chapter on the management of the Bank. It seeks to provide an overall summary description of the key aspects of its activity last year, without prejudice to the specific reports published annually by the Bank's different departments (Banking Supervision, Balance of Payments, Complaints Service, Central Balance Sheet Data Office and Book-Entry System).

This chapter reviews the main tasks conducted by the Banco de España during 2003, both as a national central bank belonging to the Eurosystem and in respect of the exercise of the other functions statutorily entrusted to it. The chapter is structured as follows: description of the activities of the Banco de España as a member of the Eurosystem (section 2); its international activities (section 3); economic analysis and research conducted (section 4); banking supervision and banking regulation (section 5); operational functions relating to monetary policy implementation, conduct on domestic financial markets, the management of payment systems and banknote circulation (section 6); the compilation and release of statistics (section 7); the activity of the Complaints Service (section 8); external communications (section 9) and developments in internal organisation and administration (section 10).

2 Activities of the Banco de España as a member of the Eurosystem

2.1. FUNCTIONS PERFORMED BY THE BANCO DE ESPAÑA

As an integral part of the Eurosystem, the Bank participates in carrying out the functions laid down by the Treaty on European Union for the central banks of countries that have adopted the euro. This involves matters relating to monetary policy, the issuance of banknotes, the management of external reserves, the sound functioning of payment systems, the maintenance of financial stability and the collection of statistical information.

Eurosystem participation is structured around several channels. Firstly, the Governor, as a member of the governing bodies of the ECB, takes part in the decision-making process at the fortnightly ECB Governing Council meetings and at its quarterly General Council meetings. In terms of significance, the decisions on official interest rates, which are generally taken at the first of the Governing Council's two monthly meetings, stand out. In 2003, the monetary policy interest rates set by the ECB were cut on two occasions, for a total amount of 75 basis points, as explained in detail in chapters I and III of this *Annual Report*. Secondly, a high number of Banco de España specialists are involved in Eurosystem tasks, participating in the 13 committees set up and in the working groups and task forces which report to them. In these fora the national central banks and the ECB study and discuss together the matters on which the governing bodies of the ECB must finally take decisions. Lastly, the Banco de España is directly entrusted with several functions which are executed in a decentralised fashion, such as monetary policy implementation, the management of reserves and payments systems, the placement in circulation of banknotes or the gathering of statistical information.

2.2 KEY EVENTS IN 2003

During 2003 and in early 2004, the Eurosystem has been involved in various institutional matters, some of which have significant repercussions for Spain. In particular, in March 2003, on a proposal by the ECB, the European Council approved new voting arrangements for the Governing Council to be applied once the Economic and Monetary Union (EMU) comprised more than 15 countries. The new system involves a rotation by the governors in the exercise of their right to vote, so that decision-making may retain its current degree of efficiency irrespective of whether the number of governing council members may increase substantially in the future. According to the characteristics of the rotation arrangements decided upon, the

Governor of the Banco de España will be part of a group of five governors who will have the right to vote on the council over a longer period of time.

The Banco de España participated actively in several Eurosystem initiatives on preparing the accession into the European Union of the ten countries involved in this process. These tasks included meetings, visits and various exchanges of information and experiences, covering technical, operational, legal and institutional aspects. In particular, in March 2004, the 5th High-Level Seminar on the accession process was held in Paris, closing the course of meetings first organised in 1999 to discuss this matter.

Against the background of the monetary policy operational framework, the changes to the minimum reserves calendar and to the maturity of the main refinancing operations agreed upon in 2003 came into force in March 2004. Broadly, the new operational framework will diminish interest rate volatility by reducing uncertainty in the money markets about the level of official rates that will be in force during the reserve requirement maintenance period. Further, the Eurosystem is analysing the assets currently accepted as collateral for monetary policy operations, so as to unify the present "tier one" and "tier two" lists and harmonise the characteristics of the instruments accepted. In the public consultation conducted so that credit institutions might express their views in this connection, Spanish interested parties showed widespread support for the proposed measure.

A further highlight in 2003 was the agreement to create a new shared platform for the payments systems of the Eurosystem called TARGET2, which will come into force in 2007. This new platform, which will replace the current TARGET, will be a more integrated and technologically more efficient system in which the services provided will be extended and homogenised, and transaction prices will be brought on to a level footing. At the same time, it will make for readier connection of the new countries joining EMU. Although a final decision has not yet been taken, it is possible that all the central banks will form part of TARGET2. In Spain's case, the Spanish component of TARGET – the Banco de España Settlement Service – will foreseeably join the new shared platform.

Finally, in the area of regulation and financial supervision, the Banco de España signed a protocol governing co-operation for crisis situations between national central banks and the supervisory authorities of European credit institutions in 2003. The protocol establishes the bases for managing bank crises with a cross-border origin or impact and, in particular, for identifying the necessary flow of information between the authorities involved in the face of an emerging crisis. Moreover, the central banks of Austria, Belgium, France, Germany, Italy, Portugal and Spain entered into a co-operative agreement between Central Credit Registers in order to exchange information on economic agents' debt levels and credit institutions' on- and off-balance sheet exposures.

3 International activities

3.1 INTERNATIONAL RELATIONS

This section analyses the international activities of the Banco de España in relation to the European Union (with the exception of the Eurosystem, whose activities were described in the preceding section), and also the Basel Committee on Banking Supervision, the Bank for International Settlements, the International Monetary Fund and other fora in which the Banco de España regularly participates.

Regarding activities in the European Union, the Banco de España participated in the representation of Spain in various fora and committees, including most notably the Economic and Financial Committee and the Economic Policy Committee. Some of the most significant matters addressed by these committees were the evaluation of national budgetary programmes, their consistency with EU fiscal discipline rules, the structural weaknesses of European economies and the reforms that may help them overcome such problems.

The Bank also took part in drawing up the European Commission's spring and autumn economic forecasts and sat on several committees and groups on supervision and regulation: the Banking Advisory Committee, chaired by the Banco de España since June 2003; the group set up to organise the European Banking Supervision Committee, which came into being in January 2004 and which, under the chairmanship of the Banco de España, will act as a level 3 banking committee under the Lamfalussy approach; and the Groupe de Contact of European Banking Supervisors. The activity of these committees was chiefly aimed at implementing the Basel Capital Accord in Europe, essentially through the publication of technical documents on the impact of the New Accord or on its application in specific sectors.

The Banco de España also participated in 2003 in different European Commission working groups to draw up various banking directives relating both to transparency and consumer safeguards, and to prudential supervision. Of note here was its active participation in the work to prepare a European directive in connection with the new Basel capital regulations.

In this respect, the Banco de España was highly prominent in 2003 regarding the Basel II accord and participated actively in all the working groups of the Basel Committee on Banking Supervision. At the meeting of the G10 central bank governors and heads of banking supervision on 9 March, the Governor of the Banco de España was appointed Chairman of the Basel Committee on Banking Supervision. This enabled the Bank to take a leading position in the discussions to see through the New Capital Accord. This was duly reflected in the Basel Committee's meeting in Madrid on 10-11 October, which proved pivotal to achieving the consensus reached in May 2004. Against this background, the Banco de España has been able to make relevant contributions to discussions, including most notably aspects relating to the impact of the New Accord on the financing of SMEs and to the retaining of specific prudential elements of the system still in place.

The Banco de España also participated in the Joint Forum, which comprises the Basel Committee, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors. In 2002 and 2003, this forum was chaired by the Banco de España.

As part of its close co-operation with the Basel-based Bank for International Settlements (BIS), the Banco de España regularly participates in the bi-monthly meetings of governors and in other high-level fora (such as the Committee on the Global Financial System and the Markets Committee). It is also present at the half-yearly meetings of economists organised by the BIS and at those on matters of interest for central banks and supervisors.

During 2003, and in close collaboration with the Spanish Ministry of Economy, the Banco de España participated in the representation of Spain in the International Monetary Fund (IMF). By means of the permanent monitoring of the Executive Board's agenda, the input provided for discussions and active participation in these discussions, the contribution of the Bank to drawing up the positions defended by the Spanish representation in the IMF has increased significantly. In addition, the Bank has continued to participate in other IMF meetings in which matters within its competence are discussed, and it has, for the first time, also taken up a seat in the IMF's Balance of Payments Committee.

The greater presence in the IMF has enabled the Bank to play a more active role in the debates about the reform of the international financial architecture. Regarding financial crisis prevention, various proposals to improve the IMF's surveillance of its member countries were discussed. Possible amendments or alternatives to the Contingent Credit Lines, which expired in November last year, were also explored. As concerns financial crisis resolution, discussions focused on the highly controversial proposal to create a statutory mechanism for the restructuring of sovereign debt. This proposal gradually lost support in favour of the contractual approach. Under this approach, Collective Action Clauses (CACs) – which provide for agreements between debtors and creditors in debt restructuring processes – have been incorporated into sovereign debt issues by a large number of emerging countries. In this context, the voluntary adoption of a Code of Good Conduct for debt restructuring was also an issue for discussion.

The Banco de España is not only a collaborating member of the Center for Latin American Monetary Studies (CEMLA) but also participates in its Governing Board and in its Alternates Committee, as well as in other specific meetings on central banking matters. Likewise, the Bank is a collaborating member of the Association of Supervisors of Banks of the Americas, and participates actively in its annual General Assembly.

Together with the Spanish Ministry of Economy, the Banco de España has continued to participate in the meetings of the Paris Club, providing technical guidance on the matters addressed in this forum, which deals with the rescheduling of official bilateral debt. Experts from the Banco de España also participate in various OECD groups such as the Economic Policy Committee, the Financial Markets Committee, the Committee on Short-Term Economic Prospects and the Single Premiums Committee. The Banco de España has likewise maintained a fruitful working relationship with the Inter-American Development Bank (IADB) and the World Bank, having collaborated with both institutions in the organisation of meetings on matters of common interest, as well as launching joint work projects.

Bilateral relations between the Banco de España and other central banks and supervisory authorities were further enhaced in 2003, and meetings of various types were held in this regard. While there is a permanent working relationship with the euro area countries within the Eurosystem (as detailed in section 2), there are close relations on matters of common interest with numerous central banks and supervisory authorities of Latin America and the main developed countries.

Throughout 2003, the Bank promoted international technical co-operation activities, mindful that exporting its technical expertise is a key factor of international relations. The approval of a Technical Co-operation Master Plan involving establishing a schedule of offered activities and giving priority to certain subjects and geographical areas was planned, as well as defining specific targets to increase the level of activity and a new organisational model in line with these objectives and priorities. The technical co-operation activities conducted in 2003 were focused on Latin America and the EU candidate countries, chiefly in the areas of banking supervision and regulation, payment systems, statistics and banknotes.

3.2 CONFERENCES, MEETINGS AND SEMINARS ORGANISED BY THE BANCO DE ESPAÑA

During 2003, the Banco de España organised several conferences and seminars on international matters ranging from the business cycle in the euro area or regional integration to labour markets and the growth prospects for Latin America. Mention might be made here of the Joint Conference staged by the Banco de España, the European Central Bank and the Centre for Economic Policy Research (CEPR) on Prices, Productivity and Growth, which addressed matters relating to the identification and measurement of the sources of economic growth. The emphasis was placed in the Conference on the analysis of productivity developments in different geographical regions, on the influence of technological innovation processes and on its implications for public policies. Further, the Bank participated in the organisation of numerous public events of an international nature. These included most notably the conference by the Managing Director of the International Monetary Fund, Horst Köhler, in March; the XL Meeting of Central Bank Governors of the Americas and the LXXV Meeting of Central Bank Governors of Latin America and Spain, organised jointly with the Center for Latin American Monetary Studies (CEMLA) in Seville in May; and the presentation of two reports by the Inter-American Development Bank on aspects relating to the economic situation in Latin America.

4 Economic analysis and research

In order to advise the governing bodies of the Banco de España on the execution of the tasks entrusted to them, including representation in the Eurosystem and in other international organisations, several departments of the Bank systematically examine the different facets of the Spanish economy and of its international environment and develop relevant research projects that are used as a basis for analysis.

The Bank seeks to make the results of these studies available to society and to the scientific community by disseminating them through a series of wide-ranging publications with different degrees of specialisation.

4.1 PRIORITY AREAS FOR ANALYSIS

The analyses conducted at the Banco de España seek to place the different aspects of the Spanish economy in its international environment.

In 2003, studies relating to the external environment of the euro area paid particular attention to the financial problems of the emerging economies and, in particular, to those of the Latin-American countries. Studies were conducted, inter alia, on the effects of exchange-rate misalignments on the net financial position of economic agents and on the sovereign risk premium of these countries, the presence of contagion phenomena in emerging financial markets, the determinants of financial development and of foreign direct investment in these countries, the influence of exchange rate regimes on fiscal policy and the determinants of equilibrium exchange rates.

Research was also conducted on global matters relating to financial stability, monetary policy design and the functions of central banks. Likewise, various issues relating to the international financial architecture and to the process of nominal and real convergence of the EU accession countries were analysed. Finally, mention must be made of certain matters of a more monographic nature, such as deflation in the Japanese economy, the US imbalances, the banking crisis in Argentina and the outlook for the Brazilian economy.

Analysis of the euro area focused particularly on studying the macroeconomic divergences between the Member States and on the estimation of behavioural functions of the external sector. Headway was also made in learning about the cost formation process and other aspects relating to the workings of the institutional framework in which fiscal policies operate.

So as to continue perfecting the instruments used in the analysis and forecasts of Spanish economic developments, the re-estimation of a quarterly macroeconomic model was completed in 2003. Progress was also made in the areas of price modelling and household spending decisions. Regarding the labour market, progress was made in analysing the characteristics of collective bargaining, using individual firm data. In the field of public finances and fiscal policy, the focus has been on the impact of the latest tax reforms and on the determinants of the participation rate in the labour market of the oldest cohorts.

As regards sectoral analysis and structural policies, there were studies of the Spanish economy's patterns of productive and trade specialisation, in-depth analysis of productivity and of the electricity and retail distribution industries, and analysis of the implications for growth of the ageing of the population.

Financial studies covered three main subjects: the wealth position of Spanish non-financial corporations and its influence on investment and employment decisions; house price developments; and the study of certain characteristics relating to the development of domestic financial intermediaries.

Other research focused on the determinants of inflation differentials and on the characterisation, in general, of the cyclical differences between the countries making up the Economic and Monetary Union. Studies were also conducted on monetary policy design and the workings of money markets in the euro area, and on the effects of fiscal policy and its interaction with monetary policy.

The analysis of financial stability was geared to the study and monitoring of the banking industry, to the different risks (credit, market, etc.) assumed by banks, to the returns obtained and to the level of solvency attained in Spain and in Europe. As concerns banking regulation policy, efforts focused, on one hand, on the new Basel Capital Accord and, on the other, on the reform of accounting regulations and, most particularly, on the regulations governing provisions for bad debts. Regarding Basel II, the impact of the New Accord on the financing of SMEs was studied. In connection with provisions, work is under way on the design of a new system which, in some fashion, will retain the important prudential elements of the current system. Finally, great interest has been shown in the modelling of credit risk at banks, at both the micro- and macroeconomic levels, and in the study of the role bank collateral plays.

4.2 RELATIONS WITH THE ACADEMIC COMMUNITY

The Banco de España maintains ties with the academic community, and with other central banks and international organisations, with a view to seeking interaction and exchange of knowledge and encouraging the learning of the latest developments in economic analysis. The information-exchange commitment with the scientific community is pursued through an external visitors' and collaborators' programme, which seeks to promote specific projects considered strategic in different areas.

Further, the Bank participates in several research networks on matters that enhace collaboration with other central banks and with international experts. Mention may be made here of the completion of the *Monetary Transmission Network* and the beginnings of the *Inflation Persistence Network* in the context of the Eurosystem, and participation in the Network of American Central Bank Researchers and in that of the Inter-American Development Bank, and in congresses organised by the Basel Committee.

Mention should also be made of research collaboration with CEMFI (Centre for Monetary and Financial Studies), a foundation created by the Banco de España devoted to training and research in economics.

Finally, the Economic Research Seminar regularly invites various national and international specialists to discuss matters of interest that may enhace the development of research work in the different areas of the Bank.

4.3 DISSEMINATION AND COMMUNICATION

The Bank regularly disseminates its work through its monthly *Boletín Económico* (and a quarterly *Economic Bulletin*). The bulletin includes various reports on the main aspects of the Spanish and international economy, along with articles on specific subjects and abstracts divulging the main areas of research pursued.

In 2003 it was decided to create a new series of publications entitled *Occasional Papers*. The aim was to provide an outlet for different pieces of research conducted at the Banco de España deemed to be of general interest. The *Working Papers* series is confined to research work in economics and finance that seeks to further knowledge both of the Spanish economy and of its international environment. These papers are evaluated by an anonymous external referee, which ensures their quality and originality. A total of 22 working papers and 9 occasional papers were published in 2003, and they are all accessible on the Bank's website (www.bde.es).

The half-yearly review *Estabilidad Financiera* was launched in 2001 with a view to offering a channel of communication and dialogue for matters relating to prudential regulation and supervision. In addition to the *Informe de Estabilidad Financiera (Financial Stability Report)*, which contains a comprehensive analysis of Spanish banks' risks, profitability and solvency, the review includes other articles of an institutional nature and by individual researchers and financial system professionals. The review focused particularly in 2003 on the new Basel Capital Accord, the change in the accounting framework, corporate governance and the specialisation of European credit institutions.

The Bank's economists participated regularly in national and international seminars and conferences in their areas of specialisation, submitting papers and discussing those presented by academics and researchers from other institutions. Lastly, the projection and acknowledgement of the quality of papers comes about with their publication in specialised journals. In 2003, for instance, economists from the Banco de España saw their articles published in journals as prestigious as the *Journal of Finance, Journal of Banking and Finance, European Economic Review, Journal of Monetary Economics, Economic Journal, Investigaciones Económicas, Hacienda Pública, Moneda y Crédito* and *Revista de Economía Aplicada*.

5 Banking supervision and regulation

5.1 SUPERVISORY MEASURES

As at 31 December 2003, a total of 350 credit institutions were supervised by the Banco de España according to the breakdown shown in Table VI.1. Moreover, in accordance with the provisions laid down by law, the Bank is also responsible for supervising other institutions.

In addition, the Banco de España is entrusted with the consolidated supervision of Spanish groups of credit institutions, in which 122 foreign credit institutions are included.

During 2003, the Bank continued to perfect its supervisory methods and procedures and, in particular, it updated the criteria through which institutions' risk profiles contribute to the planning of short- and medium-term measures and to developing specific supervisory strategies so that institutions may apply measures leading to the improvement of their own risk profile.

Further to its supervisory actions during 2003, the Bank sent 127 communications of recommendations and requirements to institutions, as detailed in Table VI.2.

Among the 596 requirements and recommendations contained in the above – mentioned 127 cases, those most frequently formulated referred to the assessment, management and control of credit risk (evaluation adjustments, improvements to credit extension and monitoring systems, the advisability of reflecting on the volume earmarked for financing real-estate development activity, etc.); to treasury activity and activity in the capital markets; to non-compliance with compulsory rules of varying degrees (transparency in relations with customers, reporting to the Central Credit Register, declarations to the Register of Senior Officials, risk concentration limits, qualified participations and fixed assets, etc.); to general aspects of the supervised

INSTITUTIONS SUPERVISED BY THE BANCO DE ESPAÑA TABLE VI.1

	31.12.2003
Credit institutions	**350**
Banks	80
Savings banks	47
Credit co-operatives	86
Branches of foreign credit institutions	58
Specialised credit institutions	78
Official credit institutions	1
Other	**145**
Mutual guarantee and reguarantee companies	23
Currency-exchange bureaux	55
Appraisal companies	67

REQUIREMENTS OF AND RECOMMENDATIONS TO SUPERVISED INSTITUTIONS TABLE VI.2

	2003
Credit institutions	**105**
Banks	29
Savings banks	26
Credit co-operatives	29
Branches of foreign credit institutions	5
Specialised credit institutions	16
Other	**22**
Mutual guarantee and reguarantee companies	3
Currency-exchange bureaux	10
Appraisal companies	9

institution, its actions or controls; and the need to carry out valuation adjustments and accounting corrections for various items.

The Bank also adopted in 2003 one of the precautionary measures envisaged in the legislation – the placing under administration – in respect of a particular Spanish credit institution: the bank Eurobank del Mediterráneo, S.A., which as at the date of intervention had customer deposits totalling €209 million. The measure was followed by the request by the institution itself for the suspension of payments to creditors and by rapid action by the Deposit Guarantee Fund, which currently guarantees up to €20,000 for each depositor, in accordance with the legal framework of guarantees in force in advanced financial systems, the aim of which is to afford specific protection to depositors. In any event, the situation at Eurobank was an occasional and isolated episode that has not affected or endangered the stability of the banking system, which continues to enjoy high levels of solvency, profitability and efficiency. In this connection, the address by the Governor of the Banco de España before the Spanish Parliamentary Committee on Economic Affairs on 17 September 2003, explaining developments at Eurobank in the period prior to its being placed under administration and the related action taken by the Banco de España, can be consulted on the Bank's website.

Under the provisions of Spanish legislation, the Bank collaborated actively in 2003 with other national supervisory authorities, such as the CNMV (National Securities Market Commission), the DGS (Directorate General of Insurance and Pension Funds), with which it has entered into protocols of co-operation, regional authorities with supervisory powers and the Executive Branch of the Commission for the Prevention of Money Laundering and Monetary Offences. Likewise, close collaboration with foreign supervisory authorities, especially with those of the Latin American countries in which Spanish banking groups have a strong presence, has been maintained. The Banco de España has participated actively in the international supervision fora of which it is a member (see section 3.2).

5.2 IMPOSING OF SANCTIONS

As regards sanctioning proceedings initiated in 2003, 24 cases were opened against supervised institutions and 56 against the directors or managers of such institutions. The breakdown of the specific types of institutions subject to disciplinary proceedings was similar to previous years. Proceedings were thus initiated against 3 banks, 2 specialised credit institutions, 3 appraisal companies, 8 currency-exchange bureaux and 3 unauthorised currency-exchange bureaux. One case was brought against holders of significant interests in credit institutions and, finally, 4 cases were opened for failure to meet the minimum reserve requirement of the European Central Bank.

Over the course of 2003 a total of 20 sanctioning proceedings against supervised institutions and 42 against their directors or managers were concluded by the Banco de España. As to the types of infringements in cases processed and concluded during this period, the authorities imposed sanctions on supervised institutions relating to infringements of which 9 were very serious, 35 serious and 5 minor. Further, in the case of the directors and managers of these institutions, sanctions relating to 59 very serious infringements and 131 serious ones were imposed. Also imposed were 4 sanctions arising from non-compliance with the European Central Bank's minimum reserve requirement, 3 as a result of the use of names reserved for credit institutions and a further 3 for engaging in currency-exchange activities without authorisation.

5.3 REGULATORY CHANGES

As regards the organisational and disciplinary rules to which credit institutions and other financial intermediaries are subject, legislative activity in 2003 was of a predominantly technical nature. That said, except in the case of savings banks (discussed elsewhere in this report), there have been no new rules dictated entailing important changes in the legal framework. The main regulatory changes related to the following areas:

— Rules safeguarding customers: the regulation of ATM transactions[1], requiring on-line information beforehand about the cost of the most usual transactions, and the updating and extension of the scope, in certain specific aspects, of the law on consumer credit[2].

— Mortgage market regulation: the new Law 22/2003 of 9 July 2003 on bankruptcy has reinforced and clarified the position of holders of mortgage securities. Further, the offering of mortgage loan interest rate risk hedging instruments has been promoted, lowering loan subrogation or novation costs[3]. Finally, the transparency and prudence of the property valuations that guarantee the loans extended in this market have been reinforced[4].

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1. Order PRE/1019/2003 of 24 April 2003 on the transparency of prices of banking services provided via ATMs. **2.** Amended by Law 62/2003 of 30 December 2003 on fiscal, administrative and social measures (accompanying the Budget Law). **3.** See Royal Decree-Law 2/2003 of 25 April on economic reform measures. **4.** See Ministerial Order ECO/805/2003 of 27 March 2003 on property valuation rules and on specific rights for certain financial ends.

— Solvency of credit institutions: tax arrangements have been clarified, as has the eligibility of preference shares as capital, in particular those that can now be issued in Spain by companies set up to this end[5]. Further, several Community directives, relating essentially to the valuation and hedging of different risks linked to securities and derivatives transactions, have been transposed[6].

In the case of savings banks, Law 26/2003 of 17 July 2003 and Law 62/2003 of 30 December 2003 have added substantial amendments to their corporate regime, particularly by means of the creation of new bodies (investment and remuneration committees and, where appropriate, audit committees) and the introduction of new aspects in the arrangements governing the representation of depositors and municipal corporations on governing bodies, this all without forgetting the new annual information on corporate governance that must be provided to the public as from next year.

Annually, the Banco de España publishes a *Banking Supervision Report* to increase the public's awareness of the supervisory and regulatory functions entrusted to it and to report on the action and measures it has taken each year. The report can be consulted on the Bank's website.

6 Operational functions

6.1 MANAGEMENT OF THE BANCO DE ESPAÑA'S ASSETS

Central banks are responsible for the implementation of monetary policy. In the euro area, this function is performed in a co-ordinated fashion by the European Central Bank and the national central banks; the former takes the monetary policy decisions and the latter formalise the related liquidity-supply operations with the credit institutions within their purview. Against this background, the Banco de España continued in 2003 to evaluate the quality of the collateral presented by the banking system, formalising the related pledges and implementing loan and repo transactions with the eligible counterparties. The average amounts extended under these transactions increased by 45% in 2003 to an average outstanding balance of €19,326 million.

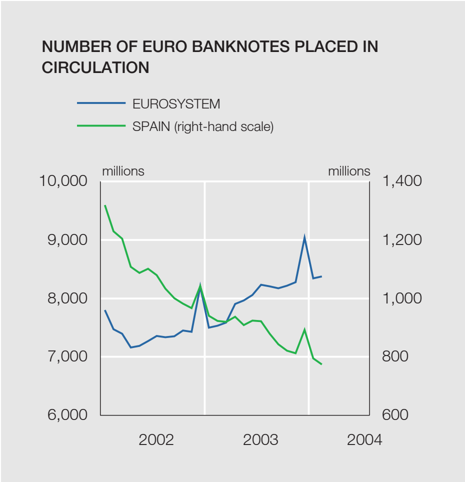
The sharp expansion in euro banknotes in the two years the new currency has been circulating and the absence of intervention by the Eurosystem in the currency markets have established the foundations for managing more effectively the internal and external assets of the Banco de España. In 2003, the Bank reduced significantly its holdings of foreign-currency-denominated assets in order to lessen exposure to exchange rate turbulence and, correspondingly, it increased its euro-denominated fixed-income assets, giving rise to a bond portfolio which, at the close of 2003, stood at around €23 billion.

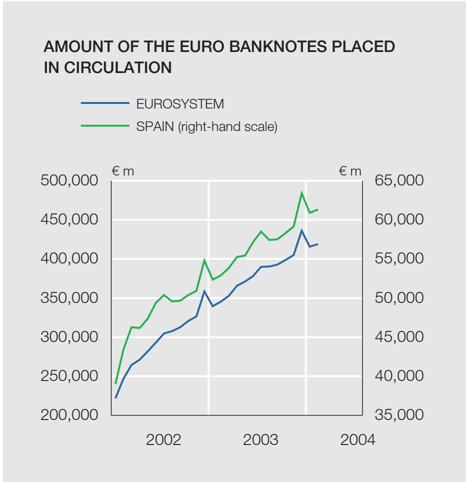
6.2 ACTIVITY IN DOMESTIC FINANCIAL MARKETS

The financial legislation enacted on 22 November 2002 provided for the integration of the clearing, registration and settlement systems of the Spanish securities markets into Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, SA (Iberclear). As the manager of the Public Debt Book-Entry System, the Banco de España undertook the legal steps necessary with the Stock Market Clearing and Settlement Service to set up a new company on 1 April 2003. The Bank provided the tangible and intangible assets of its Public Debt Book-Entry System and took up approximately 40% of the shares of the new company.

Iberclear became part of Bolsas y Mercados Españoles, SA, the holding company with title to the management companies of all the official securities markets and to their registration and settlement systems. Once Iberclear was set up, the Banco de España negotiated handing over its stake to Bolsas y Mercados Españoles (BME), exchanging its shareholding for approximately 10% of the shares of BME. As a result, the Bank would remain one of the main

BANKNOTES PLACED IN CIRCULATION





shareholders of the holding company. It consequently underwrote in full the capital increase carried out in September 2003.

6.3 MANAGEMENT OF PAYMENT SYSTEMS

The Banco de España directly manages the gross wholesale payment system known as SLBE (Banco de España Settlement System), which is one of the components of the TARGET system, the operational mainstay of the European System of Central Banks. It is a shareholder of the Sociedad de Pagos Interbancarios (Interbank Payments Company) and administrates the SNCE (National Electronic Clearing System). In 2003, SLBE was characterised by its full reliability, transacting more than three million operations for a total amount of €70 billion. The SNCE is Spain's only retail payment system, and a total of 1,145 million transactions in the form of transfers, checks, commercial paper, trade bills and direct debits were exchanged on it. The Bank also participated in the SPI (Interbank Payment Service), exchanging payment orders from abroad.

Further to discussions with the banking system throughout 2003, the basic avenues of reform for the Spanish payment systems were agreed. Following a course of change very similar to that applied in other euro area countries, this reform will involve discontinuing the SPI and absorbing into the SLBE the large-value payments in this system. Lower-value payments will be subsumed into the SNCE. The reform will also be harnessed to improve the administration of the SNCE, assigning it to a public limited company owned by the banking system, eliminating virtually all the large-value payments circulating through this retail system and transferring them to the SLBE, which is a more secure system where the booking of payments is final and in real time.

6.4 MANAGEMENT OF BANKNOTES

As an integral part of the Eurosystem, the Banco de España provided euro banknote issuance and withdrawal services to the banking system in 2003. Spain is a recipient country of foreign tourists, who arrive here with significant holdings of euro (usually low-denomination) banknotes for their spending on goods and services. Consequently, in the two years the euro has been circulating, the net placement by the Banco de España of low-denomination banknotes has been progressively declining, while the net issuance of high denomination banknotes has proceeded normally. On this trend, the value of euro banknotes placed in circulation by the Banco de España has posted rates of change that are positive but not as sharp as those of the Eurosystem as a whole, while the number of banknotes issued has fallen over the course of 2002 and 2003 (see Chart VI.1).

PESETAS CHANGED INTO EURO TABLE VI.3

PERIOD	BANKNOTES		COINS	
	MILLIONS OF UNITS	AMOUNTS (EURO m)	MILLIONS OF UNITS	AMOUNTS (EURO m)
Circulation (31.12.2001)	1.379	46.401	11.684	2.522
Changed in 2002	1.307	45.113	5.735	1.579
Changed in 2003	5	132	87	19
Circulation (31.12.2003)	67	1.156	5.862	924

If, instead of net flows, gross figures are considered, the volume and amount of euro banknotes deposited with the Bank maintained its normal rate during 2003, while the number and amount of banknotes delivered to the banking system fell slightly. That meant a lower net issue of banknotes by the Banco de España in relation to the Eurosystem as a whole, but, at the same time, it entailed a similar amount of work in respect of the reception, sorting and destruction of euro banknotes, so as to maintain the quality of the notes in circulation. Over the course of 2003 the Banco de España received and sorted 2,360 million banknotes, 650 million of which it destroyed, leaving 1,745 million ready to be returned into circulation. These figures are comparable with those for 2002, despite the fact that in this latter year 2 billion peseta banknotes were destroyed, leaving a part of the euro banknote sorting effort for 2003.

The exchange of peseta banknotes and coins continued in 2003, albeit in increasingly smaller – though still significant – amounts, as can be seen in Table VI.3, which breaks down the amounts exchanged over the past two years.

7 *Statistics*

7.1 THE STATISTICAL FUNCTION OF THE BANCO DE ESPAÑA

The statistical function of the Banco de España is addressed in Law 12/1998, amending Law 13/1994 on the Autonomy of the Banco de España, and in the Royal Decrees which, by virtue of the provisions of Law 12/1989 on the Public Statistical Function, cover every four years the statistics included in the National Statistical Plan[7]. The main statistics compiled and disseminated by the Banco de España in conformity with the Law of Autonomy relate to financial institutions and markets and to interest rates, although the underlying information for some of the statistics included in these areas is drawn from other supervisory agencies (CNMV, DGS). Statistics compiled and disseminated under the National Statistics Plan are the Balance of Payments and the International Investment Position, on one hand, and the Financial Accounts of the Spanish Economy, on the other. The Bank also compiles and disseminates, through its Central Balance Sheet Data Office, information on the financial situation and results of non-financial corporations based on questionnaires voluntarily completed by the reporting firms. Also, through its Central Credit Register (CCR), the Bank releases itemised data on the credit risks of reporting institutions (essentially credit institutions) with their customers. This information is used by the reporting institutions themselves in the granting and monitoring of their loans and by the Banco de España – which ensures the confidentiality of the individualised data – as a source for work and papers arising from its supervisory and statistical functions.

The foregoing references do not define in full the statistical function of the Banco de España. The related departments are not only involved in preparing statistics, i.e. compiling the infor-

7 Pursuant to article 7.5.f) of the Law of Autonomy of the Banco de España, reformed by Law 12/98, the Bank has to "prepare and publish statistics relating to its functions and assist the ECB in compiling the statistical information required for the functions of the European System of Central Banks (ESCB)".

mation that is used to produce statistics through specific circulars addressed to the units subject to supervision (and through access to accounting and administrative records generated by the Bank in the performance of its functions). The Bank itself is also a user of the statistics produced by the other national (INE, IGAE, CNMV, DGS, etc.) and international agencies and supervisors, in some cases so as to complement its studies on the financing of the various institutional groupings (the case of the public debt statistics for the purposes of the Excessive Deficit Protocol) and, in general, so as to place this information in the hands of the Bank's own specialists and analysts as a whole, indicating the source when it is not the Banco de España.

These activities are complemented by the active participation of Bank representatives in international statistical fora (within the ESCB, European Commission, European Committee of Central Balance Sheet Data Offices, IMF, BIS, OECD, etc.), and by a series of statistical publications, with particular attention to Internet dissemination and to databanks and databases that provide for the study of changes over time in all the variables.

7.2 MAIN CHANGES INTRODUCED DURING 2003

The year 2003 saw the updating of the statistics under the Bank's responsibility with the accepted standards of quality and their dissemination within the periods established. This update includes the methodological changes and improvements that are reflected in each of the publications in question, and which include most notably the following.

7.2.1 Statistics on financial institutions and markets and on interest rates. Financial accounts

Notable as regards ESCB-related work were:

1. The new statistic of interest rates applied by resident credit institutions to deposits received from households and non-financial corporations resident in the euro area (and to loans and credits extended to both these sectors). This statistic comprises 45 indicators of rates and amounts, for both new business and outstanding amounts, and it is in line with the statistics the European Central Bank and the other national central banks have begun to disseminate in co-ordination.

2. The monthly (previously quarterly only) breakdowns by sub-sector and nature of the deposits received by resident credit institutions from "other resident sectors" (and of the loans and credit extended to them).

3. Work has begun to set up a Centralised Securities Database (CSDB), which will provide for itemised (i.e. security-by-security) information on the key characteristics of all securities issued by the EU countries' various institutional groupings and on the most traded instruments on international markets for securities issued by residents in third countries.

Lastly, as regards the Quarterly Financial Accounts of the Spanish Economy in ESA 95 terms, the previous time series (1995-2002) has been extended back to 1990 during 2003. As a result, a quarterly 1990-2003 time series is now available.

7.2.2 Balance of Payments and International Investment Position statistics

The main changes in this field were as follows:

1. The Spanish contribution to the Monetary Presentation of the Euro Area Balance of Payments, a quarterly statistic which the European Central Bank began to disseminate in June 2003. This new presentation, which required prior work to ensure the consistency of the Balance of Payments and the Monetary Statistics, allows foreign transactions bearing on the monetary magnitudes to be analysed.

2. The implementation of a new information-gathering system for portfolio investments that provides detailed security-by-security data. The data obtained from this new compilation system have been used in the Spanish contribution to the IMF's Coordinated Portfolio Investment Survey and will be included in the preparation of the Balance of Payments and International Investment Position during 2004, which will notably improve their quality. Further, this information system will, in the near future, provide for improvements in quality and uniformity thanks to the use of the CSDB, which is destined to become a significant source for the compilation of the investment portfolio of the Balance of Payments and the International Investment Position.

3. The release on the Bank's website of a new quarterly external debt statistic.

7.2.3 Results of non-financial corporations according to the Central Balance Sheet Data Office (CBSO)

The annual (CBA) and quarterly (CBQ) databases, set up drawing on the voluntary collaboration of companies, receive questionnaires from over 8,000 medium and large corporations (whose gross value added – GVA – is approximately 30% of the total for the sector) and from over 800 large corporations (coverage of close to 20%). The database set up using consistent data from small firms provided to the CBSO by the Mercantile Registries draws already on over 250,000 firms (coverage of around 8%). During 2003, the policy to extend these bases gave priority to the inclusion of companies engaging in activities of relevance for the study of the "new economy" and other activities (such as distribution), the monitoring of which was of particular interest to the Bank's ongoing analyses.

7.2.4 Central Credit Register

The basic regulations governing the Central Credit Register (CCR) were amended by Law 44/2002 of 22 November 2002 on Financial System Reform Measures. Chapter VI of this Law, which came into force in May 2003, stipulates that the main aim of the CCR is to provide reporting institutions with the necessary data for the performance of their activity, to allow the proper exercise of supervision and inspection responsibilities and to contribute to the proper performance of the remaining functions legally attributed to the Bank. Work was under way in 2003 on the enactment of an Order to be implemented by this Law (which was finally approved on 11 March 2004); on the reform of Circular 3/1995, which regulates the functioning of the CCR (which will foreseeably be approved shortly); and on far-reaching changes to the computer programs used in its management so that, in addition to compliance with the new regulations, the latest technology in database management is used.

8 Complaints service

8.1 STATISTICS

During 2003 the Complaints Service saw the number of its cases rise to 5,313, 23.9% up on the previous year, and twice the number filed three years ago. The reason for this increase lies both in the rise in the number of banking transactions and greater knowledge on the part of bank-service users of their rights. Most of the institutions against which complaints were lodged were banks (65% of total cases).

8.2 GENERAL CRITERIA

The Complaints Service resolves complaints with regard to the so-called "good banking practices and uses" which banks should have as the basis of their mercantile relations with their clientele. These principles are based both on the associated regulations and on common law and broad legal principles. Among the broad list of criteria adhered to by the Service, the following were significant in 2003:

1. The criterion upheld by the Complaints Service, in relation to the interpretation of Law 2/1994 on the subrogation and modification of mortgage loans, on the prevalence of the creditor institution's right to render such subrogation without effect over the borrower's will. This opinion was recently upheld in a Supreme Court ruling on 25 November 2003 whereby if the lending institution offers conditions equal to those of

the institution seeking to subrogate the mortgage loan, said subrogation will be without effect.

2. The non-applicability to holders of mortgage loans extended prior to the entry into force of Royal Decree-Law 2/2003 of 25 April 2003 of the new commission of 0.5% relating to early repayment of debt, which is only applicable when there is a subrogation of a variable-rate mortgage loan entered into as from 27 April 2003 (the entry into force of the aforementioned legislation), with the maximum commission of 1% remaining effective for all other mortgages.

3. The recommendations on precautions in the sending and circulation of bills that ensure reception by the addressee, the use of forms of issuing instruments that reduce risk and precautions in communications from institutions to their clientele.

8.3 COMMISSIONERS FOR THE PROTECTION OF FINANCIAL SERVICES CUSTOMERS

Law 44/2002 of 22 November on Financial System Reform Measures stipulates, among its aims, that the efficiency and competitiveness of the Spanish financial system should not lead to financial services customers being unprotected. Thus, with the creation of the Commissioners for the Protection of Financial Services Customers, assigned to each of the three supervisory agencies, the channels through which complaints by customers of these types of services could be made have been reinforced.

The emergence and setting in place of these bodies bolsters the autonomy of the current complaints services or equivalent administrative units, which are functionally assigned to such services within the related supervisory authorities' organisations, so as to make their extensive experience in this field show. In turn, their nature in the consultative area is strengthened, where they are entrusted with the dual functions of protecting financial services customers' rights and of reinforcing transparency and good financial practices and uses.

The regulatory implementation of the rules governing their functioning, in Royal Decree 303/2004 of 20 February 2004, covers aspects relating to the Commissioners, such as their appointment; to their rank; to the procedure for resolving complaints, claims and consultations; to their functions, and to the Annual Report they must publish.

Complementing the overall protection of financial products customers is the Ministerial Order on internal bodies for the protection of customers of financial institutions. Pursuant to the mandate contained in Law 44/2002, its aim is to regulate the functioning of customer-care departments and services, and the figure of the ombudsman, as a prior step to the subsequent lodging of a complaint with the competent Commissioner.

9 External communications

9.1 COMMUNICATIONS POLICY

The communications policy of the Banco de España is geared to improving the general public's knowledge of its functions, of monetary policy and of the workings of the financial system with a view to building confidence among both the public at large and financial agents.

The overarching aim of the Bank's communications actions is, as is obligatory for any central bank, to ensure maximum credibility, seeking moreover to offer the greatest transparency possible within the established legal limits.

9.1.1 Relations with the media

During 2003, and in addition to the habitual press conferences, a new media relations strategy was launched. Its main aim is to step up and optimise the relationship with society through contacts by the Bank with media professionals.

The public appearances by the Governor are a fundamental means of disseminating the Bank's views on developments in the economic situation and in the financial system. In 2003 he appeared before the Parliamentary Commission on Economic Affairs (June), that on Budgetary Affairs (October), the Senate Budgetary Commission (November), and in various national and international fora. Further, the public addresses and speeches by the members of the Bank's governing bodies, along with interviews in the media, contribute to publicising the Bank's criteria on different aspects relating to its activity and to the overall economic outlook.

As part of this communications strategy, an economic and financial training programme for media specialists has been set up. Moreover, contacts with national and foreign media have been opened and high-level meetings between the Bank and the media have been promoted. In parallel with this personalised attention, the Bank has improved the services it offers to journalists through the Internet, setting up a virtual press room which offers useful information to them (communiqués, speeches, agenda, selected headlines and a photo gallery).

There was also notable coverage by the press – essentially the local and regional press – of the second stage of the Bank's branch restructuring plan. To meet press demands, specific explanatory materials were prepared and information sessions were organised at the ten branches which ceased to operate as at 31 December 2003.

Finally, a programme of relations with the foreign media was set up as part of the growing international activity of the Banco de España (see section 3). Moreover, the designation of the Governor as the chairman of the Basel Banking Supervision Committee in May 2003 and the progress in the related Capital Accord achieved at the Madrid meeting in October 2003 were closely scrutinised by the specialist press, meaning contacts with the international media have stepped up. In this respect, the Bank is making considerable efforts to disseminate and explain the core principles of the new Accord and its effects on banking supervision and the financial system.

9.2 INSTITUTIONAL COMMUNICATIONS PROGRAMME

Decisive steps were taken in 2003 in respect of institutional communications at the Banco de España thanks to the definition and implementation of an institutional image campaign aimed at increasing the Bank's presence in society. In addition to the development of a new graphic identity and the restructuring of its website, the Bank has stepped up the programme of visits to its central headquarters in Madrid. During the year nine institutional visits were arranged with the dual aim of displaying the Bank's historical and art heritage to key personalities from the media, finance, business and academia, and of promoting informative meetings with the Governor and the Deputy-Governor. Likewise, weekly guided visits for groups continued. So as to complement the explanations accompanying these activities, an institutional brochure entitled *Banco de España 1782-2002* was published. It covers the history, functions, architecture and art collection of the Banco de España, and the services it provides to the public at large.

9.2.1 The new institutional graphic identity

In order to avail itself of a uniform graphic identity tailored to its new circumstances as a member of the Eurosystem, the Bank invited bids in late 2002 to select a graphical design study that would take charge of developing a new visual image for the institution.

The candidate chosen was Zimmermann Asociados, in the light of its creativity, experience, procedures and timeframe. The proposal developed by this study presents the Bank as an independent institution performing its functions as the monetary authority and supervisor of the financial system, and it highlights its membership of the Eurosystem without compromising the Bank's own identity. The new corporate image seeks to give an idea of timelessness and sobriety, along with elegance, functionality and adaptive versatility, using a formula without spaces in helvetica neue font with different stroke thicknesses, on a background of temperate grey or, alternatively, copper (one of the metals most used in the minting of coins) and black.

Also, graphical arrangements based on the repetition of characteristic signs have been developed: architectural features of the main building and others symbolising the links with Economic and Monetary Union. The signs, combined with a wide colour range, shall be applied in the design of the publications and of the website. Indeed, this *Annual Report* is the first example of the new design.

The next step will be the compilation of an identity manual that provides for clear criteria when applying the graphic identity to whatsoever graphic material the Bank produces, so as to ensure unity and make them readily recognisable.

9.2.2 RESTRUCTURING OF THE WEBSITE

Direct contact with the public has also been brought about through the Bank's website, which offers detailed information on the Bank, the Eurosystem and the financial system, along with useful information for the public at large (interest rates, bank commissions, the Register of Institutions, financial regulations, the Complaints Service, the Library, historical archives, employment opportunities and scholarships, publications, etc). To make the website more accessible and useful, the Banco de España overhauled it in 2003. An attempt was made to move from a functional outline (in which each Bank department managed more or less independently one or several sections, in which it would disseminate its matter) to a more theme-based or intuitive structure offering easier access to information, although retaining the responsibility of each Directorate General for the maintenance and updating of the subjects under their remit.

The reform of the Bank's website has not only affected its formal presentation but has also given rise to a far-reaching reorganisation of its structure, along certain basic lines: unification of the site's identity; the standardisation of indexes and contents; improved navigability, giving priority to theme-based aspects in menus and increasing the number of direct accesses; giving a more expository approach to the information, especially regarding the European System of Central Banks; and extending the English version to bring it more closely into the line with the Spanish version.

The final result in February 2003 entailed, moreover, a reinforcement of certain areas, such as institutional information or the Eurosystem section, and the inclusion of new sections, such as the virtual press room, an FAQs section which attempts to respond to the general public's most habitual queries about the functions of the Banco de España and banking activity in general, and a newsflash section, showing the most significant updates and announcements published on the website.

9.3 CO-OPERATION WITH THE EUROPEAN SYSTEM OF CENTRAL BANKS

As a member of the European System of Central Banks, the Banco de España participates actively in the definition and implementation of communications policy in the euro area. Communications experts from the European Central Bank and from the national central banks meet regularly in the External Communications Committee (ECCO) to co-ordinate communications efforts in matters relating to Economic and Monetary Union.

In this connection, the Bank collaborates in the preparation of informative materials on monetary policy and conducts demoscopic surveys aimed at assessing the public's knowledge and attitudes towards the Eurosystem. Through its website, the Bank also disseminates the Spanish version of the European Central Bank's press releases and publications to the media and the general public.

10 Internal organisation and administration

10.1 BRANCH RESTRUCTURING PLAN

The changes in recent years relating to improved communications, the application of new information technologies and the growth of financial markets and intermediaries have meant that the functions performed by the Banco de España have become increasingly centralised, with the activity and content of many of its branches consequently diminishing. This has been against a background in which the recipients of the services provided by the Bank are, essentially, financial institutions and the various agencies making up the public sector.

With the introduction of the euro and the subsequent withdrawal of the peseta successfully behind us, the need to restructure the branch network was addressed. Motivated by the above-mentioned factors, the restructuring was undertaken gradually to minimise its effects.

Discussions were held and consensus reached with the legal representatives of the Bank's employees on an agreement whose implementation is being staggered over three years. The agreement involves the closure of 30 branches (10 as at 31 December in each of the years 2002, 2003 and 2004), and envisages – for the employees affected – new job placements in other branches or the headquarters of the Bank and the possibility of availing themselves of the purpose-designed early retirement plan.

The technical and efficiency-related reasons indicated advised a more rational structure for the network, with a fewer number of centres equipped with greater means and resources. The premise was that the centres that are to remain operational should have a sufficient territorial scope, maintaining the bank's institutional presence in all of Spain's regions.

10.2 HUMAN RESOURCES POLICIES

The Banco de España's management of its human resources is undergoing a process of renewal so as to adapt staff to the new requirements of the Bank's activity. These requirements stem from the greater technical complexity of its responsibilities in areas such as supervision and regulation, attention to international matters, the new technologies applied to central banking activity and the commitments arising from membership of the ESCB.

The following projects have been addressed as a result of this process of renewal.

10.2.1 Staff restructuring

At the same time as the branch network was being restructured, a voluntary retirement scheme was offered to the rest of the employees, which has both widened the possibilities of finding places for workers affected by branch closures and had a bearing on the size of the workforce. As a result of the early retirement scheme, it is envisaged that the total workforce will number approximately 2,630 employees once the closure of 30 branches has been completed by the end of 2004.

The weight of the most highly qualified group of employees in the total workforce has increased by almost 20%, while that of the least skilled employees has fallen. The workforce is also younger, with the average age dipping during the year from 47.1 to 45.8.

10.2.2 Restructuring of the Organisation Chart

The structure of the Bank's Organisation Chart has been simplified, with the former four ranks (Office Head, Deputy Head, Sector Head and Section Head) now three (Departmental Director, Head of Division, Unit Manager). Administrative units that had become obsolete have duly been eliminated, bringing about a more horizontal structure more in step with the organisational criteria of the European Central Bank and other ESCB banks.

10.2.3 Policy on new staff and collaboration

Collaboration by prestigious Spanish and foreign academics and specialists became more frequent in 2003 and agreements have been entered into allowing a greater number of exchanges involving specialists from other central banks and international organisations.

To improve selection and hiring processes, job description and evaluation has been undertaken as a necessary basis for, among other factors, achieving a hiring and promotion system that ensures knowledge and skills are in line with needs. The number of external competitive hiring processes doubled in 2003 in relation to previous years.

10.2.4 Training and development

Training was given a significant impetus last year, particularly in the following subjects:

— IT.

— Languages.

— Specific training via complementary seminars at the Bank for employees participating in international fora.

— Specific courses and instruction in Spain and abroad.

At the same time, training activities in collaboration with the ESCB aimed at different central banks' employees have been sponsored in the following areas:

— Courses on the workings of the ESCB for recent recruits.

— Management development courses for managerial staff.

Training programmes in management skills in collaboration with prestigious schools have been programmed for the Bank's managerial corps. Likewise, the design of a career development stream for the Bank's specialist non-managerial staff is under study.

10.3 EXTENSION OF THE CIBELES BUILDING

In 2003 it was decided to extend the Bank's headquarters by closing off the block comprising the streets of Alcalá, Paseo del Prado, Los Madrazo and Marqués de Cubas which they occupy. Work has begun on the corner of Alcalá and Marqués de Cubas on the construction of a new building which will reproduce the features of the traditional building's façade overlooking Cibeles.

The plans for the new building were drawn up by the architect Rafael Moneo, whose design won the competition tendered in this connection in 1978, with many other prestigious architects competing. Favourable reports were issued by the Comisión Institucional para la Protección del Patrimonio Histórico Artístico y Natural (the Spanish body responsible for safeguarding national heritage) and the Ministerio de Educación, Cultura y Deporte (Ministry of Education, Culture and Sports).

On 27 March 2003 the Madrid City Council agreed in plenary session to ratify the Town Planning Agreement entered into by the Bank and the City Council, whereunder the ongoing work is being carried out. Once the work is complete (scheduled for early 2006), the Bank's Cibeles building will have increased its surface area by around 5,000 square metres, of which approximately 2,100 square metres will be above ground.

10.4 INFORMATION SYSTEMS REFORMS

During 2003 the number of IT projects under way increased, such projects having been planned in accordance with the priorities defined in the three-year Master Plan. The introduction of practical improvements in planning and monitoring – with a new unit being entrusted with this function – made it possible to undertake a larger number of projects (30% up on the previous year).

The image and tools of the external website and the Intranet were reformed further to the introduction of latest-generation tools and on-line services, providing for an improvement in the Bank's image and in the efficiency of its internal management. The result has been a significant increase in the number of external and internal "hits". Progress has also been made on the facilities for remote connection to the Bank by means of web-mail, which allows access to the Bank's internal mail from any Internet-connected external post.

Regarding the renewal of automated office equipment, notable headway was achieved in 2003. A total of 1,600 latest-generation work stations were installed and in-house computer facilities were equipped with the latest market software and Internet navigators. Internet access is widespread (80% of staff have it), with all work stations in the Bank having secure access.

Modernisation of computer facilities at the Bank's branches also began in 2003 (at 5 branches in 2003, with the rest to be overhauled in 2004), with the latest technical means and applications being set in place and the necessary training being imparted to all staff.

The rise in the level of service to users has been a constant guiding principle for the Information Systems Department. In this connection it has fully renewed the User Help Desk, equipping it with new management tools and internal procedures so as to ensure a very high standard of service.

Surveys conducted among users have revealed favourable indices of quality and satisfaction: a score of around 7 on 10 was obtained compared with 3.5 on 10 the previous year, indicating that the reforms have been well received.

Another essential area in which action was taken in 2003 involved equipping the Bank with a more modern infrastructure enabling it to relate more flexibly to external organisations. As a result, work began last year on a PKI infrastructure project, to make it possible in 2004 to issue digital certificates and incorporate the digital signature for the Bank's procedural formalities.

Finally, the Bank promoted the creation in 2003 of a Spanish association to study the implementation of XBRL (Extensible Business Reporting Language), which culminated in 2004 in the first steps taken by this association. XBRL is an international IT standard for conveying accounting information which may provide for improved efficiency and flexibility in the transmission and handling of the information reported by financial institutions to the Banco de España.

10.5 INTERNAL AUDITING

According to the Statute approved by the Executive Commission, the aim of internal auditing is to evaluate the risks inherent in the Bank's activities and the effectiveness and efficiency of the systems established for their management and control. The internal audit function is performed by the Department bearing this same name (IAD), which reports directly to the Governor. In addition, the Internal Audit Department has to offer the Governing Council's Audit Committee every assistance it may require and provide it with the information it needs. The IAD and its audit staff shall adhere to the principles of objectivity, impartiality, confidentiality and the absence of conflicts of interest, and act in keeping with the International Standards for the Professional Practice of Internal Auditing.

The IAD's activity is subject to an Annual Plan approved by the Governor and the Deputy Governor, who report to the Executive Commission. Under the Plan for 2003, the IAD performed the following key audits: the annual accounts; the report envisaged in Law 44/2002 on Financial System Reform Measures; the security and quality of banknote production; the monetary and statistical databases of monetary financial institutions; central bank correspondent arrangements; the organisation of TARGET risk analysis; monetary income; quarterly financial accounts; and the migration of the ESCB's communications infrastructure. Seven of the Bank's branches were also inspected.

ANNUAL ACCOUNTS OF THE BANCO DE ESPAÑA
2003

Introduction

The annual accounts of the Banco de España ("the Bank") comprise the balance sheet, the profit and loss account and the notes on the accounts, as established by Article 29.1 of its internal rules, approved by a Resolution of the Governing Council of 28 March 2000 (Official State Gazette (BOE) of 6 April 2000). Pursuant to the provisions of the same article, the accounts have been prepared in accordance with the Bank's internal accounting policies. These policies follow generally accepted accounting principles, adapted to the special characteristics of the operations and functions of a central bank. They also comply, wherever applicable, 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.

In accordance with the provisions of Articles 29 and 32 of its internal rules, the Bank's annual accounts have been audited by the Internal Audit Department and analysed and examined by the Audit Committee appointed for the purpose by a resolution of the Bank's Governing Council of 19 December 2003. 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 Bank's balance sheet and accounts for the year, 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 annual accounts.

Unless otherwise indicated, the figures refer to millions of euro. It should be pointed out that, due to rounding, on occasions the totals included in the balance sheet, profit and loss account and notes on the annual accounts may not equal the sum of the individual figures.

This document presents the accounts for the year 2003. Section I includes the balance sheet and profit and loss account; Section II contains the notes on the accounts, with the accounting policies that have served as a framework for their formulation 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 Guarantee 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, Annexes 1 and 2 include the reports of the external auditors and of the Bank's Audit Committee on the annual accounts presented in Sections I-III.

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2003

(EUR m)

	NOTE NUMBER	2003	2002
ASSETS			
1. Gold and gold receivables	**1**	**5,558.96**	**5,499.85**
2. Claims on non-euro area residents denominated in foreign currency		**14,798.80**	**32,347.74**
2.1. Receivables from the IFM	2	1,852.78	1,920.38
2.2. Balances with banks and security investments, external loans and other external assets	3	12,946.02	30,427.36
3. Claims on euro area residents denominated in foreign currency		**0.06**	**0.03**
4. Claims on non-euro area residents denominated in euro		**1,528.69**	**475.34**
4.1. Balances with banks, securities investments and loans	4	1,528.69	475.34
4.2. Claims arising from the credit facility under ERM II		0.00	0.00
5. Lending to euro area credit institutions related to monetary policy operations denominated in euro	**5**	**33,188.15**	**18,203.30**
5.1. Main refinancing operations		32,964.66	17,540.94
5.2. Longer-term refinancing operations		220.90	642.12
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		2.60	20.25
6. Other claims on euro area credit institutions denominated in euro	**6**	**4.53**	**8.17**
7. Securities of euro area residents denominated in euro	**7**	**13,958.89**	**0.00**
8. General government debt denominated in euro	**8**	**9,154.92**	**9,767.91**
9. Intra-Eurosystem claims	**9**	**18,656.02**	**23,161.13**
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. Net claims related to the allocation of euro banknotes within the Eurosystem		0.00	0.00
9.5. Other claims within the Eurosystem (net)		13,764.59	18,269.71
10. Items in course of settlement		**0.71**	**0.80**
11. Other assets		**9,934.05**	**6,967.56**
11.2. Tangible and intangible fixed assets	10	200.79	208.91
11.3. Other financial assets	11	7,218.88	4,402.99
11.4. Off-balance sheet instruments revaluation differences	12	752.67	369.25
11.5. Accruals and prepaid expenses	13	531.73	638.62
11.6. Sundry	14	1,229.97	1,347.79
TOTAL ASSETS		**106,783.78**	**96,431.84**

BALANCE SHEET OF THE BANCO DE ESPAÑA AS AT 31 DECEMBER 2003

(EUR m)

	NOTE NUMBER	2003	2002
LIABILITIES			
1. Banknotes in circulation	**15**	**44,068.96**	**37,505.32**
2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**16**	**14,409.08**	**9,291.35**
2.1. Current accounts (covering the minimum reserve system)		14,408.04	9,271.35
2.2. Deposit facility		0.00	20.00
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		1.04	0.00
3. Other liabilities to euro area credit institutions denominated in euro		**0.00**	**0.00**
4. Debt certificates issued		**0.00**	**0.00**
5. Liabilites to other euro area residents denominated in euro		**17,237.94**	**15,215.26**
5.1. General government	17	15,790.14	14,022.99
5.2. Other liabilities	18	1,447.80	1,192.27
6. Liabilities to non-euro area residents denominated in euro	**19**	**21.13**	**48.25**
7. Liabilities to euro area residents denominated in foreign currency		**2.86**	**8.76**
8. Liabilities to non-euro area residents denominated in foreign currency		**92.23**	**1,371.23**
8.1. Deposits, balances and other liabilities	20	92.23	1,371.23
8.2. Liabilities arising from the credit facility under ERM II		0.00	0.00
9. Counterpart of special drawing rights allocated by the IMF	**21**	**351.99**	**387.34**
10. Intra-Eurosystem liabilities	**22**	**19,350.57**	**18,654.90**
10.2. Liabilities related to promissory notes backing the issuance of ECB debt certificates		0.00	0.00
10.3. Net liabilities related to the allocation of euro banknotes within the Eurosystem		19,350.57	18,587.05
10.4. Other liabilities within the Eurosystem (net)		0.00	67.85
11. Items in course of settlement	**23**	**91.95**	**44.97**
12. Other liabilities		**1,909.37**	**870.61**
12.1. Off-balance-sheet instruments revaluation differences	24	0.00	0.00
12.2. Accruals and income collected in advance	25	288.80	320.30
12.3. Sundry	26	1,620.57	550.30
13. Provisions	**27**	**2,814.64**	**4,004.53**
14. Revaluation accounts	**28**	**4,481.05**	**6,828.55**
15. Capital and reserves		**4.54**	**4.54**
15.1. Capital	29	1.37	1.37
15.2. Reserves	30	3.17	3.17
16. Profit for the year	**31**	**1,947.47**	**2,196.25**
TOTAL LIABILITIES		**106,783.78**	**96,431.84**

PROFIT AND LOSS ACCOUNT OF THE BANCO DE ESPAÑA FOR THE YEAR ENDING 31 DECEMBER 2003

(EUR m)

	NOTE NUMBER	2003	2002
Interest income	1	2,022.34	2,703.31
Interest expense	2	-690.15	-956.19
Net interest income		**1,332.19**	**1,747.12**
Realised gains/losses arising from financial operations	3	740.46	727.99
Write-downs on financial assets and positions	4	-1,161.69	-0.87
Transfer to/from provisions for foreign exchange rate and price risks	5	1,145.54	0.00
Net result of financial operations, write-downs and risk provisions		**724.32**	**727.12**
Fees and commissions income		13.24	16.88
Fees and commissions expense		-2.16	-1.86
Net income from fees and commissions	**6**	**11.08**	**15.02**
Income from equity shares and participating interests	**7**	**69.53**	**228.65**
Net result of pooling of monetary income	**8**	**0.61**	**-67.85**
Other income and losses	**9**	**211.04**	**144.87**
TOTAL NET INCOME		**2,348.76**	**2,794.92**
Staff costs	10	-199.77	-195.83
Administrative expenses	11	-77.84	-70.78
Depreciation of tangible and intangible fixed assets	12	-24.25	-21.25
Banknote production services	13	-48.97	-115.23
Other expenses	14	-2.93	-20.16
TOTAL OPERATING EXPENSES		**-353.76**	**-423.25**
Transfers and additions to other funds and provisions	**15**	**-47.53**	**-175.43**
PROFIT FOR THE YEAR	**16**	**1,947.47**	**2,196.25**

Countersigned by
The Governor,

JAIME CARUANA

The Comptroller,

ANTONIO ROSAS

II Notes on the accounts

Accounting policies

1 BASIC PRINCIPLES

The following accounting principles have been applied in formulating the annual accounts: economic reality and transparency, going concern, prudence, recognition of post-balance-sheet events, materiality, the accruals principle and consistency and comparability.

2 BASIS OF ACCOUNTING

The accounts have been prepared on an historical cost basis, modified as necessary to include market valuation of marketable fixed-income securities, gold and the foreign currency position. 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 method, 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 fixed-income securities and foreign currencies were valued at the market prices and exchange rates then prevailing, crediting the revaluation accounts on the liabilities side of the balance sheet, 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 in order to net off unrealised losses arising at a later date on the same asset or financial position.

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

Gold

Gold is recorded at acquisition cost, 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 net average cost method. In the event that the cash to be paid or received is specified in a currency other than the euro, 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 in euro per troy ounce of fine gold. Unrealised gains or losses (except for unrealised losses at year-end) are reflected in an adjustment account and credited or debited, respectively, to a revaluation or expense account. Both revaluation and expense accounts are reversed at the end of the following month.

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 in subsequent revaluations.

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.

Foreign currencies

Purchases are recorded at acquisition cost 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. Operations in a foreign currency that do not change the overall position therein have no effect on the book value of such position.

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

Foreign currencies are revalued monthly to market price. This revaluation is performed without netting unrealised gains against unrealised losses on the various currencies. Unrealised gains and losses (except for unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation accounts and expense accounts. Both revaluation and expense accounts are reversed at the end of the following month.

Unrealised losses existing at the end of the year are taken to the profit and loss account for the year, in which case they affect the average cost of the currency in question. Such losses are considered irreversible in subsequent revaluations.

Foreign banknotes

The criteria applied are the same as those indicated in the preceding section for foreign currencies.

Special drawing rights (SDRs)

SDRs and the net International Monetary Fund (IMF) position are valued at the year-end SDR market exchange rate by the same methods used for other currencies.

Securities

Securities are recorded at acquisition cost, which is determined by the cash amount paid, less any accrued gross coupon.

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

Securities are revalued monthly to market price. This revaluation is carried out without any netting of unrealised gains and losses on different security codes. Unrealised gains and losses (with the exception of unrealised losses at year-end) are reflected in adjustment accounts and credited or debited, respectively, to revaluation and expense accounts. Both revaluation and expense accounts are reversed in subsequent revaluations.

Unrealised 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 reversed 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 acquisition cost 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 in the "Foreign currencies" section.

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 balancing entry of which is the cash received. Securities sold under this type of agreement remain on the Bank's balance sheet and are treated as if they had 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.

In direct loans of securities, repurchase and reverse repurchase agreements conducted simultaneously are accounted for separately, each being recorded according to the valuation rules set forth in the preceding two paragraphs.

Automated security loans are not recorded in the balance sheet. The only item accounted for is the income, which is recorded in the profit and loss account. Operations outstanding at year-end are recorded off-balance-sheet.

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.

Shares and participating interests

Shares and participating interests in national and/or international institutions, including the participating interest in the European Central Bank (ECB), are valued at cost.

Tangible and intangible fixed assets

Fixed assets are valued at cost, which includes any non-deductible VAT borne and all additional expenses that may arise until they are in operation. Fixed assets whose cost is less than €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 taken monthly, starting from the month following that in which the asset is recorded in the accounts or put into operation.

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

In 2003, the depreciation percentages applied to the various fixed assets were the same as those applied in 2002, 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

Banknotes in circulation

The ECB and the 12 participating NCBs, which together comprise the Eurosystem, have issued euro banknotes since 1 January 2002[1]. The total value of euro banknotes in circulation is allocated on the last working day of each month in accordance with the banknotes allocation key[2].

The ECB has been allocated a share of 8% of the total value of euro banknotes in circulation as from 2002, whereas the remaining 92% has been allocated to the NCBs according to their weightings in the capital key of the ECB. The share of banknotes allocated to each NCB is disclosed under the balance sheet liability item "*Banknotes in circulation*".

The difference between the value of the euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of the euro banknotes that it actually puts into circulation also gives rise to remunerated intra-Eurosystem balances. These claims or liabilities, which incur interest[3], are disclosed under the sub-item "*Intra-Eurosystem: Net claim/liability related to the allocation of euro banknotes within the Eurosystem*" (see "*Intra-Eurosystem balances* in the notes on accounting policies).

From 2002 until 2007, the intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted in order to avoid significant changes in NCBs' relative income positions as compared with previous years. The adjustments are effected by taking into account the differences between the average value of banknotes in circulation of each NCB in the period between July 1999 and June 2001 and the average value of banknotes that would have been allocated to them during that period under the ECB's capital key. The adjustments are being reduced in annual stages and will continue to be so until the end of 2007. Thereafter, income on banknotes will be allocated fully in proportion to the NCBs' paid-up shares in the ECB's capital.

The interest income and expense on these balances is cleared through the accounts of the ECB and is disclosed under "*Net interest income*".

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1. Decision of the European Central Bank of 6 December 2001 on the issue of euro banknotes (ECB/2001/15), OJ L 337, 20.12.2001. **2.** The banknote allocation key refers to the percentages that result from taking into account the ECB's share of the total euro banknote issue and applying the subscribed capital key to the NCB's share of such total. **3.** Decision of the European Central Bank of 6 December 2001 on the allocation of monetary income of the national central banks of participating Member States from the financial year 2002 (ECB/2001/16), OJ L 337, 20.12.2001.

The Governing Council of the ECB has decided that the seignorage income of the ECB arising from the 8% share of euro banknotes allocated to the ECB shall be distributed separately to the NCBs in the form of an interim profit distribution[4]. It shall be so distributed in full unless the ECB's net profit for the year is less than its income earned on euro banknotes in circulation, and subject to any decision by the Governing Council to reduce this income in respect of costs incurred by the ECB in connection with the issue and handling of euro banknotes. In 2003, the Governing Council decided that the ECB would retain the full amount of this income.

The peseta banknotes that had not been exchanged by end-2002 were removed from the item "*Banknotes in circulation*" on 1 January 2003. Since then they have been presented under "*Other liabilities.- Sundry*", in accordance with the resolution of the Governing Council of the ECB of 5 December 2002.

Intra-Eurosystem balances

Intra-Eurosystem balances arise from the Banco de España's participating interest in the ECB, claims equivalent to the reserves transferred to the ECB, the net balance resulting from the transfers issued and received by TARGET[5] among the national central banks of the ESCB, including the ECB, and the balances resulting from allocation of euro banknotes within the Eurosystem.

The intra-Eurosystem balances arising from the allocation of euro banknotes within the Eurosystem are included as a net single asset or liability under *"Net claim/liability related to the allocation of euro banknotes within the Eurosystem"* (see *"Banknotes in circulation"* in the notes on accounting policies). In the case of TARGET operations, the resulting balances are included as assets or liabilities under the heading "*Other claims/liabilities within the Eurosystem (net)*".

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. To calculate the acquisition cost of items sold, the average cost method is used for securities and the daily net average cost method is used for foreign currencies and gold. In the case of unrealised losses on any item at year-end, its average cost is reduced to 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 on purchased securities are calculated and shown as interest income and accrued over the remaining life of the securities concerned, according to the internal rate of return method.

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4. Decision of the European Central Bank of 21 November 2002 on the distribution of the income of the ECB on euro banknotes in circulation to the NCBs of the participating Member States. **5.** Trans-European Automated Real-time Gross settlement Express Transfer system.

Pension scheme

The Pension Scheme is a defined-contribution occupational scheme, while the Fund is external and closed-end. The contributions made by the Banco de España on behalf of the employees who, having joined the Bank after 31.1.1986, are eligible to and do participate in the 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 recognised as a current expense in the year to which they relate.

Off-balance sheet positions[6]

Foreign exchange forward transactions and forward legs of foreign exchange swaps 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 positions are recognised and treated in a similar manner to those arising from on-balance-sheet assets and liabilities.

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 asset-liability position.

Notes on the balance sheet

1 GOLD AND GOLD RECEIVABLES

The Banco de España's gold holdings amount to €5,558.96 million, consisting of €16,827 million troy ounces of fine gold valued at €330.36 per ounce.[7] This amount is €59.11 million higher than at end-2002, basically as a result of the rise in the market price of gold during the year (at end-2002 the price per ounce was €326.83), the number of ounces having remained unchanged during the year, except for slight differences arising from deposit and swap transactions.

2 RECEIVABLES FROM THE IMF

These include: a) Special Drawing Rights (SDRs) within the reserve tranche (€1,476.47 million), which include the net International Monetary Fund (IMF) position (€1,476.47 million) and the euro tranche position and its balancing account (€2,131.15 million, with a positive and negative sign); b) SDRs at the IMF (€327.53 million), and c) other claims against the IMF (€48.78 million). In total, receivables from the IMF decreased by €67.60 million with respect to end-2002, as a result of a net increase of €98.00 million in investments and a reduction of €165.61 million in the overall position due to variation in the exchange rate. Spain's IMF quota remained unchanged in 2003 at SDR 3,048.90 million.

SDRs are valued at the year-end market rate, calculated by the ECB for all the Eurosystem national central banks, of €1 = SDR 0.8489.

3 BALANCES WITH BANKS AND SECURITY INVESTMENTS, EXTERNAL LOANS AND OTHER EXTERNAL ASSETS

This sub-item includes security investments, balances with banks, loans and other claims on non-euro area residents denominated in foreign currency. Their total amount is €12,946.02 million, with the following breakdown:

6. 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 sub-items 11.4 on the assets side and 12.1 on the liabilities side, depending on their sign. **7.** One troy ounce is equal to 31.1035 grams.

€ m

TYPE OF ASSET	2003	2002
Balances with banks	4,572.79	3,929.91
Security investments[8]	8,212.75	26,301.63
External loans and other external assets	166.69	201.05
Loan provisions	*–8.40*	*–10.07*
Non-euro area banknotes	2.18	4.85
TOTAL	**12,946.02**	**30,427.36**

At end-2003, 99.96% of the foreign-currency balances with foreign banks, security investments and loans denominated in foreign currency were denominated in US dollars. The equivalent value in euro of this US dollar amount was transferred to the balance sheet at the year-end market exchange rate (€1 = USD 1.263).

"*External loans and other external assets*" include, inter alia, certain assets amounting to €8.40 million, considered to be doubtfully recoverable. Country-risk and other provisions have been recorded for the full amount of these assets.

The decrease in the balance of this sub-item (€17,481.34 million) was basically due to the net effect of the factors listed in the following table:

BREAKDOWN OF THE CHANGE	€ m
Net purchase/sale of foreign currency	–13,738.82
Decrease in the outstanding gold swaps position at year-end	–299.07
Decrease in repos in direct security loans outstanding at year-end	–924.42
Foreign-currency-denominated interest received	645.61
Price-based gains on sale of securities and futures	655.46
Decrease in the market price of foreign securities	–811.20
Change in the market exchange rate	–3,009.21
TOTAL	**–17,481.34**

4 CLAIMS ON NON-EURO AREA RESIDENTS DENOMINATED IN EURO. BALANCES WITH BANKS, SECURITY INVESTMENTS AND LOANS

The balance sheet caption includes the balance of current accounts at correspondents resident outside the euro area and security investments denominated in euro issued by non-euro area residents. Substantially all the balance of this sub-item (€1,528.55 of a total of €1,528.69 million) relates to fixed-income securities issued in euro by international agencies, with an increase of €1,053.25 million with respect to 2002.

5 LENDING TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

This item includes the amount, classified by type of operation, of the euro-denominated lending to euro area credit institutions through which monetary policy is implemented.

8. As at 31 December 2003, repurchase agreements had been constituted over part of the euro-denominated securities portfolio, with a market value of €75.07 million, under automated security lending contracts with the depositories of these securities. Automated security lending contracts allow the depository to lend the securities to a third party in overnight operations, subject to certain limitations established in the contract.

The balance as at 31 December 2003 was 82.3% higher than in 2002 (€33,188.15 million in 2003 as against €18,203.30 in 2002). The average daily flow of financing extended during the year rose by 34.63% from €14,780.41 million in 2002 to €19,899.37 in 2003.

95.90% of the average daily financing balance was extended through "*Main refinancing operations*", 4.08% was granted under "*Longer-term refinancing operations*", and only 0.02% of the average annual balance was financed through other instruments.

a. Main refinancing operations

These operations play a pivotal role in pursuing the aims of steering interest rate, managing market liquidity and signalling the monetary policy stance. They are executed through liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks.

The balance of this sub-item was €32,964.66 million as at 31.12.2003. This was €15,423.72 million higher than at 31.12.2002.

b. Longer-term refinancing operations

These operations aim to provide credit institutions with additional longer-term refinancing. They account for a limited part of the global refinancing volume and are executed through liquidity-providing reverse transactions with a monthly frequency and a maturity of three months, by means of standard tenders.

The balance of this sub-item was €220.90 million as at 31.12.2003. This was €421.22 million less than in the previous year.

c. Fine-tuning reverse operations

The purpose of these operations is to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, their frequency is not standardised.

Their balance at end-2003 was zero, as it was at the previous year-end. No fine-tuning reverse operations took place during the year.

d. Structural reverse operations

The Eurosystem is able to adjust the structural liquidity position of the financial sector vis-à-vis the Eurosystem by engaging in reverse open-market transactions executed through standard tenders.

The end-2003 balance was zero, as it was at the previous year-end. No structural reverse operations took place during the year.

e. Marginal lending facility

Counterparties may use the marginal lending facility to obtain overnight liquidity from national central banks at a pre-specified interest rate against eligible assets. This interest rate is penalised with respect to the intervention rate set in the weekly tenders or in main refinancing operations.

The end-2003 balance was zero, as it was at the previous year-end. Very few of these transactions were carried out during the year and their amount was of scant significance.

f. Credits related to margin calls

Under Eurosystem rules for monetary policy management, all operations providing liquidity to the banking system must be backed by adequate underlying assets accepted by the system as eligible for use as collateral. If, after daily valuation, the market value of the assets used as loan collateral has fallen below the lower trigger point set for each security, the credit institution must immediately provide additional assets (or make a cash payment which is debited to its current account - see Note 16). If the market value of the underlying assets, following their revaluation, exceeds the amount of the financing obtained from the national central bank plus the variation margin, the credit institution may withdraw an amount of underlying assets equal to that excess (or receive this difference as a cash payment in its account).

In the national central banks that make margin calls by debiting or crediting the accounts of credit institutions, as is the case for the Banco de España, these debits or credits are the balancing entries of the asset-side or liability-side accounts reflecting the changes in these margins. These balance sheet accounts are remunerated at the interest rate applied in main refinancing operations.

As at 31.12.2003 this sub-item had a balance of €2.60 million, down €17.65 million on the previous year.

6 OTHER CLAIMS ON EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

This item includes claims on credit institutions unrelated to monetary policy operations. Its balance of €4.53 million includes the amount of the correspondent accounts in euro with euro area credit institutions, having decreased by €3.64 million with respect to 2002.

7 SECURITIES OF EURO AREA RESIDENTS DENOMINATED IN EURO

This item includes the amount of purchases of marketable euro-denominated fixed-income securities issued by euro area residents. Its balance of €13,958.89 million relates in full to securities issued by euro area general government (non-domestic) purchased in 2003[9].

8 GENERAL GOVERNMENT DEBT DENOMINATED IN EURO

a. State

This item includes 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 of 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 yearly payments as from 1999.

The outstanding balance as at 31 December 2003 of the loans granted to the State amounted to €7,873.37 million, broken down as follows:

€ m

	31.12.2003	REPAYMENT	31.12.2002
Treasury. Law 3/1983 special account	2,050.14	97.63	2,147.76
Treasury. Law 4/1990 special account	5,210.98	347.40	5,558.38
Treasury. Credits arising from subscription for participating interests, contributions and quotas in international agencies	612.25	40.82	653.07
TOTAL	**7,873.37**	**485.84**	**8,359.21**

The change was solely due to yearly repayments on the above-mentioned loans, as specified in the above table.

b. Social Security System

This sub-item (€1,281.54 million) 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

9. As at 31 December 2003, repurchase agreements had been constituted over part of the euro-denominated securities portfolio, with a market value of €75.07 million, under automated security lending contracts with the depositories of these securities. Automated security lending contracts allow the depository to lend the securities to a third party in overnight operations, subject to certain limitations established in the contract.

for 1995. The first includes the principal of another loan granted to this institution, which was not paid on its maturity, of €1,539.19 million, and the second includes the interest due but not paid on the previous loan to 31.12.1994, amounting to €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.

€76.96 million of the reduction in the balance of this sub-item (€127.15 million) corresponds to receipt of the fourth repayment instalment on the loan of €1.539.19 million, the unmatured balance of which amounts to €1,231.35 million. The remaining €50.19 million of the reduction corresponds to receipt of the ninth repayment instalment on the loan of €501.90 million, the outstanding balance of which is €50.19 million. The amount of this latter loan's repayment instalment 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.

9 INTRA-EUROSYSTEM CLAIMS

a. Participating interest in the ECB

The fully paid-up subscription of the Banco de España to the capital of the ECB amounts to €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.

In accordance with Article 29.3 of the ESCB Statute, the key of NCBs for subscription of the ECB's capital shall be adjusted every five years. A post-balance-sheet event calling for comment is the first quinquennial change that took effect on 1 January 2004. On 1 May 2004 a second change of the ECB's capital key followed, as a result of the accession of 10 Member States. Based on the Council Decision of 15 July 2003 on the statistical data to be used for the determination of the key for subscription of the capital of the European Central Bank, the capital key share of the Banco de España decreased from 8.8935% to 7.7758%. Consequently, asset item "9.1 Participating interest in the ECB" decreased by €11.98 million to €432.70 million as a result of the repayment of part of the capital contribution.

b Claims equivalent to the transfer of foreign reserves to the ECB

Pursuant to Article 30 of the Statute of the ESCB/ECB, the Banco de España transferred foreign reserve assets to the value of €4,446.75 million to the ECB at the beginning of 1999. These claims are equivalent to this transfer.

These claims will be remunerated at 85% of the marginal interest rate on ESCB main refinancing operations. Interests will be calculated daily by the ECB applying the simple interest method with a 360-day year.

As post-balance-sheet events worth mentioning, the adjustments to the capital key weightings and the resulting changes in the euro area NCBs' shares in the ECB's subscribed capital also made it necessary to adjust the claims which the ECB has credited to the euro area NCBs and which are equivalent to those NCBs' respective contributions of foreign reserve assets to the ECB. In order to reflect its reduced capital key share, the euro-denominated claim of the Banco de España with respect to the foreign reserve assets transferred to the ECB (asset item 9.2) decreased by €119.77 million to €4,326.98 million.

The above-mentioned changes took place on 1 January and 1 May 2004.

c. Net claims related to the allocation of euro banknotes within the Eurosystem

In accordance with Eurosystem rules, since the accounts making up this sub-item have a net credit balance, they are presented on the liabilities side of the balance sheet (see Note 22 on the balance sheet).

d. Other claims within the Eurosystem (net)

The balance of €13,764.59 million represents the algebraic sum of three components: 1) the position of the Banco de España vis-à-vis the ECB in respect of the transfers issued and received through TARGET by the ESCB national central banks, including the ECB, plus the balances held with Eurosystem central banks through correspondent accounts; 2) the position vis-à-vis the ECB in respect of the pooling and allocation of monetary income within the Eurosystem pending settlement (see "*Net result of pooling of monetary income*" in Note 8 on the profit and loss account); and 3) the Banco de España's position vis-à-vis the ECB in respect of any amounts receivable or refundable, basically in respect of the dividend relating to euro banknotes issued by the ECB.

Regarding the first component, the end-2003 balance of the transfers via TARGET amounted to €13,822.57 million, while the correspondent accounts showed a credit position of €0.08 million. From 30 November 2000, the balances arising from TARGET transfers vis-à-vis the Eurosystem banks, and vis-à-vis the rest of the European Union banks have been netted and replaced by a single balance vis-à-vis the ECB. The remuneration of the Eurosystem's debit position vis-à-vis the Banco de España is calculated daily at the marginal interest rate on ESCB main refinancing operations.

The debit position vis-à-vis the ECB, which carries out the clearing of the unsettled positions of the Eurosystem national central banks arising from the pooling and yearly allocation of monetary income, amounted to €0.61 million.

Finally, the credit position vis-á-vis the ECB relating to the interim dividend arising from the seignorage of euro banknotes issued on its behalf by the NCBs amounts to €58.50 million, since the ECB Governing Council, in the light of its estimates, decided to retain the 2003 seignorage income from its banknotes. Accordingly, the national central banks have to return to it the interim dividends received in this connection in the first three quarters of the year, which in the Banco de España's case amounted to €58.50 million as mentioned above.

10 TANGIBLE AND INTANGIBLE FIXED ASSETS

The balance of this sub-item amounted to €200.79 million at end-2003, of which €418.60 million related to cost and €217.80 to accumulated depreciation.

The breakdown of this sub-item into its components, together with their accumulated depreciation, is as follows:

€ m

COST OR VALUATION	PROPERTY AND FACILITIES	FURNITURE AND EQUIPMENT	FIXED ASSETS UNDER CONSTRUCTION	OTHER FIXED ASSETS	TOTAL
1 January 2003	234.90	106.43	10.00	61.95	413.27
Additions	1.85	13.37	9.06	3.42	27.70
Disposals	11.30	5.04	4.86	1.19	22.39
31 December 2003	225.45	114.76	14.20	64.18	418.60

€ m

ACCUMULATED DEPRECIATION	PROPERTY AND FACILITIES	FURNITURE AND EQUIPMENT	FIXED ASSETS UNDER CONSTRUCTION	OTHER FIXED ASSETS	TOTAL
1 January 2003	116,48	66,98	—	20,89	204,36
Change during the year	1,90	9,10	—	2,44	13,44
31 December 2003	118,38	76,09	—	23,33	217,80

The increase in fixed assets in 2003 was basically due to renewal of furniture and the beginning of construction work on the new building in the west wing of the Bank's headquarters, in Madrid.

As a result of the Banco de España's decision to restructure its branch network, the ten buildings housing the branches closed on 31 December 2002 were sold during 2003. This was the main cause of the disposals recorded in the year. Additionally, a sale commitment exists in respect of the other twenty buildings affected by the branch network restructuring.

11 OTHER FINANCIAL ASSETS

99.24% of the balance of this sub-item relates to the portfolio of book-entry domestic State securities, which amounted to €7,163.78 million as at 31.12.2003. The increase with respect to the previous year (€2,761.54 million) was mainly due to a net purchase of securities (€2,761.73 million), as well as to the decrease in net unrealised gains recorded at year-end (€47.78 million) and to the increase in accrued implicit interest (€47.60 million).

In 2003 the Banco de España subscribed for shares of *Sociedad de Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A.* through the non-monetary contribution of all the Banco de España's shares in *Sociedad de Gestión de los Sistemas de Registro, Compensación y Liquidación de Valores, S.A*. The shares acquired were initially recorded at the net book value of the shares given up in exchange (€8.10 million) and adjusted at year-end to reflect their underlying book value in accordance with the balance sheet of Sociedad de Bolsas y Mercados. This adjustment resulted in an addition to the balance of this sub-item of €46.57 million, which were credited to revaluation accounts on the liabilities side.

12 OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

This sub-item includes the amount of the net debtor position arising from foreign-exchange forward and swap transactions valued at the exchange rates prevailing at the end of the year. When this position is a creditor one, it is recorded under the same heading in liability sub-item 12.1. The end-2003 balance of €752.67 million, which is the net value of the forward transactions outstanding as at that date, is €383.42 million higher than at end-2002.

13 ACCRUALS AND PREPAID EXPENSES

The main components of this sub-item, the balance of which amounts to €531.73 million, are as follows:

€ m

ACCRUALS AND PREPAID EXPENSES	2003
Accrued coupon interest receivable	**299.26**
On securities denominated in foreign currency issued by non-euro area residents	71.94
On securities denominated in euro issued by non-euro area residents	17.92
On securities denominated in euro issued by euro area residents (non-domestic)	91.41
On securities denominated in euro issued by euro area residents (domestic portfolio)	117.99
Other accrued interest receivable	**220.79**
On forward foreign exchange transactions	40.90
On deposits and other assets denominated in foreign currency	51.82
On claims equivalent to the transfer of foreign reserves to the European Central Bank	88.69
On other intra-Eurosystem claims arising from TARGET transactions	29.37
Other	10.02
Accrued commissions receivable and prepaid expenses	**11.68**
TOTAL	**531.73**

14 SUNDRY

The most significant component is the transfer made to the Treasury on 3 November 2003 of €935.37 million, equivalent to 70% of the Bank's recorded profits earned to 30 September 2003.

The other main components are the home loans granted to employees amounting to €112.27 million and the accrued coupon interest as at the purchase date of euro-denominated fixed-income securities, amounting to €125.29 million.

15 BANKNOTES IN CIRCULATION

The balance of banknotes in circulation (€44,068.96 million) includes the Banco de España's share in the total euro banknotes in circulation (see "*Banknotes in circulation*" in the notes on accounting policies) according to the Eurosystem euro banknote allocation key (10.1020% of the total issue by all the central banks, after deducting those corresponding to the ECB, which are 8% of the total). This balance was €7,851.38 million higher than in the previous year because of the greater volume of euro banknotes in circulation. Until 31.12.2002 this item also included peseta-denominated banknotes that had not been exchanged as at year-end, which since 1 January 2003 have been included under "*Other liabilities.- Sundry*". Their balance as at that date was €1,287.73 million.

16 LIABILITIES TO EURO AREA CREDIT INSTITUTIONS RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

The overall balance of the different types of deposit held by credit institutions with the Banco de España amounted to €14,409.08 million at end-2003. The increase with respect to the previous year was concentrated in current accounts (covering the minimum reserve system), which grew from €9,271.35 million at 31.12.2002 to €14,408.04 million at 31.12.2003. Nevertheless, the increase in the average balance of these accounts was far less significant, growing from €11,166.00 to €11,828.09 million. Current accounts include the different types of deposits held by credit institutions at the Banco de España, in which they maintain the minimum reserves required for monetary policy implementation purposes.

Also included under this caption are the deposits placed by credit institutions at the Banco de España in relation to the deposit facility, fixed-term deposits, fine-tuning reverse operations and deposits related to margin calls.

As at 31.12.2003 an amount of €1.04 million had been deposited in relation to margin calls (see Note 5 on the balance sheet). In the previous year the balance of €20 million related to deposits in connection with the deposit facility.

17 LIABILITIES TO OTHER EURO AREA RESIDENTS DENOMINATED IN EURO. GENERAL GOVERNMENT

This sub-item includes the deposits held by general government with the Banco de España. The outstanding balance at year-end was €15,790.14 million, which breaks down as follows:

€ m

	2003	2002
Central government (State)	3,320.81	2,798.26
Treasury current account	*300.21*	*299.89*
Other central government agencies and similar bodies	*3,020.61*	*2,498.36*
Territorial government	86.30	87.97
Regional (autonomous) governments, administrative agencies and similar bodies	*80.39*	*81.20*
Local government	*5.91*	*6.78*
Social security funds	12,383.03	11,136.76
TOTAL	**15,790.14**	**14,022.99**

The rise in the balance of this sub-item (€1,767.15 million) was basically due to the increase in the balances held by the Social Security System and by other State central government agencies.

18 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 Guarantee 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-2003 was €1,447.80 million, an increase of €255.53 million on end-2002, basically due to the increase in the balances of the current accounts of "*State agencies—Regional agencies*" (€210.81 million).

19 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 euro area. The balance of €21.13 million was €27.13 million lower than a year earlier.

20 LIABILITIES TO NON-EURO AREA RESIDENTS DENOMINATED IN FOREIGN CURRENCY.- DEPOSITS, BALANCES AND OTHER LIABILITIES

Substantially all of the €92.23 million balance of these liabilities at end-2003 related to debts arising under gold repurchase agreements relating to the management of the foreign-currency reserves of the Banco de España. The total amount of this sub-item decreased by €1,279.00 million, of which €924.42 related to securities repurchase agreements, whose balance was zero at end-2003.

21 COUNTERPART OF SPECIAL DRAWING RIGHTS ALLOCATED BY THE IMF

This item of €351.99 million shows the amount of the special drawing rights allocated to Spain in proportion to its IMF quota. The total amount of this item decreased by €35.35 million with respect to the previous year, mainly due to the variation in the exchange rate.

22 INTRA-EUROSYSTEM LIABILITIES

a. Net liabilities related to the allocation of euro banknotes within the Eurosystem

This sub-item consists of the claims and liabilities of the Banco de España vis-à-vis the Eurosystem in relation to the allocation of euro banknotes within the Eurosystem (see "*Banknotes in circulation*" and "*Intra-Eurosystem balances*" in the notes on accounting policies).

b. Other liabilities within the Eurosystem (net)

[See note 9.d on the balance sheet]

23 ITEMS IN COURSE OF SETTLEMENT

Of the total balance of this item (€91.95 million), €51.37 corresponds to transfers ordered by credit institutions pending payment at year-end, and €35.82 correspond to transfers received during the day by the Sistema Nacional de Compensación Electrónica (National Electronic Clearing System) that have been settled and are pending payment. This account was also responsible for most of the increase in this item with respect to 2002.

24 OTHER LIABILITIES.- OFF-BALANCE-SHEET INSTRUMENTS REVALUATION DIFFERENCES

See note 12 on the balance sheet.

25 OTHER LIABILITIES.- ACCRUALS AND INCOME COLLECTED IN ADVANCE

The most significant components of this sub-item totalling €288.80 million relate to profits on the sale of foreign currencies under forward transactions that are pending maturity (€226.98 million) and therefore considered unrealised until that time, and to interest accrued but not yet paid (€54.82 million).

26 OTHER LIABILITIES.- SUNDRY

The main component of this sub-item is "*Banknotes in circulation.- Pesetas*", the balance of which (€1,155.57 million) decreased by €132.16 million in the year and relates to the peseta-denominated banknotes pending exchange as at year-end. As of 31.12.2002 they have been presented under "*Banknotes in circulation*".

The other important components are the contributions payable to the Banco de España employee social welfare scheme (*Mutualidad de empleados*), the amount of which (€318.13 million) decreased by €22.62 million during the year, and the "*Settled credit interest pending allocation*", corresponding to a loan granted in the past to the Social Security System, with a balance at year-end of €50.20 million, down €50.19 million on the previous year[10].

27 PROVISIONS

With the exception of country-risk provisions, which are presented in the balance sheet as reductions of the value of the assets concerned, provisions are recorded under this item, with the following breakdown:

€ m

	2003	2002
For exchange rate risks.— Pre-system account	2,622.04	3,767.58
For early and regular retirement	119.53	128.78
For sundry liabilities and charges	72.82	107.94
For other risks	0.26	0.22
TOTAL	**2,814.64**	**4,004.53**

10. This loan is referred to in Note 8.b above.

The most important provision relates to pre-system exchange rate risks. It was created by a resolution of the Executive Commission of 26 January 1999 to cover exchange rate risks affecting the external reserves of the Banco de España. It should be pointed out that the decrease of €1,145.54 million in the balance of this account as of 31.12.2003 with respect to the prior year was authorised by the Executive Commission on 9 January 2004. This decrease was due to the use of the provision to offset the unrealised exchange losses as of 31 December 2003 which arose when the accounting average exchange rates of foreign currencies were adjusted to market prices.

The decrease of €44.34 million in the other provisions was basically due to the reduction in the provision for death and retirement assistance established in art. 190 of the Banco de España Employment Rules, in accordance with the certification issued by the relevant insurance actuary.

28 REVALUATION ACCOUNTS

These accounts represent revaluation reserves arising from unrealised gains on financial assets and liabilities. Their breakdown is as follows:

€ m

TYPE OF ACCOUNT	2003	2002
Pre-system revaluation accounts	**2,749.60**	**3,727.85**
Due to exchange rate differences	—	909.43
Due to price differences	2,749.60	2,818.43
Gold	2,565.23	2,565.39
Securities denominated in foreign currencies issued by non-euro area residents	—	2.47
Book-entry public debt	184.37	250.57
Ordinary revaluation accounts	**1,731.45**	**3,100.69**
Due to exchange rate differences	0.01	638.11
Due to price differences	1,731.44	2,462.58
Gold	1,413.37	1,353.99
Securities denominated in foreign currencies issued by non-euro area residents	91.69	896.68
Securities denominated in euro issued:	179.81	210.94
By non-euro area residents	*2.30*	
By euro area residents (non-domestic)	*14.36*	
Book-entry public debt	*163.16*	*210.94*
Other	46.57	0.97
TOTAL	**4,481.05**	**6,828.55**

The difference between the pre-system and ordinary revaluation accounts is that the former, in accordance with Eurosystem rules, 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 €978.26 million in the balance of the pre-system revaluation accounts in 2003 has the following breakdown:

€ m

PRE-SYSTEM REVALUATION ACCOUNTS	BREAKDOWN OF THE CHANGE IN 2003		TOTAL
	DUE TO THE-REALISATION OF CAPITAL GAINS IN SALES AND REDEMPTIONS	DUE TO NETTING AGAINST UNREALISED CAPITAL LOSSES	
Due to exchange rate differences	–483.54	–425.88	–909.43
Due to price differences	–68.83	—	–68.83
Gold	*–0.16*	—	*–0.16*
Securities denominated in foreign currencies issued by non-euro area residents	*–2.47*	—	*–2.47*
Book-entry public debt	*–66.20*	—	*–66.20*
TOTAL	**–552.37**	**–425.88**	**–978.26**

The balance of the ordinary revaluation accounts decreased by €1,369.24 million, with the following breakdown:

BREAKDOWN OF CHANGE	€ m
Due to exchange rate differences	**–638.10**
Due to price differences	**–731.15**
Gold	59.38
Securities denominated in foreign currencies issued by non-euro area residents	–804.99
Securities denominated in euro issued:	–31.13
By non-euro area residents	*2.30*
By euro area residents (non-domestic)	*14.36*
Book-entry public debt	*–47.78*
Other	45.60
TOTAL	**–1,369.24**

29 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 EUR1.37 million and remained unchanged during the year.

30 RESERVES

Included in this sub-item, which remained unchanged during the year, is the amount of capital, reserves and profits that arose in 1973 when the now-defunct Spanish Foreign Currency Institute was included in the Banco de España.

31 PROFIT FOR THE YEAR

The net profit for the year, after deducting the transfer to the Beneficent-Social Fund (€3.90 million), amounted to €1,947.47 million, down 11.3% on 2002. Of this amount, €935.37 million was paid to the Treasury on 3 November 2003, in accordance with Royal Decree 1080/2002 of 22 October 2002.

The following amounts were also paid to the Treasury during the year out of the profit for 2002:

a) On 3.2.2003, €820.28 million, in order to reach, together with the amount paid in November 2002, 90% of the profit for 2002 (€2,196.25 million).

b) On 12.8.2003, once the balance sheet and profit and loss account for the year 2002 had been approved by the Council of Ministers, €219.62 million, representing the rest of the profit for 2002.

The details of the various components of the profit for 2003 are given in the following Section, relating to the profit and loss account.

Notes on the profit and loss account

1 INTEREST INCOME

This item includes income from interest accrued on the main assets of the Banco de España. It was made up, in 2003 and 2002, as follows:

€ m

	FOREIGN CURRENCY		EURO		TOTAL	
	2003	2002	2003	2002	2003	2002
Securities	432.62	949.52	384.15	179.06	816.76	1,128.58
Other assets	174.20	161.16	1,031.38	1,413.58	1,205.58	1,574.73
TOTAL	**606.82**	**1,110.68**	**1,415.52**	**1,592.64**	**2,022.34**	**2,703.31**

As regards the interest on foreign-currency investments (€606.82 million), the majority (€487.17 million, equivalent to 80.28%) arose from investments denominated in US dollars, which had an average balance of USD 24,408.69 million and an average yield of 2.3%, compared with 3.7% in 2002. The rest of the interest arose from much less significant investments in SDRs and other smaller investments in other currencies.

The interest on euro-denominated investments (€1,415.52 million) arose from the following assets:

€ m and %

ASSETS	AVERAGE INVESTMENT	AMOUNT	AVERAGE YIELD IN 2003
Loans to institutions related to monetary policy operations	19,899.37	460.61	2.3%
Net balance with European Union central banks arising from TARGET transactions	20,216.47	478.67	2.3%
Claims equivalent to the transfer of foreign reserves	4,446.75	88.69	2.0%
Securities portfolios	12,412.23	384.15	3.1%
Other	—	3.42	—
TOTAL	**56,974.82**	**1,415.52**	**2.5%**

The decrease in total euro-denominated interest income (€177.11 million) was due to the fall in the average return on these assets (down from 3.4% in 2002 to 2.5% in 2003), offset by the increase in average investment (€46,696.34 million in 2002).

2 INTEREST EXPENSE

This item includes interest expenditure on liabilities, with the following breakdown:

€ m and %

	AVERAGE FINANCING	INTEREST EXPENSE		AVERAGE COST IN 2003
		2003	2002	
Remuneration of minimum reserves	11,821.33	274.38	367.88	2.3%
General government deposits	11,900.56	270.73	386.30	2.3%
Intra-Eurosystem accounts.—Net liabilities related to banknote issuance	5,677.10	133.11	182.84	2.3%
Liabilities denominated in foreign currency	971.06	11.64	15.78	1.2%
Other euro- and foreign-currency-denominated liabilities	—	0.30	3.39	—
TOTAL	**30,370.05**	**690.15**	**956.19**	**2.2%**

The amount of remuneration corresponding to the days with a net credit balance in intra-Eurosystem accounts related to the allocation of banknotes within the Eurosystem was €133.11 million.

The decrease in the expense compared with the previous year (€266.04 million) was primarily due to the fall in the average cost of financing received (2.2% in 2003 compared with 3.2% in 2002) – which was the main reason for the lower cost of minimum reserves (€93.50 million), of general government deposits (€115.58 million) and of intra-Eurosystem accounts.- Net liabilities related to banknote issuance (€49.74 million) – and, to a lesser extent, to the lower interest paid on foreign currency liabilities (€4.14 million).

3 REALISED GAINS/LOSSES ARISING FROM FINANCIAL OPERATIONS

This item includes the profits and losses arising from dealing in financial assets. In 2003, there was a net realised gain of €740.46 million, basically arising from the following sources:

— Foreign exchange gains upon the sale of foreign currency totalling €86.63 million, of which €226.30 million corresponded to the loss for the year and €312.93 million to the realisation of unrealised gains arising from the revaluation as at 31.12.1998. These results arose mainly from the net daily sale of US dollars (€92.32 million), which totaled USD 12,851.32 million in the year. The rest are losses corresponding basically to the net sale of SDRs (5.97 million) and gains on other foreign currencies (0.27 million).

— The net price-related gains arising from the purchase and sale of foreign securities amounted to €657.73 million and related in full to the sale of US dollar-denominated securities. The gross sales of US dollar-denominated securities in the year amounted to USD 34,276.07 million.

Of the total of €657.73 million, €655.26 million corresponds to gains arising and realised in 2003 and the rest (€2.47 million) to the realisation of unrealised gains existing as at 31 December 1998.

Compared with the previous year, the net profit on these transactions increased by €12.47 million, the outcome mainly of a rise of €287.16 million in gains arising from price movements and of a decrease of €274.69 million in foreign exchange gains.

— The increase in gains arising from price movements (€287.16 million) basically arose on the sales of fixed-income securities denominated in US dollars (€299.57 million) owing to the increase in their market price and to the greater volume of sales. This bigger gain on the sale of dollar-denominated securities was slightly offset by lower gains (€12.41 million) on sales of euro-denominated securities and on other residual financial operations.

— The decrease in foreign exchange gains (€274.69 million) essentially arose from the appreciation of the euro against the US dollar, this effect having been countered in part by the strong increase in the volume of sales (USD 886.97 million in 2002 compared with USD 12,851.32 million in 2003).

4 UNREALISED LOSSES ON FINANCIAL ASSETS AND POSITIONS

This item includes the loss arising in the currency position derived from the exchange rate depreciation, as well as that arising from depreciation of gold and foreign currency-denominated securities, for that portion that cannot be offset by unrealised gains from previous years.

The depreciation posted in 2003 amounted to €1,161.69 million, €1,571.69 million of which related to exchange rate losses recorded in foreign currency, essentially in US dollars (€1,437.19 million) and in SDRs (€134.14 million), partly offset by the application of pre-system exchange rate gains totalling €425.88 million, of which €395.91 million were in US dollars and €29.98 million in SDRs.

Unrealised losses relating to securities price movements amounted to €15.88 million, of which €6.67 million were in US dollar-denominated securities and €9.21 million in euro-denominated securities.

5 TRANSFERS TO/FROM PROVISIONS FOR FOREIGN EXCHANGE RATE AND PRICE RISKS

In 2003 provisions covering exchange rate risks for an amount of €1,145.54 million were reversed to income.

6 NET INCOME FROM FEES AND COMMISSIONS

This basically includes income and expenses arising from fees and commissions for banking services and the like (transfers, handling of cheques, custody and administration of securities, telephone service for securities transactions, etc.). It may be broken down as follows:

€ m

	INCOME		EXPENSES	
	2003	2002	2003	2002
Foreign operations	0.80	0.96	–1.29	–1.18
Domestic operations	12.44	15.92	–0.87	–0.69
TOTAL	**13.24**	**16.88**	**–2.16**	**–1.86**

Lower fee income in 2003 (down 21.6%) was due above all to the smaller number of operations routed through Banco de España's Settlement Service, owing to the incorporation of the Book-Entry System into Iberclear.

7 INCOME FROM EQUITY SHARES AND PARTICIPATING INTERESTS

Of the total amount of €69.53 million recorded, €67.47 million was from the ECB in connection with the ordinary dividend distribution in 2003, compared with €160.03 million in 2002.

Further, in 2003 the ECB did not distribute the dividend to which the seignorage on the euro banknotes issued on its behalf by the NCBs specifically relates. The ECB had to use this income to cover in part its losses for the year. In 2002 the dividend relating to seignorage amounted to €66.54 million.

8 NET RESULT OF POOLING OF MONETARY INCOME

The amount of each Eurosystem NCB's monetary income is determined by calculating the annual income generated by the earmarkable assets held against the liability base. The liability base consists of the following items: banknotes in circulation; liabilities to credit institutions related to monetary policy operations denominated in euro; net intra-Eurosystem liabilities resulting from TARGET transactions; and net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled. The earmarkable assets include the following items: lending to euro area credit institutions related to monetary policy operations; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET transactions, whenever they have a debit balance; net intra-Eurosystem claims related to the allocation of euro banknotes in the Eurosystem; and a limited amount of each NCB's gold holdings, in proportion to its capital key. The gold is considered to generate no income. If the value of an NCB's earmarkable assets exceeds or is less than the value of its liability base, the difference will be offset by applying to it the average rate of return on the NCB's total earmarkable assets.

The monetary income pooled by the Eurosystem is to be allocated among NCBs according to the ECB subscribed capital key. The difference between the monetary income pooled by the Banco de España, amounting to €851.54 million, and that reallocated to it, amounting to €852.14 million, is the net result arising from the calculation of monetary income.

9 OTHER INCOME AND LOSSES

This includes the income and losses that cannot be included in other items, along with other diverse income of an exceptional nature. It may be broken down as follows:

€ m

DESCRIPTION	2003	2002
Profit on book-entry public debt	88.99	76.57
Extraordinary profit	121.68	67.70
Sundry	0.36	0.61
TOTAL	**211.04**	**144.87**

€66.20 million of net profit on the public debt portfolio relates to pre-system profit arising on sales and redemptions, and the remaining €26.66 million to current profit on sales. Meanwhile, end-year unrealised losses amounted to €3.87 million. Overall, net profit was €12.42 million higher than that obtained in this connection in 2002.

The €121.68 million of extraordinary profit arose mainly as a result of the receipt from the Social Security System of interest accrued in previous years (€50.19 million), the reduction in the provision to cover assistance for death and retirement (€45.26 million) and, finally, the profits on the sale of branch buildings closed in 2002 (€23.58 million).

10 STAFF COSTS

The moderate increase in this item (€3.94 million) basically resulted from the effect of the restructuring of the branch network and of human resources agreed in 2002.

11 ADMINISTRATIVE EXPENSES[11]

This item includes expenses arising from the purchase of current assets and of diverse services received during the year. The most important were office expenses (including IT costs), which amounted to €38.55 million, and costs relating to premises (especially maintenance), which amounted to €16.18 million.

It breaks down as follows:

€ m

DESCRIPTION	2003	2002
Office expenses	–38.55	–32.38
Property expenses	–16.18	–15.88
Transport and communications	–6.06	–5.65
Surveillance and security	–6.25	–6.14
Training and grants	–2.12	–1.67
Sundry operating expenses	–7.77	–8.19
Local taxes	–0.91	–0.87
TOTAL	**–77.84**	**–70.78**

"*Sundry operating expenses*" include €119,098.35 (including VAT) relating to the fees of the external auditors PricewaterhouseCoopers, S.L. for the audits in 2003 of the Bank's annual accounts and of the Bank's management of European Central Bank reserves. Also, other firms in the group were paid another €115,336.77 for the purchase of IT and legal products and services.

12 DEPRECIATION OF FIXED ASSETS

Included here is the expense of the estimated depreciation of the Bank's fixed assets, which breaks down as follows:

€ m

DESCRIPTION	2003	2002
Depreciation of property	–8.41	–8.73
Depreciation of transport equipment	–0.51	–0.26
Depreciation of furniture and office equipment	–12.27	–9.78
Depreciation of computer applications	–3.06	–2.49
Other depreciable expenses	—	—
TOTAL	**–24.25**	**–21.25**

13 BANKNOTE PRODUCTION SERVICES

This amount (€48.97 million) corresponds to payments made by the Banco de España to purchase banknotes, basically from the National Mint. The decrease with respect to the previ-

11. Given that there is no explicit provision for non-income taxes in the harmonised ESCB profit and loss account format, these are included in this item.

ous year (€66.26 million) was attributable to the lower volume of euro-denominated banknotes acquired by the Bank, in comparison with the volume that had to be purchased in 2002 to cater for the exchange of pesetas for euro.

14 OTHER EXPENSES

The decrease in these expenses (€17.23 million) was due mainly to the inexistence in 2003 of the extraordinary expenses that arose in 2002 from the peseta/euro changeover.

15 TRANSFERS AND ADDITIONS TO OTHER FUNDS AND PROVISIONS

The balance of this item at €47.53 million was €127.91 million lower than in the previous year, mainly because of transfers in 2002 to provisions for future early retirement payments relating to the Bank's agreement with its employees in August 2002, and other retirement provisions (€128.78 million). The expenses arising from payment commitments to the Banco de España Employee Social Welfare Scheme decreased by €2.24 million with respect to 2002, the transfer to the country-risk provision to cover 100% of the loans extended under the agreement with Cuba decreased by €1.77 million and the contribution to the Beneficent-Social Fund declined by €0.50 million.

Since the Banco de España provides financial services, it is not an institution with a high environmental risk. In 2003 it was not considered necessary to record any provision for environmental liabilities and charges.

16 PROFIT FOR THE YEAR

As detailed and explained in the preceding notes, the net profit for 2003 amounted to €1,947.47 million, down 11.3% on the previous year.

The table below shows that, pursuant to Royal Decree 1080/2002, €817.35 million was paid into the Treasury on 2 February 2004. This was the amount necessary, taking into account the advance payment of €935.37 million on 3 November 2003, to make a total payment of 90% of the Bank's profit for the period ending 31.12.03.

€ m

1. Profit for the year 2003		1.947,47
2. Payments to the Treasury:		
on 3.11.2003, 70% of profit as at 30.9.2003	935,37	
on 2.2.2004, balance to raise the preceding amount to 90% of the profit for the year ending 31.12.2003	817,35	1.752,72
3. Profit pending payment to the Treasury[12]		194,75
TOTAL (2 + 3)		**1.947,47**

12. The remaining amount due shall be paid to the Treasury when the annual accounts for 2003 have been approved by the Government.

III Specific information required by article 4 of the Law of Autonomy of the Banco de España

Contributions made by the Bank to the Deposit Guarantee 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 Guarantee 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 Guarantee Funds may only exceptionally be supplemented by contributions from the Banco de España, the amount of which shall be fixed by Law. In 2003 the Banco de España made no contributions whatsoever to the Deposit Guarantee Funds.

Loss of profit

The table below shows the loans outstanding in 2003 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.

AVERAGE BALANCES OF LOANS OUTSTANDING IN 2003 WITH INTEREST RATES BELOW THE REFERENCE RATES

€ m and %

	ESTIMATED AVERAGE BALANCE EN 2003	INTEREST RATE RECEIVED (%)	REFERENCE INTEREST RATE (%)	ESTIMATED LOSS OF PROFIT
Net State debt	8,039.17	0.00	2.31	185.70
Loans to the Social Security System	1,408.35	0.00	2.31	32.53
Repayable advances to employees	22.32	0.00	2.31	0.52
TOTAL	**9,469.83**	**0.00**	**2.31**	**218.75**

Included under “*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.

The reference rate used to estimate the loss of profit in all these loans is the monthly average of the interest rate on main refinancing operations during the year.

1 Report of the external auditors

AUDIT REPORT ON THE ANNUAL ACCOUNTS

To 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 2003, 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 comparison purposes, the attached annual accounts present, in addition to the 2003 figures, those for the previous year for each balance sheet and profit and loss account item. Our opinion refers solely to the 2003 annual accounts. Our audit report issued on 29 May 2003 on the 2002 annual accounts contained an unqualified opinion.

In our opinion, the attached 2003 annual accounts present, in all material respects, a true and fair view of the net worth and financial position of the Banco de España as at 31 December 2003 and of the results of its operations in the year then ended, and contain the required information, sufficient for their proper interpretation and comprehension, in conformity with the accounting principles and standards referred to in Section II.1 of the notes on the accounts, based on the accounting policies established for the member central banks of the European System of Central Banks, which are consistent with those applied the previous year.

PricewaterhouseCoopers Auditores, S.L.

[signed]

José Wahnón Levy
Partner

31 May 2004

2 Report of the Audit Committee

We the undersigned, Eduardo Bueno Campos, Juan Muñoz García and José Manuel González-Páramo Martínez-Murillo, members of the Governing Council of the Banco de España and of the Audit Committee appointed by the Governing Council, were given the task of reviewing the accounts of the institution for the year 2003.

By virtue of this mandate, the Audit 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 2003, 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 2003, 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 persons responsible for the independent external audit, for the Internal Audit Department and for the Control and Accounting Department; 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 in place, it can be inferred that the annual accounts for the year 2003 give a true and fair view of the net worth and financial position of the Banco de España.

Madrid, 28 May 2004

EDUARDO BUENO CAMPOS

JUAN MUÑOZ GARCÍA

JOSÉ MANUEL GONZÁLEZ-PÁRAMO MARTÍNEZ-MURILLO

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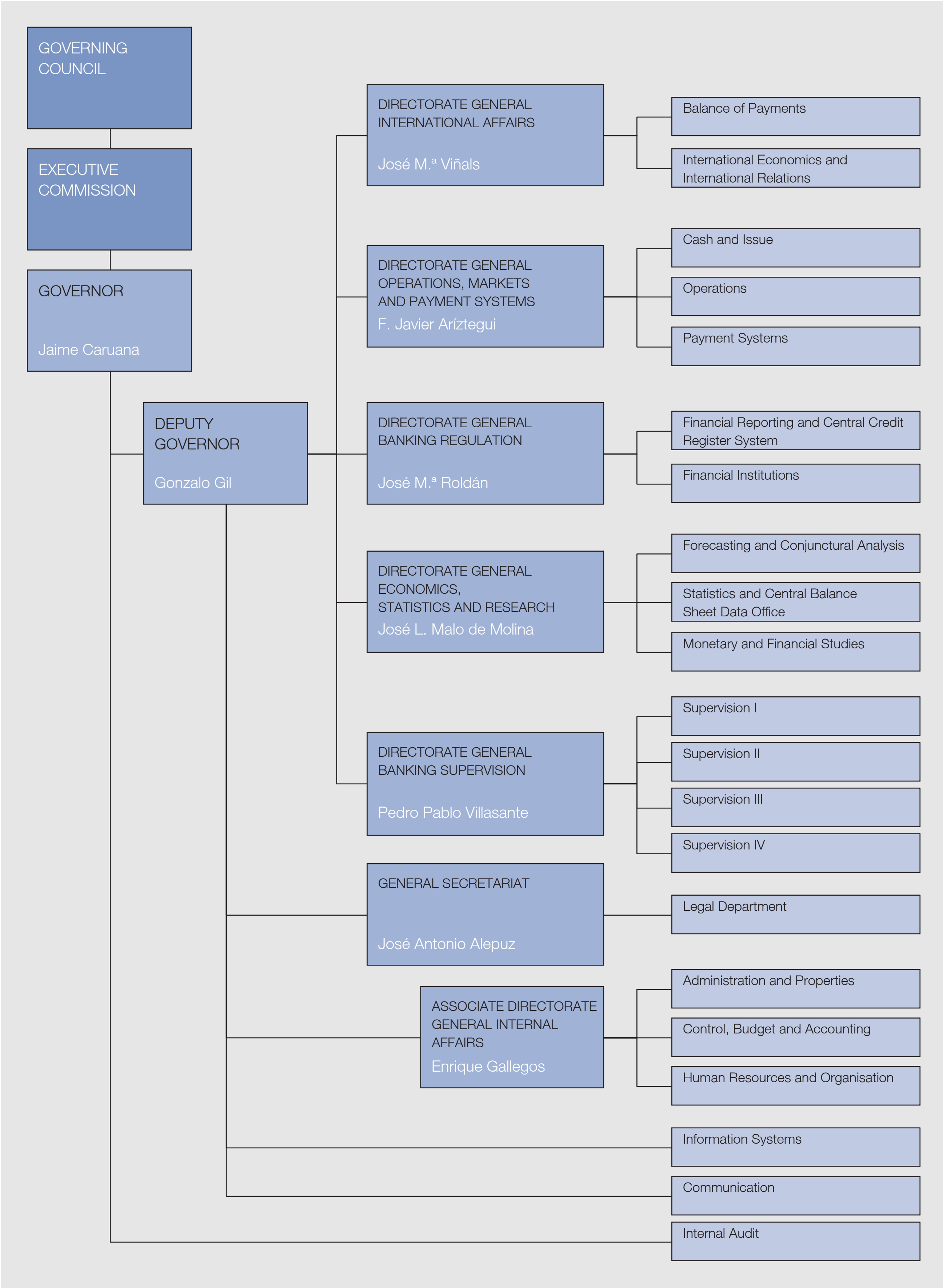

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DEPUTY GOVERNOR	Gonzalo Gil
COUNCIL MEMBERS	Eduardo Bueno José M. González-Páramo Joaquín Muns Juan Muñoz Jaime Requeijo Julio Segura
DIRECTOR-GENERAL OF THE TREASURY AND FINANCIAL POLICY	Belén Romana
VICE-PRESIDENT OF THE NATIONAL SECURITIES MARKET COMMISSION	Juan Jesús Roldán
DIRECTORS-GENERAL OF THE BANK *(Without a right to vote)*	José Luis Malo de Molina F. Javier Aríztegui Pedro Pablo Villasante José María Roldán José María Viñals
SECRETARY *(Without a right to vote)*	José Antonio Alepuz
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	José Luis Malo de Molina
(Without a right to vote)	F. Javier Aríztegui
	Pedro Pablo Villasante
	José María Roldán
	José María Viñals
SECRETARY	José Antonio Alepuz
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